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# Auditing and Internal Control

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## INTRODUCTION

No other single factor is more important than internal control in shaping the design of the audit. It affects both the type and the amount of work that is done. An audit is largely custom-made, judgment concerning the effectiveness of internal control being the principal feature of the pattern from which it is tailored. Unlike most other cases of design, however, the audit is carried on as the pattern itself is being formed.

Improvements in recent years in systems-techniques and in ways of making the internal organization more effective has permitted the emphasis in auditing to shift importantly from verification of transactions and balances to appraisal of internal control. The overriding purpose, of course, has not changed. Ascertainment of the likelihood that the records can be relied upon to furnish a reasonable basis for a fair presentation in the financial statements when viewed as a whole, continues to be the principal aim of the usual audit. The amount of work that auditors ordinarily do today in connection with cash, for example, is in part a carry-over from the period when detail checking was the main part of the audit. Verification of transactions and balances undoubtedly will play a diminishing role as general understanding of the limits of the usual audit widens.

## AUDITING STANDARDS RELATING TO SURVEY OF INTERNAL CONTROL

The significance of internal control in shaping the audit is recognized in the literature. For example, the second standard of field work set forth in "Generally Accepted Auditing Standards," a special report by the Committee on Auditing Procedure of the American Institute of Accountants states, "There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing proce-

dures are to be restricted." This standard recognizes that the study of the system of internal control is central to the audit.

You will recall that the standard short-form report, in its earlier days, in describing the scope of the examination, included a statement that the auditor had reviewed the system of internal control. As acceptance of the standard concerning evaluation of internal control grew and as general understanding of its significance widened, the importance of referring to it in the ordinary report diminished. Accordingly, internal control is seldom mentioned today.

The reasons for the increasing importance of internal control have their roots in the evolution of business. Multiplicity of products and locations and intricacy of specialized skills and techniques in production, distribution, finance, and research require that control be obtained through internal checks, separation of duties, and the like, rather than through personal supervision. This demand has provided an impetus to the development of improved methods of internal control.

#### PHASES OF INTERNAL CONTROL WHICH CONCERN THE AUDITOR

Acceptance of reliance on internal control as the basis of an audit requires a general understanding of the phases of internal control which concern the auditor.

Increasing emphasis in recent years on various aspects of scientific management have caused a broadening, in management circles generally, of the matters constituting the system of internal control. For example, it is frequently referred to as comprehending, among other things, budgetary control, standard costs, periodic operating reports, statistical analyses, personnel training, quality control, and time and motion studies. The purposes served by some of these tools are, of course, significantly different from those served by the methods and measures which are adopted to safeguard the assets of the business and to insure the accuracy and reliability of its accounting records. The former are designed to control operating efficiency, and are concerned with such things as maintaining the desired level of income, realizing a fair rate of return on investment, and achieving an effective allocation of resources — all of which are important to the attainment of satisfactory operating results, but unrelated to the fairness of a financial presentation.

I understand the Committee on Auditing Procedure of the Amer-

ican Institute of Accountants is considering ways of enlightening the business public generally as to the particular phases of the broad view of internal control which are considered by the independent certified public accountant as he undertakes to ascertain how reliable the accounting records are. I think this should be done. An auditor cannot be expected to assume responsibility for the investigation of phases of the internal control beyond those directly related to accounting matters. He may, and in most cases he undoubtedly does, make general inquiries concerning other facets of the internal organization, but he does this incidentally, in obtaining background information about the concern he is examining, to assist him in his consideration of accounting matters. He does not make a professional evaluation of the training program for new employees, of the method of controlling quality of product, and the like. All who have occasion to use the reports of independent certified public accountants should understand this clearly.

#### FACTORS IN APPRAISAL OF INTERNAL CONTROL

Survey of internal control ordinarily comprises physical observation of facilities, inquiry of employees and others, examination of evidential matter, test of underlying documents, and evaluation of the whole. To state these factors in any order belies their interdependence, but to recognize their unique characteristics facilitates understanding of the broad-judgment base upon which the audit is built.

Observation entails, among other things, seeing the plant lay-out, the movement of goods, and the physical circumstances in which the enterprise carries out its business transactions. Inquiry involves talking with key-personnel and other employees about various matters, knowledge of which may not be obtainable by observation. Examination comprehends looking at evidential matter originating within and without the enterprise, to ascertain authenticity, points of approval, internal checks, the flow of documents, and the like. Test involves selecting documents, records, entries, footings, or transactions, and proving the reliability or authenticity of those selected. Evaluation concerns gaining a perspective to see how all of the elements of the system fit together, and means appraisal, which in turn implies judgment. Judging internal control implies rating its effectiveness.

Too much reliance on observation and inquiry and too little on examination and test may be ineffective. Too little observation and in-

quiry may, on the other hand, result in too much examination and test, and perhaps the wrong kind. Balance is important.

These steps are not taken in any particular sequence. And the auditor is observing and appraising at every step. Moreover, they are woven into the audit itself and frequently lose their identity as separate activities. Individually, or in combination, however, they are likely to be meaningless unless the auditor satisfies himself that the system actually operates in the way intended.

In other words, the survey of a system of internal control, especially in a smaller organization, is to a large extent a process of trial and error. The auditor inspects the premises — observing, incidentally, not only interesting manufacturing processes and the like, but also the flow of paperwork and the care taken with it by the employees — and asks questions. He thus forms an impression of the system of internal control, and decides upon the kind and degree of examination and test which appear to be called for. He then proceeds with this work. The results may confirm his initial impression. Or they may raise suspicions in his mind, or indicate that the system is not operating as intended, in which case he may have to extend his work in order to satisfy himself.

I hope I have made clear the desirability, in the ordinary audit, of integrating the survey of internal control with the other audit work. They usually are inseparable. Work done in surveying the internal accounting arrangements helps the auditor to form an opinion as to the fairness of items in the financial statements, and examination and test of evidence underlying such items aid him in arriving at a conclusion as to the effectiveness of the internal control.

I hardly need say that only a thoroughly experienced accountant should be assigned the responsibility for the survey of internal control.

#### RELATION OF INTERNAL AUDITING TO INTERNAL CONTROL

Internal auditing is an element of internal control, or at least it should be viewed as such by the outside auditor. His survey of internal control should include a study of internal auditing and an appraisal of the reliability of its results.

Developments in internal auditing probably have done more to reduce the extent of the tests made by the outside auditor than to change the nature of his procedures. This is understandable. Internal auditing

is designed primarily to safeguard the assets of the enterprise, to prevent or to detect errors and irregularities, and to ascertain that managerial policies are being observed. Outside auditing, on the other hand, is designed ordinarily to enable the independent certified public accountant to judge the fairness of the financial statements taken as a whole. He is concerned with the accounting principles underlying the statements, the consistency of their application, and the reasonableness of the amounts shown in the statements.

Because their main purposes are different and because the independent auditor must satisfy himself, no matter how clearly separated internal auditing may be from other internal departments, his auditing procedures, at least as to nature, ordinarily are unaffected by variations in the types of work done by the internal auditor. There may be significant variations, however, in the extent of his tests.

This may call for a little elaboration. I am not concluding that the independent auditor should repeat, for example, the details of an analysis already made by the internal auditor, simply because the attitude of independence must be brought into the work. If the internal auditor has analyzed a particular account and the independent auditor deems it necessary to satisfy himself concerning the same account, he may do so by studying the procedures followed by the internal auditor in making the analysis, and by checking, perhaps on a test basis, the internal auditor's working papers. Having done so, the independent auditor may feel that no further steps are necessary. He has satisfied himself; he has made maximum use of the work of the internal auditor.

#### WHEN TO MAKE THE SURVEY OF INTERNAL CONTROL

Study of the system of internal control ordinarily should be undertaken in planning the work on an audit. As stated in "Generally Accepted Auditing Standards", previously mentioned, in discussing the planning of field work, "The review of internal control is one of the most important of the steps in proper planning of the audit and must not be casually undertaken or carelessly performed." Except in very small engagements, this usually can be done advantageously as interim work prior to the end of the year.

Reliance on internal control, rather than on verification of transactions and balances, as the basis of an audit, ordinarily permits the auditor to do a considerable amount of interim work. This, of course,

yields benefits to the client as well as to the accountant. Where the accountant has reason to believe the internal control is good, he can complete an important part of his examination before the end of the year.

In such circumstances he should, of course, satisfy himself at the end of the year that there has been no weakening of the controls and no lapses in their application since the interim survey. In some instances this may require a greater aggregate number of tests of the records than where all of the work is done at the end of the year, but the benefits of earlier and thus more timely consideration of the affairs and operations of the client, away from the pressure of year-end work, usually are significant.

#### MAKING A RECORD OF THE SURVEY OF INTERNAL CONTROL

All of us, I am sure, have considered at various times the question of the type of record most useful in connection with the study of the system of internal control. There are several purposes served by such a record. It lends assistance to the staff accountant who is directing the survey in the field and supervising other staff accountants. It furnishes a concise over-all view of the system as an aid to evaluating its effectiveness. It furnishes an adequate, but not excessive, record for review by the principal who is responsible for the audit. He will wish to know that all important matters were considered in making the survey and that the auditing steps taken and the tests made were adequate and reasonable in the circumstances.

Some accountants like to prepare a memorandum concerning the internal control, describing the organization, the internal checks, the flow of papers, and other such matters, and, of course, referring to the points at which control may be missing, or nearly so. Those who prefer this approach apparently feel that to write such a memorandum the accountant in charge of the field work must have a thorough understanding of the system as a whole and of its interrelated parts. They feel further that the chances of a perfunctory study are lessened if the person making it is required to write intelligibly about what he did and what he found.

Other accountants prefer to use a formal check-list or a questionnaire. They think there are important common characteristics of systems of internal control and the chances that all significant features will be considered are strengthened if a standard form is used to call

attention to them. Moreover, they believe less time is required to accomplish an equally effective evaluation if written guides are furnished.

I shall outline briefly my own preferences. In a small concern where most of the bookkeeping is done by one person, there being practically no internal control, it seems to me that a brief handwritten memorandum should suffice to set forth the essential information as to the examinee's records and the lack of effective internal control. But in medium- and large-sized engagements, I prefer some kind of formal check-list or questionnaire.

At this point let me say that in auditing work generally, I do not like rigid standard questionnaires, work programs, or check-lists which purport to be all-inclusive and to be suitable for universal use. I think anyone using them runs the risk of doing too much work, or too little work, or the wrong kind of work. On the other hand, I do favor flexible standard forms which are designed to suggest rather than to prescribe procedures, and to provoke rather than to stifle thought. With these as a foundation, the peculiar requirements of each engagement can be met.

#### INTERNAL-CONTROL QUESTIONNAIRE

I have used the questionnaire approach in evaluating the system of internal control for a good many years.

An internal-control questionnaire of the kind I have found satisfactory covers several pages. Each page is devoted to one of the usual major accounting and custodial activities of a business enterprise, and contains space for the names of the pertinent officers and employees, or departments, and questions, together with certain explanatory material, relating to the more important functions within each activity.

The questions are designed to focus attention on particular points at which internal control may be weak, so as to facilitate concentration of testing on the specific records affected and to eliminate unnecessary auditing of records which are adequately controlled. All questions are stated so that an affirmative answer indicates a satisfactory situation as to control and a negative answer indicates a bad or weak situation. Some of the questions relate to simple facts, such as whether the employees who process suppliers' invoices have access to cash or to inventories. Most of the questions, however, relate to the auditor's opinion as to the examinee's accounting in certain respects, and are



designed to make him think about the possibilities before expressing himself. For example, one question is as to whether the preparation of sales invoices is controlled to prevent errors and irregularities. The explanatory material referred to above sets forth some of the more usual means of obtaining effective control over various functions and records, and is intended to aid the auditor in formulating answers to questions of this kind. The form has a liberal supply of blank space for explanations, suggestions, and other uses.

Space is provided for the auditor to express his over-all conclusions concerning the internal control as to each activity of the business, based upon his findings as developed through answering the questions. In those cases where there is some weakness or lack in the internal control he is expected to state the respects in which this is the case, identifying the specific procedures followed by the examinee which are not good, or the points in the examinee's routine where the control is weak or lacking. He should identify also the accounting records involved, upon which attention may need to be focused in selecting the audit procedures and determining the extent of tests.

Where the use of the questionnaire is feasible in smaller organizations it usually is filled out as far as practicable at the outset of the engagement. In larger organizations it may be filled out part by part, in each case just prior to and in conjunction with taking up the related audit work with respect to a given activity of the business.

#### SUPPLEMENTING THE QUESTIONNAIRE

In any case, the auditor must satisfy himself, not only by careful inquiry, but also by inspection of the records, and as far as practicable by actual observation of the procedure, as to the routine actually employed. Knowledge acquired by questioning the examinee's employees at the outset of the work should be considered subject to substantiation by other means as the examination progresses. It is not sufficient to accept a casual explanation of the routine followed.

The auditor also must consider the probability of changes in routine and personnel during the period under examination, including temporary changes due to vacations and other absences of individuals. It is not enough to accept only a description of the situation existing at the time of taking up the work.

In evaluating the effectiveness of internal control for the purpose

of deciding upon the extent to which various audit procedures should be applied, the auditor should be concerned not only with possible combinations of duties which would permit concealment of irregularities single-handed. He should be concerned also with the possibilities of collusive action. He should consider also the possibility that important errors might exist in the records, which, although not due to fraud, might result in inaccurate or misleading financial statements.

In investigating the various routines and procedures, the auditor should consider carefully the extent to which unusual or infrequent transactions are controlled. For example, there may be adequate controls over regular sales of merchandise but virtually none over occasional sales of damaged or obsolete items, waste, salvaged materials, etc., which may be likely to involve currency receipts. There may also be well-established procedures for controlling disbursements in payment of vendors' invoices, but these procedures may not be applied to disbursements representing transfers between banks, expense-fund advances and reimbursements, loans to employees, etc.

The auditor must exercise a high degree of judgment in analyzing the effect of any deficiencies in control. In each case where the situation is not good, he must consider carefully the possibilities of irregularities or errors being perpetrated. Nevertheless, he should do this with the practical aspects of the situation well in mind. The existence of alternative controls may justify dispelling any misgivings that have arisen. For example, a theoretically bad situation exists if the person who prepares sales invoices also has access to cash. But there need be no particular concern if the cash to which such access is had consists of a small petty cash fund, or even if it consists of incoming collections, provided such collections have been listed for control and there is adequate independent accounting for the sales invoices. Furthermore, bad situations occasionally will appear to exist as the result of a bookkeeper's participating in the performance of several accounting functions by virtue of preparing several different records on mechanical bookkeeping equipment. But this situation is not necessarily bad if there are adequate controls over the use of the equipment.

An important consideration in the evaluation of a system of internal control is whether or not the prescribed procedures are being effectively carried out; that is, whether the records are adequate, whether the employees (including supervisory personnel) are competent, and whether errors, discrepancies, and other irregularities developed

during the work are being properly followed up. The auditor should consider whether the duties and responsibilities of the various departments, as well as those of individual officers and employees, are clearly fixed and defined, whether officers and employees are required to take vacations annually, and whether accounting employees are rotated where practicable. He should consider whether irregularities might occur where executives are also executives of other businesses or where employees known to be related to each other are in key-positions. If the records appear to be ill-adapted to the needs of the business, if they fail to provide essential information readily, if they are maintained in a slovenly manner, there are opportunities for manipulation that do not exist, other things being equal, where the opposite conditions prevail. In a department where the bulk of the work is done by apparently underpaid, incompetent, uninterested clerical help, there are possibilities of irregularities that do not exist where the contrary is the case. A domineering supervisor may be able to impose his will on a group of below-average clerks and cause records to be manipulated to his advantage. If errors and the like are not properly followed up and corrected when they are developed, if the import of irregularities is not sensed by the employees who work on the records, latent dishonesty may be encouraged. Things such as these should be constantly in the mind of the auditor in making his survey of the system of internal control.

In order that the questionnaire be used most effectively, the contents, or the pertinent portions thereof, should be made known to the assistants performing the audit work on the related activities. The accountant-in-charge should be sure that his assistants are thoroughly familiar with the situation and the implications therein, and with the audit procedures necessary to uncover fraud which may be perpetrated or errors which may be made because of system deficiencies.

### FIRST AUDIT

The purpose of surveying internal control in a first audit is the same as in repeat audits. It is possible, however, that some of the work done the first time will not have to be repeated subsequently. But the degree of satisfaction the auditor wishes to gain concerning the effectiveness of the system does not change from year to year. In a subsequent audit, therefore, he should make maximum use of the work done

in earlier years, and should do enough additional work to ascertain either that the operative controls have not changed or, if they have, what the changes are.

Addition of a column for the current year, to the completed questionnaire for the earlier year, may be desirable in assisting to achieve this end. It may have the disadvantage, however, of tempting the accountant to assume, rather than encouraging him to ascertain, that conditions of control have not changed from one year to the other. Nevertheless, it usually is a practical way of accomplishing a desired end. In any event, a new form should be prepared every few years, or when there is a change in accountants in charge of the engagement.

### SITUATIONS IN WHICH INTERNAL CONTROL IS WEAK

Throughout the foregoing I have assumed the existence of a system of internal control, which, although not perfect, nevertheless is reasonably effective. What does the auditor do when there is no internal control, or when he finds that the system is weak in important areas?

For one thing, he may have to extend his examination and test, and apply additional procedures. Answering the questions of how much more examination and test and what other procedures are appropriate, frequently taxes the auditor's ingenuity to the limit.

Where the internal control is weak — and this includes cases where it is weak because small size prevents the establishment of effective internal check — special attention should be given to analytic review. This means study of the situation. It means comparison of items that should be comparable, and investigation of discrepancies. It means a business man's consideration of conditions.

Furthermore, early in any audit, the auditor should take whatever time is required to call to mind all of the points at which it is most likely that irregularities might be perpetrated, and the steps that might be taken to conceal them. These areas should have special consideration during the progress of the work. These are the areas in which the amount of detail work may have to be extended. They are the points at which the auditor should search for signals that something is wrong.

The internal controls commonly found in large and medium-size concerns may be wholly absent, or almost so, in a small concern. The

exercise of close personal supervision by the owner of the small business, however, may furnish reasonably effective control.

There are circumstances, of course, in which there is nothing the auditor can do practicably to satisfy himself. In such a case, he may have to qualify his opinion, or even to disclaim an opinion.

Where the area affected by weakness in the internal control is small and relatively unimportant, the auditor probably will not have to take notice of the matter in expressing his opinion. However, prudence usually requires that he either satisfy himself, by extending his work, or come to an agreement with his client, preferably in writing, limiting his responsibility

Important traits for the auditor are alertness and the ability to sense the unusual. Equally important is the capacity to judge the circumstances in which test of the accounting records should be extended. Statistical sampling may hold some promise for the future as an aid to the auditor in resolving this important question. In theory, however, it cannot do more than furnish him with a measure of sureness for a given amount of sampling. Its application in practice today is quite limited. Further extension of random sampling apparently awaits resolution of a number of problems.

In short, it seems likely that the auditor will always find it necessary to bring to the engagement an imaginative and inquisitive mind and an ample measure of good common sense.

#### REPORTING WEAKNESSES IN INTERNAL CONTROL

The examinee usually expects his auditor to report material deficiencies, and to recommend improvements, in the system of internal control. For his own protection, the auditor usually finds it desirable to place himself on record with his client concerning significant weaknesses in the internal accounting arrangements.

Sometimes the auditor does this in his long-form report. I think, however, that comments of this kind are more likely to be effective if they are set forth in a separate letter or memorandum. Of course, any comments the auditor makes in a separate document should not be of such a nature that, when considered with his report, they would tend to cast doubt on the reasonableness of his opinion. Ordinarily, such a separate letter or memorandum might be addressed to the chief accounting officer of the examinee. There may be circumstances, nonetheless, in which the nature of the deficiencies in the system or the

possibilities of collusion at higher levels of management are such that it should be addressed to the president of the company, the chairman of the board, or some other such individual.

I am sure all of us have had the experience of having our recommendations concerning improvements in the system go unheeded. In such circumstances, should the recommendations be repeated, and, if so, for how many years? A categorical answer to this question is not meaningful. In some cases, particularly where it seems unlikely that personal discussions with officers and key-personnel would be fruitful, it may be desirable to repeat the substance of the recommendations over a relatively long period. In extreme cases, where the officers of the examinee have been disinclined to consider repeated recommendations for improvements, the auditor may find it necessary to call them to the attention of the board of directors or one of its committees.