

## 1. Introduction

Since the second world war, the international flow of capital has undergone modifications that are manifest in an intensification, in a change of course and in the creation of new forms.

Whereas the flow of capital to provide the funds generally required in a certain area was formerly mainly effected by international loans to governments, a new form of capital movement - Marshall Aid - appeared after the war, and governmental aid is now being continued in the form of financial assistance to under-developed countries.

In addition, the introduction and trading of international stocks on the various national exchanges is steadily increasing; most of these stocks find their way to private investors.

Investments in businesses abroad have increased appreciably, mainly by the establishment of foreign subsidiaries and by direct investments in foreign companies. Parent companies in the United States of America have played a large part in setting this trend, the most important motives for which may be:

- labour costs in Europe, which are considerably lower;
- the advantages of production and distribution on an international scale, which advantages result from an improvement in the competitive power, large-scale production, better utilization of machinery, and from research and knowhow;
- the formation of larger economic units in Europe as a result of the agreements establishing the European Economic Community (EEC) and the European Free Trade Association (EFTA).

In some cases tax considerations have also affected the decisions.

Inside the territories covered by the EEC and EFTA treaties, too, an international flow of capital, manifesting itself in the establishment of foreign subsidiaries, is developing as a consequence of the removal of various impediments. Apart from the natural incentive to expand, it is mainly the expected increase of competition that has stimulated this trend. Here, too, the tendency towards bigger production units is prominent; recently, the number of amalgamations and combinations of enterprises has increased greatly.

If no disturbing influences of another nature make themselves apparent, it must be expected that, inasmuch as international agreements are concluded or take full effect and the foreign currency regulations still in force in various countries are withdrawn or relaxed, international capital movements and the tendency to form large international concerns will grow still more.

## 2. *The functions of the public accountant in the international field; the lack of uniformity in auditing standards*

In his *advisory function*, the public accountant can already be of much assistance to prospective investors by giving information about local tax conditions, social-

security laws and the various forms of financing and by giving general information in the fields of law and economics.

When giving advices in such circumstances, the public accountant must realize that developments in different countries have followed their own course and that the investor and his auditor will be well acquainted with the situation in their own country but usually much less familiar with conditions prevailing abroad.

The public accountant's *auditing function* stems mainly from the need to attach an independent expert opinion to the financial accounts of those who must render such an account. Such opinion provides a reasonable certainty about the reliability of such an account and this facilitates the judgement by the interested parties.

The significance of this function is more evident if the capital markets are spread out geographically. Language differences and shortcomings in familiarity with local customs result in a certain lack of orientation of the interested foreigner, and thus in a greater need of an independent expert opinion on the reliability of the accounts rendered. He will want to know whether they have been drawn up in accordance with accounting principles generally applied in his own country or to what extent they differ from those principles.

All this presupposes a mutual understanding, which in turn gives rise to the desire for a terminology that is accessible to both parties concerned.

Mutual understanding is even more necessary in relations between public accountants in different countries. In performing his commission, the public accountant of a parent company will in many cases find it appropriate to use the reports of foreign public accountants on the annual accounts of a foreign subsidiary. He will have to know to what extent the standards applied in the audit made abroad comply with his own standards or, if they do not comply, what bearing this can have on his report.

On the other hand, the auditor who directs his report to foreign interested parties must be aware that the foreign reader is entitled to expect at least his own auditing standards to underly the audit. This is particularly so when, in their capacity of representatives of the foreign community, governmental or stock-exchange committees have issued regulations governing those standards. The auditor must then acquaint himself with such foreign regulations, the prevailing standards of presentation, and with the usual extent of disclosure; if necessary he will do this with the aid of colleagues in the country in question. It should be noted, that this should never result in a non-adherence to his own standards if these require more extensive procedures.

Auditing standards still vary from country to country; the development has been very dissimilar and, inter alia, is determined by the intensity of economic relations, the degree of international contact, jurisdiction of national Courts, governmental regulations and theoretical reflection. Only an elaborate study would make it possible to give a survey of the auditing standards valid in different countries. Not only is there a great divergence in the degree in which the profession has been developed, but the sources from which knowledge about the standards attained must be derived and the manner in which those standards are applied in practice are often not easily accessible without extensive study and close contact.

Greater uniformity in auditing standards and in their handling is not only desirable but will also become necessary in view of the expected expansion of

international capital movements; such uniformity should therefore be encouraged.

In a number of countries, the audit in fact comprises no more than a balance-sheet audit. An audit which is confined to two consecutive balance sheets, implies to the non-expert reader that the result for the intermediate period, too, is covered by the auditor's opinion. For this reason, the Netherlands Institute of Accountants prescribes in its Rules for Professional Activities:

„Members shall not issue corroborative reports on two consecutive annual balance sheets without including the profit and loss account for the period ended at the date of the second balance sheet in the report on such balance sheet.”

Even in countries where the profession has reached a high stage of development, essential differences in auditing standards may still be ascertained. In some countries, the examination of the instructions given in respect of and the activities performed under the system of internal control and a verification of the opening and closing balance sheets, together with a critical analysis of the recorded figures, form the basis of the report to be issued.

In the Netherlands, the standards include, in addition, an examination of the various organic relations between the flows of monies and of goods, which examination is based on a verification of expenditures. (See R. Burgert: Proceedings of the Seventh International Congress, Page 315.)

Moreover, in several countries, including the Netherlands, public accountants hold the view that they must satisfy themselves about the existence of assets by taking inventory themselves; in some other countries this is not the case.

The procedures followed in performing the audits are divergent, too. The verification of the existence of receivables may be taken as an example. In some countries, it is held that this is only possible by requesting confirmations from the debtors. As Burgert has already explained in the paper mentioned above, the technique to be applied here is dependent on the customary manner of payment. In the Netherlands, where payments are usually made through bank transfers and the bank statements include the name of the debtor and the date of payment, the existence of amounts receivable can usually be verified with the actual payment made after the balance-sheet date. If payments have not yet been received or if the payments are not traceable to the individual amounts receivable, confirmations are used.

### *3. Co-operation between public accountants in international audits*

Auditors from different countries already co-operate to a considerable extent; the form varies from co-operation on a single auditing job to co-operation in a partnership.

If there is co-operation within a partnership between public accountants who, in view of their membership of various accountancy bodies, must be regarded as working on differing educational bases and according to divergent auditing standards, an interested party may become confused and thus begin to doubt the degree of certainty provided by the report. The same applies in the case of different firms acting under the same name or under a joint name.

Experience shows that effective co-operation between auditors in different countries can quite satisfactorily be obtained in another way. When giving an

opinion in the international field, the public accountant of the parent company often makes use of the reports of foreign public accountants in respect of that part of the audit that has to be performed abroad. This use may be supported by a review of the work done.

In this respect, the Rules for Professional Activities of the Netherlands Institute of Accountants require as a minimum that, if use is made of a report of an accountant established abroad, such an accountant must be practising as a public accountant, that, in selecting him, the necessary care has been exercised, and that this use must be mentioned in the report. The idea is gaining ground that the concern of the parent company's auditor with the audit of the subsidiary must depend on the extent to which the figures of the subsidiary affect the financial position and results of the parent company. If the subsidiary's figures are material the auditor's attention should be directed towards both the auditing standards and the procedures underlying the foreign accountant's report.

#### *4. Some special aspects of audits of large enterprises*

Predominantly in large enterprises international relationships come to the fore. It will therefore be of interest to consider some of the aspects that present themselves when audits of such businesses are made.

##### *a. The relation to internal control*

In the following, internal control is meant to comprise both the verification, safeguarding and checking measures resulting from the administrative organization, especially in respect of the proper segregation of the various functions, and the verification executed by the various officials on the activities performed under their responsibility. For management, the internal control is of importance because it increases the degree of security with regard to:

- the timely and efficient execution of instructions given;
- the safeguarding of the assets of the company;
- the appropriateness and adequacy of information received.

An effective system of internal control, together with his own work, can give the public accountant a reasonable certainty that all transactions are properly recorded and that frauds - as long as they have not been committed by officials who can cut through or evade the internal control by virtue of the authority granted to them - will be prevented or brought to light by it.

The foregoing implies that the auditor must satisfy himself about the efficacy of the measures of internal control prescribed by the management and the compliance with instructions given. Naturally, this does not mean that he can be held responsible for a flawless functioning of the system of internal control.

The means that the management of a large business has at its disposal to attain these aims can lead to a high degree of perfection; in a smaller firm, economic motives tend to limit the possibilities. These means are in particular

- the segregation of the functions of disposing of, safeguarding and recording assets and the audit thereof;
- the establishment of separate functions in the successive phases of the flow of goods and money;
- the delineation of the delegated powers to act.



Besides, the possibility of applying more mechanical and automatic devices and the greater possibility of utilizing budget control put the large enterprise in a better position as regards the means to obtain the best possible internal control.

For the public accountant of a large enterprise, the consequence of this is that he must have a thorough knowledge of the techniques of internal control developed by the science of administrative organization. Generally, these techniques can be applied to their full extent in the larger enterprises. On the basis of this knowledge the accountant must form an opinion on whether the actual situation is in compliance with what could reasonably be expected. In respect of the auditing steps to be taken by him, a properly functioning system of internal control implies that he can limit his activities in those fields that cannot essentially be affected by a possible encroachment by the management upon the existing system of internal control.

In the smaller enterprises, too, a certain extent of internal control is a prerequisite for enabling a public accountant to give a satisfactory opinion on the annual accounts. It should be borne in mind that certain activities can only be checked through internal control. So, the regulation that obligations can only be contracted by two officers of the company cannot be replaced by auditing measures. Another instance is that the lawful use of tickets issued by a passenger-transport company could not reasonably be verified through personal observation by the accountant who audits the accounts of that company and, through this, the business' activities. A verification that requires expert technical knowledge, too, will generally have to be exercised by the company's own staff.

#### *b. The auditor's responsibility with respect to fraud*

A report recently issued by the Advisory Committee on Professional Matters of the Netherlands Institute of Accountants, laid down that the primary responsibility for the occurrence or discovery of fraud rests with the management of the enterprise, which should create an effective internal control for that purpose.

In the opinion of the Committee, the accountant, in the function in which his expert opinion is asked on the financial picture given by the annual accounts, is only responsible for fraud if the correct application of the professional technique intended for that purpose should have led to the discovery of the fraud. Besides, the Committee recognizes that the accountant has a duty towards the management of the business. This duty includes, inter alia, the examination of the measures of internal control and the regular testing that they are operating properly. As an expert on the subject, he will have to point out to the management possible shortcomings in the system of internal control and will have to consider with, and under the responsibility of the management, whether these shortcomings can be eliminated effectively either by extending the internal control or by a supplementary examination of his own. Should the management tolerate deficiencies in the internal control that the accountant considers impermissible in an orderly administration, then it will be impossible for the accountant to remain in office. If the accountant has duly fulfilled the above-mentioned duties, then, in the view of the Committee, he is not responsible for the fraud not having been discovered.

The Committee also points out, that not every fraud can be brought to light by means of an audit of the accounts, and that with respect to the technical aspects of the enterprise the accountant has no more knowledge than an interested lay-

man, and that forgeries of such a quality may have been used, that the accountant cannot recognize them as such. Naturally, even where internal control is properly established, frauds may occur as a result of collusion between officials; in some cases these will not even be discovered.

The Committee gives separate attention to the possibility of an encroachment upon the system of internal control, as mentioned in the previous section. The accountant may not count on such irregularities always being detected by internal control. He will have to consider what special steps he could take, but they, too, are limited by the economic principle.

For good order's sake it should be noted that the discussion on this subject between the members of the Institute is still in progress and that, consequently, it is not yet possible to speak of a generally accepted conclusion.

In performing an audit of a large company, the accountant must be aware that, as was explained in the previous section, the means of internal control can be brought to a higher level of perfection than is usually possible in a smaller business. The acceptable margins expressed in absolute amounts, seen in relation to the picture of the annual accounts, are normally greater than in the smaller concern; the effect of this on the work to be done by the accountant, however, is limited by the possibility of irregularities committed by the management of the company. In this connection irregularities are not meant to be frauds in the narrower sense only. Furthermore, the accountant should realize that any irregularities committed by the managements of large enterprises often have a deeper social effect than those committed by the managements of smaller enterprises. In determining the scope of his activities, he will have to take these aspects of the matter into account, because they have a bearing on his responsibility.

### *c The use of test samples*

In auditing large enterprises, in particular, the question has arisen if and to what extent the accountant can make use of test sampling. It is understandable that this question was raised in this connection, because it is only a test sample taken from a mass of data that will enable the accountant to attain an acceptable certainty about the reliability of the totality of those data. Furthermore, it is clear that test sampling, which always sacrifices something of the certainty, only makes sense if it leads to a significant curtailment of the work to be done.

The development of statistical science, in particular in respect of the use of mathematical test sampling, and the change of opinion as to the part that test sampling can play in the whole scheme of auditing have given rise to the view that the accountant can make use of statistical test-sampling. This should, however, not affect the systematic structure of the audit activities: the test sampling must be regarded as a quantitative reduction in those procedures which up to now covered all items individually.

Statistical test-sampling makes it possible to indicate with a certain probability the extent to which the result of an observation of a phenomenon in a sample taken from a mass deviates from the actual occurrence of that phenomenon in the whole mass.

When the accountant is prepared to accept a series of entries if, with a predetermined degree of probability, that series contains no greater total error - whether in number or amount - than a certain fraction of the total of that series, then this type of test sampling can be applied.

If the number or amount of errors found in the test is in excess of the number or amount permissible for the desired conclusion, then the range of the test sample will have to be extended till a positive or negative conclusion is obtained. Consequently, if the method of test sampling is really to reduce the accountant's work, it is important for him to ensure that measures have been taken to minimize the errors in the series. The internal control clearly is of importance in this connection, too.

In the Netherlands two methods of statistical test sampling have mainly been developed for application in the field of auditing: the stratification method and the „guilder number” method. The stratification method requires that the mass to be examined is divided into groups according to the size of the amounts. The tolerance accepted by the accountant, expressed as a percentage of the total amount, together with the probability accepted by him determine the extent of the tests that should be made in each group.

The „guilder number” method, which has been developed by the Dutch accountant A. van Heerden, attaches an equal probability of being selected to each guilder rather than to each item in a series of entries. This results from giving each guilder its own sequence number, which equals the cumulative total up to and including the guilder in question. Thus the highest number is then equal to the total amount of the series. By doing so, the series is in fact being transformed into a series of items of one guilder. Consequently, the probability of one entry being selected increases with the size of the amount of that entry. Any other unit than one guilder can, of course, be used.

These methods of test sampling are not primarily used to judge the efficacy of the internal control but to arrive at an independent opinion on the reliability of the totals to be verified. As regards the latter point, statistical test sampling methods can make a substantial contribution to a rationalization of the verification of masses of data in the enterprise.

#### *d The influence of punch-card equipment and electronic data-processing*

Of the problems that arise in large businesses in particular, attention should be given to the consequences for an audit of such enterprises if punch-card and/or electronic equipment is being used by them.

It can be held that the use of punch-card equipment has presented no fundamental difficulties to auditing; the accountant has been able to adapt his techniques accordingly. Generally, this equipment supplies the data the accountant needs for his audit; mostly they are even grouped in such a manner that the audit can be performed more effectively than would be possible without such a grouping. Moreover, the functional situation of this section of the accounting department in the organization is often such, that the internal control is intensified. In a number of cases the accountant has also been able to make a successful use of the punch-card material for his audit; this is then processed under his supervision on his client's equipment, by a service bureau or on his own equipment.

As the number of electronic data-processing installations now in use in the Netherlands is still limited, Dutch accountants have not yet been able to acquire much experience with such material, but the studies that have already been made and the applications that have so far been put into practice justify the expectation that, here too, an adequate solution will be reached of the problems involved.

e. *The functioning of the internal auditor*

Another usual characteristic of large enterprises is the functioning of internal auditors. Internationally, the problem of how far the opinion of the public accountant can also be based on the result of the work performed by an internal auditor is of importance, too. In professional circles in the Netherlands there is no doubt that only the report of a public accountant may be published. The internal auditor's report should, as a matter of principle, go no further than the management of the business, because the internal auditor is, by his very function, tied to that management. In the Code of Ethics of the Netherlands Institute of Accountants this is expressed as follows:

„Members not practising as public accountants may give a report to their employers only. They shall exercise due care to ensure that their reports are not published.”

With regard to the question of what the scope of the internal auditor's duties should most rationally be, and of the extent to which the public accountant can base his opinion on the work done and judgements formed by the internal auditor, there is, I feel, a difference of opinion between Dutch accountants and most foreign ones.

Professional preference in the Netherlands is generally given to an internal audit that covers the internal annual accounts. The paper given by Stokvis at the Seventh International Congress <sup>1)</sup> derives this logically from the internal auditor's function, which in itself originates from the management's duty to supervise and control delegated activities. The management must be satisfied that it is accurately informed about the results of its orders and instructions given, and of the authority it has delegated. The accounting department, since it, too, participates in the business' activities, can only partly satisfy this requirement. Hence the need for a check on the data supplied by the accounting department, the natural culmination of such data being the internal annual accounts. This task, which, functionally, is one of management, is naturally assigned to the internal auditor. This also implies that the internal auditor must be placed directly under the top management.

Stokvis demonstrates that only then does the function give the best result to management.

If the internal auditor functions in this manner, then it follows that he should at least take all those audit steps that the public accountant would have taken if there had been no internal auditor. An exception is conceivable in those instances where the public accountant has reserved certain activities for himself; the efficient procedure is, then, for the internal auditor to receive the appropriate information about the scope and results of his external colleague's activities.

To enable the internal auditor to perform his duties, an organization will have to be created that will inform him of the instructions given and the authorities delegated, so that he can judge - at least within the orbit of his expert knowledge - whether anyone has exceeded his authority. He will also have to take all auditing steps necessary to establish the reliability of the administrative data required for a proper management on the various levels. This implies, among other things,

---

<sup>1)</sup> W. N. A. F. H. Stokvis: *The internal auditor* - Proceedings of the Seventh International Congress of Accountants, pages 522 through 530.



that he must see to it that an effective system of internal control is built up and that he must continually satisfy himself about its functioning, so that the management will be reasonably certain that fraud by subordinates is prevented as far as possible and that, if a fraud has, nevertheless, been committed, it will be discovered in due time.

As an adviser, too, the internal auditor can be of great service to the management at all levels of the business; this stems from his expert knowledge of the relevant subjects, his detailed knowledge of the business in question and his independent position vis-a-vis the executive functionaries. In view of the nature of the auditor's specialized knowledge, his advice will generally be in the fields of organization and commercial economics. Purely technical and commercial problems are, naturally, outside his specific orbit, albeit that his extensive knowledge of the business, resulting from his regularly comparing estimates and costs, budgets and realities, and his making of other analyses, will often put him in a position to support the forming of the management's opinion.

In the Netherlands, too, several internal auditors are entrusted with other duties than those described here. Still, Dutch public accountants generally feel that it is preferable for big companies to entrust their internal auditor with an audit up to and including the internal annual accounts.

Only if the status and the function of the internal auditor have been established, can the scope of his task be determined and an answer given to the question of how far his activities have a bearing on the task of the public accountant. To answer this question, it is here assumed that the internal auditor extends his audit through the internal annual accounts.

To ensure the optimum result for the public accountant's activities, it is essential that the internal auditor is a member of the same or of a professionally equivalent accountancy body, and is thus also subject to a discipline based on the same auditing standards. This provides an objective test of his professional abilities and also subjects the internal auditor to an authority outside his employer's business.

The Rules for Professional Activities of the Netherlands Institute of Accountants provide that a member may make use of another member's report; if, however, such other member is not a public accountant, the member shall provide a reliable basis for his report by performing a supplementary examination himself.

The public accountant's supplementary examination must be aimed at ascertaining that the internal auditor has performed his task expertly and that his opinion has not been influenced by his dependence on his employer. The public accountant will have to give special attention to those fields in which interpretations and judgments may have an appreciable bearing on the picture presented by the annual accounts.

It has been assumed in the above that the internal auditor is placed directly under the top management of the business, so that, objectively, his independence of the lower echelons is safeguarded; it has also been assumed that the internal accountant takes no part in the management. The public accountant will, naturally, have to establish whether this is so.

To reduce the dangers attached to the internal auditor's functional dependence,

and to have the expert performance of his duties tested, the management of the business will have to allow the internal auditor, and he will have to agree:

- to inform the public accountant directly and unrestrictedly of his findings;
- to provide the public accountant with a copy of all outgoing documents in which he reports on his activities and to hold his working papers at the public accountant's disposal;
- to bring to the public accountant's knowledge everything that - in his expert opinion - may be of special importance in forming the public accountant's opinion.

Then the scope of the external accountant's examination comprises:

- (a) the organization of the business - particularly as regards to systems and procedures;
- (b) the instructions given in the accounting manual as to the drafting of the annual accounts and the bases of valuation;
- (c) the internal auditor's audit program; this program and the amendments to be made to it should be drawn up in consultation with the public accountant, who cannot judge its completeness and efficacy unless he has carried out the examination mentioned in (a) above;
- (d) the performance of the audit and the reporting by the internal accountant and his assistants:
  - by studying all reports issued by the internal auditor;
  - by reviewing the working papers of the internal auditor, especially the summaries of important findings included therein;
  - by checking, by means of test samples, the books and annual accounts already audited by the internal accountant; (The selection of the objects that, as a minimum, should be tested in this way, and the frequency and extent of the tests are determined by the significance of those objects within the framework of the picture presented by the annual accounts.)
- (e) the adherence to the instructions and the bases of valuation mentioned under (b):
  - by reviewing the financial records and periodic accounts drawn up by the company, the minutes of meetings, important contracts, etc., insofar as the contents may have a bearing on the picture given by the annual accounts;
  - by ascertaining that the annual accounts are in accordance with the books of the company;
  - by ascertaining that the consolidated accounts - if drawn up - tie in with the individual accounts of the amalgamated companies;
  - by ascertaining that all important audit findings have been taken into account when the annual accounts were drawn up;
  - by a critical analysis of the annual accounts.

In large enterprises the activities of the internal auditor and the resulting curtailment of the activities to be performed by the public accountant will result in a more effective relation between the public accountant and his client. Then, he will not be obliged to work with a relatively large staff and for some length of time on behalf of one client, which might endanger the impartiality of him and his staff and might lead to a narrowing of his general experience.

## 5. *Conclusion*

One of the ways in which the growth of the world economy expresses itself is the increase in the international flow of capital, an important part of which is supplied by foreign investors, who participate in local enterprises and establish subsidiaries abroad. Furthermore, there is a steady increase in the size of businesses, both by expansion and by amalgamation.

The accountant has in these developments a function, both as an advisor and as an auditor. The latter function is more evident in the case of geographically-spread capital markets.

Those interested in financial reports need to know what accounting principles those reports are based on and what auditing standards have been applied in the audit made by the accountant. It has been stated that there is no uniformity in the auditing standards of various countries; the Dutch views in respect of some auditing standards and procedures have been explained above, with particular reference to some aspects of the audits of large concerns.

It is to be expected that the international flow of capital and the growth of enterprises will increase, and so will the services rendered by foreign accountants and the international co-operation between accountants. The study of the auditing standards applied in different countries should, therefore, be continued with a view to arrive at a greater uniformity.