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Internal control is thought of most frequently as internal accounting control, the subject of our discussion. However, contemporary thinking about internal control is considerably broader and extends beyond matters relating directly to accounting. It comprehends activities in other fields as, for example, time and motion studies, which are of an engineering nature, and use of quality controls through a system of inspection or laboratory testing, which fundamentally is a production function.

A special report on internal control issued by the auditing procedures committee of the then American Institute of Accountants defined internal control as comprising "the plan of organization and all of the co-ordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies."

SYSTEM OF INTERNAL CONTROL

Internal control is a tool that enables management to obtain reliable information, control, and reasonable protection against error, waste, and inefficiency. The increased significance of internal control is attributable primarily to the increased size and complexity of business organizations. Corporate management is usually not able to be personally familiar with or to control all operations of a business, but must rely on reports to keep informed about finances and operations. Most of this information comes from accounting records. The information must be adequate to supply answers to questions such as: What is the present inventory position by classes? How much is on order? Will it be necessary to borrow money to pay present obligations? How much will be required? The reliability of the information supplied can be reasonably assured through a satisfactory system of internal control.

Control is obtained through accounting and clerical procedures in various ways. Budgets, standards, and objective planning are good examples of this, as they encourage performance according to plan through reporting or explanation of variances.

Protection against error, waste, and inefficiency can be obtained through keeping all assets under accounting control and reporting any discrepancies. Physical inventories differing from book amounts may indicate careless warehousing procedures. Inefficiencies in production may be disclosed by the value of scrap sales, or variances from standards. Errors in reporting or recording source information may be disclosed through cross-checking, such as reconcilement of bank accounts by a person independent of recording and receiving cash.

ACCOUNTING ERRORS

This might be a good time to discuss the classification of errors that occur. In their origin all accounting errors are classified as intentional or unintentional and may result in errors of principle, omission, or commission. The unintentional error is simply a mistake that arises from carelessness or a lack of sufficient accounting knowledge. The intentional error arises from studied or deliberate planning, usually carried on by a dishonest employee. The intentional error may become the basis of legal action against the dishonest employee. An error of principle is an incorrect application of an accounting principle and results in incorrect accounts and statements, as do also errors of omission and commission. An error of omission is the failure to make an accounting entry and is the most difficult type of error to prevent and detect. An error of commission usually is the result of carelessness or deliberation.

All intentional errors may not be the basis of legal action. As an example, internal reports may be intentionally misrepresented through deliberate errors of principle, omission, or commission to obtain rewards for good performance, particularly if such performance is measured in part by adherence to budgets or standards. This type of action cannot be condoned by management but there is no crime to serve as a basis for legal action. To have a basis for legal action there must be a crime, and to have a crime there must be criminal intention and a criminal act.

Fraud is a crime and, as applied to accounting, constitutes any act or omission to act of a deceitful and dishonest nature, or negligence so gross as to constitute fraud, the result of which is to take property from its rightful owner without permission or knowledge of the owner. Defalcation, misappropriation, peculation and embezzlement are all terms used to designate fraud. Collusion is another term often mentioned in connection with fraud and refers to the agreement and cooperation of employees in order to perpetrate a fraud. Common forms of fraud are: theft of merchandise; theft of securities; shipment of merchandise to fictitious customers; failure to account for cash receipts; execution of fraudulent disbursements.

ELEMENTS OF CONTROL

Through planning for good internal control the likelihood that the foregoing errors may occur is minimized. The characteristics of a good system of internal control would include the following elements:

- A plan of organization that provides appropriate segregation of functional responsibilities
- A system of authorization and record procedures adequate to provide reasonable accounting control over assets, liabilities, revenues, and expenses
- Sound practices to be followed in performance of duties and functions of each of the organizational departments
- A degree of quality of personnel commensurate with responsibilities

These elements are so basic to proper internal control that serious deficiencies in any one normally would preclude successful operation of the system.

PLAN OF ORGANIZATION

Proper division of responsibilities is one of the principal means by which good internal control is achieved. The division should be such that no single person or department is responsible for handling all phases of a transaction from beginning to end without the intervention or cross-check of another person or department. It is a cardinal rule of internal control to have organizational independence and separation as between operating, custodian, and accounting departments, and also within such departments, to segregate operating responsibilities associated with a transaction from the responsibility for recording the transaction. A good example of the separation of operating, custodian, and accounting functions in a large organization would be as follows: An operating department requests purchase of certain materials by preparing a purchase requisition which is acted on by a purchasing department, materials are received by the receiving clerk, the invoice is paid by the accounting department, and the material is issued by the stores clerk. Each department would be acting organizationally, independently of the other, thereby establishing accountability for the authorization, purchase, receipt, payment, and issue of the materials requested by the operating department.

Similarly to the segregation of responsibilities between operating, custodian, and accounting departments, the broad accounting responsibility is often segregated by making the financial officer responsible for the operating function of receiving and disbursing cash and the controller responsible for the accounting function of establishing accountability over operations.

LINES OF RESPONSIBILITY

The plan of organization should be as simple and flexible as possible and should provide for clear lines of responsibility. It is usually defined in manuals or set up in the form of an organizational chart to preclude misunderstandings. In this paper I shall discuss some typical charts developed by the American Institute of Certified Public Accountants from case studies. The charts are not reproduced here inasmuch as they are conveniently available in the Special Report on Internal Control prepared by the Committee on Auditing Procedure of the American Institute. The first chart (Chart 1 of the aforementioned Report) is an organization chart showing the segregation of functional responsibilities between the various operating and staff or non-operating departments on both the supervisory and non-supervisory levels.

SEGREGATION OF DUTIES

Chart 2 of said Report is an organizational chart showing the segregation of duties at the top supervisory level. The board of directors at the top of the "chain of command" exercises control over the opening of bank accounts, the withdrawal authority, borrowings in the name of the company; assigns responsibility and delegates authority at the top level to provide a basis for good internal control; authorizes major fixed asset transactions, and determines certain policies. The responsibilities of the controller are primarily accounting while those of the secretary-treasurer are primarily custodian.

It is interesting to note that the responsibilities listed for the controller conform substantially with a statement of the Controllers Institute of America, which stated:

> The duties of the controller shall be to maintain adequate records of all assets, liabilities, and transactions of this corporation; to see that adequate audits thereof are currently and regularly made; and, in conjunction with other officers and department heads to initiate and enforce measures and procedures whereby the business of this corporation shall be conducted with maximum safety, efficiency, and economy.

CONTROL BY OPERATING SECTION

Chart 3 of said Special Report covers the controller's division and shows the functions exercised in internal control by operating section. The organizational independence is carried through to the sections in this division. The payroll section under the chief accountant is responsible for establishing the payroll liability on the basis of time reports and authorized rates; under the factory accountant the time-keeping section is responsible for control over payroll liability by verification of time and earnings, and the cost distribution section is responsible for the accounting distribution of the labor charges.

From the standpoint of internal accounting control, business transactions fall into the following main classes:

The purchasing of materials, supplies, assets and services;

Payroll procedures;

Sales of products, assets, and services;

Receipt of cash;

Disbursement of cash; and

Requisitioning of materials from storerooms.

Since we do not have time to discuss all classes we will limit our discussion to cash receipts and disbursements. This choice for discussion is in no way intended to slight the necessity for adequate control over other classes of business transactions, but was chosen because of the large number of accounts affected by cash transactions and the relative risk associated with the handling of cash.

The internal control over any business transaction should be sufficiently good to preclude serious errors.

Although cash is seldom a significant portion of a company's assets from the viewpoint of possible loss, cash has characteristics that are peculiar when compared with other assets. Cash, once taken, is difficult to trace. It does not require conversion into another medium to be useful by the taker, it does not take up much room, and it is hidden easily. Generally, other assets are not so easily hidden and require conversion into another form, which necessitates dealing with one or more persons, thereby establishing a traceable link to the taker.

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In our discussion, so far, we have pointed out certain principles of internal control which are summarized as follows:

- Responsibility must be fixed. Without the proper charge of responsibility, the quality of the control will be inferior.
- The accounting and the operation must be separated. An employee should not be in the position of controlling the records and at the same time control the asset or operation.
- All available proofs of accuracy should be used in order to assure accuracy of operation and accounting.
- No one person should be in complete control of a business transaction. Everyone will at times make errors, but the chances are that an error will be discovered by another if the handling of a transaction is separated between employees.

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INTERNAL ACCOUNTING CONTROL

CASH RECEIPTS

The objective of a good system of internal control over cash receipts is to see that all cash received is accounted for and properly recorded. Cash receipts usually originate from these sources:

1. Cash sales of merchandise or product.
2. Collections on accounts receivable, which may be either counter or mail receipts, and
3. Cash sales of scrap and other assets.

The handling of these transactions, from the standpoint of cash receipts, would include three operations—receipt, recording, and depositing—to which the principles of internal control should be applied. We need to fix clearly the responsibility for each operation in such a manner that the person physically handling the cash does not prepare the record thereof, that no one person controls all of the operation, and that all available proofs of accuracy are utilized. As we have seen from the organizational chart at the top supervisory level, the treasurer often has the responsibility of custodianship of all cash, including cash receipts and disbursements, and may have a cashier or cashier's department, depending on the size of the organization, directly responsible to him for the physical handling of cash.

Cash sales present the most serious control problem since ordinarily the same person will make the sale, handle the cash, and initiate the accounting record. However, in many instances additional personnel can participate in the handling of the sales transaction to increase internal control. Department stores use a variation of this proceure by having the salesman prepare a sales ticket which together with merchandise is brought to a central cashier-wrapping department where the price is compared with the sales ticket and the cash received. The cash received daily must agree with the accumulation of the sales tickets. The salesman retains a carbon copy of the sales ticket for follow-up. Under such a system perpetration of a fraud would require collusion between the cashier and salesman.

Theaters usually apply another form of divided responsibility to establish accountability for cash receipts. The cashier is issued prenumbered tickets and at the end of each day must have either the tickets or the cash. The ticket-taker admits patrons only on presentation of proper tickets. It would thus require collusion between the ticket-taker and the cashier in order to misapply cash receipts.

There are numerous ways in which responsibility can be divided to assure accountability and custodianship of cash received. Some concerns supplement direct control over cash collections with careful inventory control.

Adequate control of collections on accounts receivable can be obtained by the posting of accounts receivable and the follow-up of delinquent accounts by persons other than the person receiving the collection. Under such a procedure, failure of the cashier to report all collections would cause a prompt response to credit department follow-up on delinquent accounts from customers who made payments but did not receive credit for them.

Mail receipts should generally not be opened by the cashier. To prevent abstraction they should be handled by as few persons as possible between receipt and deposit, and responsibility for their custody should be definitely fixed. If listings are made they should be checked subsequently to assure that all item and totals are entered in the cash-receipts record and deposited in the bank; the checking should be done by a person who does not have access to cash. The procedure for receiving and subsequent recording of customers' remittances should provide for checking them for amounts that the customer may have improperly deducted, such as unauthorized discounts, freight or other charges. To the extent practicable, it also should provide for safeguarding these remittances against manipulation of such charges or allowances by the company's employees.

Cash receipts should be recorded by an employee whose arrangement of duties and procedures is such as to safeguard against falsification of the record. If the person posting the cash-receipts record is the cashier, he should not have access to or post the detail customers' accounts-receivable ledger. Although the person responsible for receiving cash will usually prepare the deposit, additional protection is gained if after carefully comparing the checks and cash with the deposit slip some other employee makes the deposit. Cash receipts should be deposited intact daily since this procedure reduces the possible loss from burglary and precludes or reduces the possibility of making disbursements therefrom.

To assure effectiveness of internal control, the segregation of duties should be absolute. Only an authorized employee should receive cash and that employee should not have any access to the receivable records. Unless that access is denied, a dishonest cashier can make fictitious postings to cover a shortage.

The organizational flow chart for cash receipts (Chart 7 of the Special Report described earlier) portrays the segregation of functional responsibility. On that chart it may be observed that the transaction originates in the sales department; the cash is received by the cashier in the treasurer's department; and the sale and cash are recorded by the controller's department. There is, therefore, segregation of responsibilities between operating, custodian, and accounting departments. In addition, the organizational independence is reflected within the controller's department—for example, the sales journal is posted by the billing section; the detail of the receivable ledger is posted by the accounts-receivable section; and the accounts-receivable control account is posted by the general-ledger section.

The objective of a good system of internal control over cash disbursements is to assure that all disbursements are made for a valid business purpose. Generally, except for petty cash, all disbursements are made by check since they are more readily controlled in this way. The check stubs afford a complete record of all disbursements, and the canceled checks also constitute receipts for such payments, as shown by the endorsements thereon.

The handling of disbursements by check includes four principal operations:

1. Preparation of check,
2. Recording check,
3. Signing check, and
4. Reconciling bank accounts.

Although making disbursements by check offers certain control in itself, there are additional controls that should be considered. Procedures for some of these may be described thus:

Checks should be prenumbered and all numbers should be accounted for. Spoiled or voided checks should be retained in order that the disposition of all checks can be determined. The supply of blank checks should generally be safeguarded. Accounting for all checks reduces the possibility that an unauthorized unrecorded check, issued by a dishonest bookkeeper, might be destroyed after its return by the bank.

Persons who prepare checks or have access to unissued checks should generally have no other cash duties.

Officers or key employees authorized to review supporting documents and to approve them for disbursement should be clearly designated.

The amount of the checks should be written by means of a check-protecting machine to prevent alteration of the amount either after it is signed or after it is returned by the bank.

The officers or employees authorized to sign checks should not consider this duty as just a mechanical procedure, but should review the disbursement from the standpoint of its being a valid business disbursement properly authorized and approved.

After the check has been signed the supporting documents should be defaced in some manner to preclude their being paid a second time, either intentionally or by accident.

The signed check should be mailed by the person signing it or under his direction and should never be returned to anyone responsible for its preparation.

Bank accounts should be reconciled promptly each month by a person having no other duties in connection with cash receipts or disbursements. This is to preclude the possibility of concealing a shortage through manipulation of the reconcilement. The bank statement and checks should be delivered unopened to the person responsible for the reconciliation.

Referring again to the Special Report on Internal Control mentioned above, the procedural flow chart for cash disbursements (Chart 9 there presented) portrays the previously mentioned principles of internal control—no employee or department has complete control of the transaction, responsibility is fixed, the accounting and the operation are separated, and all available proofs of accuracy are used. The check is prepared by the accounts-payable section, recorded by the cash-disbursement section, and signed and mailed by an authorized check signer.

CONCLUSION

Any comments on internal control must necessarily assume that the size of the organization is sufficiently large so that there are enough employees to make proper segregation of duties in order to obtain a satisfactory system. In business, however, this is not always true. Nevertheless, even in a small office or organization, with a little imagination or ingenuity, reasonable internal control can be developed.

A system of internal control once established must be continually evaluated, for the most carefully formulated procedures and policies are of little value unless carried out as intended. Short cuts and modification of procedures have a way of developing, at first as exceptions to normal procedure, perhaps when a key employee is ill or on vacation, and then to become a generally followed rule.

In conclusion, I would like to say that it is the common objective of accountants and management to have a sufficiently good system of internal control to preclude serious losses.