Influence of Internal Control Upon Audit Procedure

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During the past few years renewed emphasis has been placed upon the consistent application of recognized accounting principles and conventions in the periodic determination of income and financial condition. Similarly, the full disclosure of material facts and the description of accounting methods pursued have become more important. These objectives are by no means new. They have been advocated for many years by the accounting profession. However, by reason of the passage of the securities and exchange acts it may be assumed that these factors have become prime considerations in the presentation of financial reports in this country.

Reliance Upon Internal Control

The transition toward full disclosure has given rise to many questions. To what extent, if any, must the public accountant enlarge the scope of his audit to meet present-day requirements? May he continue to rely, as in the past, upon the client's system of internal audit, or should he ignore the work performed by the client's internal audit staff?

Manifestly, the volume of business, even of medium sized companies, precludes the detailed examination of every transaction. The accounting profession, by long established practice, has recognized this fact and, therefore, restricts itself to reasonable tests as a means of passing upon the general accuracy of routine bookkeeping entries. It has been the accepted practice of public accountants to consider the adequacy of the system of internal check in determining the extent of the examination required to satisfy themselves as to the accuracy of the records. The securities and exchange commission officially recognizes this principle in its instructions and regulations in which it is pointed out that:

> "In certifying to the financial statements, independent public or independent certified public accountants may give due weight to an internal system of audit regularly maintained by means of auditors employed on the registrant's own staff. In such case the independent accountants shall review the accounting precedures followed by the registrant and its subsidiaries and by appropriate

measure shall satisfy themselves that such accounting procedures are in fact being followed."

In deciding the amount of "testing and sampling" to be undertaken by the independent public accountant in checking the effectiveness of the system of internal control, the circumstances of each case must be considered. The character of the business, the form of the records and the use of mechanical equipment are all factors which will influence the extent of such examination. The element of judgment is of major importance, and the accuracy of the external audit will be affected greatly by the accountant's technique in handling this phase of his work.

It is not the purpose of this article to outline the auditing procedure to be followed under varying conditions of external check, but, as stated above, this is largely a matter of judgment and must be decided by the accountant for himself. Rather, it is proposed to give examples of the accounting safeguards and internal procedure with which an accountant would have to deal in a medium sized organization. A program to be followed in auditing such organizations is set forth in the bulletin published in January, 1936, by the American Institute of Accountants. The discussion which follows suggests the elements of adequate internal check contemplated by that bulletin.

THE THEORY OF INTERNAL CONTROL

Internal check and control may be described as the proper distribution of tasks among the clerical staff so that the work of each employee may be coördinated with, and independently checked by, the work of other employees. Such an arrangement provides a system of continuous internal audit and requires for its complete fulfillment an organization large enough to warrant departmental segregation of accounting functions. Complete systems, therefore, are rarely found in small companies. Even in the largest organizations, perfect control of all details can not be accomplished, as the cost involved might greatly exceed the possible losses incurred through lack of such control. For both large and small enterprises, the ideal system seems to be one which reduces the possibilities of loss to a minimum, at a commensurate cost. One does not "spend a dollar to save a dime." The independent accountant should bear this in mind and be chary of recommending controls the expense of which may be disproportionate.

Effectiveness of Internal Control Should be Tested

The true merit of any system of internal control is measured by the effectiveness with which it is carried out. Detailed accounting procedure is at best monotonous and tends to become perfunctory unless subjected to frequent review. Internal check often breaks down through the unauthorized discontinuance of established routine. It is natural to seek short-cuts and, once found, the short-cut becomes the beaten path. The accountant, therefore, should include as part of his work the examination of detail transactions to satisfy himself that the established system of internal control is operating properly and has not been rendered ineffectual by deviations or "short-cuts."

Examination of the internal-control system should be undertaken preferably at a time other than the regular audit date so that the public accountant may concentrate his attention on this important phase of the examination. During his investigation, the accountant should retain a brief outline of the system and record his conclusions as to its adequacy. This outline should be carried in a permanent file and each year reviewed and modified to reflect the changes, if any, made by the management in the prescribed routine.

After satisfying himself as to the adequacy of the established system, the accountant must determine whether the system as outlined is being carried out effectively. For this purpose it is probably better to select a representative period and to check thoroughly all the transactions of that period rather than to make superficial, although in the aggregate more extensive, spot tests. Practical experience has shown that the exhaustive examination of a representative period will reveal sufficiently to the alert investigator the typical operation of a business. Indeed, a mathematically inclined observer has pointed out that if out of 100 items it is equally probable that anything from one to ten items may be wrong, then if only 50 out of, say, 2½ million items are checked and are found correct, it is probable that 98.1 per cent of all the transactions are recorded correctly.

The detail checking of the underlying documents should be done thoroughly and efficiently. Missing vouchers and invoices should be listed and investigated. Deviations from prescribed procedure should be noted. It is the essence of a test check of this type that all questionable items and departures from established routine be satisfactorily explained.

The management should be apprised of all findings and recommendations. Although the accountant can not insist upon the adoption of his recommendations, he can point out their purpose and the extent to which the scope of his examination will be affected by the observed departure from established practice or by the inadequacy of prescribed methods.

Illustrative Methods of Internal Control and Related Tests of Compliance

In the review of a system of internal control, the accountant has to consider primarily the two things discussed in the preceding paragraphs: (1) that the system is adequate and will minimize errors and defalcations and (2) that the system is being effectively maintained. With this in mind the following material has been arranged to deal with these two phases under each of the accounting functions discussed: the first section outlining a system of adequate internal check and the second describing methods of testing the effectiveness of the control.

Cash receipts:

The purpose of a strong cash-receipts system is to assure that receipts from all sources are properly recorded. The routine, therefore, should provide for the prompt entry and deposit of daily cash receipts. The cashier should not have access to the customers' ledgers or monthly statements and should be solely responsible for the entry, receipt and deposit of all corporate funds. Duplicate deposit slips should be obtained or confirmations of the amounts of deposits should be mailed by the bank direct to the comptroller.

Receipts from cash sales are best recorded by registers or other mechanical devices. In any event, numerically controlled sales tickets should be provided. Register readings and totals of sales tickets should be compared regularly with the cashier's daily record by the comptroller's department or some other independent employee. Receipts from C. O. D. sales should be similarly controlled.

As previously pointed out, cash received from "charge" customers should be handled by cashiers who do not have access to the customers' ledgers and are not concerned in any way with the preparation and mailing of monthly statements. Outside salesmen and collectors who receive cash from customers should be subject to close supervision. Instructions on invoices and statements should caution customers against making payments without obtaining official receipts. Customers should also be advised that cheques are to be drawn to the order of the company and in no circumstances to the order of salesmen or collectors.

Proper control should be set up to insure the prompt recording of all cash received by mail. A responsible employee, not associated with the cashier's department, should supervise the opening of the mail and prepare, for subsequent review by the accounting department, an independent list of cash received in this manner.

Special consideration should be given to cash received from miscellaneous sources. The difficulty of checking miscellaneous receipts makes it important that all such items be handled directly by the comptroller's office.

It must be emphasized that in no case should the accuracy of cash receipts records be checked by members of either the sales force or cashier's department.

After investigating the system of cash-receipts control, and satisfying himself as to its adequacy, the accountant should next determine whether the system as outlined is being carried out. For this purpose he should make tests, for the selected period, of the following types:

(1) Compare cashbook receipts with independent reports or summaries of:
   (a) Cash-register readings and cash sales tickets.
   (b) C. O. D. collections.
   (c) Duplicate receipts for collections received directly by cashiers.
   (d) Cash received by mail.
   (e) Cash received by outside salesmen and collectors.
   (f) Miscellaneous receipts.

(2) Check footings and cross-footings of cash-receipts book.

(3) Check deposit of receipts into banks.

(4) Compare itemized amounts on duplicate deposit slips (or, if circumstances warrant, on copies of original slips obtained from banks) with corresponding entries in cash-receipts book to determine that deposits are promptly made and to detect collections withheld from books to cover shortages.

(5) Reconcile total receipts and deposits.
(6) Vouch discount and other deductions from settlements.
(7) Check postings to general ledger accounts.

Cash disbursements:

The cash-disbursements system should insure that no improper payments are made, that every payment represents a properly authorized business transaction and that a record thereof is made upon the books. To achieve this result there should be in force a sound method of passing invoices for payment. All disbursements, except petty items, should be made by cheque and every cheque should be definitely related by stamp or otherwise to the invoice paid or the voucher authorizing the disbursement. Moreover, it is important that cheques be accompanied by supporting vouchers and invoices when presented to executives for both original signature and countersignature. Bank balances should be reconciled periodically with ledger cash balances, by employees independent of the cashier's department.

Many defalcations have been effected by drawing cheques in payment of improper credit memoranda, adjustment slips and other items of a similar nature. Hence special care should be taken that no such disbursements shall be made unless supported by approved memoranda bearing the authorization of responsible officers.

The accountant should satisfy himself as to the effectiveness of the cash-disbursements system by checking the selected period as follows:

(1) Compare disbursements per cashbook with related vouchers and paid bank cheques, noting particularly:
  (a) As to bank cheques:
    1. Name of payee.
    2. Signatures.
    3. Endorsements (special attention should be given to cheques which bear the endorsement, initially or subsequently, of the company's employees).
  (b) As to vouchers:
    1. Approval for receipt of goods or services.
    2. Approval of prices and calculations.
    3. Approval of payment.

4. Some form of designation on invoices that they have been paid.
5. Authority for expenditure.

(2) In reference to partial payments made during the period vouched, transactions with vendors should be examined to make certain that they are in order. Determine the correctness of approvals by inspection of the supporting documents. Satisfactory explanation should be obtained regarding the propriety of the partial payment.

(3) Check footings and cross-footings of cash-disbursements book.

(4) Check postings to general ledger accounts.

(5) Trace cash transfers between banks and between offices to determine that the transactions are simultaneously recorded at both ends.

Petty cash:

The best method for controlling petty-cash disbursements is provided by the imprest system. Under this system it is desirable that the fund be fixed at the smallest amount commensurate with requirements and that a report of the disbursements therefrom be made at least once a month.

There should be a rigid system in force if cash is disbursed unavoidably out of cash receipts. When such disbursements are made for merchandise returned, allowances, payroll and other purposes, supporting data should be attached giving complete details of the transactions.

Whether or not the imprest system be used, all petty-cash disbursements should be finally approved by an officer or responsible employee and the vouchers and supporting invoices, if any, should be effectively cancelled.

The independent public accountant should check the effectiveness of the system by vouching all petty-cash disbursements for a representative period. He should note particularly (a) approvals for reimbursement, (b) dates of invoices and receipts, (c) alterations and erasures and (d) compilation of the summary for the period and the posting thereof to the general books.

Accounts receivable:

Accounts-receivable operations should be handled as a separate functional subdivision of the accounting department. Ledger clerks should not have access to the cashier's records and, as previously noted, cashiers should not have access to the customers' ledgers or statements. Entries in the accounts-receivable controlling accounts in the general ledger should be based preferably upon totals compiled in other departments. Detail ledgers should be balanced with the controlling accounts at regular intervals, and all unpaid balances should be confirmed periodically.

A systematic method should be employed in the collection of accounts. Collection follow-ups, however, should be supervised by the credit department, the operations of which should be independent of the accounts-receivable department. Accounts charged off as uncollectible should be supported by properly authorized vouchers and should be transferred to a separate ledger. Subsequent collection efforts regarding such accounts should be under strict supervision.

To determine whether the prescribed system is being properly maintained, the following type of examination of detailed transactions, for the period selected, should be undertaken:

(1) Check postings to accounts-receivable control accounts from cash, sales and other records.

(2) Check postings from detailed accounts receivable to cash, sales and other records.

(3) Test footings and balances of detailed accounts receivable (2 and 3 may be omitted on large engagements where machine bookkeeping is used, where average balances are small and where control appears to be particularly effective).

(4) The vouching of sales and sales returns and allowances is provided for under the sales section; the procedure as to cash is covered under the cash-receipts section. Therefore, vouch other classes of debits and credits to customers' accounts.

(5) Secure from attorneys or company's legal department a list of collections on accounts previously written off and compare this list with amounts recorded on books as recoveries from bad debts. If this procedure is impracticable, examine correspondence and collection

files relating to accounts written off to determine that bad debt recoveries have been duly recorded on the books.

Inventory:

Perpetual-inventory records of stock on hand afford ordinarily the most satisfactory check of physical count and provide a safeguard against losses through theft or inefficiency. Controlling accounts should be maintained and should reflect all materials received, purchased, manufactured, issued and sold. The detail records should be balanced regularly with the control accounts and checked periodically by physical count. Adjustments of perpetual-inventory records to physical count should be approved by an authorized executive.

The following operations are typical of the examination which may be made to ascertain whether the perpetual-inventory records are effective:

(1) Test the purchase and other debit postings.
(2) Test the sales and other credit postings.
(3) Test the footings of larger items.
(4) Scrutinize general ledger control accounts (in order) to make certain of their regularity and to guard against fictitious items. Trace a representative number of entries to their original sources to obtain satisfactory evidence of the propriety and consistency of constituent elements.

Accounts payable:

The accounts-payable department should be a separate unit of the accounting department. Clerks engaged on accounts-payable ledgers and voucher registers should not have access to the cashier's records; neither should cashiers have access to accounts-payable records or creditors' statements. Entries in the accounts-payable controlling accounts in the general ledger should be based preferably upon totals compiled in other departments. Voucher registers or accounts-payable ledgers should be balanced with controlling accounts at regular intervals. Monthly statements received from creditors should be checked independently.

Adjustments of accounts for errors, erroneous deductions, etc., should be approved by an authorized executive.

The adequacy of the system may be checked in the following manner:

(1) Check postings to accounts payable control accounts from cash, purchase and other records.

(2) Check postings from detailed accounts payable to cash, purchases and other records.

(3) Test footings and balances of detailed accounts payable. (These two steps may be omitted on large engagements where machine bookkeeping is used, where the accounts are large in number and where control appears to be particularly effective.)

Purchases and expenses:

The entire system of ordering goods, checking invoices and authorizing payments should be under strict supervision. Purchases should be made through the medium of prenumbered purchase orders, and invoices should not be approved by executives for payment unless they have been checked in every respect. Some form of invoice register should be used to control invoices and as an aid in the determination of the amount of unrecorded liabilities as at closing dates. Return purchases should be closely supervised to insure the receipt of proper credits from vendors. Expense vouchers should be paid only upon the approval of an authorized executive; and traveling expense vouchers should be sufficiently detailed to indicate the propriety of the charges. After invoices or vouchers are passed for payment, the check number should be noted thereon to prevent duplicate payments.

The following types of examinations should be made to establish the fact that prescribed routine is consistently observed. (The detailed vouching of purchases has been covered previously under "Cash disbursements.")

(1) Check the record of returned goods (as maintained in shipping department) against the purchase-return journal to determine that full credit was received in all cases.

(2) Check footings of purchase, expense and purchase-return journals.

(3) Check postings from purchase, expense and purchase-return journals to general ledger.

(4) Ascertain what steps are taken to trace lost or missing invoices.

Sales:

The sales system should be so arranged as to prevent either omission or inflation of sales. Summaries and analyses of sales should be prepared from numerically controlled sales tickets by employees not associated in any way with sales, accounts-receivable or cashier's departments. These summaries and analyses should be compared regularly by the accounting division with the cash sales receipts and the charges to customers' accounts. Sales tickets and invoices should be checked as to prices, extensions, totals, discount, etc. Sales returns and allowances should be approved by an authorized executive.

The effectiveness of the sales system should be checked as follows:

(1) Cash and C. O. D. sales:
- (a) Check footings of sales journal.
- (b) Check sales tickets to sales journal or summary of sales, noting particularly that:
  - (1) Quantities and calculations have been checked.
  - (2) All sales ticket numbers are recorded.
- (c) Reconcile cash sales with cash-register readings or tapes.
- (d) Check postings to general ledger from sales journal.

(2) Charge sales:
- (a) Obtain shipping tickets or other evidence of delivery of goods and compare them with sales invoices to make certain that all shipments have been billed.
- (b) Check returned-sales-and-allowances memoranda to returned-sales-and-allowances journal, noting particularly that:
  - (1) Quantities and calculations have been checked.
  - (2) All ticket numbers are recorded.
  - (3) Allowances for other than returned goods have been approved by an officer independent of the cashier's and bookkeeping departments.
- (c) Check footings of returns-and-allowances journal.
- (d) Check postings to general ledger from returns-and-allowances journal.

Payrolls:

The importance of payrolls requires that their handling be subjected to close internal check. The functions of timekeeping, preparing payrolls and paying off should not be combined under the control of one employee. Ordinarily the payroll operations should be conducted as follows:

(a) Payrolls should be prepared in the paymaster's department from time-clock cards or from other forms of time reports submitted by timekeepers.

(b) A labor recapitulation should be prepared in the accounting or cost department from time tickets or piece-work production records.

(c) The comptroller's department should verify the payroll prepared in the paymaster's department and reconcile such payroll with the labor recapitulation.

(d) Payrolls should be approved for payment by an authorized executive after he has satisfied himself that the necessary internal verification of the payroll has been made.

(e) Payrolls should be disbursed in the presence of a witness who has had nothing to do with the preparation or verification of the payroll.

In addition, certain rules should be observed in payroll accounting, as follows:

(a) Payroll departments should be operated on the imprest plan so that the paymaster must account at all times for all money in his hands.

(b) Timekeeping should be based on automatic time records. If such recorders can not be provided, daily time reports should be made by timekeepers and approved by foremen or executives to whom employees report.

(c) No name should be added to the payroll except on formal authorization of the person responsible for employment.

(d) All rate changes should be approved by the head of the department affected.

(e) Every employee should be provided with a receipt on which the name, identification number, amount and pay period are shown. On pay day each employee should turn in to the paymaster a receipt, with his name and address signed by him, in exchange for his pay envelope. (There are, of course, infinite variations of this type of control.)

(f) Lists of unclaimed wages should be prepared and submitted to the comptroller's department, which should examine all receipts for amounts subsequently paid. If unclaimed wages are temporarily held intact, provision should be made periodically for the return of such funds to general cash.

After examining the system in force, and satisfying himself as to its adequacy, the public accountant should determine that it is being carried out effectively by making the following kinds of tests for a representative period:

1. Check time records against payroll.
2. Check rates on payroll against rate records.
3. Check extensions and footings.
4. Compare totals of payrolls with payroll cheques drawn.
5. Check addition and removal of names against employment department records.
6. Compare totals of payrolls with labor recapitulations of cost records.
7. Vouch deductions from payroll for absences, merchandise, rentals or other charges.
8. Vouch subsequent payments of unclaimed wages by examining receipts and tracing name of employees and amounts to original payrolls.
9. Account for extraordinary fluctuations of payrolls.

Branch offices:

Branch offices may be sales units, production units or completely independent organizations. The type of control best suited to branch operations will depend, therefore, upon the basis of such operations.

When branches are merely sales offices, branch expenses should be paid from an imprest fund. Reports of disbursements accompanied by receipted invoices or approved vouchers should be sent to the head office for reimbursement. When branch offices operate, more or less, as complete units, the following system of controls is desirable:

(a) A perpetual inventory of all goods shipped to or purchased by the branch should be kept at the head office.
(b) Copies of all branch sales invoices should be sent to the

head office where a controlling account of the branch accounts receivable should be maintained.

(c) A trial balance of branch ledgers should be sent to the head office each month.

(d) Copies of all approved credits and journal entries should be sent to the head office for examination.

(e) Cash collections should be deposited in a local bank account over which the branch has no control. All cheques on this account should be drawn by the head office.

(f) Copies of branch cash records and duplicate deposit slips should be sent to the head office.

(g) Bank statements and paid cheques should be sent directly to the head office by the local bank.

(h) Properly approved disbursements for petty-cash expenses should be reimbursed by the head office on the imprest system.

Unless the head office adequately controls branch operations through the medium of field examinations by its own staff, it will be necessary usually for the public accountant to visit branch offices to satisfy himself as to the accuracy of branch transactions. When the head office does adequately control branch operations, a field examination by the public accountant ordinarily may not be necessary. A study of the effectiveness of prescribed routine therefore is essential before planning the audit program.

Internal audit:

The accounting functions reviewed in the foregoing sections of this discussion are vital in almost every business, but the order of their importance varies in different industries. In a finance or factoring establishment, receivables may represent ninety per cent of gross assets, requiring emphasis upon the control of purchase of accounts, custody of instruments and collateral, credits and collections. In an investment house, securities may similarly represent ninety per cent of gross assets, necessitating closer attention to problems dealing with the acquisition, sale, custody and safeguarding of securities. In a manufacturing business, inventories and the problems relating to the adequate control of material, labor and all phases of costs demand particular attention. These divergent examples illustrate the need for flexibility and the importance of judgment in planning the examination of internal control in any business, bearing in mind that the extent and character of the general audit to be undertaken by the independent public accountant are built upon the foundation of underlying interest check. It is obvious that no system of internal control can be satisfactory without some provision for internal auditing, including at least (a) the verification and reconciliation of bank balances by someone other than the employee who maintains the cash records, (b) similar verification of petty-cash funds, (c) periodical confirmation of receivables by an employee who does not keep the customers' ledgers or record cash receipts, (d) periodic tests of inventory records by physical count conducted by other than storekeepers, (e) constant and alert supervision of the approval of vouchers before payment and (f) verification of cash sales.

There are rudimentary precautions which should be observed in any office regardless of size, among which the following may be noted: Every member of the clerical staff should be required to take an annual vacation, and employees should be rotated as much as practicable. It is through such training that many of the most satisfactory internal auditors have been developed, particularly if this training be coupled with technical accounting education. Officers and employees responsible for cash, securities, valuable merchandise, etc. should be bonded. Access to securities and valuable documents should be had only by two or more officers or employees jointly. Custodians of securities and negotiable instruments should take no part in keeping the general ledger or accounts receivable. Cheques, notes and acceptances should be signed and countersigned, and it should be stressed constantly that this routine should not be permitted to become perfunctory.

Coöperation Between the Internal and External Auditors

The professional accountant intent upon the responsibilities of his engagements (not unlike other professional men) often fails to obtain a sympathetic comprehension by clients of the intent and necessity of auditing procedures. The client is left in a fog of mystery and sometimes believes he is being subjected to needless time-consuming red tape. How much better it is to devote some attention to the elucidation of the purpose of certain steps undertaken in the examination of financial statements. Relatively few clients understand that financial statements are primarily representations of management and that the report of the public accountant expresses the considered opinion of a skilled third party as to the fairness of the representations of management.

The work of the internal auditor may not be substituted for that of the public accountant, but all evidence which the comptroller may produce in support of his representations that internal control is effective will influence the extent of the related work undertaken by the public accountant. On the other hand, the periodic examination conducted by the public accountant does not take the place effectively of the "constant vigilance" of internal auditing. The two are complementary.

Management may rely upon competent internal audit in the determination of financial condition and result of operations, whereas the investing and credit-granting public rely not only upon the representations of management but also upon the opinion of the unbiased public accountant. The functions of the two should be coördinated to minimize the detail checking to be undertaken by the public accountant.

Reports of internal auditors to the comptroller, with underlying working papers, should be retained for review by the public accountant. Such working papers, if properly prepared, will expedite the rechecking of supporting evidence. Similarly the internal audit staff may lend substantial assistance in the preparation of analyses and in assembling corroborative documentary evidence which will facilitate the work of the public accountant.

The need for efficient and economical external audit service will continue to encourage reliance upon internal control and internal audit, but the public accountant should apply "such appropriate measures as will (in his judgment) satisfy him that such accounting procedures are in fact being followed."