CHAPTER

INTERNAL CONTROL SYSTEM

Introduction

4.1 The second phase in the audit process, as stated in Chapter 3, is concerned with the study and evaluation of the client's internal control system. Such an evaluation is required to determine the nature, extent and timing of audit procedures to be used during the examination of the financial statements.

Meaning and nature of internal control system

4.2 SA 315, *Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment,* defines internal control as,

(i) The process designed, implemented and maintained by those charged with governance, management and other personnel;

(ii) To provide reasonable assurance about the achievement of an entity's objectives in following categories :

(a) reliability of financial reporting,

(b) effectiveness and efficiency of operations,

(c) safeguarding of assets, and

(d) compliance with applicable laws and regulations.

Features

4.3 The following points emerge from above definition

- It is the *responsibility of those charged with governance and management* to lay down an internal control system.
- The controls generally, *most relevant* to audits are those that pertain to the entity's objective of preparing financial statements to give a true and fair view of state of affairs and profit (loss) of the business (is category (a) above).

- *Controls over operations and compliance objectives* [categories (*b*) and (*d*) above] *may be relevant* if they pertain to data the auditor evaluates or uses in applying audit procedures, e.g., cost date generated by cost accounting system may be used by the auditor to ascertain the truthful and fairness of valuation of closing stock. Thus, related controls in become relevant.
- Controls to safeguard assets [category (*c*)] include aspects such as safe-guarding them from unauthorised use, limiting access, taking adequate insurance coverage, etc. The auditor's responsibility with respect to safeguarding of assets is limited to those controls that are relevant for assessing the reliability of financial reporting. For example, the company's use of passwords for limiting access to account receivable data files may be relevant to the auditor but quality controls over production may not be of much interest to him.

Inherent limitations of internal control (as laid down by SA 315)

4.4 No system of internal control can be good enough to ensure accomplishment of all the objectives mentioned in the definition of internal control. This is because of the following limitations :

(*i*) **Potential of human error** - The potential of human error due to employee carelessness, misunderstanding of instructions and errors in judgment have an impact on the effectiveness of internal control system.

Example : The finance manager did not adequately review the documents attached to the voucher for reimbursement of medical expenses claimed by assistant manager sales. The result was payment of certain bills without the required prescription by the doctor actually being submitted.

(*ii*) **Breakdown can occur** due to human failures such as simple errors or mistakes.

(*iii*) **Possibility of collusion** - One of the fundamental principles in the design of an internal control system is the segregation of duties of employees. If two or more employees recording different aspects of a transaction collude, the effectiveness of internal control system will be compromised.

Example : A, who had custody over incoming cash receipts, colluded with B, who was responsible for processing and recording those receipts, to misappropriate cash by non-recording of cash receipts.

(*iv*) **Manipulations by management** - The internal control system is devised and maintained by management. Manipulation in accounts and misappropriations perpetuated by members of management responsible for monitoring the control structure cannot be detected or prevented by the control system.

Example : A company has a reliable system for recording credit sales and a proper segregation of duties between billing and accounts receivable clerks. The company's top management wanted the financial results to reflect sales growth. They instruct both clerks to record fictitious sales near the end of the accounting period, thus, undermining the utility of internal control system.

(v) **Management discretion** - The responsibility to choose internal control system lies with the management. It makes decision as to design and implementation of controls which may be inadequate.

Components of an internal control system

4.5 An entity's internal control system encompasses much more than entity's record-keeping procedures. It consists of the following components :

(i) **Risk assessment** : For financial reporting purposes an entity's risk assessment is its identification, analysis and management of risks relevant to the preparation of financial statements in accordance with relevant accounting principles. The following risks may affect an entity's ability to properly record, process, summarise and report financial data :

(a) Changes in operating environment

(b) New personal

(c) New information systems

(d) Rapid growth

(e) New technology

(f) New business models, products or activities

(g) Corporate restructuring

(h) Foreign operations

(i) New accounting pronouncements

(ii) **Information and Communication** - It includes the accounting system, consisting of the methods and records established to record, process, summarise and report entity transactions and to maintain accountability of the related assets and liabilities. To be effective, such a system must accomplished following transaction related goals—

(a) Identify and record all valid transactions

(b) Describe on a timely basis

(c) Measurement of proper value

(d) Record in the appropriate time period

(e) Properly present and disclose

(f) Communicate responsibilities to employees

(iii) **Control environment** - Control environment is the foundation of all other components of internal controls. It reflects the overall attitude, awareness and actions of the board of directors, concerning the importance of control and its emphasis in the entity. AAS-6 (revised) has mentioned some of the factors which influence the control environment. These are listed below :

Factor	*Example*
(*a*) Organisation structure	Segregation of incompatible functions helps in fixing accountability.
(*b*) Board of directors and their committees	A board which is independent of management or an effective audit committee points out to strong internal control environment.
(*c*) Management's philosophy and operating style	Management should not adopt policies that encourage company personnel to manipulate data.
(*d*) Management control system	A competent internal audit department and clear-cut hiring training; promoting and compensating policies for employees are indicators of strong control environment.

(iv) **Control procedures** - Control procedures are those policies and procedures in addition to control environment that management establishes to ensure that their objectives are achieved. Example include control procedures for—

(*a*) authorisation

(*b*) design and use of documents and records

(*c*) access to assets and records and so forth

(*v*) **Supervision** - Supervision involves continuous evaluation of system of internal controls by management to assure it is functioning as envisaged and modifications, if any, are done on a timely basis.

Internal control system and the auditor

Study and evaluation of internal control system

4.6-1 SA 315, "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment" has established the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements, through understanding the entity and its environment, including the entity's internal control. He shall —

- **Adopt risk assessment procedures** such as **enquiries of management** and others within the entity (which may assist him in identifying risks of material misstatement due to fraud or error); **observation and inspection** of entity's operations, documents, interim financial statements, plant facilities, etc. (may support enquiries of management and others); **assess the relevance of information obtained in prior periods** in present period;

and **hold discussion among the engagement team** about the susceptibility of the entity's financial statements to material misstatements.

- **Evaluate the design of the controls** relevant to audit and determine whether they have been implemented by performing audit procedures.
- Study **major components** of internal control system.
- **Identify and assess the risks of material misstatement** to provide a basis for designing and performing further audit procedures.
- If during the course of audit, the auditor's assessment of risk at ascertain level changes, he shall **revise the risk assessment** and modify further planned audit procedures.

4.6-2 Material weakness in internal control

a. The auditor shall evaluate whether, on the basis of the audit work performed, the auditor has identified a material weakness in the design, implementation or maintenance of internal control.

b. The auditor shall communicate material weaknesses in internal control identified during the audit on a timely basis to management at an appropriate level of responsibility.

c. The types of material weaknesses in internal control may include:
   - Risks of material misstatement that the auditor identifies and for which the relevant control is not existing or is inadequate.
   - A weakness in the entity's risk assessment process.
   - Material weaknesses may also be identified in controls that prevent or detect error or fraud.
   - In case of certain audit engagements, there may be additional communication or reporting requirements. For example, internal control weaknesses may have to be reported to the regulator.

4.6-3 Surprise checks (based on Guidance Note on Surprise Checks issued by ICAI)

- *Definition* - Surprise checks are checks on transactions which the auditor conducts without prior notice to the client.
- *Need* - These are incorporated in the audit programme to assess the effectiveness and reliability of internal control system. They also assure the auditor that the books of account have been kept up-to-date.
- *Where* - Surprise checks are considered more appropriate in certain cases, for example, where internal control system is weak and when the operations of the client are geographically spread. For certain types of accounts such as for verification of cash and investments surprise checks are very suitable.
- *Frequency* - Frequency of surprise checks is a matter of professional judgment of the auditor, But wherever possible surprise checks should be made at least once a year.

- *Communication of weakness to management* : If the surprise checks indicate some weakness in internal control system or any fraud or error or lacunae in the maintenance of books of account and other records the auditor should communicate it to the management and ensure that it has addressed the issues raised.

Internal check

4.7 Internal check is a valuable part of internal control. It is the built-in check in accounting process itself.

Definition

4.7-1 Paragraph 8.05 of the ***Guidance Note on Terms used in Financial Statements*** issued by ICAI defines it as,

> *"A system of allocation of responsibility, division of work and method of recording transactions, whereby the work of an employee or group of employees is checked continuously by correlating it with the work of others. An essential feature is that no one employee or group of employees has exclusive control over any transaction or group of transactions."*

Thus, internal check means the "arrangement of duties of staff in such a manner, that the work of one person is automatically checked by another during the course of carrying out, recording and processing a transaction."

Objects/characteristics of internal check system

4.7-2 From the above definition, the following characteristics of internal check system can be inferred :

(i) *Segregation of duties* : An internal check system helps in fixing up responsibility for particular acts or omissions by segregating the duties.

(ii) *Automatic checking of work* : The work done by one person is automatically checked by another. It ensures the reliability and accuracy of information produced by the accounting system.

(iii) *Division and rotation of work* : Every audit assistant gets the workload according to his capacity and qualification and the duties are rotated to break the monotony. It results in improving his efficiency.

(iv) *Recording of different aspects of transaction* : The internal check system divides the work among clerks in such a way that each aspect of a transaction is recorded by a different person. This helps in minimising and preventing errors.

(v) *Separation of custodial and recording functions* : Access to the books of account and other records and document is limited. Care is taken to ensure that the persons responsible for physical custody of assets (*e.g.* cashier) is not allowed to record any aspect of the transaction (*e.g.* no access to receivable records for cashier).

(vi) *Periodic review :* An efficient internal check system has procedures designed to review accounting records, work of employees and recording of transactions.

4.7-3 Advantages of internal check

(i) **Fixation of responsibility** - Internal check entails a proper segregation of duties among the staff of a business. As duties are well defined, it becomes easier to fix responsibility in case of errors and frauds. For example, in case goods are stolen from the stores, storekeeper can be held responsible.

(ii) **Increases efficiency of clerks** - Work is distributed according to qualification and experience of the clerks. Proper division of work leads to specialisation and, hence, increases efficiency of clerks to perform work.

(iii) **Prevention of errors and frauds** - No one person is allowed to record more than one aspect of a single transaction and work of each worker in the ordinary course is checked by other. This helps in preventing errors and frauds.

(iv) **Reliability of information** - The information generated in the entities, which establish an efficient system of internal check, is reliable and accurate. Consequently, the preparation of final accounts would be quick after the end of financial year.

(v) **Reduces the workload of auditor** - A reliable internal check reduces the extent of audit procedures and, hence, the workload of the auditor.

(vi) **Increases the profitability of the business** - By preventing errors and frauds and increasing efficiency of clerks, a good internal check system increases the profitability of business.

4.7-4 Disadvantages of internal check

(i) **Expensive** - Establishment of an internal check system involves additional costs. It is not advisable for a business, especially a small entity, if expected benefits are less than additional costs.

(ii) **Carelessness of employees** - Employees feel over confident that the work is being automatically checked and errors would be brought to their notice. Therefore, they may become less serious about their work.

(iii) **Does not reduce the risk of the auditor** - The internal check system may be relied upon by the auditor to reduce the extent of his audit procedures. But such reliance does not in any manner reduce the audit risk. The auditor's liability for negligence is also not affected.

To provide a safeguard against these disadvantages, the management should review the efficiency of internal check system from time to time.

Inter-relationship of internal control, internal check and internal audit

4.9-1 Internal control and internal check

(i) **Scope** - Internal control comprises the *whole system of controls*, financial or otherwise established by the management for the conduct of business. It includes internal check and internal audit besides other controls. But internal check refers to a *system of allocating duties* among the staff in such a manner that every person records a different aspect of a transaction. It is narrower in scope.

(ii) **Objects** - A system of internal control strives to achieve objectives such as adherence to policies and procedures laid down by management, safeguarding of assets, prevention and detection of errors and frauds, accuracy and completeness of records and timely preparation of reliable financial information. On the other hand, internal check system is designed to prevent errors and frauds and fixing responsibility and safeguarding assets. It is a part of internal control system.

(iii) **Flexibility** - Internal control system is *reviewed occasionally* by the management in the light of changes within the organisation, in the economic environment and suggestions of internal auditor and external auditor. But internal check once introduced in the business is generally *stable* for a certain period and, hence, less flexible as compared to internal control system.

(iv) **Example** - Internal control with regard to credit sales in an organisation would consist of internal check system, physical controls, authorisation procedures and review. Internal check system will comprise of allocation of functions among various departments-sales department (for accepting customer order); credit department (for credit approval); warehouse (for issue of merchandise); despatch department (for despatching goods) and finance or billing department (for billing customers).

4.9-2 Internal audit and internal check

(i) **Meaning** - Internal audit is an *independent review* of operations and records. While internal check is an *arrangement of duties* allocated in such a manner that the work of one clerk is automatically checked by another.

(ii) **Object** - The object of internal audit is to *detect* frauds and errors. But the object of internal check is to *prevent* frauds and errors.

(iii) **Staffing requirement** - Internal audit is carried out by *staff especially assigned* for it. At times, entities engage the services of professional auditors, to carry out the internal audit, in order to save cost. On the other hand, for internal check *no special staff* is required to be engaged.

(*iv*) **Timing** - Internal audit is a *post-mortem analysis* and starts after the completion of recording of transactions. But internal check is *simultaneous i.e.*, starts operating the moment a transaction is finalised and continues till all its aspects are recorded.

(*v*) **Submission of report** - Internal auditor submits his report to the *management.* While under the system of internal check, the statement relating to the transactions for the whole day is to be submitted by the clerk to *departmental heads.*

Internal check with regard to specific transactions

4.10 The management of an entity is primarily responsible for designing and implementing an efficient system of internal control. Such controls should be designed for all phases in processing of a transaction. An efficient internal control system should be based on following principles—

- *Segregation of functions or internal check* - Involves assignment of responsibility for a transaction in a manner such that the work of one employee is automatically checked by another. These should be designed at all the points of a transaction cycle.[1]
- *Authorisation procedures* - Designed to ensure that transactions are authorised by management personnel acting within the scope of their authority.
- *Physical controls* - Relate to (*i*) security devices and measures for the safekeeping of assets, accounting records and unused preprinted forms and (*ii*) use of mechanical and electronic equipments in execution and recording of transactions such as use of electronic cash registers for receiving cash.
- *Internal verification/internal audit* - Involves a review of accuracy and propriety of transactions recorded, by a person unrelated to and independent of personnel and the department involved in transaction cycle.

The following discussion suggests illustrative ways of designing internal check system for specific transactions in a typical manufacturing concern.

Credit sales

4.10-1 Internal check with regard to recording of sales is summarised in Table 4.1. The main points at which it should operate are mentioned below :

(*i*) *Accepting customer order* - The sales department receives *a purchase order* from a customer. Initial important steps include the registering

1. The term 'transaction cycle' refers to the policies and sequence of various procedures to be adopted for processing a particular type of transaction.

customer's purchase order, fixation of selling price and delivery dates, granting of any special discounts and preparation of *sales order.*[2]

(ii) *Credit approval* - Before sales orders are processed, the credit department must determine the creditworthiness of the customer. If the order is from an existing customer, checks must be made to ensure that the new order will not put the account beyond predetermined credit limit. In case of new customers, banks and trade references may be obtained along with reference reports of credit agencies. On being satisfied, the credit manager may initial or stamp sales order.

(iii) *Issuance of merchandise* - The storekeeper who maintains custody over inventory, issues the goods covered by the sales order to despatch department after the sales order has been approved by credit department.

(iv) *Despatch of goods* - The despatch department will be responsible for arranging space in railways, roadways, aircraft or ship. This department packages the goods. At the time of loading each consignment, *goods outward notes* may be created in duplicate which are numerically controlled. They are entered in the *despatch register* and one copy is surrendered at the gate and another is sent to the customer, which after being signed by the customer is to be returned to the company as proof of delivery. Acknowledgement of goods received and being transported by the carrier booked, which may take the form of *railway receipt* or *transporter's receipt* or airway bill or *bill of lading*, is obtained.

(v) *Billing customers* - After the despatch of goods, the customer is billed *i.e.* is notified about the amount due for goods delivered. This notification is done by billing unit of finance department or a separate billing department, if it exists, through preparing and mailing sale invoices at agreed price and terms. Before preparing *sales invoices*, it must match despatch documents with sales order and customer purchase order. The billing unit/department must also prepare daily summary of sales billed.

(vi) *Recording the sales invoices* - The clerk who maintains *accounts receivable/customers' accounts ledger* should be responsible for recording serially controlled sales invoices against appropriate debtors.

(vii) *Sending monthly statements to customers* - Most receivables are collected through mailed receipts and the names of the debtors who have paid are deleted subsequently. For the debtors outstanding, *monthly statements* should be sent out by a senior official to customer to verify that there is no overstatement of debts or understatement of remittances received.

2. 'Sales order' is a document to communicate the description, quantity and related information about goods ordered by a customer for the guidance of various departments including the credit, production or warehouse and billing and accounts receivable units of finance department.

(viii) *Granting of write offs and credits* - The authority to write off receivables and the approval of credit notes for sales returns should be vested with a responsible official. Stringent safeguards such as appropriate supporting voucher (*e.g.* correspondence with solicitors) and properly raised and approved documentation such as goods returned notes signed by sales manager and credit manager should be required for the exercise of this authority.

TABLE 4.1

INTERNAL CHECK WITH REGARD TO CREDIT SALES

Function	*Department or unit*	*Related activities*	*Documents or records*
1. Accepting customer order	Sales	Receives orders; fixes terms and conditions of sales; prepares sales order; and maintains unfilled order file.	Customer's purchase order; and sales order
2. Credit approval	Credit	Determines creditworthiness of new and present customers; sets credit limits for customers and obtains references from banks, trade and credit agencies.	Sales order (for stamping approval) customer credit files
3. Issue of merchandise	Warehouse or production department's warehouse unit	Maintains custody over inventory and issues goods to despatch department.	Sales order (for stamping the issue of goods)
4. Despatch of goods	Despatch	Undertakes packaging of the goods and arranges transportation for despatch.	Goods outward notes; acknowledgement issued by transporter; despatch register
5. Billing customer	Billing or billing unit of finance department	Matches despatch documents with sales order and customer's purchase order; prepares and sends sales invoices to customers and prepares daily summary of sales billed.	Sales invoice; sales journal; summary sales report
6. Recording the sales invoice and sending	Accounts receivable or accounts	Records sales invoices against debtors; records payments and sends state-	Cash receipts; monthly statements

Function	*Department or unit*	*Related activities*	*Documents or records*
statements to customers	receivable unit of finance department	ments to customers.	
7. Granting of write offs and credits	Depends upon the circumstances	To write off receivables and approval of credit notes.	Goods return notes; write off authorisation