

## **Illuminating the Limits of Auditor Accountability For Fraud Detection through a Historical Study of Internal Control Evaluation**

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### **Abstract**

*Messner (2009) and Roberts (2009) argue that there are limits of accountability and transparency for accountants. We study the 20<sup>th</sup>-century development of independent auditors' evaluation of internal controls as a U.S. example of attempted limits on auditors' fraud detection responsibilities. While internal controls provide market value, their evaluation during an audit has value largely to auditors themselves, who shift some of the costs of the audit and much of the responsibility for fraud detection to management. A content analysis of the Montgomery's Auditing series from 1912 to 1998 demonstrates that the percent of text devoted to both internal control techniques and their evaluation was a positive function of time, while the attention given to fraud detection techniques moved in the opposite direction. Our data do not support the literature that explains internal controls evaluation by auditors as an efficiency measure or reaction to competitive price pressures.*

### *Key Words*

*Accountability, auditing, fraud detection, history of auditing, internal controls, Montgomery, Sarbanes-Oxley Act*

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What, if any, are the “limits of accountability” (Messner, 2009) or “the limits of transparency” (Roberts, 2009) for auditors? The public, investors, and company management often assume implicitly that there are no limits. Even a collusive management fraud, which is “really extremely difficult for the auditor to find,” as Deloitte Touche Tohmatsu CEO William Parrett unhappily remarked, is supposed to be found by the auditor in the opinion of most stakeholders (Taub, 2005).

But Messner argues that more accountability is not “always and unambiguously desirable” (2009, p. 918). Roberts asserts that “the ideal of a complete transparency is an impossible fantasy” (2009, p. 958). Both scholars believe that these ideals, pushed too far, cause more harm than good. Accountability and transparency, depending on the dose, can be “dangerous” (Messner, p. 937).

Auditors, widely held accountable for the detection of fraud, would agree with those views. This study illuminates the limits of accountability that U.S. auditors have attempted to impose in an actual, long-running conflict – to reduce the responsibility for fraud detection<sup>1</sup> pressed upon them by management, the courts, and the investing public. Specifically, we examine a substitute that auditors have successfully promoted: the evaluation of the auditee’s internal controls.

Over the 20<sup>th</sup> century, the U.S. auditing profession’s interest in internal controls soared, according to our evidence. The results suggest that this interest originated at least partly in a desire to reduce the pressure to discover fraud. The ebb and flow of procedures, standards, court decisions, and regulatory impulses concerning fraud detection responsibility spring from the struggle of stakeholders to assign, increase, or abolish the limits of accountability for material fraud in business entities. The Sarbanes-Oxley Act of 2002 (SOX), which mandates that independent auditors report on the effectiveness of an entity’s internal controls, is simply the most recent skirmish in an enduring conflict over where the fraud detection hot potato will land.

In addition to exploring the limits to accountability, this study also helps fill several gaps in the literature. Maltby laments the lack of studies of auditing development in the early to mid-20<sup>th</sup> century, “the period which

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<sup>1</sup> “Fraud detection” in this paper refers to the seeking of both asset theft and financial statement fraud. In many contexts, especially outside the United States, “fraud detection” refers only to the former meaning, while “statement verification” seems to encompass the identification of fraudulent financial statement representations as well as other material errors in the statements (see, e.g., Chandler et al., 1993; Maltby, 2009; and Noguchi and Bátiz-Lazo, 2010).

included ... the institution of accounting and auditing standards” (2009, p. 240). Power regrets that “studies of what auditors actually do as opposed to what they claim to do scarcely exist” (1992, p. 39). And while some prior historical work has been done on internal controls (see especially Heier et al., 2005, and Hackett and Mobley, 1976), little attempt has been made at somehow measuring the change in attention given to the subject over time (see Matthews, 2006, for an exception).<sup>2</sup> The present study covers the entire 20<sup>th</sup> century, develops quantitative evidence that measures a century of changes in U.S. auditors’ internal control-related *evaluation* as opposed to their attention to internal control-related *techniques*, and in the process, raises questions about the auditor’s claimed justifications for today’s intense focus on internal controls.

The paper begins with a brief review of the debate over fraud detection and internal control, and of the literature that casts doubt on how effective external auditors’ evaluation of internal controls can be in helping to detect fraud. We then describe our study method – a content analysis of the 20<sup>th</sup>-century auditing reference series, *Montgomery’s Auditing*. Our results follow; they show a dramatic increase in auditors’ attention to internal controls over the course of the 1900s, which we contrast with the simultaneous decline of attention to fraud detection methods. We conclude with a discussion of the results and some unanswered questions.

### Context and Prior Literature

“The reaction against SOX’s section 404 requirement [for the auditors] to document internal controls and test them annually came from far and wide,” according to Dodwell (2008, p. 39). These reactions spurred research that has raised serious questions about the usefulness of the auditor’s evaluation of a company’s internal controls.

Note that the value of internal controls themselves is not in question. Internal controls are an old phenomenon, long pre-dating the regulations of the last century or so. Jones (2008), for example, finds evidence of internal controls in medieval Britain. Markley (2007) reports internal controls in medieval France. Hackett and Mobley (1976) review literature that reports internal controls from 3600 B.C.

Watts and Zimmerman (1983), observing evidence of medieval audits, argue that there is intrinsic value to audits in solving an agent-principal problem, so that they are performed in many times and places

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<sup>2</sup> Matthews interviewed British auditors of all ages and classified their training experience by age cohort.

regardless of regulatory requirements. The same argument might be made about internal controls, which if anything are even older than audits. Internal controls, like audits, have long been considered to add value to an entity's functioning. They have generally been valued as fraud detection and deterrence tools (see, e.g., Pratt, 1952, referring to internal controls as "embezzlement controls"), but they are also means of informing management decisions and improving the efficiency of operations.

But the *mix* of internal controls with audits – the practice of auditors formally *evaluating* an entity's internal controls as a routine part of their audit procedures - is not so ancient. It is only sometime in the last century or so that auditors have spent much time evaluating internal controls,<sup>3</sup> and only in recent decades have regulations actually required them to do so in the United States. Does this activity also add value to firms' operations and the market that supports them?

Post-SOX research suggesting that the auditor's evaluation of internal controls is of dubious utility includes a study by Hermanson et al. (2009). They found that shareholders are less likely to vote for the retention of an auditor who issues an adverse opinion on internal controls. As the authors point out, this could be the result of the generational conflict of interest between current shareholders and prospective shareholders, with the former presumably disliking, and the latter supporting, such disclosures as they differentially impact their economic interests (p. 395).

On the other hand, it may be that current shareholders have other reasons for opposing such opinions, at least in the case of the public companies studied by Hermanson et al. Beneish et al. (2008) examined disclosures of internal control weaknesses under SOX Section 404, which are performed by external auditors, and compared them to internal control disclosures under Section 302, which were performed by management. The researchers found that Section 302 findings negatively affect share prices, while Section 404 findings do not.

Beneish et al. speculate that there is so much other information available on the larger companies subject to early implementation of Section 404 that the market obtains no useful additional information from Section 404 disclosures about them. Public dissemination of the adverse opinion on internal control simply confirms previously known information, and hence fails to affect stock prices. If so, the money spent finding and improving

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<sup>3</sup> Matthews (2006, chap. 5) describes the development of British auditors' attention to the evaluation of internal controls in detail. He finds that the evaluation of internal controls sometimes occurred in Britain in the late 19<sup>th</sup> century, but was not routine in the majority of audits until perhaps the 1970s.

defective internal controls would be largely wasted, and shareholders voting to change auditors who report such findings are acting rationally.

SOX's section 404 requirement thus may exemplify Power's (1997, p. 98) point that an audit procedure, carried too far, can lead "to the opposite of what was intended, i.e., creates forms of dysfunction for the audited service itself." Internal control verification procedures may "distort organisational performance" (Roberts, 2009, p. 963) by requiring the expenditure of (substantial) funds on an audit procedure that often adds no value to the audited entity.

The conventional wisdom commonly offered to explain auditors' promotion of the evaluation of internal controls is that it is a requirement of efficiency. In an age of large and complex businesses, the evaluation of internal controls is the most efficient way of identifying those aspects of an entity that need closer substantive examination in an audit.

Myers (1985, p. 66), for instance, assumes that the increased emphasis on internal controls in the 1949 edition of *Montgomery's Auditing* (see results below) reflected the greater efficiency required by World War II manpower shortages. Heier et al. (2005) agree that the requirements for the evaluation of internal controls are an efficiency measure, citing numerous statements by authorities to that effect in the early 20<sup>th</sup> century. The U.S. Committee of Sponsoring Organizations of the Treadway Commission, in presenting its initial version of the integrated framework for internal control (Committee of Sponsoring, 1994, p. 90), describes the auditor's attention to the subject as a way of determining the extent of tests needed for the audit.

Similarly, in the United Kingdom, auditors' examination of internal controls spread widely in the 1930s as a "basis of determining the extent of examination required," according to Hackett and Mobley (1976, p. 4). Auditors of U.K. building societies were allowed in the 1950s to substitute the examination of management's internal controls for the previously-required examination of 100% of mortgage deeds, after the profession complained that the latter procedure was so onerous as to be essentially impossible (Noguchi and Bátiz-Lazo, 2010). Matthews (2006, pp. 161-162) sees the adoption of internal control examinations by auditors in Britain as one of a group of changes made in response to cost pressure.

In effect, the auditing profession has successfully argued that the old audit methods, while aimed at complete transparency, were so inefficient that they actually impeded a good examination of the clients. In contrast, the evaluation of internal controls leads to improved fraud detection and prevention through efficient identification of possible problem areas, as the Government Accounting Office has argued (O'Reilly et. al [under primary

sources in reference list], 1998, p. 1-21).

But the efficiency explanation relies heavily on some dubious assumptions. It assumes that the audit will find any internal control weaknesses, that auditors will investigate the weak area in detail for evidence of irregularities, and that management will then strengthen the weak areas. In fact, though, even when auditors do find evidence of internal control weaknesses, they do not always follow up with increased substantive examination of the area (National Commission, 1987). Nor does management by any means always correct identified weaknesses. Hermanson et al. (2008, p. 48) point out that even after implementation of the section 404 procedures of SOX, substantial revenue recognition weaknesses remained in many companies. A 1936 court case in England faulted company management for not having corrected internal control weaknesses brought to their attention by the auditor when such correction would have discovered a fraud (Chandler and Fry, 2005, p. 32).

Additionally, internal controls are notoriously susceptible to management override (National Commission, 1987, p. 29; Wells, 2004; Apostolou and Crumbley, 2005), further weakening their fraud detection and deterrence capabilities. Joseph Wells, a leading writer in forensic accounting, argues (2005, p. 3) that SOX relies too heavily on internal controls for fraud prevention and detection. He notes that hotlines are more effective (see also Apostolou and Crumbley, 2005).

Finally, internal controls have other purposes than fraud detection. Hermanson et al. (2008), for instance, found that simple ignorance of revenue recognition techniques for complex sales situations – not fraud - was the most common source of section 404 material weaknesses related to revenue recognition.

In short, auditors' evaluation of a client's internal controls is at most an indirect and limited means of identifying material fraud. Many organizations victimized by management fraud have had well-documented and staffed internal control systems and would not have received an adverse internal control opinion.

Internal control evaluation may be necessary and efficient, but as a fraud detection procedure it is far from sufficient. Focused fraud-specific procedures are also needed if auditors are to be effective in both preventing and detecting fraud. Consequently, calls for auditors to re-adopt their old practices of directly testing for fraud have been rising in recent years (see Gray and Moussalli, 2006, for a discussion of the history of the separation and subsequent rapprochement of forensic accounting and auditing).

But do auditors *wish* to accept significant responsibility for fraud detection, as current U.S. audit standards require? Often, they do not. For instance, the O'Malley Panel on Audit Effectiveness (Public Oversight Board, 2000, p. 90), noting that tests of internal controls are not always effective, recommended a forensic-type phase in all audits. Respondent auditors objected on the grounds that such procedures would increase the public's expectations for fraud detection and increase auditors' litigation risk. When the subsequent Statement on Auditing Standards No. 99, "Consideration of Fraud in a Financial Statement Audit" was issued, the forensic phase recommendation did not appear.

Under the present requirements of Sarbanes-Oxley, the U.S. auditing profession remains heavily invested in the evaluation of internal controls. This study suggests that the internal control emphasis of SOX is a successful effort by auditors to deflect attention from the incessant demands that they detect material fraud in the entities they examine. Such an effort could be predicted in light of the Messner and Roberts insights (2009) into the limits of accountability. Our methodology is discussed in the next section.

### Method and Variables

If a purpose of today's emphasis on internal control evaluation is to allow the auditor to avoid some measure of fraud detection responsibility, then in the past, when auditors did not so systematically avoid the responsibility, there should have been less emphasis on auditor involvement in the evaluation of internal controls. To investigate past U.S. auditor practices, we performed a detailed content analysis of the *Montgomery's Auditing* series<sup>4</sup>.

*Montgomery's Auditing* was published in 12 editions from 1912 to 1998. As the standard reference work for the U.S. auditing profession during the 20<sup>th</sup> century (Commission, 1978, p. 33), it has been used as primary source material in many prior historical studies (Brown, 1962; Chandler et al., 1993; Clikeman, 2009; Commission, 1978; Gray and Moussalli, 2006; Hackett and Mobley, 1976; Heier et al., 2005; Moussalli, Gray, and Karahan, 2011; Myers, 1985; Nouri and Lombardi, 2006) as primary source material for historical studies. Robert Montgomery was a founder of one of Price Waterhouse Cooper's predecessor firms, of the American Institute of Certified Public Accountants' predecessor organization, and of the *Journal of Accountancy*. He was one of the creators of the first U.S. authoritative standards of accounting and auditing in 1917 and the first income tax act in

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<sup>4</sup> The bibliographic citations for all the *Montgomery* volumes used appear in the reference list.

the 20<sup>th</sup> century (Zeff, 1987). Montgomery was the lead author of the *Montgomery's Auditing* series until his death in 1953. His colleagues continued the work until the end of the century.

Our initial content analysis identified two variables of interest – discussion of internal control *techniques* and discussion of internal control *evaluation* (see variable list below). We counted the words concerning these variables (twice for consistency) in each volume and analysed the results, as reported in the next section. This analysis of *Montgomery's Auditing* is, as far as we know, the only study involving a line-by-line count of the material in the entire series. We controlled for the length of the individual volumes, which varied substantially over the century.<sup>5</sup>

A manual examination of the pages proved necessary, since there were many passages in which “internal control” or earlier variants such as “internal check” did not appear. For example, the 1916 edition has the following (p. 165):

“There should be ample safeguards surrounding the handling of [customer deposits for public utilities], as the deposits are frequently offered by ignorant persons and foreigners who are not familiar with business methods and who might be induced to accept irregular receipts from clerks not authorized to handle the money.”

The entire paragraph was included in the content analysis, despite not being in a section explicitly concerned with internal control. Such manual examination was time-consuming, but more accurate than relying on the various indexes or on a computer search.

### **Variables**

The variables discussed in this paper are the following:

IC-TECH% - the percentage of the total words in a volume describing proper or customary internal control techniques and advocating their use. For instance, we included a section called “System of Internal Check” in the 1918 edition that ran to six pages (pp. 53-58) and discussed controls for incoming mail, cash, purchase and sales invoices, vacations, payrolls, and branch office accounts among other topics.

IC-EVAL% - the percentage of the total words in a volume describing how the auditor should evaluate internal control. The 1975 edition had a chapter on internal control (chap. 3); all of its words counted as one of our two variables. Certain sections of the chapter clearly concerned the auditor’s evaluation of internal control, e.g., “Internal Control and

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<sup>5</sup> For an introduction to content analysis, see Hodson, 1999.



Auditing Theory” and “Internal Control and Auditing Practice” (pp. 61-63). For instance: “Thus, an auditor’s evaluation of internal control establishes the first term of the audit equation: how much he can rely on the underlying evidence of the accounts” (p. 62).

2-IC% - the sum of the first two variables, i.e., the percentage of the total words in a volume that describe how to either implement or evaluate internal controls.

We compare these variables to another, developed in an earlier paper<sup>6</sup>:

FR-DET-TECH% – the percentage of the total words in a volume describing how an auditor should go about detecting fraud.

## Results

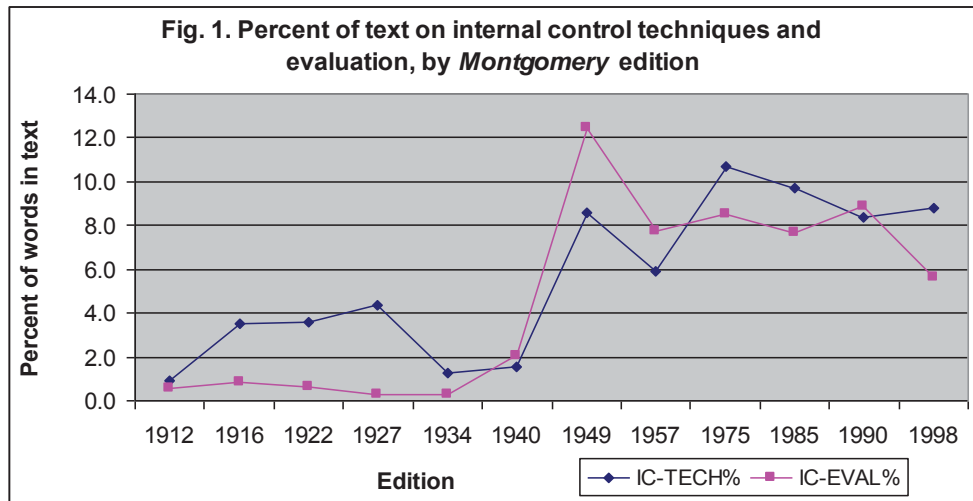
In his early volumes, Montgomery remarked that internal controls obviate the need for detailed audit work (e.g., 1916, pp. 48, 50; 1922 vol. 2, p. 41). His clear implication was that because internal controls deter and detect fraud, they can serve the fraud detection function of an audit (see 1934, pp. 42-43 for a good example). Indeed, in 1949, he praised internal controls because prevention of fraud was better than detection (pp. 6-7). However, despite this interest in the subject, the amount of text devoted to internal controls in the early volumes of *Montgomery* was not nearly as great as it was in the post-World War II editions.

Figure 1 shows that from 1912 to 1940, the share of each edition of Montgomery devoted to *describing* internal control techniques (IC-TECH%) ranged from about 0.9 to 4.4 percent. From 1949 to 1998, in contrast, the Montgomery volumes spent far more time on the subject, from 5.9 to as much as 10.7 percent. IC-TECH% is a positive linear function of time (adjusted  $R^2=.67$ ,  $p<.01$ ).<sup>7</sup>

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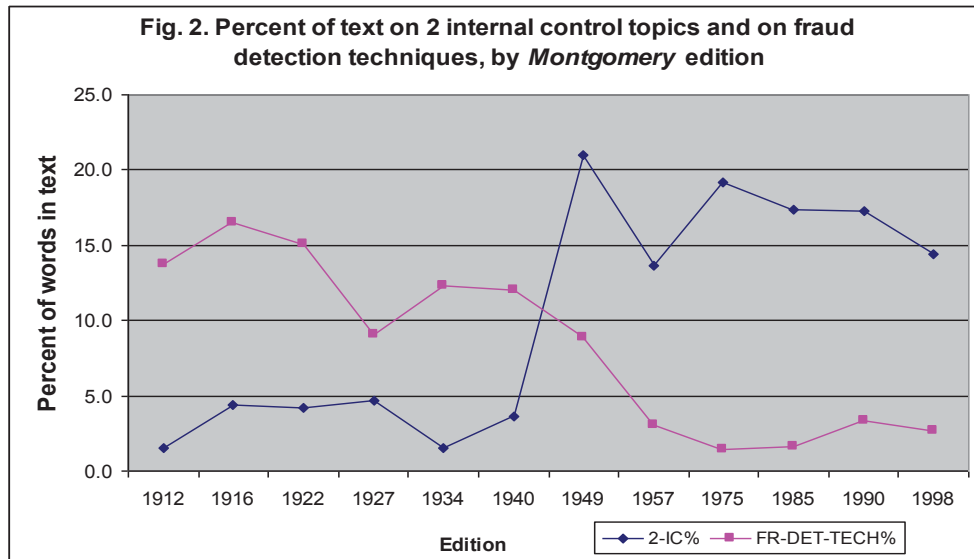
<sup>6</sup> Citation suppressed for anonymous review purposes.

<sup>7</sup> Due to the irregular nature of the time series, TIME was measured in terms of the passage of time from a starting point value such as 1900.



The pre-war percentage of the text devoted to explaining how the auditor should *evaluate* internal controls (IC-EVAL%) was even lower, from 0.3 to 2.1 percent. In the second half of the century, IC-EVAL% soared to between 5.6 and 12.4 percent of each volume. Like the description variable, IC-EVAL% is a positive linear function of time (adjusted  $R^2=.46$ ,  $p<.01$ ).

There is no overlap in the pre-World War II and post-war ranges of these two variables. No more than 4.6 percent of any volume was devoted to internal controls in total (2-IC%; see fig. 2) from 1912 to 1940. After the war, at least 13.6 percent of the words in every volume concerned internal controls. In 1949, an astonishing fifth of the entire text was on that subject, and the 1975 edition was almost equally single-minded. 2-IC%, like its component variables, is a positive linear function of time (adjusted  $R^2=.60$ ,  $p<.01$ ). To the extent that Montgomery's series represents audit practice in the 20<sup>th</sup> century, the profession gave far more attention to internal controls (techniques and evaluation) in the second half of the century than in the first half.



The *mix* of internal control concerns – techniques vs. auditor’s evaluation – also changed over time. Comparing the graph for IC-TECH% to that for IC-EVAL% (fig. 1) shows that in the first half of the century more text was usually given to techniques than to evaluation. That is, *Montgomery* spent significant time in the pre-war volumes on what constituted good internal controls, but very little time on telling the auditor to evaluate them.

Then, when both variables soared after the war, the volumes gave about the same amount of space to evaluating as to describing internal controls. Indeed, in several editions, evaluation words outnumbered descriptive words. The two measures tracked each other closely in the second half of the 1900s. The correlation between the number of words on each subject from 1949-1998 is 82 percent (versus negative 6.5 percent before the war).

We assume that the instructions in *Montgomery’s Auditing* roughly represent the profession’s internal control practices and knowledge. Supporting this assumption is the fact that U.S. authoritative bodies increased their statements concerning internal controls in the second half of the century, at the same time as *Montgomery’s* attention to the subject increased.

For example, in 1948, the AICPA’s Committee on Auditing Procedure issued a standard requiring the evaluation of internal controls (Heier et al., 2005; Lenhart and Defliese, 1957 [under primary sources in reference list]). In 1977, the Foreign Corrupt Practices Act was passed, requiring U.S. companies subject to SEC registration under the Securities

Exchange Act of 1934 to have an adequate system of internal control, though it did not require auditor evaluation. In 1983, Statement of Internal Auditing Standards 1 was issued, requiring *internal* auditors to evaluate internal controls (Goza, 2005). In 1987, the Treadway Commission recommended that independent auditors develop improved ways to judge the quality of internal controls (National Commission, 1987, pp. 53-54). Finally, the Sarbanes-Oxley Act of 2002 required publicly-traded companies to have their independent auditor issue an opinion on their internal controls.

If auditors intended internal control evaluations to relieve them of the need to detect fraud, we would expect the *Montgomery* series to reduce its attention to directly detecting fraud in the second half of the century, when internal control text was rising. Figure 2 demonstrates that this did in fact happen. The figure graphs the percentage of each text devoted to explaining fraud detection techniques (FR-DET-TECH%; this variable is a negative function of time) and contrasts it to 2-IC%.

The summed internal control variable (2-IC%) and the variable on fraud detection techniques and (FR-DET-TECH%) are negative functions of each other (-82%). The series devoted as much as 21% of its text to internal controls after World War II, but dropped discussion of how to detect fraud to minimal levels.

In fact, a regression model for the fraud detection variable finds that 63% of the variation in FR-DET-TECH% is explained by changes in the amount of text devoted to internal controls, 2-IC%. For every percentage point that 2-IC% rises, FR-DET-TECH% drops 0.6%. This finding supports our contention that auditors' purpose in increasing their attention to internal controls was to be able to reduce their attention to specific fraud detection techniques.

In the last decades of the 20th century, the U.S. auditing profession and the *Montgomery* series both claimed a renewed interest in fraud detection, but the series did not back that up with practical guidance. Most of the profession's interest, at least as represented by the advice given in the century's main practitioner reference series, lay in internal controls

### **Discussion and Conclusions**

This study of 20<sup>th</sup>-century changes in the U.S. audit profession's attention to internal controls suggests the following conclusion: in the 1940s, auditors dramatically *increased* their attention to internal controls. This was at about the same time that they dramatically *decreased* their attention to direct fraud detection procedures. We believe the two changes are related: auditors adopted an intense focus on internal controls in order to limit the

incessant demands that they be accountable for fraud detection – demands they considered (and still consider) excessive.

Our findings are limited in several important ways. First, the *Montgomery* series can only be taken as evidence of U.S. audit history. It is an open question whether auditors in other countries have pursued the same path as have American auditors. Secondly, our statistical tests did not control for other variables that may have affected auditors' interest in internal controls and in fraud detection techniques. It is possible that a third variable, which we did not consider, was the real driver of changes in both these areas. Finally, the method – a content analysis of a practitioner's reference series – is an indirect measure of changes in audit practice. Other research methods might or might not find the same results we did. One interesting alternative method is Matthews' interviews with older British auditors; he recorded the changes in experience of different age cohorts as a way of capturing past practice. That method would be a very different way to measure changes in internal control practices among U.S. auditors.

But our study does provide support for our view that internal controls have been used by U.S. auditors to help them limit their responsibilities. Humphrey et al. (1993) suggest that auditors in practice take steps to “protect against detection of fraud.” As Messner put it, a high demand for accountability, “in the name of ethics, forces the accountable self to account for something which is very difficult or even impossible to justify and which, in this respect, does ‘violence’ to the accountable self” (2009, p. 918). Auditors react by seeking to insulate themselves from professional liability. A focus on internal controls is an attempt to shift the blame for any fraud to management, who must have failed to maintain effective internal controls. In fraud cases, the auditor becomes a victim of the client's poor internal control system. By emphasizing internal control evaluation, an auditor's failure to detect fraud is less damning than it would be in the presence of procedures specifically focused on fraud detection.

Other explanations are offered in the literature for the increasing interest in internal controls. Some argue the change in focus sprang from competitive price pressure for auditing services and the explosion of lucrative consulting services. Wyatt, for example (2004), asserts that the profession changed its practices and culture substantially under such pressure. Under this view, auditors needed to shift some of the costs of expensive substantive auditing to management. An internal controls focus would pressure management to implement the controls that might obviate the need for a great deal of substantive work by the auditors.

But this begs the question of timing. Our study shows the shift in

internal control focus occurred in the 1940s; did price pressures and consulting soar then, too? Wyatt (2004) himself dates the competition changes to the 1960s, and believes that they increased through the 1990s. Our evidence places the change in internal control focus decades earlier.

Heier et al. (2005) are among many who believe that changes in internal controls standards usually result from reactions to various scandals and court cases. But the question of timing arises again. According to Clikeman (2009, p. 3), there were two major scandals before 1970 that sparked accounting-related reforms: the collapse of Ivar Kreuger's pyramid scheme in 1932 and the McKesson & Robbins fraud trial in 1938. From 1970 on, Clikeman counts 12 additional major accounting scandals. If the two scandals of the 1930s explain the increase in internal control interest that began with the 1949 edition of *Montgomery*, then why did the 12 subsequent scandals not lead to continued increases for the last 30 years of the 20<sup>th</sup> century?

If we focus on why auditors' interest in internal controls more than quintupled between 1940 and 1949, it seems possible that the biggest event of those years – World War II – may be the simplest explanation, albeit one that has been little explored. Heier et al. (2005) briefly mention that the “major focus of internal control measures from 1941 to 1945 [in the United States] was to identify and reduce fraud and abuse among defense contractors.” Did the adoption of extensive internal control evaluation by government auditors somehow boost the procedure in the post-war profession as a whole?

This possible connection between the war and changes in U.S. audit procedures is an area that needs much more study. Worldwide wars, after all, tend to shift a lot of limits. The long-running conflict among auditors, business managers, and the investing public over accountability may well have seen some battles during World War II.

An explanation that weaves the scandals-and-courts theory with the World War II-era timing is that the auditing profession successfully enlisted the help of the government in shifting fraud detection duties to others during the war. After all, long before the Ivar Kruegar, Ultramares, and McKesson & Robbins scandals of the 1930s, auditors were aware of the possibilities offered by the study of internal controls, as numerous statements in the early volumes of the *Montgomery* series demonstrate.

But the series did not dramatically shift its attention to internal controls in the 1910s or 1920s, or even in the 1930s, when the decade's scandals and court decisions significantly raised auditors' legal liability for fraud detection. It did so in the 1940s, when many auditors joined the war

effort as examiners of defense contracts (Heier et al., 2005) and cost accountants (Fagerberg, 1990). In these roles, they persuaded the war-time government that they should concentrate on internal controls (Heier et al., 2005), thus successfully shifting accountability to company managers. The government's weighing in on the side of auditors' focus on internal controls may have given internal control evaluations the boost needed to endure as a focus after the war.

Recall that Noguchi and Bátiz-Lazo (2010) studied the requirement by the British government in the 1950s that building society auditors begin extensive internal control evaluations. These scholars interpreted the change as an imposition by the government on the auditing profession in exchange for dropping the statutory requirement of item-by-item substantive examinations. But evidence cited in their article demonstrates that it was the Institute of Chartered Accountants of England and Wales that suggested substitution of internal controls for complete substantive audits. This seems more consistent with our speculation that auditors seized the opportunity of government intervention to obtain legislation (in the British case) or authoritative auditing standards (in the American case) that would help them limit their accountability for fraud detection.

The shifting limits of accountability for fraud detection is a 100-years' war, and still counting. Contrary to Messner's and Roberts' recommendations that appropriate limits should be placed on auditors' responsibilities, the public in general and shareholders in particular continue to insist, as they always have, that fraud detection is a primary function of audits. Auditors' attention to that subject declined as the 20<sup>th</sup> century wore on. In reaction, demands that auditors return to some fraud detection responsibility rose to such a pitch that the profession was forced to institute standards that explicitly require fraud detection by auditors (Gray and Moussalli, 2006).

Then came the Sarbanes-Oxley Act of 2002, the declared purpose of which was to "protect investors by improving the accuracy and reliability of corporate disclosures." Widely perceived as a rebuke of auditors and a raising of their accountability, in fact the major change the law produced for accountants' work was section 404, which dramatically increased requirements for internal control evaluation while simultaneously increasing management's responsibility for the controls. That is, SOX effectively threw the government behind auditors' position that fraud prevention and detection responsibilities lie overwhelmingly with management. If the *Montgomery* series still existed today, presumably internal controls would consume a larger proportion of it than ever. Note that auditors paid a high price for SOX: they relinquished professional control of auditing standards to the U.S.

government for the first time, with the creation of the Public Companies Accounting Oversight Board.

At the end of the day, we would modify Messner's and Roberts' recommendations that the profession focus on limiting its accountability. The courts, investors, and the public in general will never stop insisting on greater fraud detection achievements by auditors, so the profession's unilaterally-declared limits are always tenuous. Internal control evaluation has been emphasized beyond the needs of efficiency in order to satisfy the needs of avoiding responsibility. Why should the profession not instead decrease its focus on internal controls in favor of seriously improving its techniques for fraud detection? We will give Montgomery himself the last word. He made just such an argument in 1921 (vol. 1, pp. 21-22):

While an auditor who brings to bear all of his skill and resources, and who leaves no stone unturned in his search for fraud, but fails to discover a well-concealed defalcation, is legally exempt from liability therefore, yet he is, and properly should be, considered professionally responsible for such failure, and his practice suffers accordingly. Therefore particular attention must be paid to all possible avenues which are open to the dishonest clerk or official ...



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