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Robert M. Rennie

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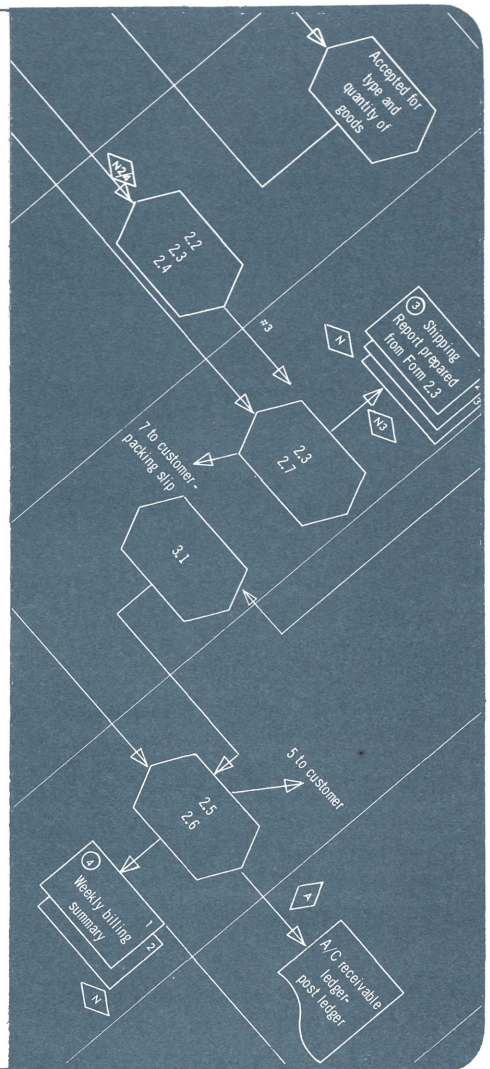
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Flow Charts for Audit Purposes

by Robert M. Rennie



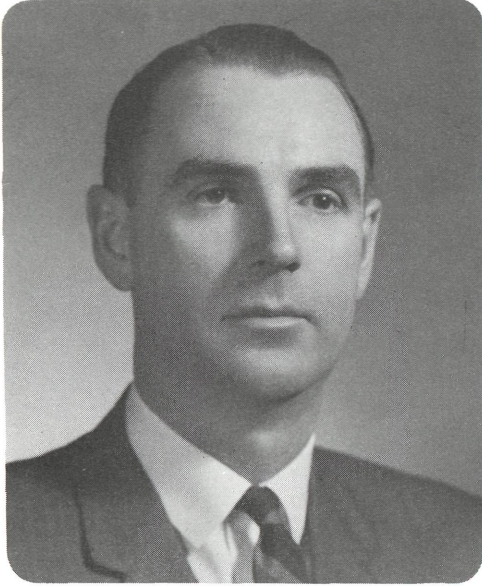
INTRODUCTION

A fundamental requirement for the auditor in expressing a competent opinion of the credibility and fairness of financial statements is that he has sufficient knowledge — particularly from the point of view of internal control — of the accounting system which produced the information used in the statements. It is therefore essential, particularly because of the continuing nature of most audit engagements, that this knowledge of the system be recorded in such a way as to facilitate future reference and to highlight any system deficiencies.

The purpose of this article is to illustrate and explain the use of flow charts as an aid in the determination and evaluation of a client's accounting system, and as a means of recording these findings in an orderly, concise and comprehensive manner. It should be clearly understood

that flow charts and their related narratives are only a part, though an important one, of the information we must have in our files with respect to a client's accounting procedures and internal controls. They are not intended to be an elaborate or detailed system's study; their prime purpose is to assist the auditor in evaluating the client's accounting system as a means of producing satisfactory information for financial statement purposes.

The flow chart techniques used in this outline are not elaborate. Using six basic symbols, a simple but effective method is demonstrated of flow charting two major segments of an accounting system in a medium sized manufacturing company. The accounting procedures which are illustrated are not intended to be ideal but are used only as a means of showing how flow charts may be developed on an audit assignment. The following sections



Robert M. Rennie, our partner and director of auditing in Canada, has spent his entire business career with the firm. Born and educated in Montreal, he graduated from McGill University with a Bachelor of Commerce in 1948. He became a chartered accountant in 1951, and was made a partner in the firm in 1957.

Mr. Rennie is presently serving on the Accounting and Auditing Research Committee of the Canadian Institute of Chartered Accountants.

indicate some of the advantages and disadvantages of flow charts for audit purposes as well as outlining how the techniques may be applied.

ADVANTAGES

There are a number of advantages in the preparation of flow charts and they include the following:

Comprehensive survey — highlight weaknesses

In order to prepare proper flow charts a *comprehensive survey* of the accounting functions must be made. The fact that information is incomplete or piecemeal is usually more evident when it is being recorded on flow charts rather than by some other means — for example in complete narrative form. In addition, because of their

graphic nature, flow charts tend to indicate and highlight more clearly weaknesses or deficiencies in accounting systems and systems of internal control. This is one of the prime functions of flow charts for audit purposes and is sufficient in itself to justify their use.

Understand system

It enables the system to be more quickly understood by the members of the audit staff; the information is presented in a concise graphic manner which may be understood with minimum difficulty. This is particularly important where for various reasons members of the audit staff are being rotated. For larger clients it is often the most desirable way of acquiring an overall grasp of accounting procedures and the system of internal control.

Creates interest

It creates more interest and enthusiasm on the part of the audit staff because they can better appreciate the functioning of the system and hence the reasons for our tests.

Recommendations for improvements

It produces more valuable and more realistic recommendations to clients on internal controls and system efficiency because of the increased awareness by the audit staff of accounting systems and document flow.

Better use of audit time

It emphasizes more forcibly those areas of the accounts which require more attention and therefore assists in a better budgeting and use of audit time.

Reduces interference with client's staff

It fosters client's goodwill because new audit staff usually require less time for system orientation, and interference with client's staff is kept to a minimum.

Reduces test checking

It can result in a reduction in the volume of test checking. This may be achieved by (a) indicating certain areas where the internal controls are satisfactory and the volume of test checking could be reasonably reduced; or (b) by suggesting certain areas where it would be more appropriate to test in depth a lesser number of transactions instead of checking a greater volume in a superficial manner.

DISADVANTAGES

In spite of the number of advantages which flow charts have for audit purposes, they do have several disadvantages:

Unusual transactions overlooked

Flow charts are usually concerned with the normal type of transactions. Unusual transactions which are also of interest to the auditor may be overlooked. This is perhaps the most serious disadvantage that flow charts have from an audit point of view and it must be guarded against. One of the safeguards is an effective test of transactions which is designed to expose any unusual conditions which may exist and which are unacceptable deviations from normal procedures. However, there may be acceptable deviations from a procedure which are not practical to flow chart. These deviations should be indicated in a supplementary narrative to the flow chart as described in the following sections of this article. Such a record is necessary to prevent these acceptable deviations from being overlooked by the auditor in his review of the system in subsequent years.

Difficulties in preparation

Some auditors because of lack of familiarity or training in preparation of charts may not produce neat and intelligible flow charts in a reasonable length of time. This could be a serious shortcoming which would defeat the purpose of preparing flow charts. However, some brief instruction and subsequent practice in using the simple techniques described in this article should reduce this disadvantage to a minimum.

Changes in system

Minor changes in the client's system may occasion the complete redrafting of certain of the charts. However, the same condition applies regardless of the method the auditor employs to record his review of the client's accounting procedures. In some cases involving a completely narrative type of system description, it could require a complete rewriting of a narrative with considerably more time involved.

The advantages, therefore, under normal circumstances far outweigh the disadvantages of using flow charts for audit purposes.

WHEN TO USE FLOW CHARTS

The decision to use flow charts must rest with the partner in charge of the audit. Very small clients operating mainly on a cash basis would not normally require flow charts. Usually a brief narrative description would provide the necessary information. However, where a client has a number of accounting procedures requiring the use of various forms in each procedure, then the use of flow charts is recommended. In a medium-sized trad-

ing or manufacturing company the auditor should have on file flow charts for at least the following eight general areas. In the larger companies it may be necessary to have two or more flow charts in a particular area.

| | |
|---------------------|-------------------|
| Sales | Payables |
| Accounts receivable | Payments |
| Receipts | Payrolls |
| Purchases | Inventory control |

Generally speaking, the larger the client in terms of accounting paper flow and diversification of accounting procedures the more appropriate and useful are flow charts.

In summary, it is essential that we have adequate information in our files which outlines the client's accounting procedures and our opinion on the internal control. If this information is lacking the audit files are deficient, and flow charts are recommended to correct the deficiency.

PREPARATION OF CHARTS

There are two stages in flow charting a client's accounting system. These are:

- a) A preliminary survey
- b) The preparation of the charts and supplementary narratives

Preliminary survey

As the description implies, the preliminary survey involves the selection of a particular accounting procedure (for example, sales), determining the type of transaction involved in the procedure and then investigating and documenting the forms and methods which are used to record and account for the transactions. This may be achieved by the selection of a number of transactions — for example sales orders — and tracing them through the client's accounting system and obtaining any explanations necessary from the employees actually performing the work.

It is usually helpful to obtain blank copies of the forms in question, making whatever notes are necessary on the respective forms as to approvals, routing and other significant information. It is also helpful to draw very rough flow charts to show where documents are routed and where the internal control check points are. (An example of an internal control checkpoint is the balancing of subsidiary ledgers with control accounts.) The determination of internal control check points and whether or not they appear to be working, as evidenced by the test samples being used, is *extremely important*. Careful notes should be made in this area. An internal control ques-

tionnaire should be very useful during the preliminary survey.

The time required to complete a preliminary survey is dependent almost entirely on the size and complexity of the client's accounting procedures but it should be continued until the auditor is satisfied that he has sufficiently accurate information to prepare his flow charts and have a reasonable idea of the system of internal control.

Up to this point the auditor's approach to a system review for audit purposes is the same for any audit whether or not flow charts are used to document the results of the review.

Drawing flow charts

The flow charts which are presented for illustration in this article are divided into two main parts:

1. The chart
2. The supporting narrative

The preparation of the charts, using the information obtained in the preliminary survey, is relatively simple. However, the following points should be kept in mind:

1. The standard set of symbols used in the illustration should be used for sake of uniformity by our offices when charting non-EDP systems.
2. The arrangements of the departmental columns on the chart should be such that the direction of flow on the chart is from left to right as much as possible.
3. The description of the form should appear only once at the point of origin.
4. Avoid charting those copies of a form which are used for non-accounting purposes. These may be mentioned briefly in the narrative and the destination indicated.
5. The disposition of all forms on the chart *must be indicated* — at any stage a form can be either (1) filed or (2) used in another operation. This must be indicated in each and every case.
6. The consecutive number reference of each form on the flow chart should if possible follow the actual sequence of the form in the system. For example, a weekly payroll would precede the payroll summary and this should be indicated by the numerical sequence.
7. When a document originates in a department it should appear, where possible, in the departmental column above other documents coming into the department.
8. Where possible the operation to be performed should be indicated in the operation symbol. If the

operation is lengthy, a numerical cross-reference to the supporting narrative may be made in the operation symbol and the narrative would then outline the procedure.

9. Do not crowd the chart—use enough space. If necessary a second sheet may be added to complete the flow charting of the procedure in question. The rough flow chart prepared in the preliminary survey will provide some idea of how much information is required on various portions of the chart.
10. If two flow lines for different forms intercept, the lines causing the interception should be broken by means of a half loop.
11. Every chart should have a title, showing the client's name and procedure as well as the person preparing the chart and the date it was prepared.
12. Use an eraser freely. You may find you erase more often than you write — even after long experience.
13. Use chart paper and template.

Supplementary narrative

The supplementary narrative to the flow chart will, like the chart, be developed out of the information gathered during the preliminary survey of the system. This narrative is intended to supplement and *must not duplicate* information that is evident on the chart. The narrative should show for example the approvals required on various documents, the reasons for sending certain documents to a particular department (unless this is self evident) and any other information which cannot practically be placed on the chart but is essential for understanding the accounting system and the features of internal control.

In addition, the narrative should also show any exceptions which cannot be charted. For example, the chart may show that a reconciliation of certain information must be prepared at a particular point. If the items do not reconcile, the narrative should indicate what adjustment steps are necessary — the narrative should show particularly the name of the individual who investigates and approves the adjustment.

It is recommended that a concise outline of the major features of internal control in the accounting procedures be indicated in the narrative outline as well as any weaknesses which have been detected in the system review. This information on internal control is essential since it is the logical and necessary outcome of the system review and it supports our audit program.

If possible an estimate of the volume of paper processed per period (weeks, months, etc.) should be indicated

for the respective accounting forms. This is significant for our audit test work as well as for possible suggestions for improving the system.

In summary then the following points should be observed when preparing a narrative supplement to a flow chart:

1. Be concise.
2. *Do not duplicate* information which is evident on the flow chart.
3. Deal with matters that are concerned primarily with the accounting system and the system of internal control.
4. Highlight the major features of internal control.
5. Outline any major weaknesses detected.

6. If possible estimate the volume of the respective forms — per period.

CONCLUSION

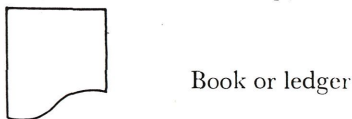
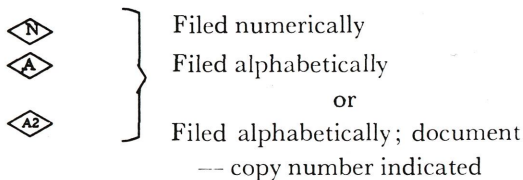
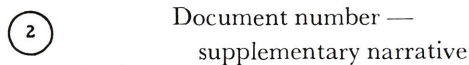
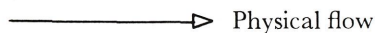
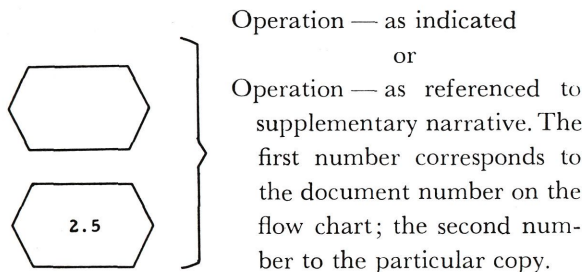
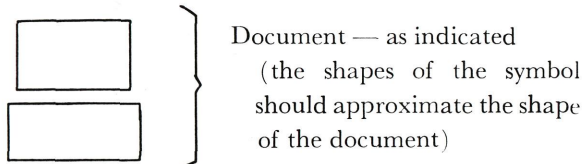
Flow charts are a simple and effective technique for recording in a clear, concise manner information which is essential for an efficient and productive audit. Their use is strongly recommended —

- 1) for the increased efficiency they can promote in our work,
- 2) as a means of highlighting weaknesses and deficiencies in a client's accounting system and
- 3) for the savings in time and money they can produce for us and our clients.

APPENDIX A

Client: ABC Company Limited
 Procedure: Weekly factory payroll
 Chart No.: I

STANDARD FLOW CHART SYMBOLS



ACCOUNTING PROCEDURES AND INTERNAL CONTROL

ACCOUNTING PROCEDURES

Document Number

- 1 *Employment and rate authorization slip*
 All forms have rate authorized by personnel manager. Rate changes are by means of an approved rate change slip prepared in triplicate by personnel department; routing similar to original slip — 300 employees — changes 10 per month.
- 2 *Deduction slips*
 Both copies signed by employee. Changes effected by new forms which are signed by employee (as above).
- 3 *Job time tickets*
 Prepared by employees daily for each job, including indirect labor. All tickets approved by shift foreman. This includes the approval of any overtime. On Friday of each week, factory cost clerks sort all tickets by employee number, review all tickets for foremen approval and general completeness. Tickets are batched and a duplicate adding machine tape is prepared of hours shown on time tickets; the original tape is sent with the batch to the time keeping department; duplicate tape is kept by factory cost clerk.

Any differences in hours are investigated by time keeping department with factory superintendent who must approve any adjustments. Tickets are sorted after reconciliation into job number order — 400 direct labor; 60 indirect labor tickets per week.

4 *Employee time cards*

All factory employees are required to punch a time card. All punch clocks are at main door under surveillance of time keeper — 300 per week.

5 *Time reconciliation report*

Approved after completion by cost accountant.

6 *Labor distribution summary*

Approved by factory superintendent; used for standard journal entry 15. (Debit work in process and indirect labor, credit payroll clearing.)

7 *Weekly payroll*

Payroll sheets are reviewed and initialed by department foremen. A payroll accounting machine is used to prepare the payroll and this also produces the payroll checks and the payroll summary.

8 *Payroll summary*

Prepared simultaneously with weekly payroll. Both copies are approved by the comptroller and the factory superintendent.

9 *Payroll voucher*

Payroll voucher is approved by secretary-treasurer and is the basis for making a bank transfer from the general fund to payroll bank account. (Debit payroll clearing, credit withholding taxes, deductions, etc., general bank account.)

10 *Payroll checks*

Payroll checks are prepared simultaneously with weekly payroll sheets and are signed by secretary-treasurer and comptroller. Checks are drawn on an imprest payroll bank account and are distributed on Wednesday of the week following the pay week. Checks are delivered by payroll accountant to the shift foremen on Wednesday morning and afternoon. Pay is distributed by shift foremen accompanied by a general accounting department employee. Unclaimed wages are returned to the payroll accounting department and after three days are deposited

in payroll bank account — 300 checks distributed per week.

INTERNAL CONTROL

Main features

Internal control is satisfactory and the following are the main features:

- 1) There is a clear separation of duties between employees preparing payroll (payroll department), timekeeping (factory and timekeeping department) and distribution (foremen and general accounting staff). Occasional pay-offs are made on a surprise basis by the chief accountant on positive identification.
- 2) There is an internal check between two independent departments on hours and dollars —
Hours—time reconciliation summary for job time tickets in the factory and clock cards in timekeeping department.
Dollars—payroll clearing account in general ledger which records clearing entries from the cost department (labor distribution summary—journal entry 15) and accounts payable department (payroll voucher).
- 3) Authorizations are required for all rate changes, additions and separations.
- 4) Approvals are required for overtime (foremen)—payroll sheets examined and initialed (foremen)—and payroll summary is approved by comptroller and factory superintendent.
- 5) Time clocks are in use.
- 6) Employees paid by pre-numbered checks drawn on an imprest bank account which is reconciled monthly by an employee (general accounting clerk) unrelated to the payroll function. This clerk picks up checks and bank statements directly from bank. Reconciliation is reviewed and initialed by chief accountant.
- 7) Proper control is exercised over unclaimed wages, deductions from payrolls, old outstanding checks and blank checks.
- 8) All clerical work checked.

Weaknesses noted in system

Our payroll examination has disclosed the following weaknesses (which have been reported to the client) and our audit procedures have been designed with these weaknesses in mind.

CLIENT: ABC COMPANY LIMITED
PROCEDURE: WEEKLY FACTORY PAYROLL

GENERAL ACCOUNTING

ACCOUNTS PAYABLE

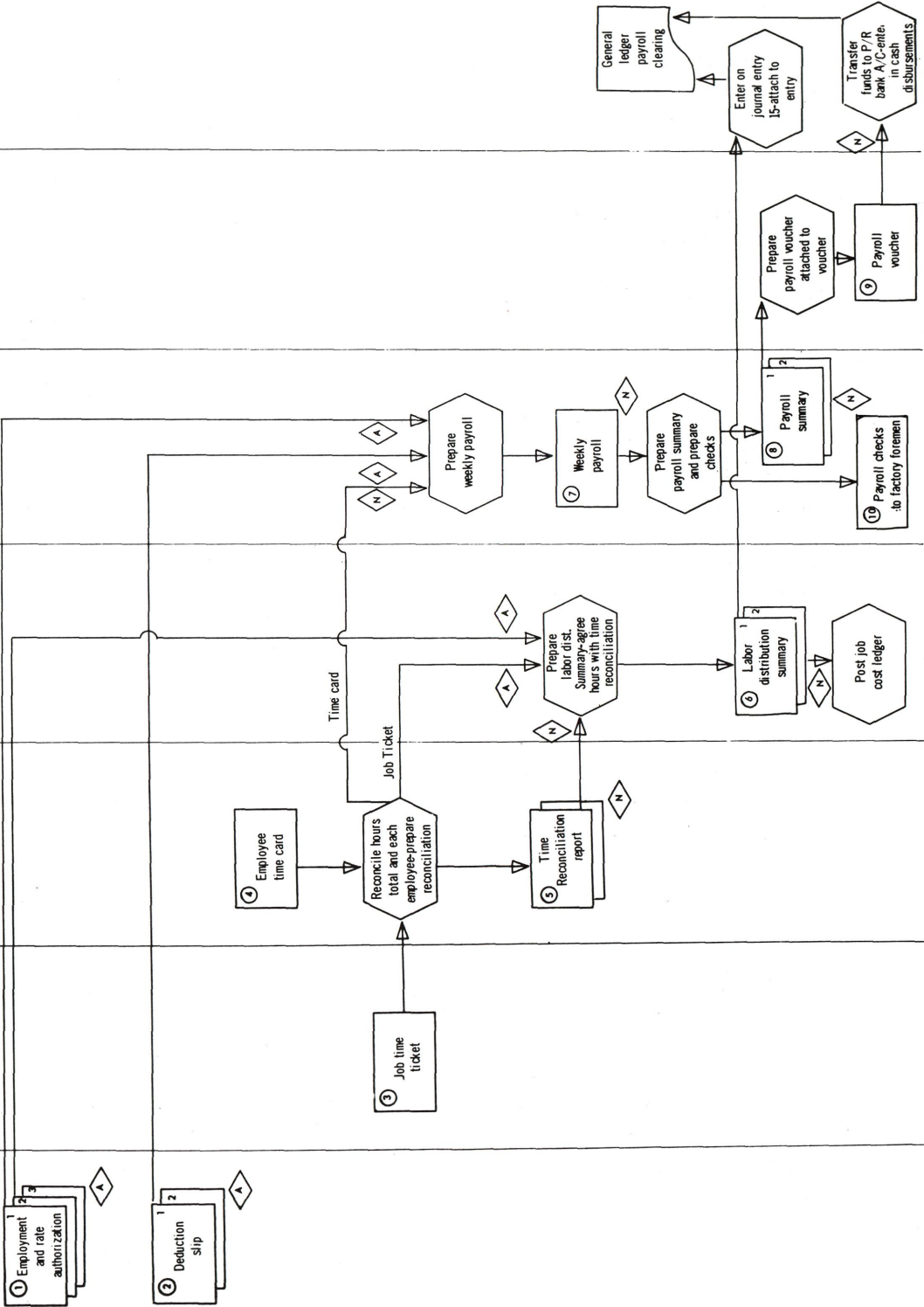
PAYROLL

COST

TIMEKEEPING

FACTORY

PERSONNEL



1. Missing approvals on labor distribution summaries and payroll summaries.
2. Several instances of unexplained differences between clock card hours and job ticket hours.
3. Missing foremen approvals on payroll sheets.
4. Delays in investigation of differences in general ledger clearing account.

Prepared by: A. Auditor
Date: October, 1964

Client: ABC Company Limited
Procedure: Sales (credit)
Chart No.: II

ACCOUNTING PROCEDURES AND INTERNAL CONTROL

ACCOUNTING PROCEDURES

*Document
Number*

1 *Customer's order*
The customer's mail request is attached to the original order. All customer's orders pre-numbered and numbers are accounted for. Acceptance of order is indicated by department managers initialing form — volume 800 per week.

2 *Sales invoice and shipping set*
Copy
Number

Operation

- 2.1 Order acknowledgement — after acceptance.
- 2.2 Approved by the manager sales department as authorization for finished goods department to send goods to shipping department. Posted to material quantity control Kardex in finished goods department.
- 2.3 Approved for quantity and type of material by inventory control manager in finished goods department; sent with material to shipping department; shipping department must have this approved form before material is shipped.

- 2.4 Inventory turnover report.
- 2.5 Held as control over customer's orders awaiting shipment—regular follow up is made of orders delayed more than three days in absence of special instructions.
- 2.6 On receipt and comparison of completed shipping report document 3.1, copy 5 is sent to customer; and copy 6 with shipping report attached is entered on weekly billing summary and then sent to accounts receivable department for customer account posting.
- 2.7 Packing slip copy — held pending receipt of goods with copy 3 — compared with copy 3 and packed with material — sent to customer.
- 2.8 File copy for sales order department.

All clerical operations are checked and the numbers of all sales invoice sets are accounted for in sales order department. Customer's order, shipping report and sales invoice numbers are correlated and numerically cross referenced. Billing department checks quantities, prices, extensions and terms before mailing invoice to customer. Billing department also accounts for the numerical sequence of sales invoice numbers. Delays longer than three days in receiving shipping report from shipping department are investigated by the billing department manager. Differences between quantities shipped (per shipping report) and customer's invoice are also investigated by billing department manager who must have sales manager's approval of any adjustments. Special terms or discounts must be authorized in writing by credit department with a copy to the billing department.

Chart No. II Dates: 8/64
Prepared by: A. Auditor

GENERAL ACCOUNTING

CLIENT: ABC COMPANY LIMITED
PROCEDURE: SALES (CREDIT)

SALES

CREDIT

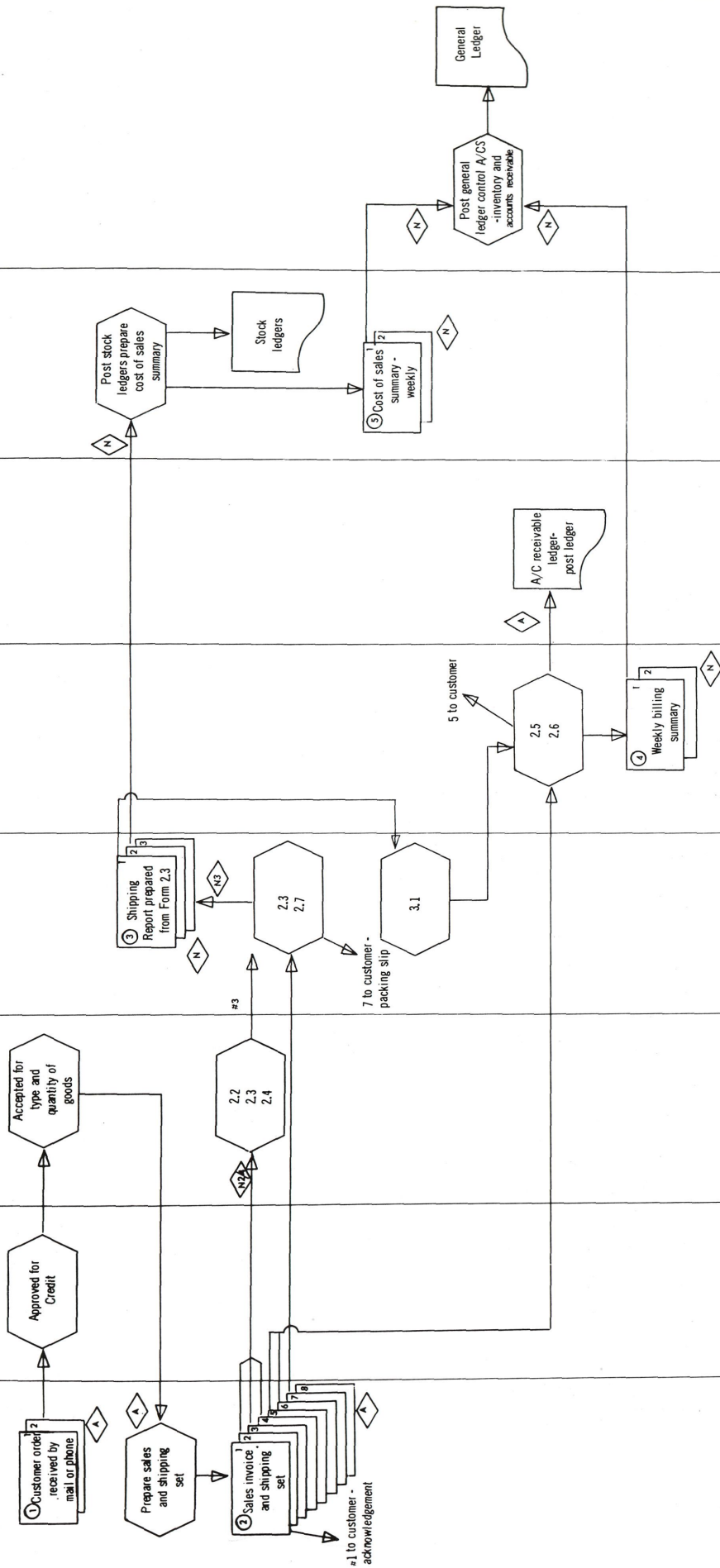
FINISHED GOODS

SHIPPING

BILLING

ACCOUNTS RECEIVABLE

COST



ment. Standard terms are 2% 10 days net 30 days—volume 800 per week.

3 *Shipping report*

The material to be shipped together with document 2.3 approved by the inventory control manager is received from the finished goods department. Document 2.7 is removed from pending file and agreed for quantity and type of material with form 2.3 and prenumbered shipping report is then prepared.

Copy

Number

Operation

- 3.1 Local delivery—sent with goods to customer for signature as acknowledging receipt; returned by trucker to shipping department. Out-of-town—copy of bill of lading attached by shipping department.

Attached and routed with document.

All numbers are accounted for. Any undue delays in receiving material for shipment (file of open packing slips document 2.7) are investigated by head shipper. Any differences in quantities or types of goods are investigated by head shipper. Differences require approval of both sales order and billing managers—volume 750 per week.

4 *Billing summary—weekly*

Summary approved by billing department manager.

- 5 *Cost of Sales summary-weekly*
Approved by cost accountant.

Internal Control

Main features

Internal control is satisfactory and the following are the main features:

1. Approval of credit terms; approval and acceptance for quantity and type of merchandise.
2. Department originating invoices is divorced from custodianship and record keeping.
3. Goods are released only on receipt of approved orders (sales department approval to finished goods; finished goods department approval to shipping).
4. Internal check points correlate sales order, sales invoice and shipping report.
5. Independent accounting control over accounts receivable and inventory.
6. All major documents prenumbered, cross referenced and numbers accounted for.
7. Proper approval of all adjustments.

Weaknesses disclosed in the system

A few minor weaknesses have been disclosed by our examination but they are isolated, infrequent, relatively unimportant and have been corrected. Our sales audit program therefore may be kept to a minimum.

Prepared by: A. Auditor

Date: October 1964.

TRB&S People Pass CPA Examinations

Boston—Everett Howe

Cincinnati—Richard Manheimer

Dayton—Joel T. Presby

Denver—Milton W. Bollman, Fred E. Martin, Richard L. Peterson, Allan M. Striker

Detroit—Armen Asher, Maurice G. Marr

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