REFOCUSING THE STATUTORY AUDIT APPROACH IN LINE WITH THE MODERN MANAGEMENT APPROACH

By

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CHAPTER 1

INTRODUCTION, PURPOSE AND MOTIVATION OF THE STUDY

1.1 INTRODUCTION

The study (and subsequent evolution of management as a science) has probably changed more in the last 30 years than in all the preceding years.

Companies are subjected, by law, to have a statutory audit by external auditors once a year. (Companies Act, 61/1973). What exactly constitutes a “satisfactory audit” has been the topic of much research by members of the auditing profession across the world. One principle in this search for “satisfactory audits” which was never questioned is the principle of compliance to “standards” which should then \textit{prima facie} give the auditor the right to claim that a “satisfactory audit” has been performed. Standards in this context means standardised uniform approaches based on best or appropriate practices. Mautz and Sharaf (1961:47) expressed their news on standards as follows: “... judging the fairness of financial statements requires the existence of a standard, and that this standard exists in the form of generally accepted accounting principles”.

In order to \textbf{formulate a uniform audit approach}, which will then constitute the “standard”, certain generally accepted \textbf{assumptions} must be agreed upon by the auditing profession. The most \textbf{important assumption} lies in the way the audit profession views the \textbf{control philosophy}, taking into account the management practices of the day. “... Matters such as industrialisation and related technologies, capital and other markets, and improved management and controls are believed to \textit{have shaped the audit function into its present form}”. (Lee, 1993:65) The audit profession has had for the past 30 years a coherent, widely accepted view of the internal control environment which formed the basis in developing an audit approach setting the standard in the process. The evolution of the audit approach for statutory
audits during the last 30 years has focused on the efficiency of the audit approach. By focusing on efficiency (doing things right) the auditing profession looked inwards and developed practices which resulted in added economic value to the customer. However, the fundamental assumptions regarding management philosophy and approach to the control aspects of conducting business in particular have changed tremendously during the past 30 years. "... The post-war decades were boom years for management systems. A generation of top level managers embraced the development of a rich portfolio of planning and control tools designed to help them deal with the rapid pace of corporate growth and diversification". (Bartlett and Ghosal. 1995:132)

The control component as one of the four corner-stones of management functions, in practice differs in philosophy to that of 30 years ago when the bureaucratic organisation was a common organisational structure. By continuing with an audit approach which was based on management practices and assumptions which are outdated today, the audit approach has developed a gap which could be closed by refocusing the audit approach.

1.2 MOTIVATION OF THE STUDY

The business environment of the nineties is where changes take place at great speed, changing the task of management to focus on flexibility. "A fundamental problem facing managers in the 1990s is how to exercise adequate control in organisations that demand flexibility, innovation and creativity. How do managers ensure that subordinates with an entrepreneurial flair do not put the business at risk? One solution is to go back to the fundamentals of control developed in the 1950s and 1960s for machine-like bureaucracies. In that era, managers exercised control by telling people how to do their jobs and monitoring them." (Simons, 1995:80) The control responsibility of today’s manager focuses on a much wider perspective and level of control activities than those of 30 years ago. Control as a task of management focuses on concepts like effectiveness of environment scanning; reaching strategic and operational objectives; measurement of the implementation of strategies, policies,
action plans and projects and controls to prevent fraud, error and misstatement of financial information. (Simons, 1995:80-88).

The control philosophy and practices differ from 30 years ago in that control as generally found in organisations today, is viewed as a positive function. It gives the individual or organisation the opportunity to contribute, achieve, create or measure against a norm to provide feedback to effect renewal, which usually makes the individual or organisation so much the better (more effective, efficient and productive). Management thinking has made a paradigm shift to enticing commitment rather than eliciting compliance. The differences in the two philosophies are listed in table 1.1.

TABLE 1.1 DIFFERENCES IN MANAGEMENT CONTROL PARADIGMS

<table>
<thead>
<tr>
<th>CONTROL PARADIGM</th>
<th>COMMITMENT PARADIGM</th>
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<tr>
<td>Elicits compliance.</td>
<td>Engenders commitment.</td>
</tr>
<tr>
<td>Believes supervision is necessary.</td>
<td>Believes education is necessary.</td>
</tr>
<tr>
<td>Focuses on hierarchy.</td>
<td>Focuses on customers.</td>
</tr>
<tr>
<td>Has bias for functional organisations.</td>
<td>Bias for cross-functional organisations.</td>
</tr>
<tr>
<td>Manages by policy.</td>
<td>Manages by principle.</td>
</tr>
<tr>
<td>Favours audit and enforcement processes.</td>
<td>Favour learning processes.</td>
</tr>
<tr>
<td>Believes in selective information sharing.</td>
<td>Believes in open information sharing.</td>
</tr>
<tr>
<td>Believes bosses should make decisions.</td>
<td>Believes workers should make decisions.</td>
</tr>
<tr>
<td>Emphasises the means.</td>
<td>Emphasises the ends.</td>
</tr>
<tr>
<td>Encourages hard work.</td>
<td>Encourages balanced work/personal life.</td>
</tr>
<tr>
<td>Rewards conservative improvement.</td>
<td>Rewards continuous improvement.</td>
</tr>
<tr>
<td>Encourages agreement.</td>
<td>Encourages thoughtful disagreement.</td>
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</table>


A system of internal controls as comprehended by auditors is based on the assumption that the principles of the control paradigm apply or should apply in organisations of the 1990s. These control paradigm measures are in essence negative in that they do not motivate but rather focus on the negative actions such as fraud, error or poor decisions. In this regard it is clear that the power to punish, also known as coercive power, is one which can only be applied in organisational forms which have a centralised hierarchy as base. On coercive power Gatewood et al (1995:494) states that “... the use of punishment to gain compliance has the negative side effect
of creating hostility and resentment towards the punisher and possibly reduced dedication to an organisation”.

Audit practice requires from an auditor to make a study of internal controls. “If an auditor is of the opinion that he is to rely on internal controls he should study and evaluate such controls”. (AU 230, 1986:01) “Those internal controls relating to the accounting system should be those controls designed to ensure that the information produced by the accounting system is complete, accurate and valid.” (AU 230, 1986:04) The auditor usually makes a study of internal controls in his audit procedure. Such a study is necessary for him to make an assessment of the potential of the control environment relating to the accounting system. If the auditor comes to the conclusion that such internal controls are satisfactory, he would then proceed to test the control environment by testing the compliance to confirmed internal controls. The results of these compliance tests will influence his judgement as to the nature and scope of substantive tests.

It is clear that control philosophies and practices lie at the heart of the audit approach. Business in the nineties expect management to focus its control responsibilities more on the positive controls. Control, like the other fundamentals in the task of management, is essentially a self-imposed generic task, with one difference. Unlike planning, organising and providing leadership the internal control environment relating to accounting is assessed by an external party, namely the independent external auditor. These control practices are enclosed and elevated through the audit process via channels such as management letters and audit committees to directors’ level. These board members respond to the lack of internal controls as defined by the audit profession. The perception of whether an organisation is well controlled stems to a large extent from the external auditors’ findings, which is a very narrow view. A well controlled organisation is one where a balance is found to control all aspects in the broadest definition.
1.3 PROBLEM STATEMENT

The negative side of control is that the more rules, the better the chances of having them broken. Not only because of the statistical reality of the statement, but because it is impossible to have a “correct” or applicable rule for every situation.

The control approach in an organisation can be seen as lying on two poles. On the one hand is a centralised rule/standard for every occasion, and on the other hand a broad framework defined, wherein one can decentralise decision making to the judgement of lower level workers. During the last three decades the focus has shifted towards more decentralised decision-making environment. This is not because management does not want to control anymore, it is because the benefits of decentralised decision making exceeds the benefits of closely controlled organisations.

Understanding control systems without seeing them in the context of management philosophy and an inclination towards risk, is impossible. Ideally the auditor would want to audit in an internal control environment where judgement and decision making are made as highly as possible, where a policy is formulated for every conceivable situation which needs a decision, where rules or confirmed procedures dictate the nature and predictability of each and every task to be executed in the organisation. By having little prescribed procedures and a relatively open decision-making ability at low levels, the auditor would feel less secure in stating that financial information is complete, accurate and valid.

The reasons for financial information produced not being complete, accurate or valid can be ascribed in the final analyses to fraud, error or misstatement. For the auditor to issue a clear audit report there should be no material fraud, error or misstatement of the accounting records. A philosophy of decentralised decision making can make it impossible for the auditor to assess the possibility of fraud, error or misstatement as the rules, policies and procedures are not prescribed, but rather lies in the integrity of the low level decision maker. On the other hand, a centralised decision-making philosophy should make it easier for the auditor to assess the possibility of fraud, error
or misstatement as policies, rules and procedures are defined, clear and uniform. This acts as the norm against which adherence for all actions and tasks can be measured, quantified or qualified.

The problem is defined as follows: as management practices on control move away from closely controlled environments, it increases the risk of fraud, error or misstatement. As the auditor shares in the information risk of fraud, error and misstatement he is faced with the problem of an audit approach which is based on non-relevant assumptions as organisations are not the closely controlled bureaucracies of 30 years ago. On the other hand, management is faced with the problem of management practices (regarding control) which are developing further away from the expected standard which external auditors want to rely on.

1.4 OBJECTIVE OF THE STUDY

The main purpose or primary objective of this study is to develop an audit approach model by analysing the changes in management practices since the start of the development of the basic modern audit approach. These changes in management practice will challenge the basic assumptions in the present audit approach. Finally, the changed basic assumptions will form the building blocks of the new audit approach model.

The secondary purpose is to

- place the principles of control as it is expected of management, into perspective against those prevalent 30 years ago.
- study the external audit product in terms of input and deliverables.
- open the debate between business and external auditors on the “control expectancy gap”.
1.5 RESEARCH METHODOLOGY

A literacy study focusing on management control practices and the audit approach will serve as the source of reference.

1.6 ARRANGEMENT OF THE CHAPTERS

Chapter 2  Looks at the development of the control philosophy and practices of management from the middle 1900s up to the present. It focuses on the differences between the two eras.

Chapter 3  Traces the development of the audit approach from late 1950s and early 1960s up to the present and define the audit mandate, the approach and the practices.

Chapter 4  Compares the management control developments with the audit approach developments. It highlights the control environments from an external auditor's point of view as well as from a management point of view. It will show the deficiencies and positive points of relying on internal control in the narrow sense upon which the audit approach is based.

Chapter 5  Will summarise the incongruencies, and the synergism between the audit approach and management's approach towards control. It concludes with the relevancy of the audit approach based on the evidence and it recommends a changed model for the audit approach.
CHAPTER 2

RECENT DEVELOPMENTS IN THE CONTROL ENVIRONMENT OF BUSINESSES

2.1 INTRODUCTION

Gatewood et al (1995:646) defines management control as "... all the activities an organisation undertakes to ensure that its actions lead to achievement of its objectives".

Control in organisations will differ in the execution thereof, just like discipline will differ from household to household. Some parents will have a list of rules to be obeyed by the children whilst other parents will concentrate on instilling a few basic core values in their children, which must serve as the guiding principles for decision making. The important point to notice is that both sets of parents have their children's best interest at heart, but they chose to do it differently.

From an auditor's perspective it is important to understand what the fundamental assumptions in the control task of manager is. The relevant questions to address are:

- Is there a right and wrong way to execute control in an organisation?
- Is control a static or dynamic concept?

Control is multifaceted. To devise a management control system to control only what the customer wants (for example speed, quality), or only what the auditor wants (for example separation of duties), or only what the regulator wants (for example compliance to the law), or only what the shareholder wants (for example profits, growth), would bring about an organisation which will be unbalanced in its controlling mechanisms.
This chapter will examine the control task specifically from an angle of:

- A common understanding of the control environment.
- What major drivers influence the control task environment.

2.2 THE CONCEPT OF MANAGEMENT WITH SPECIFIC REFERENCE TO "CONTROL"

No uniform definition of what management is exists in the literature, mainly due to the magnitude and complexities of the issues involved. Management in its broad context has to do with the following concepts:

- The generic functions of management include planning, organising, leading and controlling (Bateman & Zeithaml, 1990:18).
- Decision making on all four of the functions is the responsibility of managers.
- Management activities take place on different levels, generally referred to as strategic, tactical and operational levels (Bateman & Zeithaml, 1990:25). Anthony et al (1989:23) states that control measurement in organisations should take place on the strategic planning, implementation of strategy and specific task control levels. It thus follows that the “what” and “how” of planning, leading, organising and controlling will differ, depending on the level of management activities to be performed.
- External and internal environments as defined in terms of the organisation are equally important variables to be managed (Bateman & Zeithaml, 1990:208). The level of management will determine to a great extent the environment which needs to be managed. The higher the level, the more externally focused it will be and the lower the level, the more internally focused it will be.

The functions of management include the four elements, planning, organising, leadership and control.

- Planning is defined as “. . . a conscious, systematic process during which decisions are made about the goals and activities which an individual, group,
work unit or organisation will pursue in the future”. (Bateman & Zeithaml, 1990:764)

- Organising is defined as management’s efforts to assemble the human, financial, physical and informational resources needed to complete the job and to group and co-ordinate employees, tasks and resources for maximum success (Bateman & Zeithaml, 1990:764).
- Leadership is defined as the manager’s efforts to stimulate high performance among employees (Bateman & Zeithaml, 1990:762).
- Control is defined as monitoring the progress of the organisation or work unit towards goals and then, if necessary, taking corrective action (Bateman & Zeithaml, 1990:759).

These functions are interrelated with one another and the division between the specific functions may not be clear. For example, by taking corrective action as part of controlling one may regard it as replanning or reorganising or even providing leadership, depending on the accent of the corrective action.

Management has many facets. To take control as one of the responsibilities of management and elevate it as a single task that can be looked at on its own is incorrect. Control is always part of the total concept of management and is more often than not interrelated with all the other functions of management. Gatewood et al (1995:662) specifically states that an effective control system is typically well-integrated with planning.

There are varied definitions in the literacy on what the meaning of control is. Rue & Byars (1986:296) defines control as "... the process of ensuring that organisational activities are going according to plan, accomplished by comparing actual performance to predetermined standards or objectives, then taking action to correct for any deviations”. Certo (1992:519) defines control as “... making something happen the way it was planned to happen”. From the above definitions one can deduce certain basic assumptions about control.
• The "what" of control is a variable as an organisation's activities and objectives change constantly.
• Control does not only focus on outputs but also on inputs.
• Control can be qualitative or quantitative provided the standard is defined clearly.

Anthony et al (1989:8) states that "... control consists of four steps. First a standard of desired performance is specified. Second there is a means of sensing what is happening with the entity and communicating that to the control unit. Third the control unit compares the information to the standard. Fourth is if any deviation occurs, the control unit directs that corrective action is taken". The control process is described in figure 2.1.

FIGURE 2.1: THE CONTROL PROCESS

Using the control process (figure 2.1) as a base, further deductions about control characteristics can be made:

- control is an **interactive dynamic** process because corrective action implies replanning at least (defining the "new work situation").

- control can only be exercised if a **norm or standard** has been set. To define this norm or standard is critical in every control process because the result to be measured should be specific, whether qualitative or quantitative. For example, if one wants to measure a profit centre’s return on assets, the norm or standard would be set as a defined return/assets = x%. If, however, one wants to simultaneously increase the capacity levels as part of a growth strategy the norms should state that capacity levels should ≥ y% and return/assets = x%. By not stating both norms, it is possible that the required norm on return/assets can be met, for instance by selling off capacity.

- only the entity which can have **influence** over the result to be measured, can be controlled. Control is thus only possible over those who have the authority to affect the actions of another element. **Authority or empowerment or delegated freedom to act** are synonyms which must reside in the entity to be measured, otherwise corrective action cannot be taken by such an entity.

- control is not necessarily always expressed in **positive** terms but can be stated in **negative** terms and can be **explicit** or **implicit**. Taking the above example of capacity levels ≥ y% and return/asset = x%, implicit or explicit can be the norm or standard not to exceed the authority vested in the entity. For instance, to deviate from set product quality standards policies or set manufacturing standards policies would not be allowed and could be controlled in a negative way by monitoring the non-compliance of such company policies.

Control in its broadest sense can be summarised as being the measurement of any action, goal, objective, strategy, policy, procedure, mandate, legal requirement, responsibility or accountability against a norm or standard, and the taking of corrective actions if deviations occur.
2.3 RECENT DEVELOPMENTS IN THE PHILOSOPHY OF CONTROL

As can be seen from the above the "what" of the control function is broadly defined and a generic consensus on the objectives of control exist. In practise the "how" of control differs from organisation to organisation. Gatewood et al (1995:652) states that "... the two dominant forms of organisational control are bureaucratic and clan control". Bureaucratic control reaches its objectives with "formal mechanistic structural arrangements" whilst clan control reaches its objectives through "informal, organic structural arrangements". Gatewood et al (1995:653) then cites IBM (bureaucratic) and Apple (clan) as two examples of companies which perform their control responsibility in total different ways, yet both becoming excellent organisations in own right. The question is why two control philosophies exist in the 1990s which are totally different in nature. The answer lies in the developments taking place in the fields of organisational structuring and behaviour, organisational culture, the changing environment and the Stakeholder Theory.

2.3.1 THE ROLE OF ORGANISATIONAL STRUCTURE DEVELOPMENTS IN CONTROL

Organisational structure is defined as "... the formal pattern whereby people and jobs are grouped in our organisation". (Gibson, 1991:746) It specifically relates to relationships between humans as a resource. To control people it is necessary to understand the human behavioural aspects of the more influential organisational structures of recent times. Drucker (1992:131) shares his view on the changes in organisational structure as a "... sharp turn in the structures of management. For 35 years, from the end of World War II until the early 80s, the trend ran toward more and more layers of management, and more and more in supporting staff specialists. The trend now goes in the opposite direction". Starting with the bureaucracy model of the 1950s it is necessary to look at the developments of organisational structures up to the 1990s and beyond.
2.3.1.1 Bureaucracy model

Max Weber in 1948 described a model for management in his book *The Theory of Social and Economic Organisations* which is called the bureaucracy. Bateman & Zeithaml (1990:58) summarises the organisation structure principles prescribed by this theory as *inter alia*:

- **All relationships** between humans are **structured and formal**.
- **Rules and regulations** specify the activities of each job.
- Jobs are staffed by specialists.
- Important decisions are **centralised** at the top.
- **Hierarchy** defines the relationship of jobs to one another.

The **philosophy** regarding control for the bureaucracy is summarised as follows:

- Everyone in the organisation knows exactly what his **authority and accountabilities** are. Changes should be formalised and approved. **Managers** should control subordinates not to exceed their authority.
- **Policies, procedures and rules** exist for each job. Managers should control subordinates to follow them.
- Devising tasks is the job of the manager. The manager can create each job for maximum efficiency, effectiveness or control and should then control compliance with these aims.
- **Decisions** are, as far as possible, accounted for in policies, procedures, job descriptions and rules. If something outside these parameters has to be decided, the decision will be pushed upwards in the hierarchy. **Managers** should exercise control so that no unauthorised decision or action is performed.

The basic **assumptions** in the bureaucracy organisational structure is one of clear and explicit authority, accountability, policies, rules and decision making by informed and empowered people. Auditors who were tasked with certifying the financial information of an organisation saw the opportunity in the bureaucracy structure to enable them to render the audit service in an efficient manner. Instead of verifying each transaction the audit approach
could change to **examining** the management **control process** regarding authority, accountability, policies and decision making. Provided the control process is sound, an **assumption** can be made on the **integrity** of all the transactions, limiting the number of transaction to be tested. Woolf (1986:36) links the bureaucracy organisational form and the auditor’s approach by stating that: **"The systems-based approach to audit work was a natural response to the increasing post-war demands of business revival, which manifested in greater centralisation of business units, a rising tide of take-overs and mergers, and the commensurate ability of data-processing technology to cope with the recording of the greatly increased number of transactions consequently involved. The system-based approach emerged in the late fifties and have formed the documentary cornerstone for more than twenty years".**

The reason why the bureaucracy as an organisation form was so dominant (up to today still) is because of its many **positive aspects** described by Jacques (1990:129) as follows:

- "**to add real value to work as it moves through the organisation**”.
- "**to identify and nail down accountability at each stage of the value-adding process**”.
- "**to place people with the necessary competence at each organisational layer**”.
- "**to build a general consensus and acceptance of the managerial structure that achieve these ends in the organisation.**”

However the **shortcomings** of the hierarchical bureaucracy becomes obvious for the following reasons:

- "**Excessive layering. Information passes through too many people, decisions through too many levels, and managers and subordinates are too close together in experience and ability which smothers effective leadership, cramps accountability and promotes buck passing."**
- "** Few managers seem to add real value to the work of their subordinates.**”
- "**(It) brings out the nastier aspects of human behaviour, like greed, insensitivity, careerism and self-importance.**” (Jacques, 1990:128)
These shortcomings send many behavioural scientists in search of co-operative, group-orientated, non-hierarchical organisation forms.

2.3.1.2 Organisational behavioural model(s)

During the 1960s organisational behaviourists heavily influenced the field of management. Douglas McGregor's theory X and theory Y marked the transition to managing human relations as basis for control. Table 2.1 explains the differences between theory X and theory Y assumptions:

**TABLE 2.1: DIFFERENCES IN MANAGEMENT ASSUMPTIONS ABOUT HUMANS**

<table>
<thead>
<tr>
<th>THEORY X</th>
<th>THEORY Y</th>
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<tr>
<td>• Most people are lazy.</td>
<td>• People like to work.</td>
</tr>
<tr>
<td>• Most people need to be controlled.</td>
<td>• People have self-control.</td>
</tr>
<tr>
<td>• Most people need to be motivated.</td>
<td>• People motivate themselves.</td>
</tr>
<tr>
<td>• Most people are not very smart.</td>
<td>• People are smart.</td>
</tr>
<tr>
<td>• Most people need encouragement to do good work.</td>
<td>• People want to do a good job.</td>
</tr>
</tbody>
</table>


McGregor advocated theory Y, suggesting that managers who encourage participation and opportunities will achieve superior performance. This sparked off a number of approaches addressed and devised by people who wanted to create organisational behaviour in congruency with theory Y's principles. Some of these approaches were:

- Argyris (1957) advocated greater autonomy and job enrichment.
- Management by objectives as described by Weihrich (1987:12) suggests that objectives are needed in every area where performance and results directly and vitally affect the survival and prosperity of the business. He emphasised the importance of participative goal setting, self-control and self-evaluation.
- Fisher (1993:3) stated that “... self-directed work teams replaced quality circles - which dominated the discussions and practices in the late
seventies and early eighties - as the great managerial panacea for the demands of the coming decade. People assume numerous management tasks and work in **big flexible teams** instead of **rigidly functional departments**. These are big changes, often causing managers to rethink fundamental hierarchical and bureaucratic practices and beliefs that are the skeleton for most organisational structures. Empowerment is transformation of the workplace”.

- **Participative management** is advocated by Kruger (1995:3), who states *inter alia* that “... the chief aspects to be borne in mind during the implementation of a participative management style are flexibility, open communication, recognition and the allowance of people to reach their full potential.” Furthermore, he states that flexibility encompasses *inter alia* the following concepts:
  - Be open and receptive to new ideas and advice rather than to hide behind a rigid “company policy”
  - Be prepared in general to adapt to changing circumstances
  - Be prepared to experiment, rather than be inflexible.

- **Management by Walking Around (MBWA)** (Kruger, 1995:3.8) is described as having as a purpose to utilise a broad network of contacts and sources of information, formal and informal, in order to perform its function.

- **Management by improvement of goals (MBIG)** (Kruger, 1995) describes the characteristics as:
  - High participation
  - Joint responsibility
  - High accountability
  - Equal attention to end results and to methods for inducing the results

The **philosophy** regarding control underlying the organisational behavioural model can be summarised as follows:

- The basic framework is still a bureaucracy with degrees of deviation from the fixed principles of bureaucracy, depending on what the organisation wants to achieve.
• The leader does not necessarily know best. **Subordinates** should be encouraged to make their own decisions on condition that they add value, compared to the previous practice or norm. The manager should control his subordinate or co-worker by assessing whether his action or decision added value to the end result.

• Control engenders commitment and does not elicit compliance. The manager should put equal trust in the end result and not always control the process (means).

• **Education and empowerment** are increasingly more necessary and have more benefits on a long-term basis view than supervision, which is a short-term view.

• The emphasis is on cross-functional/matrix organisation structures rather than on one line of reporting. Control on any subordinate now comes from multiple managers who always place individual performances subject to the bigger picture of cross-functional benefits.

The basic **characteristics** of the organisational behaviour model are that decision making authority is pushed down in the organisation, self-control, self-evaluation, self-directed teamwork, flexibility and joint responsibility are encouraged. The focus is still internal orientated so that the important controls were those regarding the efficiency of the resources or processes. The auditor was faced with the problem that authority, accountability and policies were much more flexible, although the basic business environment were relative stable.

The **positive aspects** of the organisational behavioural model are as follows:

• **Increased performance** by increasing participation, greater autonomy, individual challenges, initiative encouragement and enriched jobs.

The **negative aspects** of the organisational behavioural model are as follows:

• Focusing on human behavioural (labour and entrepreneurship) production factors to a large extent, to the detriment of all the other influences such as the environment, technology and capital (Bateman & Zeithaml, 1990:62) made for an organisation which are not effective.
This shortcoming was the primary reason why management scholars started to bring to the fore the role played in the organisation's successes by the management of the external environment as well as by the micro-environment in its broader context (not only humans).

2.3.1.3 The systems theory or model

Taking the principles of the bureaucracy and the organisational behavioural model into account and building on the insight of the earliest system theorists, the system theory was developed. By looking at the organisation as a whole, it was realised that all the development in management practices went into efficiency (doing things right) and not into effectiveness (doing the right things). By measuring the external environment's reaction to the things an organisation does, one can measure it against a set norm or goal and assess whether the organisation is doing the right things (irrespective of its efficiency). Bateman & Zeithaml (1990:67) listed the major contribution which the systems theory brought to management practice as the identification of the operational, tactical and strategic subsystems, as a scientific way had to be found in order to control performance against goals set in managing the external environment.

The philosophy regarding the control aspects of the systems theory can be summarised as follows:

- The philosophy is basically the same as for the organisational behavioural model with the added aspect of managing the strategic aspects of the organisation. Sawyers (1990:33) describes three primary strategic levels, namely the product, business and enterprise levels which require management on both a bottom-up and top-down approach. The bottom-up approach is based on the fact that product and business performance should be successful in the face of competition. "From this point of view each product plan is an element that must aggregate into a business and into the total enterprise." The top-down approach comes from the attractiveness of
each product and business to top management (and the owners) “to merit that investment”. Management thus had to control not only all the behavioural aspects as described in the organisational model but also had to evaluate all the outputs against another dimension, namely the organisation’s effectiveness. For the first time a legitimate efficient process in the value chain (for example, an administrative controlling function) were judged obsolete because it hampered the effectiveness of the organisation. The internal focuses prevalent in the bureaucratic organisations have shifted finally to include the active management of the external environment. No longer could the internal environment be viewed in isolation. All decisions should be made within the broad context of their effect on the external environment. Employees’ actions were no longer judged in terms of the organisation’s rules and policies, but rather on how these harmonised with the target market’s reaction to whatever the organisation does. Rigid “right and wrong” issues were replaced by pragmatic adjustments to a very fast moving external environment with the client as a focal point.

The characteristics of the system theory are that decision making is pushed down in the organisation, self-control, self-evaluation, teamwork, flexibility and joint responsibility are allowed. The focus has shifted to the external environment. Resources and processes were judged in terms of the value brought to the organisation as a whole. Formal control systems were judged as to how the value exceeds the cost. The auditor is faced with a situation that sound control procedures were aborted for the mere fact that the cost or opportunity cost to control exceeded the perceived benefit not to control. The information risk which the auditor is co-responsible for, has increased still more.

The weakness of the systems theory is that it focuses exclusively on the management of the environment without providing specific guidance on the functions and duties of managers (Bateman & Zeithaml, 1990:67). This gave rise to the contingency perspective.
2.3.1.4 Contingency Perspective

Based on the systems theory, the contingency perspective has developed. This philosophy contends that “. . . the management strategies, structures and processes that cause high performance depend on the characteristics of contingencies of the situation. They recognise that differences exist between and within organisations.” (Bateman & Zeithaml, 1990:70) The argument is against a universal set of management principals. Some of the techniques which were applied with success during the last 20 years are:

- Applying motivational theories as basis to direct human behaviour and control. Gibson (1991:102) categorised the different motivational theories in two categories. Firstly the content base theories which focuses on factors within the person that energise, direct, sustain and stop behaviour, for example those which were developed by Maslow, Herzberg and McClelland. The implication for managers are that they need to be aware of differences in needs, desires and goals of each individual as individuals are unique, and must be managed differently. Secondly the process base theories which describes the how of behaviour. The implication for managers are to understand the different theories (expectancy, re-enforcement, equity and goal-setting) as they provide practical tools - which will differ from situation to situation - to enhance subordinates’ performance.

- Recognising organisational politics as “real” and managing it.

- Various change management techniques (for example the Lewin’s model for implementing change (Gatewood et al, 1995:561)).

- Various strategic management and planning tools such as the BCG Matrix (Gatewood et al, 1995:286).

- Various strategic management and implementation tools such as the McKinsey 7-S framework (Gatewood et al, 1995:292).

- Non-traditional organisational structures such as adhocracy being defined as “. . . a centralised, informal, but complex organisation which tries to maintain flexibility in the face of rapid environmental changes by using a matrix or network formal structure”. (Gatewood et al, 1995:384)
Other examples include the cross-functional/product/geographical/matrix organisation forms.

- Contingency leadership models
  - Hersey & Blanchard (1969:2-4) developed the “life cycle theory of leadership” which suggest that each individual in your organisation should be handled differently. The variables which the leader must take into account is the competency and commitment of the follower(s). Depending on where the follower is on the continuum of the variables, there are basically four leadership styles summarised in figure 2.2. In practise it suggests that leaders move from highly autocratic to highly democratic within the same organisation and span of control, all dependent on the situation with the follower.

![FIGURE 2.2 : LIFE CYCLE THEORY OF LEADERSHIP](source: Hersey & Blanchard (1969:4)).

- Fiedler (1965:115-122) asserts that a leader is either relationship or task oriented. Depending on the variables of leader-member relations, task structure and position power, the leader will either get the job done at all costs or be concerned with the relationship as basis to get the job done. In practise this theory states that different
authority and responsibility styles are prevalent in the organisation (based on the individual different leader’s styles) irrespective of what the formal organisational structure is.

- House (1974:81-97) developed the Path-Goal theory which identified four different leadership styles, namely directive leadership (task guiding, maintaining standards); supportive leadership (approachable, satisfy personnel’s personal needs); participative leadership (consulting subordinates, get inputs before decisions) and lastly the achievement-oriented leadership (concentrate on outputs, show confidence in subordinates’ ability to achieve). This theory postulates that different organisational styles are present in one manager who has the ability to adapt from style to style according to the situation.

- Gatewood et al (1995:507) describes the Vroom-Yelton-Jago participation model as on the one hand decision styles are listed (two autocratic, two consultative and one group style) whilst on the other hand eight different situational characteristics related to the problem itself or the problem’s impact on the subordinate are listed. By working through the eight characteristics in a specific order the manager is led to the best style for handling a specific situation. Once again the basic assumption is that a manager must and in fact is managing in styles which vary between autocratic, consultative and group leadership styles, dependent on the situation.

Non of the above are viewed as a fundamental management approach, as some organisations may never use these techniques whilst for some organisations the situation requires them to implement such special techniques. The positive aspect of this theory is greater flexibility to adapt to any situation, whether internally or externally created.

The control philosophy in the contingency theory can be summarised as follows:
Control in the sense of universal principles by which one can categorise an organisation and apply universal control mechanisms/principles, does not exist. Each and every organisation may differ, combine, add or subtract on the whole or partially any managerial principal which may justify the situation. Rigid standards or norms are discouraged as the solution lies in solving the situation optimally.

The auditor is faced with no universal set of management practises against which he can understand and judge the predictability of management actions. There is great difficulty in placing the control function and environment in a framework to be easily understood and comprehended by all. Within the normal time-frame of an audit (the book year) the management practice may differ depending on the situation prevalent.

Environmental factors played a role in defining the corporate mandate in a broader context than just the profit maximisation objective. These factors played a role in the rise of the so-called third wave organisation.

2.3.1.5 Third wave organisation

Kruger (1995:8) described Alvin Tofler’s identification of the need for third wave organisations in 1980. “. . . Organisations should become multipurpose, not just see them as economic entities, but become involved in the ecology, politics and social environment, indeed they should be involved in the complete spectrum of activities to which each individual is exposed.” Recent developments in defining the purpose of organisations led to the adoption of the Stakeholder Theory. This theory underlies the third wave organisation and poses a model where “. . . all persons or groups with legitimate interest participating in an enterprise do so to obtain benefits, and there is no prima facie priority of one set of interest of benefits over another”. (Donaldson & Preston, 1995:68) It rejects the idea that “. . . the enterprise exists to serve the interest of its owners, be that maximising their wealth or some other reason”. (Weiss, 1996:1) Stakeholder Theory has many critics mainly as to the “. . .
rendering of the enterprises goals as it will require fundamental changes in the institutional structure of capitalism which shift the interest that drive capitalist enterprise”. (Weiss, 1996:14)

Third wave organisation differs with the systems theory organisation and the contingency approach organisation, in degree, as to their management approach of the external environment. Not only is performance with the external environment measured in terms of product and market effectiveness but effectiveness is also measured in terms of the organisation’s social role and conscience. Table 2.2 summarises the contrasting management paradigms.

**TABLE 2.2: CONTRASTING MANAGEMENT PARADIGMS**

<table>
<thead>
<tr>
<th>CHARACTERISTIC</th>
<th>SECOND WAVE</th>
<th>THIRD WAVE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Organisation</td>
<td>Hierarchy</td>
<td>Network</td>
</tr>
<tr>
<td>Output</td>
<td>Market share</td>
<td>Market creation</td>
</tr>
<tr>
<td>Focus</td>
<td>Institution</td>
<td>Individual</td>
</tr>
<tr>
<td>Style</td>
<td>Structured</td>
<td>Flexible</td>
</tr>
<tr>
<td>Source of strength</td>
<td>Stability</td>
<td>Change</td>
</tr>
<tr>
<td>Structure</td>
<td>Self-sufficiency</td>
<td>Interdependencies</td>
</tr>
<tr>
<td>Culture</td>
<td>Tradition</td>
<td>Genetic code</td>
</tr>
<tr>
<td>Mission</td>
<td>Goals stratégic plans</td>
<td>Identity/directions/</td>
</tr>
<tr>
<td></td>
<td></td>
<td>values</td>
</tr>
<tr>
<td>Leadership</td>
<td>Dogmatic</td>
<td>Inspirational</td>
</tr>
<tr>
<td>Quality</td>
<td>Affordable best</td>
<td>No compromise</td>
</tr>
<tr>
<td>Expectations</td>
<td>Security</td>
<td>Personal growth</td>
</tr>
<tr>
<td>Status</td>
<td>Title and rank</td>
<td>Making a difference</td>
</tr>
<tr>
<td>Resource</td>
<td>Cash</td>
<td>Information</td>
</tr>
<tr>
<td>Advantage</td>
<td>Better sameness</td>
<td>Meaningful differences</td>
</tr>
<tr>
<td>Motivation</td>
<td>To complete</td>
<td>To build</td>
</tr>
</tbody>
</table>

Source: Sculley (1990:140).

The control philosophy of the third wave organisation is that, as for the contingency perspective organisation, no universal framework exists for control with the added dimension of managers having to control the effectiveness of the social, moral and ethical conscience of the organisation and by implication the behaviour of the individual working for the organisation.
2.3.1.6 Fourth wave organisation

Looking into the future an organisational form, the fourth wave organisation, will take us into the 21st century. This organisation will "... address the challenges of globalisation and the global mindset. Business people will become more prominent as global and transformative leaders in the future. The organisation is moving away from conducting business purely for profit - towards a wider range of stewardship - overtaking the public sector as the basic provider of wealth and stability around the globe." (Kruger, 1995:20)

Kruger (1995:20) speculates on the characteristics of the fourth wave organisations as follows:

- in structure, a community model
- in locus of control and authority it will be consentient decision making, everyone a leader and a follower
- the role of managers will be non-existent.

The approach of the auditor in such an organisational form still has to develop. It is important however to note that the trend moves into the direction of communal accountability.

2.3.2 THE ROLE OF CULTURE AND VALUES IN CONTROL

Organisational culture is defined as "... the pattern of beliefs and expectations shared by the organisation's members which powerfully shape the behaviour of individuals and groups within the organisation" and also "... culture is the set of important beliefs and values (often unstated) that members of an organisation share". (Weeks and Lessing, 1988:23)

Shrivastava (1994:148) points to the world view an organisation holds, depending on his decision culture of which there are three types:

- Bureaucratic cultures: organisations with bureaucratic cultures prefer to use objective and documented data. They interpret data through a battery of well-established rules and regulations. Organisation rules and policies
serve as reality tests. Decision making goes according to predetermined bureaucratic rules. Standard operating procedures are ubiquitous and widely used.

- **Entrepreneurial** cultures: the entrepreneurial culture relies on subjective and impressionistic data, often from personal sources. The cognitive maps used are the personal maps of key managers. Their personal bias often colour data interpretation. Their personal values are broadly adopted by the rest of the organisation. Decision making is centralised in the key manager who makes decisions with supporting information from subordinates.

- **Anticipatory** cultures: anticipatory cultures encourage the use of objective information and interpret it as using scientific cognitive maps. They stress pro-active, rational technical analyses of problems. Work relationships in these organisations are informal and are guided by a shared code of professional ethics. This culture self-selects members and encourages professionalism at work.

Weeks & Lessing (1988:43) further typify organisational culture as follows:

- A **power culture** (depending on a central power source, where individuals regularly take high risks).

- The **role culture**, where emphasis is placed on rules, procedures and status within the organisation and creative and innovative behaviour is discouraged as a rule.

- The **task culture**, where emphasis is on finishing the job or project with as few risks and innovations and as quickly as possible. The focus is on the end result.

- The **person culture**, where the focus is on the individual and the organisation exists primarily to serve the needs of the employees.

Understanding the culture type of an organisation will reveal more about the organisation’s philosophies towards control, than what the "formal" manifestations (such as organisational structure, processes, policies, et cetera) will tell you. Furthermore it is important to note that the values symbolised by managerial behaviour will be accepted as the true values of the organisation (Weeks & Lessing, 1988:53).
Martin (1992:97) states that defining culture from a differentiation perspective means that there are subcultures within the corporate culture. She states that “. . . (it) is a group, rather than an entire organisation, that is doing the sharing. Like the integration view, the differentiating view defines culture as that which is shared, but defines the boundaries of a culture at the group level of analysis, focusing on consensus within subcultures. Some differentiation definitions deny the possibility of an organisation wide culture whilst other state that subcultures co-exist with organisation wide sharing.”

It is thus possible to have an organisation culture where the corporate culture can be described as autocratic, control orientated and theory X inspired (typically a financial function) whilst a function within the organisation may be described as democratic, loose on controls and theory Y inspired (typically a marketing function). The question is: What happens when these sub-cultures clash with each other or with the corporate culture? Martin (1992:101) states that the “. . . integration view of culture might provide cognitive clarification, engender commitment, increase productivity and improve financial performance. Differentiation studies observe that because of the prevalence of inconsistency and the dearth of organisation-wide consensus, such benefits are unlikely to be forthcoming or are gained at the cost of some disempowered group.” It is clear that sub-cultures within an organisation may become dysfunctional if they contradict sharply.

By instilling a certain culture as far as control is concerned, each and every manager can have a powerful tool to steer control in the direction he or she wants the organisation and its functionaries to be controlled. This culture regarding control in an organisation is possibly the strongest driver to affect strong or weak control. Peters & Waterman (1982:75), state that “. . . without exception, the dominance and coherence of culture proved to be an essential quality of the excellent companies. Moreover, the stronger the culture and the more it was directed towards the marketplace, the less need was there for policy manuals, organisation charts or detailed procedures or rules. In these companies people way down the line know what they are supposed to do in
most situations because the handful of guiding values is crystal clear". Peters & Waterman (1982:76) further state that ". . . poorer-performing companies often have strong culture too, but dysfunctional ones. They are usually focused on internal policies rather than on the customer." Peters & Waterman made a case here of the informal mindset of employees with regard to "the way we do things here" being probably stronger than any procedure manual or policy book.

Describing the cultural characteristics regarding control of the organisation of the 1990s would differ from those in the 1950s and 1960s. Today's environment requires a culture which must be built on values such as "change", "flexibility", "customer needs", "entrepreneurship", "innovation", "creativity" and "adaptability". Many organisations of the 1990s have one common (integrated) culture described as above. Some organisations have sub-cultures (differentiation view) as on the one hand the organisation has to adapt to the customer orientated cultures necessitated by the environment of the 1990s, but on the other hand being forced by powerful factors, noticeably the external auditors, to control organisations in the traditional manner. For auditors to understand the culture of an organisation, will give insight on the control philosophy prevalent in the organisation.

2.3.3 THE CHANGING ENVIRONMENT AS A DRIVER FOR NEW CONTROL PHILOSOPHIES

The organisation of the 1990s cannot afford to become stagnant. The forces of change affect all and it requires a new mindset to operate constantly with new rules of the game. Simons (1995:80) says "a fundamental problem facing managers in the 1990s is how to exercise control in organisations demanding flexibility, innovation and creativity". Managers of the 1990s will not be able to successfully manage today's organisations with yesterday's methods and assumption. "The top managers in large corporations describe their roles as being agents of disturbance, as much as agents of alignment". (Ghosal & Bartlett, 1995:94) The old scientific management was about ensuring control. The new will be about making sense out of chaos (Freedman, 1992:26).
Globalisation, GATT, open world markets, quicker product life cycles, shifts in social trends, the technology explosion and a number of other factors made stability more and more an extinct concept. Drucker (1992:14) summarises the trend for businesses as "... (they) will integrate themselves into the world economy through alliances: minority partnership, joint ventures, research and marketing consortia, partnerships in subsidiaries or in special projects, cross-licensing, and so on". He goes on to say that "... alliances, while needed, are anything but easy to control. They require extreme - and totally unaccustomed - clarity in respect of objectives, strategies, policies, relationships and people". (Drucker, 1992:15)

Rue & Byars (1986:297) states that: "The manager (in order to control) must balance two major concerns: stability and object realisation. To maintain stability, the manager must be sure that the organisation is operating within its established boundaries of constraints which are determined by policies, budgets, ethics, laws, and so on. Object realisation requires constant monitoring to ensure enough progress is being made toward the established objectives." Control comprises the issues of setting standards, monitoring performance and correcting deviations. The setting of standards have become a difficult task as there are so many variables changing constantly that the mechanism of a centrally controlled organisation does not address the efficient setting of standards. The work-force has to adapt to the changing environment so quickly that control as one of the core functions of management had to be either scrapped (an abdication of management responsibility) or the method of control had to be re-evaluated. The method of control was re-evaluated by changing the fundamental thinking on job-design principles, structure and employee participation policies. Table 2.3 summarises the differences between a traditional stable (control) environment and a dynamic changing (commitment) environment.

The work-force strategies which are implemented as a solution for quick response to the ever-changing environment, clearly moves away from the centralised, rigid approach to one of decentralised decision making to
accommodate flexibility. Drucker (1992:14) argues in this regard that "... all available evidence indicates that work rules and job restrictions are the main cause of the 'productivity gap' of American manufacturing industry". He argues the case for more flexibility and decision-making at a decentralised level with a case study. "In Nissan's (Japanese owned) plant in the Midlands of England a worker turns out 24 cars a year. At English Ford in Dagenham outside London a worker turns out 6. Dagenham has 125 job classifications, each restricting the workers to one small task; Nissan has 5 classifications". (Drucker, 1992:15) Management - not prepared to abdicate its control responsibility chose a pragmatic approach to control - rely more and more on individuals in the organisation to control themselves. In the past the monitoring of performance and the correction of deviations were delegated down in the organisation. Today the third element of the control process, being the setting of standards are also delegated down in the organisation. Having done so, organisations are able to respond to changes whilst still being able to control efficiently.

<table>
<thead>
<tr>
<th>TYPICAL ENVIRONMENT</th>
<th>STABILITY SEEN AS DESIRABLE.</th>
<th>DYNAMIC AND ORIENTED TO THE MARKETPLACE.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Job design principles</td>
<td>Individual attention limited to performing individual job.</td>
<td>Individual responsibility extended to upgrading system performance.</td>
</tr>
<tr>
<td></td>
<td>Job design destroys skills, fragments work and separate doing and thinking.</td>
<td>Job design enhances content of work, emphasises whole task and combines doing and thinking.</td>
</tr>
<tr>
<td></td>
<td>Accountability focused on individual.</td>
<td>Frequent use of teams as basic accountable unit.</td>
</tr>
<tr>
<td></td>
<td>Fixed job definition.</td>
<td>Flexible definition of duties, contingent on changing conditions.</td>
</tr>
<tr>
<td>Management organisation: structure, systems and style</td>
<td>Structure tends to be layered, with top-down controls.</td>
<td>Flat organisation structure with mutual influence systems.</td>
</tr>
<tr>
<td></td>
<td>Co-ordination and control rely on rules and procedures.</td>
<td>Co-ordination and control based more on shared goals, values and traditions.</td>
</tr>
<tr>
<td></td>
<td>More emphasis on prerogatives and positional authority.</td>
<td>Management emphasis on problem solving, relevant information and expertise.</td>
</tr>
<tr>
<td></td>
<td>Status symbols distributed to reinforce hierarchy.</td>
<td>Minimum status differentials to de-emphasise inherent hierarchy.</td>
</tr>
<tr>
<td>Employee voice policies</td>
<td>Employee input allowed on relatively narrow agenda. Attendant risks emphasised. Methods include open-door policy, attitude surveys, grievance procedures and collective bargaining in some organisations.</td>
<td>Employee participation encouraged on wide range of issues. Attendant benefits emphasised. New concepts of corporate governance.</td>
</tr>
<tr>
<td></td>
<td>Business information distributed on strictly defined &quot;need to know&quot; basis.</td>
<td>Business data shared widely.</td>
</tr>
</tbody>
</table>

Ghosal (1995:87) said that "... we acknowledged that the strategy-structure-systems doctrine of management made possible the growth of huge corporations that operate multiple businesses in numerous markets. That classic doctrine gives top management three core responsibilities: to be the company's chief strategist, its structural architect, and the developer and manager of its information and control systems. However, it has become clear that the organisational model that follows from that doctrine - today's hierarchical structure supported by highly sophisticated management systems - no longer delivers competitive results. From atop the hierarchy, the leader looks down on order, symmetry, and uniformity - a neat step-by-step decomposition of the company's tasks and responsibilities. From the bottom, front-line managers look up at a phalanx of controllers whose demands soak up most of their energy and time. The result, as General Electric's chairman and CEO Jack Welch puts it, is an organisation with its face toward the CEO and its ass toward the customer." Ghosal then proceeds to argue that managers began to see their organisations not only vertically but horizontally as well. Horizontal processes such as total quality made sense across-functional lines and should be managed horizontally. When managers today look at their organisations they do not see structures but rather processes. At the core of this philosophy is decentralised decision making as a foundation to optimise cross functional integration. The effect of all this on control, is that processes are designed around the value it adds to the customer and the product. Whilst this makes for quicker reaction time in changes in the environment, it also makes for control to be focused around the success or not defined in markets/customer terms. The traditional control paradigm of focusing on tasks, input and efficiency plays a secondary role.

2.3.4 THE ROLE OF STAKEHOLDER THEORY IN CONTROL

"Corporate governance is the system or process by which companies are directed and controlled." (KPMG, 1995:5) It refers specifically to companies and thus relates to directors as the people responsible for the governance of their companies. Interested parties and bodies regulating companies, stock
exchanges and directors started to issue guidelines on corporate governance relating to their particular constituency. The *Cadbury Report* was released in the United Kingdom whilst the *Treadway Report* was released in the United States of America. South Africa followed with the *King Report on Corporate Governance* in 1994. The *King Report* had as intention to prescribe to the top management structure of companies, being the board of directors, the “what” and “how” of direction and control as it relates to the directors level. It firstly summarises the requirements placed on directors from a legal point of view. (KPMG, 1995:27-60). It secondly proceeds to give direction on directors' behaviour from the environment's point of view. The environment is defined in terms of the stakeholders of the company and what their interests would be. Attitudes regarding high ethical standards in big corporates, relentlessly move in recent times to one where unethical behaviour is unacceptable (Boatright, 1993:385). From this drive on high ethical standards comes the Stakeholder Theory which “... does not consist merely of the fact that there are many groups besides shareholders who have a stake in the corporation. It has inescapable normative implications about the obligation of corporations to take the interests of other groups into account”. (Boatright, 1993:404) This third wave organisational form as represented by the Stakeholder Theory brought different dimensions on the governance of companies. “... The concept of corporate governance has however grown in prominence in recent times as a result of the increasing involvement and interest of stakeholders, other than shareholders. Although statutes compel the stewardship of directors toward the shareholders, the other stakeholders cannot be overlooked and influence corporate governance in a variety of ways”. (KPMG, 1995:5) The *King Report* provides direction (leadership) on a number of issues for directors to follow *inter alia* those involving worker participation, affirmative action programmes and a code of ethics. The Stakeholder Theory as embodied by the *King Report* thus is an attempt to collectively define the claims stakeholders may have in companies and to enforce these claims in the strongest possible terms without giving it legal status. It further requires adaption of certain control philosophies, specifically those regarding the implementation of *internal audit functions* and reporting on the *internal control environment*. The *King Report* - and equivalent
reports in the United Kingdom and the United States - require directors “... to report on their responsibility to maintain an effective system of internal control”. (KPMG, 1995:19) This will force organisations to critically review their attitude towards the internal control environment, as the environment (defined as stakeholders) clearly wants the protection an effective internal control environment will bring to them. Whether the Stakeholder Theory as a new source of corporate governance will force organisations to revert back to the control paradigm as being manifested by the bureaucratic organisations of the 1950s should still be seen.

Control of organisations (companies) has become more complex with the arrival of the Stakeholder Theory. Management are faced with monitoring and controlling the objectives of every entity which may have a legitimate interest in the organisation. Management has to continuously weigh up the different demands made by stakeholders and perform in terms of that.

2.4 THE NATURE AND SCOPE OF CONTROL IN BUSINESS

2.4.1 WHAT NEEDS TO BE CONTROLLED (SCOPE OF CONTROL)

The “what” to be controlled is a broad concept and varies according to a number of factors. These factors may include the changes in the environment, the organisational form, the stakeholders’ expectancy, the level of the position, the mandate or the person. The list of things to be controlled may include inter alia every decision, action, objective or strategy. It becomes clear that there is no universal definition of “what” needs to be controlled in an organisation. As can be seen in the definition of control, a standard or norm must be set. This implies that some stakeholder, functionary or outside agency must at least set the norm or standard. With concise and detailed norms and standards the measurement will be more objective and easily measurable. With vague or general norms and standards it would be more subjective and difficult to measure. With no setting of standards or norms (explicit or implicit) there can be no control.
Therefore although a potentially endless list of norms and standards needs to be controlled, there is no right or wrong as to "what" to control. There is only an optimum.

2.4.2 **HOW TO CONTROL (NATURE OF CONTROL)**

2.4.2.1 **Accountability, responsibility and authority as core concepts**

The way control takes shape in practice in an organisation is by means of an authorised stakeholder, functionary or outside agency setting a standard or norm and then to communicate with the person (resource) accountable or responsible to meet the standard or norm.

In order to be accountable for something, one must have the authority to act or influence the outcome. From a control and legal perspective it is important to distinguish between accountability and responsibility. Theoretically the chief executive officer will have all the accountability and responsibility in the first instance. If the task or activities become too many in quantity or specialised to the extent that more resources are necessary, the chief executive officer may appoint people and delegate authority to such subordinates. Bateman & Zeithaml (1990:378) describe the steps in delegation as:

- to define the goal (or standard or norm)
- select the person for the task
- give a subordinate the time, authority and resources needed to perform
- review/measure progress

The subordinate may decide for his part to delegate certain of his tasks to subordinates. The question arises when the subordinate six levels down from the chief executive officer does something inappropriate which damages the organisation, whether the chief executive officer should take the blame alone or with the subordinate(s) or not at all. Bateman suggests that the accountability to higher-ups lies with the manager delegating. One cannot delegate your accountability (management involvement) although you can delegate the responsibility (individual involvement) to do the specific job or
task, but always with the authority to do it. In the above example, the chief executive officer should control the key output of his subordinate. If he did that to a satisfactory degree, he can account for his responsibility. This test must be performed down the line to see whether anyone except the person who made the mistake is co-responsible.

2.4.2.2 How to control

Simons (1995:80) observes that “...most managers tend to define control narrowly - as measuring progress against plans to guarantee the predictable achievement of goals. Such diagnostic control systems are, however, only an ingredient of control. Three other levers of control are equally important in today’s business environment: believe systems, boundary systems and interactive control systems”. Simons suggests these four levels as a framework to understand and execute control as is summarised in table 2.4.

TABLE 2.4: THE FOUR LEVERS OF CONTROL

<table>
<thead>
<tr>
<th>Potential</th>
<th>Organisational Blocks</th>
<th>Managerial Solution</th>
<th>Control Lever</th>
</tr>
</thead>
<tbody>
<tr>
<td>To contribute</td>
<td>Uncertainty about purpose</td>
<td>Communicate core values and mission</td>
<td>Beliefs systems</td>
</tr>
<tr>
<td>To do right</td>
<td>Pressure or temptation</td>
<td>Specify and enforce rules of the game</td>
<td>Boundary systems</td>
</tr>
<tr>
<td>To achieve</td>
<td>Lack of focus or of resources</td>
<td>Build and support clear targets</td>
<td>Diagnostic control systems</td>
</tr>
<tr>
<td>To create</td>
<td>Lack of opportunity or fear of risk</td>
<td>Open organisational dialogue to encourage learning</td>
<td>Interactive control systems</td>
</tr>
</tbody>
</table>


- **Beliefs systems** are systems to “...articulate the values and direction senior managers want their employees to embrace. Typically beliefs systems are concise, value laden and inspirational”. (Simons, 1995:82) Because beliefs systems are created to appeal to the broad spectrum of personnel it is often “...ridiculed for lack of substance. But this criticism overlooks the
principle purpose of the statements: to inspire and promote commitment to an organisation’s core values”. When managers adopt beliefs systems because they are fashionable, cynicism will set in. “However managers who use their beliefs systems as living documents - as part of a system to guide patterns of acceptable behaviour - have discovered a powerful lever of control”. (Simons, 1995:82) He goes on to describe its role in the large, ever more decentralised organisation. “Without a formal beliefs system, employees in large decentralised organisations often do not have a clear and consistent understanding of the core value of the business and their place within the business. In the absence of clearly articulated core values, they are often forced to make assumptions about what constitutes acceptable behaviour in the many different, unpredictable circumstances they encounter”. (Simons, 1995:83)

- **Boundary systems** are “... an organisation’s brakes. The boundaries in modern organisations embedded in standards of ethical behaviour and codes of conduct are invariably written in terms of activities which are off-limits. Boundary systems are based on a simple management principle that can be called the ‘power of negative thinking’. Ask yourself the question, If I want my employees to be creative and entrepreneurial, am I better off telling them what to do or telling them what not to do? The answer is the latter. Telling people what to do by establishing standard procedures and rule books discourages the initiatives and creativity unleashed by empowered employees. Telling them what not to do allows innovation, but within clearly defined limits”. (Simons, 1995:84)

- **Diagnostic control** systems are “... systems to help managers track the progress of individuals, departments or production facilities towards strategically important goals. Feedback allows managers management to adjust and fine-tune inputs and processes so that future outputs will more closely match goals”. Simons (1995:81) These controls include the basic financial controls which were in the past a constant monitoring of the process (input). Simons (1995:82) acknowledges the changes which occurred in recent times on the basic internal control structure, stating that “... with the elimination of many middle managers jobs, basic internal controls, such as segregation of duties and independent oversight, have often been sacrificed”. 
He then proceeds to explain that whilst diagnostic controls focuses on the outputs or goals it effectively means that the other levels of controls must be in place to attain a total level of control, especially as far as internal control is concerned.

- **Interactive** control systems are "... systems where management involve themselves regularly and personally in the decisions of subordinates. It tracks the strategic uncertainties that keep senior managers awake at night. It differs from diagnostic systems in four ways. First it focuses on unstructured potentially strategic information. Secondly it is significant enough to draw attention from all levels of the organisation. Third the data is interpreted best in discussions with superiors, sub-ordinates and peers. Fourth, it is a catalyst for ongoing debate about underlying data, assumptions and action plans." (Simons, 1995:87).

### 2.5 CONCLUSION

Control is one of the four fundamental functions of management. The method of control has changed substantially since the post-war years and up to the 1990s. The drivers for these changes can be understood against the background of developments in the organisational structure, the culture of organisations, the constant changes in the environment and the focused approach of corporate governance.

**Organisational structures** developed from the bureaucracy model to the third wave organisation of the 1990s. These organisational structures each have a set of human behavioural characteristics which must first be understood in order to understand control. Not understanding the basic organisational model in which an organisation operates, will lead to auditors judging (the effectiveness of) control against their own framework of the control concept. Tracing the developing of organisational structures it is clear that the shift has been away from **rigid control paradigms** to **open self-regulatory control** systems.

**Cultures and value systems** became an important tool to control organisations. The binding effect of culture and values is so great that these informal, often not written
rules of "the way we do things here" directs organisational behaviour more than written rules and policy. Management being tasked foremost with reaching the organisation's objectives have a focus on customers and products. Organisational cultures invariably builds around the external focus of organisations instead of the internal focus. Although the importance of comprehensive control systems is understood by managers of the 1990s, the environment requires them to establish cultures and value systems supporting organisational effectiveness instead of organisational efficiency.

Change required in the environment of the 1990s forced organisations to be quick and adaptable. Managers were faced with a fundamental rethink on how to balance the inherent slowness a comprehensive control system brought, against the quickness required by the environment. Management practices developed to weigh the benefits of quick reaction time against the opportunity cost of a flexible control environment. If the perceived benefits exceed the perceived opportunity cost the decision would always be to be more flexible, even though it means the risks increase due to the relaxed controls. Managers' appetite for taking "control environment risk" increased due to the increased rewards that can be gained in the process.

The Stakeholder Theory implies that the organisation's reason for being are not only vested in the relationship between corporation and shareholder, but should also be found by looking at the expectancies of all legitimate interested parties. In the past the interests of the stakeholders were addressed by the legal environment to protect and enhance the relationship between the organisation and the macro-environment. Recent developments saw stakeholders (via the King and similar reports) bringing the issue of effective internal control environments to the fore. The "what" of control has been changed due to it, though the "how" of control could only be judged in future.

The traditional method of control made the risk for incorrect financial information disclosure relatively small. However, in the organisation of the 1990s the controlling function is more unstructured, increasing the risk of inter alia incorrect financial information. Less rules, policies, fixed job descriptions and detail standards and more decision making and employee participation at lower levels bring the risk of unauthorised and/or poor decisions to the centre of the external auditor's field of
involvement. Chapter three will examine the development and adaptation the audit process underwent to address the changes in the control arena of the management science.
CHAPTER 3

THE STATUTORY AUDIT APPROACH AND PRACTICES IN PERSPECTIVE

3.1 INTRODUCTION

Every company in the Republic of South Africa registered under the Companies Act 61 of 1973 is required to appoint an auditor (Act 61/1973; section 269/270). Section 300 (h) states inter alia that "... it is the duty of the auditor of the Company to examine the group annual financial statements and satisfy himself that they comply with the requirements of this Act" stating that it is the duty of the auditor "... to examine such of the accounting records of the company and carry out such tests in respect of such records and such other auditing procedures as he considers necessary to satisfy himself that the annual financial statements fairly present the financial position of the company and the results of its operations". (Act 61/1973; section 300 (h) I)

The auditing profession in South Africa is regulated by the Public Accountants and Auditors Act (Act 51/1951). Auditors are subject to high ethical standards, as well as standards regulating the quality of their main product, the statutory audit service. "These auditing standards prescribe the basic principles and practices which members are expected to follow in the conduct of an audit". (Howard, 1992:11) The South African Institute of Chartered Accountants’ code of professional conduct prescribes that "... a member should carry out professional services in accordance with the relevant technical and professional standards. Members have a duty to carry out with care and skill, the instructions of the client or employer in so far as they are compatible with the requirements of integrity, objectivity and, in the case of members in public practice, independence. In addition, they should conform with the technical and professional standards promulgated by the Institute, relevant authorities and relevant legislation". (ET 1995:13(f)) In addition to this explicit instruction there are
formal statements of generally accepted accounting practices, accounting guidelines, accounting opinions, statements on auditing standards, constitution on by-laws, ethical code, circulars and a host of other publications, all in an effort to enhance the quality and standard of audits.

Internationally enforced are the International Standards on Auditing issued by the International Auditing Practising Committee of the International Federation of Accountants. Robertson (1993: 34) states in this regard that accountants and regulators have an interest in harmonising the standards, and to a large degree this is successful.

3.2 OUTPUT OF THE AUDIT - THE AUDIT PRODUCT

3.2.1 Introduction

The statutory audit product in South Africa is described by law, which states that beneficiaries will receive audit services once a financial year, culminating in a report expressing some opinion about the company's financial position and the result of its operations. (Act 61/1973; section 300 (h))

Kotler & Armstrong (1990:226) defines a product on three levels: the physical product, the augmented product or additional benefits, and finally the core benefit or "what the buyer really is buying". Using this as a framework, the audit product can be described.

3.2.2 The physical product

The physical product or service is the physical process of auditing culminating in an audit report stating an opinion on the fairness of the financial position and results of its operations (Act 61/1973; section 301). In the event of the auditor being unable to make such a report, or to make it without qualification, he shall include the facts and reasons precluding giving an unqualified report (Act 61/1973; 301(2)).
3.2.3 The augmented product

The augmented product is usually the management letter stating where weaknesses in records, systems and controls may lead to material errors. Dodge (1990:144) describes some of the objectives of the management letter as to:

- comment on records, systems and controls where weaknesses may lead to material errors
- give constructive advice

The nature of these objectives is such that it provides additional benefits or the augmented product, though it is clearly not the main reason or core benefit of the audit.

3.2.4 The core benefits

To define the core benefits of the statutory audit one has to look at the social and economic role the statutory audit plays.

Steele (1992:2) states that there are two theories about the economic role of auditing, namely the information hypothesis and the agency theory. "The information hypothesis is that shareholders demand audited financial information because financial information of integrity is needed to determine market values (of the shares)." He further states that "... no one would deny that the function in lending credibility to financial statements has been growing in importance. Such reports are relied on heavily by investors, creditors, security analysts, government and other. This credibility is vital in establishing and maintaining confidence in the capital markets. Without such confidence the whole basis of our capitalist system would be destroyed." The agency theory see auditing as a service to risk sharing. "Companies are managed by technocracy which may not have equity stakes in the organisation but has control over the wealth and information flow. There is considerable scope for conflict of interest of which the simplest form is the honesty and integrity of the company directors". (Steele, 1992:4) The agency theory is
then described as resolving the conflict of honesty and integrity between owners and managers in the most cost effective way (Figure 3.1).

**FIGURE 3.1. THE AGENCY THEORY**

<table>
<thead>
<tr>
<th></th>
<th>Cost</th>
<th>Quantity/Pool Managers</th>
</tr>
</thead>
<tbody>
<tr>
<td>A1</td>
<td>Solution using nepotism (own family or trusted friend) or a caste system (honourable and most trustworthy managers). As the pool is limited and management is a factor of production, the economy will be restricted in its scale of investment and activities. <strong>Low cost as non-specialists are used.</strong></td>
<td></td>
</tr>
<tr>
<td>A2</td>
<td>Solution being optimum by using specialists (auditors) to check (audit) on honesty and integrity. <strong>Cost is higher as expertise is bought.</strong></td>
<td></td>
</tr>
<tr>
<td>A3</td>
<td>Solution using managers to such an extent that control can be exercised to a sufficient degree by managers (controlling one another) in the absence of auditing.</td>
<td></td>
</tr>
</tbody>
</table>

Source: Steele (1992:6) adapted.

Arens & Loebbecke (1992:10) argues that the reduction of information risk is the prime economic reason why there is a demand for an audit. Information risk is defined as “...the risk which reflects the possibility that the information upon which the business risk decision was made was inaccurate. A likely cause of the information risk is the possibility of inaccurate financial statements”. (Arens & Loebbecke, 1992:10) Credit and funding providers can
assess the business risk of an organisation, **provided** they get information about the business which is trustworthy. According to Arens & Loebbecke (1992:10) the likelihood that unreliable information can be given to financiers and investors is high in today’s world due to the following **reasons**:

- **remoteness** of information as even executive managers do not have first-hand knowledge and information of their organisations anymore.
- **bias** and motives of provider of information will be in favour and in support of the motive for giving such information.
- **voluminous** data and transactions make it easier to conceal information.
- **complexity** of transactions and the recording thereof make it easier to manipulate.

According to Arens & Loebbecke (1992:11) the alternatives to reduce information risk is:

- for **users** to verify the information themselves which is usually impractical because of cost in the repetitive effort.
- for **users** to **share** information risk with **management**, banking on the common understanding that management has a positive duty on them to provide reliable information. If that proves to be untrue the user can sue the organisation and management in their own capacity for damages. In that sense managers are at risk and will be forced to do their utmost to provide correct information.
- to have **professional auditors auditing** financial statements. In this way it is less expensive, **independence** is assured, **expertise** and **standards** are assured and lastly the **users can sue** the auditors (in addition to management) for incorrect information.

Lee (1993:3) states that the audit is a “... crucial means of operationalising corporate governance and accountability - that is, of controlling **corporate behaviour** generally and holding corporate managers accountable particularly”. He goes on to state that the audit’s “existence can also be argued to have **economical, political and sociological implications in the various communities in which it operates. In particular, it has a role to play in the formulation and consequences of economic decisions, modes of organisational control and interplay between state and business**”. (Lee, 1993:3)
Flint (1988:14) states that “... audit is a social phenomenon. It has no purpose or value except in its practical usefulness. The function has developed in response to a perceived need of individuals or groups in society who seek information or reassurance about the conduct or performance of others in which they have an acknowledged and legitimate interest: it exists because the interested individuals or groups are unable for one or more reasons to obtain for themselves the information or reassurance they require”.

Kell et al (1989:35) cites the economic benefits of an audit as:

- for corporations to access capital markets and funding in general as audited financial statements improve an entity’s credibility.
- having a favourable effect on employee honesty and efficiency.
- helping the efficiency of the market by limiting the life of inaccurate information or deterring its dissemination.

In summary it can be said that the core benefits of the audit product lies on two levels. At the one level is the direct beneficiaries, being the company, its management, its creditors, suppliers and capital providers who benefit in the reduction of information risk in the most cost effective manner. On the other level is society as a whole where society decided that low information risk on financial information is one of the pillars without which no successful economic structure can do. Lee (1993:68) argues that “... corporate auditors have entered into implicit covenant with society to protect the public interest from unacceptable behaviour by corporate management in its stewardship reports. In return for a monopoly of service provided by corporate regulation, and the high financial rewards and social status which go with the latter, the auditor has accepted certain specific responsibilities”. By making audits compulsory by law society recognises that the potential social costs, in not having a mechanism to ensure low information risk, can be disastrously high. Wallace (1985:51) states in this respect that “... entity owners are effectively paying a tax in the form of the cost of audit monitoring, and the benefits from this tax is being shared by the community at large”. Regulating the audit product acknowledges per implication the fact that successful societies put a
premium on low information risk to the extent that supply and demand for audits are not left to market forces to determine, but are a non-negotiable principle in society.

By giving auditors an identity, certain privileges and responsibilities, society acknowledges the efficiency a specialised profession (with external and self regulated boundaries) can bring. Thus the emergence of a self-regulating accountancy profession whose members were educated and trained sufficiently to take the responsibility for the corporate audit (Kodslie, 1990:135-171).

3.3 DELIVERABLES OF THE STATUTORY AUDIT

3.3.1 The value chain of the audit

Lee (1993:23) defines auditing as “... a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between these assertions and established criteria and communicating the results to interested parties”. The audit is a process designed to provide useful economic information - in the form of an opinion on the financial statements - of a judgmental nature.

The basic utility of financial statements is that it relays all the subjectivity and qualitative measurement criteria of all the organisation’s endeavours to one common denominator namely the monetary value derived from its activities. The auditor is thus not concerned with management’s responsibilities at all except to the extent that it can influence the financial assertions in financial statements. Secure in the knowledge that the objectives, outputs, strategies, resources and decisions will in the final analysis reflect in some monetary result, the auditor focuses all its efforts on the representation of the financial information. Lee (1993:64) describes the evolution of the prominence of financial statements as follows: “The corporate audit can be viewed historically as switching its primary operational attention away from human
beings and their behaviour (as expressed in formal accounting recording of economic events) to the records itself and, most recently, to the written financial statements derived from these records - that is, from the observable reality of the individual human being and his accountable actions in stewardship, to a quantitative data base of these actions, and, finally, to summary reports of certain aspects of the content of that data base”.

“Management is responsible for preparing the financial statements and the contents of the statements are the assertions of management”. (Kell et al, 1989:36) The external auditor’s responsibility is confined to the expression of his opinion on them (Kell et al, 1989:36). Looking at the value chain of the audit it can be described as follows: All actions from an organisation have directly or indirectly a monetary effect. Management is responsible to represent these monetary effects in financial statements. For financial statements to be meaningful it needs to be prepared uniformly on the same basis, according to generally accepted accounting principles. The auditor carries the responsibility to ensure that the risk of incorrect information as represented by management’s financial statements is reduced to an acceptable level. This responsibility is fulfilled by performing an audit according to generally accepted audit standards and reporting their findings.

3.3.2 The audit report in context

Generally accepted auditing standards requires the auditor to comply with the following reporting standards (Arens & Loebbecke 1992:17):

- The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.
- The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.
- Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
- The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an
opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefore should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

Arens & Loebbecke (1991:152) summarises the assertions by management about accounts as follows:

- Existence or occurrence
- Completeness
- Rights and obligations
- Valuation or allocation
- Presentation and disclosure

To understand these assertions is a prerequisite to understand and do an audit, according to Arens & Loebbecke (1991:152). All actions undertaken by an organisation will directly or indirectly result in a financial impact for that organisation. The auditor is not particularly concerned with those actions which indirectly result in a financial impact for the organisation (for example, the implementation of a quality control programme, the content of a sales promotion, the quality of the strategic plan). Once the action results in a direct financial impact for the organisation (for example, the cost and disbursement of the quality control programme, the actual occurrence of a sale irrespective of the fact that the sales promotion could have effected the sale, the deployment of resources and subsequent payment for resources in terms of the strategic plan of the organisation) the auditor must be concerned with the action, and the concern lies in the implied assertions by management. Stating it in other terms, an unqualified audit report implies an evaluation on each and every action by the organisation having had a direct impact on the financial resources of the organisation - which must be disclosed in financial terms. Each and every action so being certified have the risk of: non-existence or -occurrence; not being complete, that rights and liabilities are misunderstood, that the valuation is incorrect and that the information could be misrepresented and/or disclosed. The auditor must have done fieldwork which is adequate to address all these risks. If not, he cannot express an opinion on
the financial statements of an organisation even though he might have an appetite for risk to the extent that he is willing to express an unqualified report without having done an audit which complied to general accepted auditing standards.

3.4 **THE IMPLIED NON-DELIVERABLES OF THE STATUTORY AUDIT**

3.4.1 **Fraud and irregularities**

Looking at the standards of reporting it is clear that the auditor is not expected to judge value for money decisions. Any subjective assessment of management judgement to evaluate and judge the business decisions is clearly out of the auditors scope. The auditor will **not be liable or co-responsible** for any bona fide business decision that **does not add economic value** to the organisation. The prime responsibility is only to ensure that the financial results of the decision is **disclosed correctly** in its full context. The auditor however may become co-liable if the **decision** or the **resultant action** in executing the decision is **fraudulent** or contrary to the **company memorandum of agreement or articles of association**, or is **mala fide** or **negligent**. "The auditor is not responsible for **preventing** illegal acts, other than irregularities and errors". (AU 005, 1992:5) However, the auditor is responsible to plan, perform and evaluate audit work in such a way that there is a reasonable expectation of detecting material misstatements in the financial information which result from illegal acts, other irregularities and errors, and which affect the fair presentation of the financial information (AU 005, 1992:16). Lee (1993:121) argues that the auditor “. . . **has a responsibility for fraud and error detection only when he failed to use reasonable care in what was suspicious circumstances**. In a more recent case Thomas Gerrard and Son Ltd. 1968 the judge ruled that the auditor is guilty of negligence if he fails to detect fraud because the nature and quality of the audit procedures were **below what is regarded as best practise**”. The auditor is thus not accountable for fraud - irrespective of the scale on which it took place - provided that the
auditor followed general accepted audit standards. This puts into perspective the importance of the term GAAS (General accepted audit standards) from two points of view:

- Firstly for the individual auditor who, from an own business risk point of view must stand in for the full legal recourse which affected parties may have when they suffer damages in dealings based on the unqualified audit report. However in this regard Act 51 of 1951 (Section 26 (5)) severely limits the circumstances in which an auditor can be liable to a third party, even if he did not comply to GAAS.

- Secondly for the profession to ensure that general accepted audit standards (GAAS) are always relevant and specifically designed to pick up material fraud.

However when the auditor uncovers fraud as part of his normal “reasonable care” procedures, there is a positive responsibility to report it to different parties as follows:

3.4.1.1 Reporting fraud to management

“The auditor should be satisfied that the audit committee, the board of directors or senior management are adequately informed about illegal acts, other irregularities or errors of which the auditor becomes aware”. (AU 005, 1992:27)

3.4.1.2 Reporting fraud to members

“A material error will normally be corrected in the financial information, therefore the auditor will not need to report such an error to the members or owners of the entity”. (AU 005, 1992:30) “If an illegal act or other irregularity has taken place and the financial information does not adequately disclose the financial effect of the illegal act or other irregularity, the auditor would have to apply judgement to assess whether or not fair presentation has been achieved”. (AU 005, 1992:31)
3.4.1.3 Reporting fraud to third parties

"Except where the auditor has a duty to report which is imposed by the courts or by statute, the auditor would not normally report an illegal act or other irregularity to a third party, as such a disclosure is precluded by the auditor’s ethical and legal duty of confidentiality". (AU 005, 1992:32)

3.4.2 General non-deliverables

To put the audit product into perspective it is useful to highlight the aspects which the auditor is not liable for, and subsequently does not express an opinion on.

- **Management’s effectiveness** as represented by their objectives or goals set for the company.
- **Management’s planning, organising or leadership capabilities**.
- **Management’s or the company’s general efficiency** in terms of the resources, inputs or strategies utilised to reach their objectives or goals.
- The effectiveness and efficiency of the internal control environment.

In summary it could be stated that an unqualified audit report does not mean that money or assets aren’t squandered on unnecessary resources. Nor does it mean that no fraud took place. However an unqualified audit report implies the following:

- that the financial implications of the organisation’s transactions (whether they are wasted or not in the opinion of the auditor or even management) are **technically accounted** for correctly in the financial statements
- that the organisation’s transactions (whether they are wasted or not in the opinion of the auditor) are valid, complete, authorised accurate, classified and accounted for in the correct period in the financial statements
- that if **fraud** was committed and the auditor becomes aware of it, the financial implications of such fraud would be **technically accounted** for correctly.
3.5  INPUT IN THE STATUTORY AUDIT - THE AUDIT PROCESS

3.5.1  The audit approach - a history

In the 19th and early 20th century the purpose of auditing was fraud and error detection. Sikka et al (1922:15) states that fraud and error as primary purpose were gradually translated to where accounting and disclosure compliance was the major aim. Lee (1993:63) speculates that the reasons for this change are a mixture of organisational change, economic and professional self-interest. Self-interest includes the cost of fraud and error detection exceeding the economic benefits and the pressures on the corporate auditor induced by litigation for fraud and error failures. The audit profession adjusted to the pressures of “value for money” by realising that the cost of providing error and fraud free opinions on financial statements will not exceed the benefits thereof, and hence changing the effectiveness (doing the right things) of the audit to one where correct accounting disclosure became the value added. Since the 1960s the then reason for existence or effectiveness of the audit profession (being the expression of an opinion on accounting and disclosure compliance) had general consensus and broad support (Lee, 1993:64). The auditor having to deal with the constant “value for money” question, resorted to focusing on the efficiency (doing things right) of the audit. The result was fundamental changes to the input or process of the audit.

As a profession bound by high ethical standards the audit profession is faced with collecting evidence to the highest and most comprehensive standard possible but at the same time not allowing the costs of the audit service exceeding its benefits. In this regard Lee (1993:85) states that the audit task “... is not narrowly phrased in terms of just the sufficiency and availability of audit evidence. It specifically required sufficient competent and reliable evidence to be gathered and used within reasonable time and cost constraints. No corporate auditor should expect an abundance of evidential material to be immediately available for examination and judgement. Nor can the reporting corporate organisation be expected to retain indefinitely all the material which evidence the processes of financial accounting. Yet, despite these
constraints, it must be assumed that the auditor will be able to gather evidence of sufficient quality to support his audit opinion, but that this can be done within a reasonable time and at a reasonable cost”. These conflicting objectives of high standards with low cost drove the audit profession to continuously develop audit approaches which tried to limit the scope of activities and resources whilst not going beneath a certain standard of comfortableness.

3.5.2 **Recent developments in the audit process**

Lee (1993:5) states that the audit is “... *predominantly concerned with verifying calculational matters relating to the production of financial statements and the accurate maintenance of the underlying bookkeeping function*. Many authorities during the past decade proposed alternative purposes for the audit. Sherer and Kent (1983:93) proposes that audits should “...*test the efficiency of operations, the quality of management information systems and the social behaviour of organisations*”. Tinker (1985:205) states that “...*the auditor should be involved in adjudicating social conflicts involving corporate organisations and the communities in which they operate*. Gray (1990:134) suggests a need to amend traditional reporting practises to incorporate environmental issues. Briloff (1990:5) argues on evidence of recent corporate failures, how the audit profession desecrates its covenants to protect the public interest highlighting the so-called expectation gap requiring the auditor to accept responsibility for fraud. However, all these ideas of what the auditor should do remain ideas as the profession either is not prepared to take the risk or the beneficiaries are not prepared to pay the price for such services.

Dodge (1990:xiii) describes the evolution of the auditing process or approach as “... over the past 25 years, auditing procedures have evolved through three stages: first, the *vouching audit*; then the *systems-based audit*; and now the *risk-based audit*. In the vouching audit we saw little more than the books and papers. In the systems-based approach we saw the systems which controls the transactions. In the risk-based approach we look at the *people* who control the system”. Dodge (1990:xix) further states that “... *despite our refinements to the system-based approach we were still criticised because, although the systems acted as a control over the staff, there was*
nothing controlling the management". The audit approach of the 1980s can be described as a system-based approach, described in FIGURE 3.2

**FIGURE 3.2 THE AUDIT PROCESS - SYSTEMS BASED**

- **Phase I**
  - Planning and Designing An Audit Approach
  - Evaluate Auditability
    - Obtain Background Information
    - Obtain Information about the Client's Legal Obligations
    - Appraisal of Desired Level of Assurance
    - Evaluate Likelihood of Material Errors

- **Phase II**
  - Tests to Be Performed
    - Yes: Apparent Reliability of Controls
      - High
      - Moderate
      - Low
      - Tests of Controls
        - Compliance Tests
        - Observation Tests
        - Evaluating Auditability
    - No: Phase II Substantive Tests
      - Assessment of Likelihood of Errors in Financial Statements

- **Phase III**
  - Direct Tests of Financial Balances
    - Low
    - Moderate
    - High or Unknown
    - Analytical Review
      - Verification of Key Items
      - Additional (non-routine) Review

- **Phase IV**
  - Post Balance Sheet Review
    - Review of Working Papers
    - Evaluation of Results of Audit
    - Issue Audit Report

Source: Arens & Loebbecke (1979:269).
It is apparent from the system-based audit approach that certain processes were incorporated to enhance the efficiency of the audit product. These are detailed below.

- **Using the control environment** as an instrument in scaling down audit tests.
- **An appraisal of desired level of assurance**, relates to the "... subjectively determined level of confidence that the auditor wants to have about the fair presentation of the financial statements after the audit is completed". (Arens & Loebbecke, 1979:142) It can vary depending on factors such as the degree external users rely upon the financial statements, the likelihood of bankruptcy, lawsuits, competition between audit firms, etcetera. (Arens & Loebbecke, 1979:142-145). Auditors are thus required to increase or decrease their effort in the audit process depending on their assessment of the desired level of assurance.
- **Concept of materiality** which is defined as "... the maximum error that can exist in the account before it is considered to be materially misstated". (Kell et al, 1989:78)

The system-based audit had inherent deficiencies of which the most important one was that, whilst it took into account the fact that in certain circumstances it would make sense to do more or less examination of the internal control environment, it was not specific enough with regards to exactly what constitutes those circumstances. The audit approach was thus adapted to the so-called risk based audit, taking into account the generic risks which an auditor faces as the basis for defining their broad audit approach.

### 3.5.3 The present audit approach (the risk-based audit)

The auditor - as it stands today - is in the business of managing risk and more specifically managing of information risk. "As society becomes more complex, reliance on auditors to reduce information risk increases". (Arens & Loebbecke, 1991:12) Steele (1992:16) states that "... the professional judgement of an auditor should concentrate on himself. In offering certification services the accountant assumes legal responsibilities and voluntary participates in risk. Unlike the doctor, whose legal exposure is incidental to his principal service, the auditor's legal
exposure is at the crux of his service. The whole activity of gathering audit evidence can be characterised from the auditors perspective as a process of managing risk.” Steele (1992:17) goes on to say that “... it follows that risk management goes to the core of the audit process. The auditor is not concerned with minimising risk, because the least risk is to refuse to certify, or to certify while disclaiming any responsibility for the opinion”. From these remarks it is clear that the auditing profession cannot reduce its risk-sharing responsibility as this will alleviate the core reason for its existence.

Audit professions around the world tried to aid their members in fulfilling their professional responsibilities. Arens & Loebbecke (1991:17) list the 10 generally accepted auditing standards (GAAS) in the USA as follows:

- **General standards**
  - The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
  - In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
  - Due professional care is to be exercised in the performance of the examination and the preparation of the report.

- **Standards of field work**
  - The work is to be adequately planned and assistants, if any, are to be properly supervised.
  - The auditor should obtain a sufficient understanding of the internal control structure to plan the audit and to determine the nature, timing, and extent of tests to be performed.
  - Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

- **Standards of reporting**
  - The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.
  - The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.
Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefore should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

The standards of field-work are of particular interest as the term “field-work” refers to the actual audit process to be followed. Most of the innovations and developments in the audit process were in this field-work arena.

The audit approach of the 1990s can be described as a risk-based audit. The risk-based audit is the systems-based audit taken one step further. The auditor still uses the systems in an organisation to reduce his work, but first assessing his own risk before deciding on the appropriate audit approach. Figure 3.3 gives a diagrammatic representation of the present audit process.

3.6 THE CONTROL ENVIRONMENT FROM THE AUDITOR’S PERSPECTIVE

3.6.1 Why auditors are interested in the control concept

AU 230 (1986:01) states that “the auditor should obtain an understanding of the entity’s accounting system and related internal controls to assess their adequacy as a basis for the preparation of financial information and to assist in designing his auditing procedures. If the auditor intends to place reliance on any internal controls he should study and evaluate those controls”. AU 230 (1986:04) focuses the auditor on those controls which will ensure that the accounting of transactions comply with certain objectives, stating “internal controls relating to the accounting system are those designed to ensure that the financial information produced by the accounting
FIGURE 3.3  THE MODERN AUDIT PROCESS

<table>
<thead>
<tr>
<th>PRE-ENGAGEMENT ACTIVITIES</th>
<th></th>
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<tbody>
<tr>
<td>Perform new client investigation, or consider change in circumstances of existing client</td>
<td>AU221</td>
</tr>
<tr>
<td>Determine skills and competence requirements</td>
<td>AU120, AU123, AU130, AU226</td>
</tr>
<tr>
<td>Establish terms of engagement</td>
<td>AU210, AU211</td>
</tr>
<tr>
<td>Obtain, or update, knowledge of the business</td>
<td>AU210, AU225</td>
</tr>
<tr>
<td>Make a preliminary judgement of materiality for planning purposes</td>
<td>AU210</td>
</tr>
<tr>
<td>Assess inherent risk of misstatement relating to each assertion</td>
<td>AU210, AU230</td>
</tr>
<tr>
<td>Obtain an understanding of the accounting system and related internal controls</td>
<td>AU210, AU225, AU265, AU270</td>
</tr>
<tr>
<td>Formulate an audit approach</td>
<td>AU210, AU230</td>
</tr>
<tr>
<td>Study those internal controls on which it is intended to place reliance</td>
<td>AU210, AU230</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>PLANNING</th>
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<tbody>
<tr>
<td>Carry out compliance procedures, where required</td>
<td>AU231</td>
</tr>
<tr>
<td>Evaluate results of compliance procedures and modify planned substantive procedures, if necessary</td>
<td>AU231</td>
</tr>
<tr>
<td>Carry out substantive procedures</td>
<td>AU240, AU252, AU257, AU259, AU265</td>
</tr>
<tr>
<td>Evaluate results of substantive procedures</td>
<td>AU240, AU290, AU291, AU292</td>
</tr>
<tr>
<td>Carry out further substantive procedures, if necessary</td>
<td>AU240, AU290, AU291, AU292</td>
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<tr>
<th>COMPLIANCE AND SUBSTANTIVE PROCEDURES</th>
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<tbody>
<tr>
<td>Evaluate results of substantive procedures</td>
<td>AU240, AU290, AU291, AU292</td>
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</table>

<table>
<thead>
<tr>
<th>EVALUATING, CONCLUDING AND REPORTING</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Carry out overall review of the financial information and evaluate the audit evidence</td>
<td>AU225, AU265, AU290, AU291, AU292, AU293, AU294</td>
</tr>
<tr>
<td>Conclude and formulate audit opinion</td>
<td>AU240, AU290</td>
</tr>
<tr>
<td>Report accordingly</td>
<td>AU300 section</td>
</tr>
</tbody>
</table>

Source: SAICA (AU 015:APPENDIX).
system is complete, accurate and valid. Specifically, related internal controls are those intended to ensure that:

- **transactions are executed in accordance with management's general or specific authorisation**
- **all transactions are promptly recorded at the correct amount, in the appropriate accounts and in the accounting period in which executed so as to permit preparation of financial information in accordance with the entity's accounting policies**
- **access to assets is permitted only in accordance with management's authorisation**
- **the recorded assets are compared with the existing assets and vice versa at reasonable intervals and appropriate action is taken with regard to any difference**.

AU 230 (1986:11) reconfirms the notion that control in its broad context is not the focus for the auditor, as follows: "There may be controls which the auditor does not study and evaluate because they are important to the achievement of management's objectives but have no relevance to the auditor".

Robertson (1993:484) gives the framework in which the auditor should understand the control structure as follows: "An internal control structure is divided into three elements: The control environment is a set of characteristics that defines good control working relationships in a company. The accounting system contains policies and procedures for recording transactions properly. The control procedures are specific error-checking routines performed by company personnel". Robertson (1993:485) describes the three elements in more detail starting with firstly the control environment elements which comprise of:

- Management's philosophy and operating style
- Company organisational structure
- Functioning of the board of directors, particularly its audit committee
- Methods in assigning authority and responsibility
- Management's monitoring methods, including internal auditing
- Personnel policies and practises
- External influences (for example bank regulatory agencies)
Robertson (1993:488) takes cognisance of the complexities and variables which management have to deal with in the control environment by stating that “... a wide variety of activities characterise the control environment. Consequently it is sometimes hard for auditors to understand it and document it”. Robertson (1993:486) secondly addresses in more detail the accounting systems stating that: “All accounting systems, whether computerised or manual, consists of four essential functions - data preparation, data entry, transaction processing and report production and distribution”. He then proceeds to list the internal control objectives of any accounting system as one where all the transactions should be:

- valid
- complete
- authorised
- accurate
- classified
- accounted for technically correct
- accounted for in proper period (Robertson, 1993:489).

Robertson (1993:487) lastly expands on the control procedures as: “Client procedures (both computerised or manual) imposed on the accounting system for the purpose of preventing, detecting and correcting errors and irregularities that might enter and flow through to the financial statements”.

Kell et al, (1988:150) has a similar approach, by adopting a framework of internal controls structure elements. These are summarised in table 3.1.

It is clear from both the frameworks provided by Robertson and Kell et al that the internal control structure, as viewed by auditors, comprises on the one side a qualitative element being the control environment where perceptions, management philosophies, external variables, style, the human element and culture (tone at the top) play a major role. On the other side there is a measurable element being the accounting system and control procedures with its focus on the production of financial information of integrity. In evaluating this side of the control structure the
<table>
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<tr>
<th>CONTROL ENVIRONMENT</th>
<th>ACCOUNTING SYSTEM</th>
<th>CONTROL PROCEDURES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Organizational Structure</td>
<td>Records - Journals and Ledgers</td>
<td>Segregation of Duties</td>
</tr>
<tr>
<td>Audit Committee</td>
<td></td>
<td>Documents and Records</td>
</tr>
<tr>
<td>Methods of Assigning Authority and Responsibility</td>
<td></td>
<td>Access Controls</td>
</tr>
<tr>
<td>Management Control Methods</td>
<td></td>
<td>Independent Internal Verification</td>
</tr>
<tr>
<td>Personnel Policies and Practices</td>
<td></td>
<td></td>
</tr>
<tr>
<td>External Influences</td>
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</table>


The auditor should view these controls in a vacuum, ignoring the broader control environment as viewed by management (AU 230, 1986:11). The purpose of evaluating the accounting system and related control procedures is simply to ensure that the organisation will reach the internal control objectives via adequate procedures as defined by the audit profession. In this regard it should be noted that once an organisation weighs up all factors in devising their accounting system and control procedures there may be very valid reasons, for instance the cost/benefit judgement (Ernst & Young, 1996:2.2) why organisations will not comply to the auditor’s idea of an ideal control environment. This fact should thus in theory not reflect negatively on management as the context in which the auditor regards the control environment is firstly with a view to evaluate it purposefully in a narrow sense (AU 230, 1986:11).
and secondly the reason for evaluating the internal control environment lies in the final analysis in a technique/approach developed by the auditor for the auditor to become more efficient (Robertson, 1993:501) and not to judge management to adherence of control elements as defined by the audit profession.

3.6.2 How auditors utilise the control concepts in their audit approach

AU210 (1986:27) states that the auditor “. . . either makes a preliminary assessment of each assertion’s inherent and control risks or, if he does not intend to place reliance on such assessments, he assumes these risks to be at a maximum. He can then determine an acceptable level of detection risk for each assertion and can design his audit approach accordingly.” Arens & Loebbecke (1991:255) describes the audit risk model in the following equation.

\[
PDR = \frac{AAR}{IR \times CR}
\]

Taylor & Glezen (1991:181) equates audit risk as follows:

\[
AAR = IR \times CR \times PDR \quad \text{(adjusted)}
\]

\[
PDR = \text{Planned detection risk}
\]

\[
AAR = \text{Acceptable audit risk}
\]

\[
IR = \text{Inherent risk}
\]

\[
CR = \text{Control risk}
\]

Planned detection risk is defined as “. . . the risk that the audit evidence for a segment will fail to detect errors exceeding a tolerable amount, should such errors exist”. (Arens & Loebbecke 1991:255) Detection risk is influenced directly by the auditor’s actions. “In contrast to inherent risk and control risk, auditors are responsible for performing the evidence-gathering procedures that manage and control detection risk”. (Robertson 1993:453) Detection risk relates to substantive procedures and not compliance testing. Robertson states (1993:453) that “. . . detection risk realised when substantive procedures fail to detect material misstatements”.

Inherent risk is defined as “... the likelihood that errors (misstatements) exceeding a tolerable amount exist in a segment before considering the effectiveness of internal accounting controls”. (Arens & Loebbecke 1991:256. “Inherent risk does not refer to the business risk or general risk per se, but refers to the possibility that the accounting of transactions are materially misstated”. (Robertson 1993:452) The source may be in business risk but a high business risk does not necessarily relate to the segment having an automatic high inherent risk. A relationship between the risk and the possibility that it can be treated materially wrong from an accounting perspective must be present before it can be classified as inherent risk.

Control risk is “... the likelihood that errors (misstatements) exceeding a tolerable amount in a segment will not be prevented or detected by the client’s internal control structure”. (Arens & Loebbecke 1991:256) Arens & Loebbecke (1991:257) specify that “... before an auditor can set the control risk at below one hundred percent he must perform three things: obtain an understanding of the client’s internal control structure; evaluate how well it should function based on that understanding, and test controls within the internal controls structure for effectiveness.”

Acceptable audit risk is defined as “... a measure of how willing the auditor is to accept that the financial statements may be materially misstated after the audit is completed and an unqualified opinion has been reached.” (Arens & Loebbecke 1991:257)

The relationship between the different risk areas is described by Puttick and Van Esch (1992:80) as having the auditor “... to make an assessment of inherent and control risk, or assume these risks to be at maximum and therefore plan to perform extensive substantive audit procedures that should reduce detection risk to a level which results in the acceptable overall audit risk by the auditor”. Arens & Loebbecke (19991:256) says that “... inherent risk and control risk are inversely related to detection risk and directly related to evidence.” The risk environment for the auditor is summarised in figure 3.4.
The concept of looking at the broad risk areas which can materialise allows the auditor a certain flexibility in its approach. For instance, the auditor in having to judge his own acceptable audit risk has the freedom to take more risk (of an incorrect unqualified opinion) on himself. Furthermore AU210:28 states that: "If an auditor concludes that the effort required to evaluate one or both of inherent risk and control risk for an assertion would exceed the potential benefit to be derived from the resulting reduction in the extent of his auditing procedures, he should assess either or both risks as being at the maximum when designing his auditing procedures."

Looking at the control risk as it relates to the auditor in isolation it is possible to extract the dilemma regarding the evaluation of the control environment. Ernst & Young (1996:2.2) expressing their opinion on the Cadbury Report requirements of management having to express an opinion on the effectiveness of internal control states that "... it is fraught with difficulty, because there can be no objective
yardstick against which to judge the adequacy of internal controls. For one thing the need for controls depend upon perceived risks, and accordingly their adequacy can only be judged in that context, there is no all-purpose standard of controls that is accepted as necessary in all circumstances. For another there is a cost/benefit judgement to be made in relation to any systems of controls, which means that some managements will legitimately decide to spend more than others on control mechanisms”. It is clear that the adequacy of internal controls is a perceived objective and that it will differ from management to management. Management will view the necessity of internal controls against a number of variables such as: cost effectiveness, their operating style, market expectations, threats of a take-over, incentive remuneration arrangements, the existence of a major project with which individual members of top management are closely identified, staff motivation, competencies and integrity (Ernst & Young, 1996:4.2). The auditor on the other hand will always evaluate the internal control environment against the criteria of adequate separation of duties, proper authorisation of transactions, adequate documenting of transactions and physical control over assets.

Robertson (1993:503) puts the role of the internal control environment in its totality into perspective in figure 3.5.

3.6.3 Management’s prerogative in taking risks - the auditor’s perspective

Management and their delegatories make many decisions resulting in financial resources of the organisation being committed. The resultant objective of such decisions would as a general rule be to generate more benefits/income than the resource committed. Sometimes it would be measurable in a very direct way, for example cost of sales relating to sales. Sometimes it would be very indirect, for example by investing heavily into training believing, for example, that the possible better service levels and quality outputs will result in better or more turnover.
FIGURE 3.5: PHASES OF INTERNAL CONTROL EVALUATION

1 Understanding

- Obtain an understanding of the control structure
- Control Environment
- Accounting System
- Control Procedures
- Document the understanding
- Narrative memo
- Questionnaire
- Flowchart

Design a preliminary program of substantive audit procedures for auditing assertions related to account balances

2 Assessment

- Assess Control Risk (preliminary assessment)
  - Can control risk be low? Consider efficiency and effectiveness
    - Yes
    - Is reduction of the control risk assessment cost-effective?
      - Yes
      - Specify the controls to be tested and the degree of compliance required
    - No
    - No

- Perform tests of controls of the specified controls

3 Testing

- Document the basis for assessing control risk less than 100%
- Is the actual degree of compliance comparable to the required degree?
  - Yes
  - Assess high control risk and design the audit program for heavy substantive audit work
  - No
  - No

- Perform the planned (or revised) substantive audit procedures

The auditor is, however, not charged with reporting on bona fide business decisions which may turn out not to be financial successes. The auditor is tasked to evaluate all business decisions resulting in a financial outcome for the organisation in terms of the five basic management assertions. If any decision or number of decisions collectively constitute an irregularity, error or illegal act the auditor will be forced to take action as prescribed. Organisations will deal with business risk and risk in general in different ways. An organisation’s **appetite for risk** will be determined by factors such as *inter alia*:

- the Chief Executive Officer’s personal style and values
- the nature of its remuneration system
- the markets it operates in
- the product life cycle
- the time to market for new product releases
- skills and experience of personnel
- rate of change in the industry

Management is defined as a “*set of activities designed to achieve an organisation’s objectives by using its resources effectively and efficiently*”. (Gatewood *et al*, 1995:4) Dealing with this “maximisation of outputs with the limited resources available” problem, management will have to take on certain risks in order to gain certain rewards. As far as the auditor is concerned, he is not interested in management’s appetite for risk, except to the extent that it can influence:

- the **fair presentation of the annual financial statements** (Act 61/1973; section 300 (H) I) for example the risk of fraud, error or misstatements of a technical accounting kind.
- his **assessment of the control environment** and subsequently his formulation to an appropriate audit approach. “*Management, through its activities, provides clear signals to employees about the importance of control. For example, does management take significant risks or are they risk averse? Understanding these and similar aspects of management’s philosophy and operating style gives the auditor a sense of its attitude about control*”. (Arens & Loebbecke, 1991:289)
- the **going concern concept**. AU294 (1986:08) states that “*in considering the risk that the going concern concept may be inappropriately applied, the auditor should be aware that the following factors may indicate doubt about an entity’s
ability to continue as a going concern. This listing is not exhaustive, nor does the existence of one or more of these factors always imply that an entity is not a going concern. However, the absence of any such factors may constitute audit evidence that the entity is a going concern”. It then proceeds to list risk indicators classified as financial indicators, operating indicators and other indicators. It thus requires the auditor to go beyond the normal evaluation of the control environment (which is limited to the impact it can directly have on the financial statements and their related assertions) to evaluate all relevant risks as it pertains to the going concern concept.

3.6.4 Synopsis of control philosophies from the auditor’s point of view

In summary it is important to highlight certain philosophies by the auditor in its view of control.

- Control is viewed in a narrow sense limited to the risk of fraud, error and misstatement in the financial statements. Arens & Loebbecke (1991:283) states that management has usually “... five concerns in designing an effective internal control structure being to provide reliable data, to safeguard assets and records, to promote operational efficiency, to encourage adherence to prescribe policies and to comply with statutes”. Arens & Loebbecke (1991:284) then clarifies the auditor’s concern with control by stating that “... the auditor is interested primarily in controls that relate to the first two of management’s internal control concerns, reliability of data and safeguarding of assets and records. Those are the areas that directly impact the financial statements and their related assertions, and therefore impact the auditor’s specific objectives. The financial statements are not likely to correctly reflect general accepted accounting principles if the controls affecting the reliability of financial data and the safeguarding of assets and records are inadequate. On the other hand, the statements can be fairly stated even if the company’s control do no promote efficiency in its operations”.

- It is not necessary for the auditor to rely on internal control. Robertson gives the economic rationale behind it in figure 3.6.
Though the auditor can choose not to rely on internal control he **cannot ignore** internal controls in defining his audit approach. If the auditor concludes that the reliance that can be placed on the internal control environment is low for whatever reason (economic or poor control environment) the auditor “. . . assumes these risks to be at maximum”. (AU 202, 1986:18) Puttick & van Esch (1992:80) state further that, “an assessment of inherent and control risk at high or maximum should reduce detection risk to a level which results in the acceptable overall audit risk set by the auditor”. Should the auditor plan to place reliance on the control environment “. . . he should gather audit evidence in support of such assessments”. (Puttick & van Esch, 1992:80) AU 202 (1986:21) puts the relationship between the internal control environment and the auditor’s eventual personal risk into perspective. It states that “. . . failure to comply with generally accepted auditing standards may well increase audit risk. Whilst an auditor may choose to reduce risk below acceptable levels by performing **more** extensive procedures than are required by generally accepted auditing standards, he may never accept a level of risk which results in failure to comply with generally accepted auditing standards”. From this it is apparent that the auditor cannot ignore the control environment as he will be liable for an incorrect opinion if he
did not correctly **address** the internal control environment according to generally accepted auditing standards.

- **The characteristics** of a sound internal control environment as defined by generally accepted audit practises should include the following. Firstly the **accounting system** should have objectives that will ensure that each transaction by the organisation will be **valid, authorised, complete, valued correct, classified correct, accounted for in the correct period, and summarised and posted correctly** (Arens & Loebbecke, 1991:297). Secondly the **control procedures** which should adhere to the following concepts:
  - **Adequate separation of duties.** The custodian of the asset should **not account** for it, as there is "... an excessive risk of that person disposing of the asset for personal gain and adjusting the records to relieve himself of responsibility". (Arens & Loebbecke, 1991:291) This reduces the risk of irregularities.
  - **Proper authorisation for transactions and activities.** Arens & Loebbecke (1991:293) puts it into context by stating that "... if any person in the organisation could acquire or expand assets at will, complete chaos will result". This reduces the risk of irregularities.
  - **adequate documents and records** which includes that they are available in a physical form. To keep track of such documents and records it is necessary to have a chart of accounts and system manuals. This is necessary to address the risk of "stealing, damaging or losing" (Arens & Loebbecke, 1991:295).
  - **adequate physical control over assets and records** to address the risk of "stealing, damaging or losing" (Arens & Loebbecke, 1991:295).

### 3.7 CONCLUSION

The auditor is concerned with the expression of an opinion on the financial statements of an organisation. The auditor is not allowed to take the risk of an incorrect audit opinion on himself. He must satisfy himself that he complied with generally accepted auditing standards (AU 202, 1986:21). The auditor thus has to follow generally accepted auditing standards or approaches, failing to do so will result in his not being
able to claim that a "satisfactory audit" has been performed, taking the risk of an incorrect audit opinion in litigation. Sheer size, volume and value for money requirements evolved the audit process from the vouching audit, to the system-based audit to the risk-based audit (Dodge, 1990:xiii). During this evolution of the audit process many techniques and approaches were formulated-making the auditor working smarter - not more. Some of these include the determination of a materiality figure to exclude insignificant rand value transactions, the breaking up of the audit risk areas into inherent control and detection risk, making it possible for the auditor to "legitimately" scale down on certain audit tests, the use of statistically sampling methods in order to reach conclusions using only a sample of tests and not testing the whole population. Generally accepted audit practises as it stands today requires the auditor to evaluate the internal control environment or assume that the risk is hundred percent. The control environment in which the auditor is interested is a sub-component of the broader control environment and is based on the principles of separation of duties; proper authorisations; adequate documents and physical control over assets and records. The control environment in which management is interested is the broader control environment. This brought about a gap between management and the auditor’s philosophies of the internal control environment, both in terms of content and importance.

Reporting on the state of the internal control environment only makes sense if the auditor’s basic philosophies match those of management. In such an instance the management of the organisation will benefit as non-adherence to their control philosophies and established environment will be exposed and management can take appropriate action. However if the control philosophies of management and the auditor differs the choice to the auditor is clear. He should accept the control risk at maximum and devise an audit approach which addresses the increased detection risk. Reporting the “deficiencies” to management via the management letter only result in a debate regarding the difference in opinion on control philosophies.

The audit product consists in its physical form of an audit report, stating an audit opinion on the fairness of the financial position and the results of its operation. (Act 61/1973, section 301). Management as decision makers and functionaries of the
organisation are liable to pay every year a substantial amount for a report, expressing an opinion on their assertions as summarised in their financial statements. The core benefits of the audit product is to a large extent to society as a whole, and thus distanced from the decision makers (management). As a result more accent has been placed on the augmented product being the management letter, giving management some direct benefits flowing from the normal generally accepted audit procedures. In the 1950s to the 1980s the comments on the internal control environment as judged and evaluated by the external auditor added real value as the basic philosophies on control by the auditors and management were aligned. In the 1990s the philosophies of management on control developed to such an extent that the definition of “what constitutes a good internal control environment” as seen by the auditor, is not necessarily aligned with what management views as a good internal control environment.
CHAPTER 4

A COMPARISON OF MANAGEMENT AND THE AUDITOR’S USAGE OF THE CONTROL CONCEPT

4.1 INTRODUCTION

Emanating from the responsibilities of management and the auditors it is apparent that both parties are interested in the control concept. Management interest lies in the execution of one of its four core functions, whilst the auditor is compelled by acceptable practices to study and use the internal controls in an organisation. With this as a departure point it is clear that the scope and utility when using the control concept have and will always differ. It is however necessary that both management and the auditor understand control to be conceptually the same. Without that understanding the general accepted audit standards would be incorrect in prescribing a certain audit approach which is then based on non-relevant assumptions. It is thus necessary to narrow down the view held by the two parties.

4.2 THE CONTROL ENVIRONMENT AS VIEWED BY MANAGEMENT

The difference between management and auditors’ thinking regarding control lies in the way management always viewed control as a total concept (Gatewood et al, 1995:646) whilst the auditor viewed control as a sub-component of the total control concept, being interested only in those internal controls which will ensure that the accounting of transactions will be correct (AU 230, 1986:11). In this respect there always was a fundamental difference between the scope of utilising the control environment between management and auditors. However what has changed in the recent past, is the fundamental philosophies regarding control as being manifested by the latest management practices and literature.
Fisher (1993:89) summarised the control principles of the organisation for the 1990s as follows.

- believe in commitment not compliance
- believe in education not supervision
- focus on customers not the hierarchy
- managers by principle not policy
- favour learning process not an enforcement process
- believe workers and bosses should make decision.

Gatewood et al (1995:652) describes the two dominant forms of organisational control as bureaucratic and clan control. The difference is the "formal mechanistic structural arrangements" of the bureaucratic form versus the "informal organic structural arrangements" of the clan control. The bureaucracy model with its distinctive control oriented approach to work-force management is far from an extinct concept. Jacques (1990:127) argues that the traditional hierarchy “... properly structured, can release energy and creatively rationalise productivity and actually improve morale”. However, he goes on to state that “... hierarchy undeniably has its drawbacks. One of businesses great contemporary problems is how to release and sustain among the people who work in corporate hierarchies the thrust, initiative and adaptability of the entrepreneur”. (Jacques, 1990:127) Walton (1985:79) explains why organisations have - since the 1970s - to a greater of lesser degree discarded the bureaucracy model, by concluding that changing expectations among workers have promoted a growing disillusionment with the apparatus of control. At the same time an intensified challenge from abroad has made the competitive obsolescence of this strategy (bureaucracy) clear. A mode that assumes low employee commitment and that is designed to prove reliable if not outstanding performance can simply not match the standards of excellence set by world-class competitors. “Many organisations of the 90s still have a component of the bureaucracy characteristics or even could be classified as full bureaucracies”. (Gatewood et al, 1995:653) The trend however is clearly towards an organisational structure model which can function effectively in the environment of the 1990s. The trend is supported by the actual evolution in the organisational structures. The organisational behavioural model of the 1960s was based on the theory Y assumptions by Douglas McGregor including concepts such as “people like to work” and “people have self-control”. The systems model’s
disposition was that controls were viewed in terms of the value it added especially when viewed against the value it added or subtracted from the customer's point of view. The contingency perspective had as a departure point that a universal set of organisations depended on the given situation.

**Culture** and the use of that by managers as a tool were brought to the fore by Peters & Waterman in their book *In search of excellence*. They made a strong case for moving away from bureaucracies by arguing that excellent companies had a strong culture and that "... the more it was directed toward the marketplace, the less place was there for policy manuals, organisation charts or detailed procedures or rules". (Peter & Waterman, 1982:76). Auditors view the control environment as those controls relating to the accounting system and procedures to ensure that certain objectives are reached. Some of these controls have their execution in the financial function only, whilst others have an organisation-wide impact. The hypothetical question management should ask itself is whether it would be possible for an organisation to function within Fisher's commitment paradigm but with regards to controls relating to the correct accounting of transactions function, on the bureaucracy principles. From a cultural perspective Martin (1992:101) argues that "... the integration view of culture might provide cognitive classification, engender commitment, increase productivity and improve financial performance". In other words, she argues that it does not matter which control paradigm is supported but in order to succeed, the organisation should have one (integrated view) culture. Martin then continues to argue that when more than one sub-culture (differentiation view of culture) exists, then "... because of the prevailing of inconsistency and the death of organisation-wide consensus, (such) benefits are unlikely to be forthcoming".

The pace of **change** in the working environment of the 1990s is so dynamic that a flexible approach to management is necessary. This changing environment also had the effect that organisational structure evolved from the bureaucratic organisation to the contingency perspective and beyond. The single most important effect it had on control was for organisations to move away from a centralised rigid control approach to one of decentralised decision making, allowing for more flexibility.
4.3 THE CONTROL ENVIRONMENT AS VIEWED BY THE AUDITOR

The auditor should obtain an understanding of the entity’s accounting system and related internal controls to assess their adequacy as a basis for the preparation of financial information and to assist in designing his auditing procedures (AU 010: 1986:02).

The auditor views control in the framework of the control environment, the accounting system and the control procedures. Arens & Loebbecke (1991:297) describes this framework in table 4.1.

### TABLE 4.1: ELEMENTS OF THE INTERNAL CONTROL STRUCTURE

<table>
<thead>
<tr>
<th>CONTROL ENVIRONMENT</th>
<th>ACCOUNTING SYSTEM</th>
<th>CONTROL PROCEDURES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subelements of control environment</td>
<td>Objectives that must be satisfied</td>
<td>Categories of control procedures</td>
</tr>
<tr>
<td>• management philosophy and operating style</td>
<td>• validity</td>
<td>• adequate separation of duties</td>
</tr>
<tr>
<td>• organisational structure</td>
<td>• authorisation</td>
<td>• proper authorisation of transactions and activities</td>
</tr>
<tr>
<td>• audit committee</td>
<td>• completeness</td>
<td>• adequate documents and records</td>
</tr>
<tr>
<td>• methods to communicate the assignment of authority and responsibility</td>
<td>• valuation</td>
<td>• physical control over assets and records</td>
</tr>
<tr>
<td>• management control methods</td>
<td>• classification</td>
<td>• independent checks on performance</td>
</tr>
<tr>
<td>• internal audit function</td>
<td>• timing</td>
<td></td>
</tr>
<tr>
<td>• personnel policies and procedures</td>
<td>• posting and summarisation</td>
<td></td>
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<tr>
<td>• external influences</td>
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</table>


Robertson (1993:484) describes the control structure as follows: "For purposes of exploration, and internal control structure is divided into three elements: The control environment is a set a characteristics that defined good control working relationships in a company. The accounting system contains policies and procedures for recording
transactions properly. The control procedures are specific error checking routines performed by company designed to prevent, detect, and correct material errors, irregularities, fraud and misstatements”.

Ernst & Young (1996:2.4) reports that the Cadbury Report defined internal control as: “. . . the whole system of control, financial and otherwise, established in order to provide reasonable assurance of:

- effective and efficient operations
- internal financial control and
- compliance with laws and regulations”

Ernst & Young clarifies further that “. . . since internal financial control is an element of the above definition, it obviously excludes the other two elements” and then defines internal financial controls as those “. . . internal controls established in order to provide reasonable assurance of

- the safeguarding of assets against unauthorised use of disposition, and
- the maintenance of proper accounting records and the reliability of financial information used within the business for publication”.

Analysing the above it is clear that parallels can be drawn back to the controls structure’s sub-elements of control procedures and the accounting system respectively. It is further clear that the auditors are not particularly interested in control ensuring “effective and efficient operations” or controls that will ensure “compliance with law regulations”. The auditor’s mandate is to “. . . verify and report on the relevance and reliability of the financial information disclosed annually by corporate entities to their shareholders and other interested parties”. (Lee 1993:9)

There is clearly no direct or implied responsibility on the auditor to for instance, verify and report and to ensure financial results are optimum. It makes perfect sense thus for the auditor not to be interested in controls that will ensure “effective and efficient operations” as those controls fall outside the mandate of the auditor’s responsibilities and are the domain and exclusive accountability of management.
4.3.1 Safeguarding assets against unauthorised use

It is, however, clear that the auditor must be interested in the controls that will ensure "the safeguarding of assets against unauthorised use of disposition". The issue is to what extent this definition should be interpreted. Arens & Loebbecke (1991:293) defines authorise as "... a policy decision for either a general class of transaction or specific transaction. Approval is the implementation of manager's general authorisation decision". Robertson (1993:1106) defines it as "... ensuring that transactions are approved before they are recorded". Although a standard definition regarding authorisation may be lacking it is clear that some management decision and support to act are required before someone can claim that his action is authorised. The only criteria in determining whether any control is "a control that will ensure a safeguard against unauthorised use of disposition" is to determine whether the person had the authority to act (implicitly or generally). In this approach, an employee who takes a small amount of cash (assets) out of petty cash for his personal use (unauthorised), would be of interest to the auditor and so will all controls relating to the prevention of this type of risk. But a person suitably authorised by a legitimate authority who makes a bone fide business decision to purchase assets or services (dispossessing the organisation of the cash (asset) in disbursing the purchase price) which subsequently turns out to be a poor investment, leaving the organisation to write off millions, will be of no concern to the auditor. The reasons are two-fold:

- the person was authorised, irrespective of the fact that he may not have been the best informed, well experienced and knowledgeable employee
- the decision (and controls that were in place to make the decision) concerns the "effective and efficient operation" of the organisation, which is not of concern for the auditor.

4.3.2 Proper accounting environment and financial information of integrity

Proper financial information will emanate from a proper accounting system and proper control procedures.
Arens and Loebbecke (1991:288) list the internal control objectives to ensure that a proper **accounting system** is maintained as controls which ensure:

- authorisation (legitimate decisions)
- validity (not non-fictitious)
- completeness (all accounted)
- valuation (correct amount)
- classification (technically correct in the accounting sense)
- timing (correct accounting reporting period)
- financially correct summarised (processed correctly through the book up to finalised state).

Of particular importance here are the controls which will ensure "**authorisation**" as the typical controls ensuring this objective is **usually outside the financial accountants domain**. It is possible for the financial accountant to devise processes and procedures to reach the objectives of validity, completeness, valuation, classification, timing and correct disclosure without:

- having a huge effect on the rest of the organisation's processes and policies
- materially affecting the "effectiveness and efficiency" objectives
- affecting the culture, the "tone at the top", the organisation structure, the ethical framework, the personnel policies, the innovativeness and so on.

However the controls regarding "authorisation" cuts right across the organisation to the core where it all starts, namely decision making. To be accountable for something one has to have the authority to act or influence the outcome. To control something (which includes to take corrective action) one must have the delegated authority to make decisions.

Looking at the controls which will ensure that **proper procedures** are in place, Arens & Loebbecke (1991:291-296) discussed it in the following categories:

- **Adequate separation of duties**. It is a control which essentially addresses the risk of error and irregularities. Linking it back to the defined management concepts it endorses the **principles** of supervision; hierarchy; functional organisations instead of network or project structure; clear policies; high accountability to the individual; fixed rules and regulations attached to each job; controlling authority; controlling compliance; theory X; fragmenting the work task; having stability as a foundation and a top-down approach.
• **proper authorisation of activities** (and transactions). It is a control which essentially addresses the risk of invalid decisions. It is important to note that it does not address the risk of valid but poor decisions. Linking it back to the defined management concepts this control endorses the **principles** of top-down hierarchy; clear policies from a central source; selective information sharing; bosses to make decisions; supervision; relationships are structured and formal whether it is in a hierarchy, network or project team; jobs are staffed by specialists; low worker participation and a high accountability by the decision maker as an individual.

• **adequate documents and records.** It is a control which essentially addresses the risk of insufficient evidence. The evidence can be necessary for tracing the source, the validity, completeness, the value, the time-frame, rights and obligations and the classification. Linking it back to the defined management concepts this control endorses the **principles** of accountability; emphasises the means not the end, and favours the audit and enforcement process.

• **physical control over assets and records.** It is a control which essentially addresses the risk of physical damage/disappearance of assets and records, in a manner which is male fide. It is important to note that "... the need for controls depend upon perceived risks" and that "... there is a cost/benefit judgment to be made in relation to any system of control, which means that some managements will legitimately decide to spend more that other in controls". (Ernst & Young, 1996:2.2) It is not necessary for the auditor - in terms of his primary responsibility to express an opinion on the financial statements - to concern himself with these controls. However he should concern himself with these control measures in terms of other reporting duties (AU 005, 1986:27). Linking it back to the defined management concepts this control endorses the **principles** of supervision, audit and enforcement processes; theory X (people need to be controlled); and high accountability.

• **Independent checks on performance.** It is a control which essentially addresses the risk of negligence, error and irregularities and comprises of independent checks on whether the above four controls are being executed diligently. Linking it back to the defined management concepts this control endorses the principles of supervision; audit and enforcement processes; theory X (people need to be controlled); compliance; hierarchy; managing by policy; relationships are structured
and formal; rules and regulations specify the activities of each job; and top-down controls.

4.4 A BASIC FRAMEWORK TO UNDERSTAND THE VIEW OF MANAGEMENT AND AUDITORS REGARDING CONTROL

Table 4.2 summarises the basic differences in management and auditors views of control

<table>
<thead>
<tr>
<th>VIEW</th>
<th>MANAGEMENT</th>
<th>AUDITORS</th>
</tr>
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<tbody>
<tr>
<td>Core definition</td>
<td>Monitoring the progress of the organisation towards goals or standards and taking corrective action on deviations.</td>
<td>Understanding an entity’s understanding an entity’s understanding an entity’s understanding an entity’s understanding an entity’s accounting system and related internal controls.</td>
</tr>
<tr>
<td>Focus</td>
<td>Reaching all the objectives and goals whether it is an input or output. It may include the controlling of decisions; actions; strategies; programmes; process et cetera.</td>
<td>Controlling specifically the controlling specifically the controlling specifically the risks of fraud, errors and irregularities only to the extent that it may have an influence on the correctness of financial statements.</td>
</tr>
<tr>
<td>Constraints/Scope</td>
<td>All controlling activities must add value for money otherwise it is unlimited in the “what” and “how”.</td>
<td>Controlling activities must be viewed within the control objectives and sound control procedures principles.</td>
</tr>
</tbody>
</table>

Table 4.3 looks at a few concepts of control adjudicating its relevance and applications to the 1960s versus the subsequent period up to the 1990s.
<table>
<thead>
<tr>
<th>CONCEPTS OF CONTROL</th>
<th>RELEVANCE AND APPLICATION IN 1960S</th>
<th>REFERENCE</th>
<th>RELEVANCE AND APPLICATION FROM 1960'S TO 1990S</th>
<th>REFERENCE</th>
</tr>
</thead>
</table>
4.5 DILEMMA FACING THE AUDITOR IN DECENTRALISED DECISION-MAKING ENVIRONMENT

Leslie & Lloyd (1986:624) define the decision-making process as "... involves searching the environment for conditions requiring a decision, developing and analysing possible alternatives and selecting a particular alternative". Certo (1992:161/2) defines a decision as "a choice made between two or more alternatives". Certo (1992:161/2) expands further as to the types of decision being programmed decisions which "... are decisions that are routine and respective, and that typical require specific handling methods" and non-programmed decisions which "... are decisions that typically are one-shot occurrences and usually are less structured that programmed decisions". Fisher (1993:89); Drucker (1992:131); Gatewood et al, (1995:652); Jacques (1990:128); Sculley (1990:140); Kruger (1995:20); Shrivastava (1994:148); Peters & Waterman (1982:75); Freedman (1992:26); Walton (1985:81) and Simons (1995:84) all point to the existence of - or at the very least a clear trend towards - the decentralised decision making work environment.

Arens & Loebbecke (1991:293) states that "... authorisation can be either specific or general. General authorisation means that management establish policies for the organisation to follow. Sub-ordinates are instructed to implement these general authorisations by approving all transactions within the limits set by the policy. Specific authorisation has to do with the individual transactions on a case by case basis. The individual or group who can grant either specific or general authorisations should hold a position commensurate with the nature and significance of the transaction. The policy for such authorisation should be established by top management". There is an important difference in assessing the soundness of internal control authorisation adherence on the one side and internal control authorisation competence on the other side. In the first approach the auditor can depart from a philosophy that management's appetite for risk is something which should not be assessed by auditors. This includes the risk of so-called competent/non-competent decision making. According to this philosophy the risk of delegating authority to low levels on a specific case by case basis is of no consequence for the audit approach.
The argument is that the important fact to consider is that the person delegated to is legally empowered to authorise transactions with the blessing of the authority with the relevant vested power. For the auditor to challenge the delegated authority framework of management based on the competency principle means that the auditor judges himself to be superior to management in valuing staff duties and competencies. For example, taking a hypothetical organisation dealing in a consumer product on the basis of a general authorisation procedure for the sale price of the goods by top management issuing a fixed price list. Any employee (provided he is not specifically or implicitly barred from selling) can sell thus any product on provision that he does so in accordance to the fixed price list. The auditor will assume in his evaluation of the control environment that top management is competent enough to set such a fixed price list and as far as this component of the internal control environment is concerned, be satisfied that control risk is low. If, however, top management decides to change to the basis of a specific authorisation procedure in determining sale prices, by delegating the price determination authority to a number of sales personnel employees, (by allowing them to make the decision to allow a discount or add a premium from a base price) the auditor may now judge that the authority lies on too low a level as - in his opinion - the sales personnel do not have the competencies allowing them to make good pricing decisions. Therefore the auditor can view the control environment risk as high and expand on his detection risks by performing additional substantive procedures. The auditor can, however, not qualify financial statements because he differs in reason as to why a specific price was set at a certain level. For example, the auditor decided to expand his substantive procedures by inquiring in direct interviews with all the sales personnel as to the validity of all discounts above a certain percentage. Summarising the answers he noticed that they are doing so because they believe it to be a sale promotion to promote long-term business relations with the customers. The auditor feels that it does not make business sense but cannot withhold an opinion based on his disagreement with a business strategy. However, if he feels that this specific business practice opens the organisation up for material irregularities, fraud or error, he should satisfy himself that it did not take place (AU, 1992:25).

Decentralised decision-making environments holds in theory two dilemmas for the external auditor.
• The integrity risk of decisions shifts to lower levels and per definition to more employees. This increases the risk of irregularities as any particular decision must be judged against the particular circumstances (variable) being taken into account by the decision maker, whereas in a centralised decision-making environment any particular decision was usually judged against a standardised policy (constant).

• The control process comprises four steps: the setting of standards; sensing of performance; comparison and corrective action. Theoretically if decision-making is pushed right down to the lowest level of the organisation, the standard which is set is in the hands of the decision maker/executioner. Effectively one needs an independent/separate person to set standards in order to have an effective division of duties.

The auditor is faced in this decentralised authority environment with a control environment which becomes extremely complex in understanding, documenting and evaluating.

4.6 INTERACTION AND COMMUNICATION BETWEEN STAKEHOLDERS AND EXTERNAL AUDITORS REGARDING INTERNAL CONTROL MATTERS

Once the auditor embarks on evaluating the internal control environment there is a duty to report on the matter.

4.6.1 Shareholders as primary beneficiaries of the audit

AU 232 (1988:04) requires that "... the auditor should report to the highest appropriate level of management or to the owners if appropriate, any weaknesses that come to his attention during the course of this examination of the financial information and which he judges to be material. When reporting such weaknesses, the auditor should, however, indicate that the material weaknesses notified are only those which have come to his attention during the course of his normal audit work and are
not necessarily all material weaknesses which may exist”. AU 005 (1992:30-31) addresses the reporting of illegal acts, other irregularities and errors to members and comes to the conclusion that material errors need not be reported to members (whether it is as a result of a weakness in internal control or not) as long as the error is disclosed correctly in the financial statements.

4.6.2 Management as secondary beneficiaries of the audit

AU 232 (1988:04) applies to management as well AU 232 (1988:08) which suggests that “... the communication of material weaknesses in internal controls may include comments suggesting corrective action for management’s consideration”. AU 232 (1988:09) further suggests “If the auditor does not become aware of any material weaknesses in internal controls during his examination of the financial information, he may wish as a matter of courtesy, to communicate that fact to management”. As far as the form and timing is concerned, AU 232 (1988:11) suggests that is should be in writing whilst AU 232 (1988:12) requires that the auditor should communicate such matters “at the earliest practicable date”. Dodge (1990:145) states that the management letter’s contents usually includes a description of:

- weaknesses in systems and controls
- deficiencies in the operations of systems and controls
- inappropriate accounting policies and practices
- non-compliance with legislation, accounting standards and other regulations.

Dodge further suggests that management letters are addressed to those who have power to act upon its findings, such as the Board or the Audit Committee (Dodge, 1990:145). Howard (1992:92) cautions that the reporting of internal control weaknesses does in itself not absolve:

- the management of its responsibilities to maintain an adequate system
- the auditors of their responsibility to consider the effect of such weaknesses on the extent of their audit work and their opinion.

It is important to note that AU 232 (1988:04) puts a positive responsibility on the auditor to report these weaknesses to management. Even though internal controls is a matter of perceived risks and accordingly their adequacy can only be judged in that context, for example taking into account a cost/benefit judgment by management
(Ernst & Young, 1996:2.2), it still does not relieve the auditor from his duty to report weaknesses in internal control the way the auditor (with the backing and application of generally accepted audit standards) experiences and perceives it. It goes further, to the extent that even if management and auditors may agree at the start of the audit that their philosophies and approach to internal control differs and that the auditor will regard the control risk at high, the auditor should still report the weaknesses he regards as material.

4.7 CONCLUSION

Management philosophies regarding control progressed substantially in recent times to the extent that the control philosophies and assumptions in the 1960s, 1970s and 1980s are outdated in a growing number of organisations in the 1990s.

The present audit approach includes an evaluation of the internal control environment. This approach was formulated in the late 1960s (Dodge, 1990:xiii). The philosophies and assumptions in an approach which are not relevant anymore brought an ever increasing gap in the way auditors want management to behave, and the actual way management behaves.

Auditors are compelled to report to management any deficiencies in the internal control arena. The management letter became the value added service for management. In this regard the auditor focuses on the accounting system and control procedures to guide their internal control evaluation.
CHAPTER 5

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 SUMMARY

- Management and their delegatories are the functionaries of the organisation and are tasked to plan, organise, lead and control the organisation. Management should balance the unlimited needs with limited resources, balancing in the process the goals, objectives, strategies and tactics of the organisation with the resources to accomplish and execute. In this quest for maximum rewards for minimum risks, management should keep in mind the macro-environment with its many opportunities and threats, as well as the internal environment with its strengths and weaknesses. Management cannot ignore the multi-complexity of its domain, having to always weigh up alternatives with the best returns and risks.

- Auditors’ core benefits are found in the social and economic role which the audit plays. The audit reduces information risk in the most cost efficient manner, whilst at the same time protecting society’s objective of good governance. One of the mechanisms to achieve this objective is by reaching consensus on what constitutes generally accepted audit standards which will give prima facie the auditor the right to claim that a satisfactory audit was performed. Auditors are in the performance of their responsibilities under pressure to perform in the most efficient manner. The audit approach developed which had the most impact on efficiency, was utilising the internal control environment as a legal source of getting to an audit opinion.

- Management and auditors are, for different reasons, interested in the control environment. Management views control in the wide sense whilst auditors utilise the controls which will ensure the safeguarding of assets and the maintenance of proper accounting records.

- Controls which auditors regard as important mainly address the risk of fraud, irregularities and errors of the financial records. Per definition these risks also
concerns management, but in the context that firstly these risks are a small portion of the total risks to be addressed by management, and secondly like all other risks to be controlled, must add more value than costs before management will expend resources on it. Auditors on the other hand are only concerned with the risk of fraud, irregularities and errors of financial information and subsequently will welcome controls which (although the cost to implement it may by far exceed the benefits) “over” address these risks.

- The auditor devised an approach in the 1960s which was based on some fundamental internal control principles, and was in equilibrium with management control practices of the day. Subsequent to the 1960s the environment forced management practice to change to the extent that these “fundamental control principles” of the 1960s had more costs than benefits, and thus a move towards more applicable controls started.

- Today an increased number of successful organisations do not comply to the “ideal” control environment as defined by the auditor. This automatically increases the risk of the auditor. The auditor would prefer a strictly controlled environment, irrespective of the costs, resources or opportunities lost in this process, as the auditor is specifically not responsible for the effectiveness or efficiency of the organisation.

5.2 CONCLUSION

- The importance of a relevant audit approach is so high that it goes to the core of the auditor’s existence.

- Generally accepted audit standards developed in the audit profession to ensure that the auditor has a prima facie case in litigation. This drive to reach this objective can be referred to as the effectiveness drive (doing the right things).

- The auditor is at the same time under pressure to perform the audit in the most efficient way. The development of generally accepted audit standards thus had to take the efficiency drive (doing the things right) into account. Hence the application of techniques/approaches which increased their productivity, for example the taking of samples in testing, the acceptance of the materiality
concept and utilising the assurances which a strict control environment can bring to reduce audit tests.

- The auditor is the only stakeholder in the organisation who must legally evaluate management performance and does so with the audit report. The audit report expresses an opinion on the “true and fair” disclosure of financial information. Effectively the auditor evaluates management performance as to the technical correctness of disclosing financial information. In this process the auditor must take cognisance of the risks inherent in disclosing information and specifically the risks of fraud, error and misstatement.

- Auditors were in the position of having to report to the shareholders and society as a whole. Knowledge, observations and other valuable information which the auditor can share with management were not required, and hence the perception from management that the audit added little value.

- The management letter which came into being with the system-based audit, commented on the records, systems and controls where weaknesses may lead to material errors giving constructive advice. The management letters are elevated to board level through appropriate structures such as the audit committee. This became the main value-added service to management.

- The auditor has a stake in a strict internal control environment. The stricter the control environment the less risk there is for material fraud, error or misstatement. Generally accepted audit standards requires that management letters are mandatory when the auditor judges the weakness as material. The auditor has thus created a platform from where he can communicate and influence his stake in the internal control environment.

- The auditor and the generally accepted audit approach has influenced the control concept of organisations over the past decades. The perception of a well controlled organisation comes to a great extent from the yearly management letter as evaluated and adjudicated by the independent, external auditor.

- Changes in the environment brought about a situation where management’s basic assumptions on what constitutes good control differs from what the auditor may regard as good control. The fundamental reason for these differences lies in the different risks and accountabilities the two parties carry. Management regards a control environment as good when the benefits exceeds the cost (opportunity cost)
thereof. Auditors regard a control environment as good when their control objectives are met, irrespective of the resources necessary.

- Concluding on today's situation it is clear that the control environment has moved substantially away from that prevalent in the 1960s. Auditors are faced with an environment where their risks of fraud, error and misstatement in disclosing financial information increased and will continue to increase as the paradigms of management practices shift to keep up with the changing world.

### 5.3 RECOMMENDATIONS

- Auditors must decide whether they regard their role as a profession as an influencing one on management practices or as a re-active one in reaction to management practices. My recommendation is a re-active role, as a philosophy of influencing management practice borders on sharing management's responsibility or alternatively providing management with alibis if they do not fulfil their responsibility.

- More specifically, auditors should firstly scrap the management letter as this serves to entrench practices such as influencing management practices and creating an incorrect perception of the control environment effectiveness.

- Secondly the auditor should take cognisance of the latest developments in management's control thinking so that applicable audit practices can be developed which will stand up in a court of law. The audit profession should thus define the relationships between the latest control developments and the eventual control results thereof. These correlations between control concepts and the results thereof should be backed up with empirical evidence and once established should become part of generally accepted audit practises. Care should be taken not to divulge the results of such newly formulated audit tests as the objective should always be to increase the efficiency of the audit process and not to influence management behaviour or practices. In this regard the following control concepts are given as examples:
  - the measurement and classification of culture and the correlation it has on control/financial reporting
– the measurement of personnel integrity (especially in the decentralised decision environment) and the correlation it has on control/financial reporting
– the measurement and classification of management philosophies (especially those regarding ethics and business conduct) and the correlation it has on control/financial reporting.

The auditor stands before an era where management practices and assumptions are going to change at a tremendous pace. Innovative ideas on how to keep the information risk low in a more efficient manner will ensure that the auditor will play the role it should - like it did in all the successful economies of recent times.
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