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Internal Control

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INTERNAL CONTROL

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One of the tools which management uses to safeguard business assets and the integrity of internal business associates is termed internal control. While internal control has been defined by many sources, a recent American Institute of Certified Public Accountants report defined it as a method "Comprising the plan of organization and all of the coordinate methods and measures adapted 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". In the past decade management and the public accountant have actively collaborated in devising a practical system of internal control. This collaboration has been the result of the growing complexity of the modern business unit and the realization by both professions that it is not feasible for them to do a sufficient amount of personal observation and checking to accomplish their individual purposes. The public accountant is especially well qualified to act as a consultant and appraiser of an internal control system because of his training, experience, and interest in his client's well being.

Logic dictates that large business units are most susceptible to the pitfalls of a lack of internal control and, conversely, better suited for an efficient system of internal control. This does not mean that small business is not subject to a system of internal control. Size only determines the method to be used. Every business, to have an effective system of internal control, must have:

(1) Distinct lines of authority and separation of business functions.
(2) An orderly method of record keeping and protection of physical assets.
(3) Qualified and active personnel.
(4) Active supervision of employees, routines, and the Company's prescribed policies.

One of the important principles of internal control requires that no one person handle a business transaction from beginning to end. This principle and practice is outlined below in a few of the major components of a good internal control system:

Petty Cash Fund

The imprest fund system should be used and the responsibility for the fund vested in one person.

The custodian of the fund should be separate from employees who receive remittances from customers.

Formal vouchers or receipts for all fund disbursements should be obtained by the custodian. Such vouchers should be approved by a responsible employee for payment and subsequently cancelled in some manner so that they cannot be reused.

Reimbursement checks should be payable to the custodian.

The fund's use should be restricted to small disbursements which, by their very nature, are not practical to be entered in the accounts through the accounts payable routine.

The fund should frequently be surprise counted by a member of the management team.

Cash Receipts

Mail should be opened and distributed by employees who have no access to the general records or customers' accounts. Responsibility for the receipts from the moment the mail is opened until deposited should be clearly fixed.

A record should be prepared by the person responsible for opening the mail of all remittances received, which should be given to someone other than the cashier or bookkeepers for later independent verification of the amounts recorded and deposited.

Cash registers, numerical sales slips and receipts should be used.

Each day's receipts should be deposited intact daily by someone other than the cashier.

A duplicate deposit slip, properly authenticated by the bank, should be returned to a person independent of the cashiers and compared (a) With the record of incoming remittances discussed above, and (b) The cash receipts book.

An independent record of all scrap and equipment sales should be kept by persons independent of the cashier.

Cash Disbursements

Checks should be prenumbered and numbers should be accounted for at all times.

Voided checks should be mutilated and filed with paid checks.

A check protector should always be used.

Authorized signatures should be limited to employees who have no access to:
(a) Accounting records
(b) Cash receipts
(c) Petty cash funds.

Checks should not be signed or countersigned in advance.

Checks are not drawn to "cash" but to an individual in order to place definite and direct responsibility.

Bank reconciliations should be made by someone who has nothing to do with the cash procedures.

The person reconciling the bank accounts should examine, for obvious reasons, the paid checks for date, name, cancellations and endorsements and compare same with the disbursement records.

Supporting data should accompany checks when they are submitted for signature.

The executive signing checks should thoroughly understand the necessity of internal control as applied to the vouchers before him.

Notes Receivable

Notes should be authorized by a responsible executive.

Negotiable collateral, if any, should be in the custody of an officer or employee other than the cashier or employee who keeps the applicable accounting records.

The notes should be inventoried periodically and reconciled with the general ledger controlling account.

Partial payments should be endorsed on the back of the notes.

Accounts Receivable

Customers' accounts should be regularly balanced with the general ledger control.

Monthly statements should be sent to all customers by a person other than the bookkeeper who will compare the statements with the accounts and keep them under control until mailed.

Accounts should be aged periodically and reviewed as to delinquent accounts and collection follow up.

Disputed items should be handled by a responsible employee other than the accounts receivable bookkeeper.

Write off of bad debts and adjustment credits should be approved by an officer. Bad debts written off should be under accounting control.

Credit memoranda should be approved by proper authority and be under numerical control.

Payment of credit balances should be approved by proper authority.

Credit, collection, accounts receivable and sales departments should be independent of each other.

Inventories

Material purchases should be delivered to a central storage department under perpetual inventory control.

Perpetual records should be kept of all major inventories by employees independent of the actual stores keepers.

Perpetual inventory records should be checked by physical inventories at least once each year.

Physical counts at year-end should be made by employees independent of the store keepers and those responsible for maintaining the perpetual records.

Approval of a responsible employee should be necessary where adjustments are made to the perpetual records based upon physical inventories.

Periodically, statements should be furnished the management, showing:
(a) slow moving items, (b) obsolete items (c) overstocks.

Accounting control should be maintained on the following classes of inventories:
(a) Consignments
(b) Materials in hands of suppliers
(c) Materials or merchandise in warehouses
(d) Merchandise shipped on memorandum.

Merchandise on hand, not the property of the company, should be physically segregated from the company's property and under accounting control.

Written instructions should be prepared for guidance of participating employees in physical inventory takings.

All steps in the inventory preparation and recapitulation should be double checked.

Securities

Securities should be kept in a bank safe deposit box or in a locked box in the company's vault or safe.

The securities should be inspected periodically.

The securities should be in the name of the company.

A detailed record should be kept by the accounting department.

Purchases or sales should be authorized by a duly authorized officer or the board of directors.

Property, Plant Equipment

Plant ledgers, should be kept on each individual item and balanced at least annually with the general ledger controls.

Capital expenditures should be authorized by the Board of Directors or some authoritative management group.

Approval of management should be obtained before equipment is scrapped.

The Company should have a well defined policy to govern accounting for capital additions as opposed to maintenance and repairs.

Retirements should be reported in a routine manner.

Accounts Payable

The vouchers payable register should be compared monthly with the general ledger control, and should be kept by someone other than the general ledger bookkeeper.

Efforts should be made to obtain statements from all vendors monthly for comparison with the amounts shown by the books.

Adjustments of recorded accounts payable should have executive approval.

Prepayments and other debit balance transactions should not be recorded in accounts payable—but rather by use of a separate general ledger account.

Sales

Customers' orders should be received and approved before acceptance by a responsible party.

Shipping advices should be prenumbered.

Completed prenumbered invoices should be checked with the customers' orders for accuracy of quantities, prices, extensions and terms.

Sales invoices should be summarized and classified by a department other than the accounting department.

The following classes of sales should be controlled in the same manner as sales to customers:

(a) Sales to employees
(b) Scrap and waste sales
(c) Sales of equipment
(d) C.O.D. sales
(e) Cash sales

Returned items should be received and cleared through the receiving department to those who are authorized to issue credit memoranda.

Purchases and Expenses

Purchasing department should be divorced from the accounting, receiving and shipping functions.

Purchases should be made on prenumbered purchase orders.

Receiving tickets should be prenumbered and a permanent record thereof kept in the receiving department.

Returned purchases should be cleared through the shipping department.

The accounting department should check the invoices against purchase orders, receiving reports, and inspection reports.

The accounting department should check all invoices as to prices, extensions, and freight charges.

Purchases made for employees should be cleared through the purchasing department in a routine manner.

Vouchers should be prepared for all purchase and expense items and the distributions established by responsible employees.

Vouchers should be examined by a responsible officer or employee to ascertain completeness of attachments and various required approvals.

Payrolls

Preparation of the pay roll should be distributed among a number of employees.

Clerical operations in preparation of pay rolls should be double checked before payment.

Changes in rates, additions, and dismissals, should be authorized on rate card by someone not connected with the pay roll repartment.

If paid by check, the checks should be prenumbered and signed by employees who do not participate in any of the cash or payroll functions.

If payments are in cash, receipt of payment should be obtained by the paymaster.

Pay roll bank account should be reconciled by employees outside of the pay roll department and in the same manner as regular bank accounts.

Other

Responsibility and duties of officers and key employees should be reasonably fixed.

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has. An audit can serve as a starting point and authority for a fair valuation of accounts in the books. If the close corporation has never had an audit, it may indeed be a revelation to the stockholders. The management may be astounded to learn how many inaccuracies have accumulated in the records. It may suddenly discover that the book value of its stock has skyrocketed, or is worthless.

Once the audit report is in the hands of management, the accountant may be called upon to explain the changes made in valuation of balance sheet accounts, or to explain why an account is now shown under a different section of the balance sheet from what it was before. This can be quite a challenging experience.

For example, have you ever tried to explain to a highly successful business man why cash segregated for the future replacement of property assets should not be shown as a current asset when he considers that cash is cash no matter how you look at it?

Or have you ever tried to explain why the value of insurance on the lives of officers should be stated at the cash surrender value rather than the premium cost, and why we just don't show this value as a current asset?

And have you ever tried to explain the difference between a prepaid expense and a deferred charge to a man who is merely amused by the accounting profession's intent concern with such definitive matters?

We have considered the importance of confidence, the value of an educational program in accounting and taxes, and the usefulness of encouraging a certified audit as part of the accountant's role in the closely held corporation. Along with this are the usual demands on the accountant. He is expected to be a one-man specialist in systems, internal controls, costs, taxes, budgeting, auditing, analyzing financial statements and the stock market, investigating employee pension and profit-sharing plans, and in general is trusted to be a living business encyclopedia.

This presents quite a contrast as compared to the very large corporation which usually has a specialist for each phase of its financial operations. Too, the corporation whose capital stock is traded on the stock exchange is required to have a certified audit of its records, and by reason thereof, its accounting procedures normally conform to the principles of accounting as set forth by the American Institute of Certified Public Accountants. The officers of these corporations, therefore, have been indoctrinated to these standards and have learned to accept them.

In summarization, it is apparent that the industrial accountant with the closely held corporation has three general challenges:

1. To satisfy management that it has a continuing need for a full-time, high-level accounting executive.
2. To realize the favorable conclusion of an educational and informative program designed to bring about management's complete understanding of why accounting and tax techniques are as they are.
3. To induce management to have an annual certified audit of its records.

The accountant who successfully brings these challenges to a satisfactory conclusion earns for himself a well-defined part in the management of the closely held corporation. Every closely held corporation executive won over to the cause of high standards of performance in accounting represents a great stride forward for our profession, and this should be the aim of every professional industrial accountant.

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Accounting department should be completely separated from sales, manufacturing, purchasing, cash receipts and disbursements and insurance.

Employees in position of trust should be bonded.

Employees should be required to take vacations.

Internal reports to the management should be adequate and frequent.

Insurance should be periodically reviewed.

Journal vouchers should be explained in detail, supported by substantiating data, and approved by a responsible employee.

From the Editor's Desk

A most cordial welcome to our new readers—the members of Tampa Bay Chapter No. 55 and New Orleans Chapter No. 56, as well as nearly five hundred new subscribers: women who are studying accounting through the International Accountants Society. All are invited to participate in the publication—not only to draw from it inspiration and technical information but to contribute their thinking and experience.