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Audit Record of the Internal Control Survey

BY STEPHEN GILMAN

THE PUBLIC accountant who uses the present short form of report or opinion is committed to a review of his client's "system of internal control and the accounting procedures. . . ."

What are the purposes of that review?

One purpose is to obtain a general knowledge of the accounting procedure and personnel as bases for defining the scope of the examination. Another avowed purpose is to determine whether accepted "principles" and methods are being followed consistently. Also it is thought that such a review may uncover opportunities for financial irregularities by management, such as balance-sheet inflation for credit purposes or inventory manipulation for tax purposes.

While these objectives are important, and even though the accountant asserts that normal audit procedure will not necessarily disclose defalcations, it can scarcely be doubted that another purpose in making a review of internal control is to locate weaknesses in organization, methods, and internal audit which invite irregularities by employees.¹

Inclusion of the internal-control clause in the accountant's report is a recent development. Nevertheless the review of internal control probably dates back to the time when test checking first became popular.

There is an obvious relationship between (1) reviewing the client's system of internal control and internal audit, and (2) determining the program of test checking. The independent public

accountant has jealously reserved to himself all decisions as to such testing or sampling and vigorously insists that he need do no more testing than is necessary to satisfy his own judgment as a professional man. It naturally follows that the satisfaction of his judgment *must* depend upon a study of the client's system of internal control.

Lacking such a survey there can be no real basis for decisions as to the extent and direction of test checking in order to compensate for weaknesses.

Unquestionably the modern form of auditor's report demands not merely a general review of internal control but a systematic, deliberate, and comprehensive study; a study which is purposeful and specific as distinguished from mere "looking around" or random questioning. Furthermore, any such survey must be a continuous one, since the plan of internal control, while adequate on paper, may have broken down in actual practice, or, if the plan is inadequate and is supposedly compensated by internal audit, the internal audit may have become ineffective.

Need for a Written Record

Granted that the review of internal control should be systematic, deliberate, continuous, and comprehensive, there are convincing reasons for preparing a formal written record thereof.

Such a written record seems necessary for at least three reasons:

1. It provides evidence that the plan of test checking used was not determined by rule of thumb but rather was specifically designed as to coverage and amount to meet the particular characteristics of the individual client's organization and accounting procedure. Such information enables the partner or principal who reviews the working papers to

¹"In a well organized concern the principal reliance for the detection of such irregularities is placed upon the maintenance of an adequate system of accounting records with appropriate internal check and control." *Extensions of Auditing Procedure*, American Institute of Accountants, October 17, 1939, p. 4.

- achieve an informed judgment on the adequacy of the examination.
2. It provides a convenient method by which a senior in charge may refresh his memory at the outset of each recurring engagement or, if he is new to the client, it has an obvious educational value.
 3. It supports the accountant's testimony if litigation should arise from irregularities undetected during an engagement. When such legal proceedings require the accountant's testimony several years after an examination has been completed the value of such record as a memory refresher should be great.

Basic Requirements of Record

Before considering the various forms which a written record of the internal-control review may assume, there are certain fundamentals deserving brief comment.

An audit, narrowly considered, is concerned with the relationship between (1) transactions, (2) custodianship, and (3) record keeping. The familiar word "shortage" springs from this threefold relationship since a shortage is suggested when the recorded responsibility of a custodian is greater than the amount of the corresponding assets which he can produce upon demand. In other words, the concept of charge and discharge is a fundamental one which refers to the record-keeping function in relation to the flow of transactions as they affect various custodians of money or other assets.

Because of the well known fact that any record of charge and discharge may be distorted by careless or improper accounting or may fail to give due consideration to such factors as collusion, multiple custodianship, improper patterns of organization, or lack of understanding by employees² of their obligations in relation to custodianship or

internal control, it becomes necessary for the auditor to examine the organization and the system of record keeping in relation to true accountability.

This discussion suggests a rhetorical question: Should not the record of the internal-control review be firmly tied to an asset classification and should it not be concerned primarily with the flow of assets from custodian to custodian?

This approach has certain obvious advantages, the foremost being that shortages are always shortages in assets (even though they may be concealed by manipulations affecting other accounting classifications).

Because accounting procedure alone cannot be relied upon fully to disclose accountability at every stage, it is necessary for the auditor to examine such related matters as the following:

1. The system by which incoming asset values first become matters of record.
2. The physical conditions of custodianship, i.e., access by unauthorized persons to properties theoretically under the sole control of one custodian.
3. The possibility of switching operations by a custodian, as where a cashier's actual shortage is concealed by his temporary borrowing from lodge or church funds for which he may be responsible as treasurer.
4. The apparent discharge of a custodian's accountability by credits based upon false evidence.

It is conceded that the most important tool for proper enforcement of accountability is an adequate accounting system which is so administered as to be a true and independent check upon all of those who are entrusted with or responsible for property.

It is the widespread recognition of

² In passing, it is suggested that such lack of understanding is rather common, particularly in the smaller business organization. As a result,

employees who are supposed to check one another may be reluctant to "tell tales out of school" or in aggravated cases may be innocent parties to a relationship having the effect of collusion.

this fundamental which justifies re-statement of an axiom of internal control, namely, that the functions of custodianship and record keeping must be kept separate in fact as well as in theory.

The practical application of this axiom is greatly affected by the relative portability, high unit value, and ease of realization of assets. The record of the internal-control review will accordingly emphasize not the flow of all assets but rather the flow of certain kinds of assets.

Tentatively, therefore, we may advance the following general proposition: The auditor's written record of the internal-control review should be classified primarily according to assets and should set forth the flow of assets into the business, their flow from custodian to custodian within the business, and their transmutation into other assets or their final flow out of the business, with emphasis upon the characteristics of such assets and upon the systems of accounting, internal control, and internal audit which attempt to establish accountability.

The record must be a practical one, giving due consideration to organizational faults which result from practical business considerations. It is a commonplace to say that these faults should be offset by adequate internal audit. Memoranda with respect to such internal auditing represent an essential feature of the record.

Furthermore, the record must be flexible since no survey of internal control is ever completed. Changes in personnel, changes in business methods, changes in accounting procedure, and changes in organization relationships are the rule rather than the exception. Often such changes occur almost unnoticed, with the result that the auditor must constantly check the effectiveness of internal control. This necessarily means that he builds a part of his survey record from day to day during the progress of his engagement.

TYPES OF RECORDS

Having tentatively outlined a basic viewpoint toward the survey of internal control, we may next consider various possible approaches to the recording problem, such as:

1. The questionnaire approach.
2. The check-list approach.
3. The organization-chart approach.
4. The accounting-record approach.
5. The flow-chart approach.

Some of these, such as the questionnaire approach, have been found to be practical in many instances. Others, such as the flow-chart approach, while somewhat promising, are still in the theoretical stage.

The naming of these specific approaches is, of course, not intended to exclude from the auditor's files such other helpful information as the client's accounting manual, if one exists; lists of authorized signatures; internal-audit instructions, working papers, and reports; notes regarding surprise checks as transcribed from the controller's calendar; and the like.

The Questionnaire Approach

If there is any standard method of recording the internal-control survey, it is the questionnaire. Various authorities have commented upon it and numerous firms are using it.

Often, however, the internal-control questionnaire is not well constructed. Sometimes it loses emphasis by being combined with questions and instructions not specifically related to the internal-control survey.

In other instances, appearing in the form of "general instructions," it includes the audit program, the internal-control questionnaire, and the time report in one unit.

Upon occasion the internal-control questionnaire is a single lengthy document. A modified approach was suggested by Fred J. Duncombe, at a round-table session at the 1940 annual

meeting of the American Institute of Accountants. Commenting upon the fact that the internal-control survey is not a project which can be completed at one time, he suggested the use of a preliminary questionnaire somewhat general in its nature, to be followed by detailed questionnaires relating to each separate phase of the audit procedure.

In addition to these variations there are marked differences in the methods of wording the questions. Often the questions are specific and capable of being answered by check-mark or merely "yes" or "no," as indicated by the following example: "Does the cashier have access to any of the ledgers?"

In other instances questions are general in nature, such as "How are cash sales handled?" The responses to such a question are apt to be unsatisfactory. The form of the question invites a rambling reply and one which must be scrutinized for omissions of significant steps in procedure.

A popular method of constructing an internal-control questionnaire is to classify the questions according to various types of assets. Thus, one group of questions will be concerned with cash, another with securities, another with accounts receivable, and another with inventories. This type of classification, as has been intimated, is logical. It is, however, apt to be inadequate unless the concepts of the flow of assets and sequence of procedure are added.

Obviously if there were no movement of assets the problems of internal control would be few in number and simple in nature. Flow and sequence are important but the questionnaire form is not well adapted to recording them.

Conceding that the questionnaire approach has been tested by practice and has been found to have real value in certain respects, nevertheless inherent disadvantages may be noted.

Somewhat important is the matter of size. To be of real value any printed questionnaire must be a lengthy one in

order to cover a great variety of situations. In certain engagements or in dealing with certain types of clients the amount of time required to answer all of the questions may be out of proportion to other phases of the engagement.

Even more important is the danger that a detailed questionnaire may tend to put a strait jacket on the auditor's imagination and resourcefulness.

Finally, it is difficult to design questions which will elicit truly informative replies.

Check-List Approach

The check list differs from the questionnaire in that it does not call for a specific answer to every item, i.e., items not applicable to a particular engagement.

The check-list approach is admirable as the basis for constructing individual audit programs. Similarly, by analogy, it would appear to be a useful device for constructing individual internal-control questionnaires specifically adapted to one client.

The check list, however, does not fulfill the requirements for an actual record of the work done in reviewing internal control. Rather, we must consider it merely as a preliminary tool.

Organization-Chart Approach

It is not unusual to find organization charts among audit working papers. Often, however, the exact uses of such a chart remain undefined.

There can be little doubt that an organization chart added to the other papers in the permanent file has a certain general informational value but the specific relationship of such a chart to the internal-control survey has seldom been stressed sufficiently. As generally used it probably does little more than to show the more basic organization faults such as, for example, the domination of the general accounting department by the treasurer of a cor-

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poration, or the domination of the credit department by the sales manager.

For the purpose of an internal-control survey the organization chart should be presented in greater than usual detail, including not only departments but divisions of those departments and in some instances individuals. Specific functions such as mail opening, cashier operations, accounts-receivable bookkeeping, receiving, and shipping are among the important elements which should be set forth on such a chart. This may mean that the organization chart for the auditor's file must be specially constructed. While often a worth-while task, it may be time-consuming, particularly when preparation of the chart is entrusted to a staff member unfamiliar with such work.

The organization-chart approach suffers from the same defect as the check-list approach in that the chart represents a tool preliminary to the survey rather than serving as a record thereof. Only too often, therefore, the inclusion of an organization chart in the permanent file must be thought of as having little more than general informational value.

Accounting-Record Approach

It is common practice for the auditor to obtain a list of the client's accounting records, together with the names of those responsible for keeping and auditing them.

If such a list is supplemented by two additional lists and the three lists are properly annotated and cross indexed, a practical survey record may result. The two additional lists required are:

1. A list of those persons having responsibilities as custodians of valuable assets. If the list is prepared according to some logical sequence, so much the better. In accepting such a list prepared by a client, however, the auditor will be alert for missing steps in the chain of custodianship.³

2. A list indicating the origins of accounting documents representing the first records of valuable incoming or outgoing assets (cash-sales tickets, inventory-shortage requisitions, shipping authorizations, and the like).

By cross-checking these lists with particular reference to the individuals named and organizational or other relationships between them, and with further reference to shifts caused by rotation policies, vacation schedules, illness, and noon-hour reliefs, a practical and informative record should result.

A variation of this plan starts with a list of employees and their duties. The duties are then scrutinized from the viewpoint of internal control.

Another variation starts with an extra copy of the client's printed booklet or book of accounting instructions which may be annotated with appropriate internal-control information.

Any of these plans has a definite advantage in that the required lists may be furnished by the client. In addition this approach is to be preferred to the questionnaire because it is individual to each client and also acts as a stimulant rather than a brake to the auditor's imagination.

Flow-Chart Approach

If an engineer were to undertake a survey of internal control he would probably employ some variation of a flow chart.

Conceivably he might use the accountant's columnar working paper for this purpose, reserving one sheet for

³ Many businessmen consider financial irregularity to be most common in relation to office work. An extensive statistical study made by the United States Fidelity and Guaranty Company, however, indicates that more than half of the number of embezzlements are committed by branch managers, salesmen, or other company representatives. Only about two out of every ten embezzlers are office men as the term is generally applied, i.e., treasurers, secretaries, accountants, bookkeepers, paymasters, cashiers, and timekeepers. See *1001 Embezzlers*, United States Title and Guaranty Company, Baltimore, Md., December 22, 1936.

each of the several important accounting routines. On the left side of each such sheet he might list operations in their proper sequence. Each separate column might be headed with the name of an individual record keeper or custodian. The intersections of lines and columns, where significant, would then be checked and annotated.

There is perhaps real merit in this engineering approach if we agree to an assumption previously made, namely, that the record of the internal-control survey must be tied up to the flow of assets and the corresponding pattern of recorded charges and discharges. By this assumption each individual is relegated to his proper position in a large scheme of shifting values, an essential element of that scheme being the concept that a discharge of custodianship at one point must (1) be compensated by a charge at another, or (2) be properly evidenced.

The flow-chart approach, therefore, has one great advantage, namely, that it provides a moving picture of inter-related procedures that cannot fail to stimulate the auditor's imagination.

The more or less graphic showing of strong and weak links in the system of internal control, as modified by the program of internal audit, provides a logical supportable basis for deciding upon the extent of each test check.

In considering the practicability of such a flow chart certain obvious ideas present themselves, such as the use of distinctive check-marks, cross-indexing designations and footnote references at appropriate intersections of lines and columns. By means of such techniques may be recorded the auditor's opinions regarding (1) methods, and (2) danger points which will require his special attention.

The flow-chart approach has, of course, certain definite disadvantages. One practical disadvantage lies in the fact that many good accountants dislike graphic methods or are unfamiliar with

charting technique. An additional disadvantage lies in the fact that such charts emphasize regular and recurring procedures and often fail to reveal exceptions, whereas in auditing it is the exceptions which may be of greater importance.

Occasionally the flow-chart approach may be impractical, particularly where there are numerous channels of flow as in certain retail establishments or in widespread branch operations. Under such circumstances the construction of numerous flow charts would be burdensome and unnecessary in view of the standardization of procedure and the constant program of internal audit characterizing such situations.

Finally, the charting procedure fails to supply answers to certain general questions of policy and administration.

No more than any of the other methods, therefore, does this one represent a sole approach to the written record of the auditor's survey.

CONCLUSION

Based upon certain stated assumptions we have considered five possible approaches to the important auditing record of the internal-control survey. If the assumptions are correct none of the approaches represents an ideal solution.

It remains, therefore, to consider combining them.

In doing so we must necessarily theorize, it being doubtful whether sufficient time has elapsed since the adoption of the present form of accountant's report to permit any serious experimentation. However, by weighing the advantages and disadvantages of each proposal and combining the proposals accordingly, a practical solution to this important problem may involve the following:

1. A fairly short general questionnaire to be filled in at the start of an engagement.
2. Lists of procedures, records, record keepers, and custodians furnished

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by the client. From such lists, under proper circumstances, may be prepared the flow charts necessary to reflect the movements of valuable portable assets.

3. Classified check lists or questionnaires, each relating to a separate feature of the audit, to be used as the basis of a running record during the progress of the engagement.

The general questionnaire under this plan need not be lengthy, since it should be limited to broad, general questions of more or less permanent significance, such as those having reference to the deposit safeguards, the origination and approval of noncash credits to customers' accounts, rules in force regarding the cashing of checks, the signing of blank checks by officials for emergency purposes, policies referring to purchases made on behalf of employees, policies regarding bonding employees, vacation and rotation policies, and the like.

The second record may be more specific since by one means or another it sets forth accounting procedures in relation to the responsibility and accountability of custodians. If we follow the recommendation of Frank G. Short,⁴ the preliminary questionnaire and the detailed outline of procedure will be referred to at the beginning of each recurring examination and also will be brought up to date during each such examination.

By adopting this suggestion the permanent file will contain full information regarding the basic plan of internal control. This information must, of course, be supplemented by notes and memoranda having to do with the current effectiveness of internal control in practice. Such notes, whether made on a questionnaire or in narrative form based upon a comprehensive check list, should be specific as to procedures in-

involved, client's employees concerned, dates, tests made, and conclusions.

If limited to such matters these papers may, as Short suggests, find their resting place in the current files. Prior to final filing, however, it would seem a wise precaution to check over the notes to see whether any should be posted to the basic papers in the permanent file.

As to whether papers in the third classification above should be in the form of printed questionnaires or should be prepared with particular reference to the peculiarities of each engagement is a matter for individual judgment. In view of certain objections to the printed questionnaire method, there is something to be said for employment of an adequate check list as basis for preparing a specially written questionnaire.

Many may regard a full record of the internal control survey as unnecessary, preferring to rely upon the proved resourcefulness and ingenuity of their supervising accountants. In partial rebuttal of this viewpoint the following points may be raised:

1. By signing the present form of opinion the independent public accountant asserts that he has made a review of the client's system of internal control.
2. By implication he asserts that he has made a systematic deliberate review.
3. The making of such a review is in itself a time-consuming operation which, if done adequately, requires reference to check lists, the asking of questions, the procuring of information as to the flow of values, and finally checking the practical working out of internal control in practice. The written record of the internal-control survey need be little more than a by-product of the survey itself.
4. The advantages of a written record to support the test-checking program, for staff educational purposes, and to serve as a protection in case of future litigation, are obvious.

⁴Short, Frank G.: "Internal Control from the Viewpoint of the Auditor." *THE JOURNAL OF ACCOUNTANCY*, September, 1940, p. 230.