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Victor Z. Brink

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Internal Check

BY VICTOR Z. BRINK

I.

WHILE there is no standardization as to just what is meant by the term, internal check, increasing recognition is being given to it in accounting literature. The growth of the size of the business unit has attracted attention to the importance of this matter, and the constant refinement and progress that is going on in the literature of accountancy has done much to clarify the nature and importance of the problem. A factor of more immediate influence has been the increased concern on the part of public accountants as to just what an audit on their part is to be, and what responsibilities are assumed when financial statements are certified. It has been frankly recognized that the outside auditor cannot practically review all of the detail transactions in a large corporation, and must rely to a considerable extent on the system of internal check employed by the company being audited.

Recognition of the influence of internal check on the audit program was given in the Federal Reserve bulletin, entitled *Approved Methods for the Preparation of Balance-sheet Statements*, published in April, 1917, and also in the 1929 revision entitled *Verification of Financial Statements*. In the latter edition, the matter is clearly stated in paragraph 1 as follows:

"The extent of the verification will be determined by the conditions in each concern. In some cases the auditor may find it necessary to verify a substantial portion or all of the transactions recorded upon the books. In others, where the system of internal check is good, tests only may suffice."

The wide and varied meanings attached by writers and accountants to

the term, internal check, make it advisable to review the concepts and assemble the various ideas properly relating to it. A starting point may very well be the definition in the bulletin of the American Institute of Accountants *Examination of Financial Statements*, published in January, 1936:

"The term 'internal check and control' is used to describe those measures and methods adopted within the organization itself to safeguard the cash and other assets of the company as well as to check the clerical accuracy of the bookkeeping."

This definition appears to treat internal check and internal control as one and the same thing, whereas internal control is usually considered to be the broader term, and internal check a part of it. Secondly, the application of internal check is limited by the definition to safeguarding of assets and clerical accuracy of bookkeeping. While every matter—including clerical accuracy of bookkeeping—can in the last analysis be related to safeguarding of assets, the definition tends to be too restrictive.

A second definition by Aubrey Smith in his *Internal Audit Control* is:¹

"Internal check may be defined as that branch of internal auditing which depends for its effectiveness in preventing inaccuracies upon a scientific division of work among the employees so that one person's duties are complementary to or checked by another clerk."

This definition sets up internal check as a branch of internal auditing and states the objective to be the prevention of inaccuracies.

¹University Coöperative Society, Austin, Texas, 1933.

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Another relatively narrow conception is expressed by DeWitt Carl Eggleston in his *Auditing Procedure*,² when he says:

“An internal check is an accounting device whereby a proof of the accuracy of figures can be obtained through the expedient of having different persons arrive independently at the same result.”

Some writers conceive internal check as something directed only at fraud. For example, George E. Bennett in his *Fraud: Its Control through Accounts*, says:³

“A system of internal check may be defined as the coördination of a system of accounts and related office procedure in such a manner that the work of one employee independently performing his own prescribed duties checks continually the work of another as to certain elements involving the possibility of fraud.”

And Jacob B. Taylor and Herman C. Miller in their *Intermediate Accounting*, say:⁴

“A system of internal check comprehends the separation of the functions of the various employees charged with the administration of the accounting technique so that it will be impossible for fraud to take place without collusion.”

A more general definition is given by Robert H. Montgomery in his *Auditing—Theory and Practice*:⁵

“Such a system [a satisfactory system of internal check] implies that the accounting records, methods, and details generally of an establishment are so laid out that no part of the accounts or procedure is under the absolute and independent control of any one person; that, on the contrary, the work of one employee is complementary to that of an-

other; and that a continuous audit is made of the details of the business.”

Other definitions exhibit the same variety of terms, usages, and ideas but it has been sufficiently shown that a great lack of uniformity exists. A review of the above definitions, and others, permits the drawing of certain conclusions. The first of these is that the term is often restricted to mechanical aspects such as the addition or proof of figures, or the proof of an employee's work. While these aspects are important and part of the field of internal check, there are other phases of the accounting and financial activities which are to be included even though they may not be reduced to a precise proof as such. Secondly, the prevention and detection of fraud is set up in many definitions as the sole objective of a system of internal check. Matters of control, efficiency, and proper functioning in general of the accounting system are ignored and only the one objective recognized—that relating to fraud. The implication in all references, however, is increasingly clear that the matter of internal check is most important and one deserving of careful attention and study. This growing importance presents the greater need of a proper analysis and interpretation of the nature of internal check and this will be our next task.

II.

The meaning of the term, internal check, is somewhat complicated and confused by the fact that it exists at all levels of authority. For example, it exists within the activities of one individual, although many definitions define internal check only as the proof *between* individuals. The bookkeeper who keeps a voucher register and then proves the mechanical accuracy of his distribution by totaling the columns and crossfooting them, is employing a form of internal check to prove—to a certain extent, at least—his own accuracy. At a higher

² John Wiley and Sons, Inc., N. Y. C., 1935.

³ Century Co., N. Y. C., 1930.

⁴ McGraw-Hill Book Co., Inc., 1933, Vol. 1.

⁵ Ronald Press Company, N. Y. C., 1934, 5th ed.

level we have an internal-check device in the proving of the accounts-receivable ledger against the general-ledger control. To the auditing department, the segregation and scientific assignment of duties in the cashier's department is a matter of internal check. To management, the work of the internal-auditing department—that is, the auditing carried on by this department—may be considered as an internal check on the other parts of the business. The conclusion is that at each level the organized activities carried on below that level are part of the system of internal check, and exactly what comprises it depends somewhat on the starting point.

The meaning of the term, internal check, is also somewhat confused by the inference of the word, check, that some precise mechanical checkoff is being carried on. We check an adding-machine tape, but this is hardly a suitable term for measures designed to encourage or require the careful handling of supplies or the judicious extension of credit. Nevertheless such measures are part of the system of internal check. We need, therefore, to broaden the scope of the term and recognize that it has a qualitative aspect over and above its more mechanical aspect. It may better be regarded as a qualitative measure of system efficiency—regardless of what the contribution is to that end.

Internal check, defined in the shortest possible way, refers to obtaining the maximum utilization of the accounting system. Because this definition depends so much on the interpretation of the term, accounting system, a longer definition is desirable and may be stated as follows: "internal check refers to the methods and practices whereby the accounting forms and records, and the procedures affecting their use, are operated in such a manner that the maximum utilization is made of them along the lines of information, protection, and control."

The breadth of this definition can only be appreciated if the terms used are clearly understood. The first terms used refer to the accounting system, or the forms, records, and procedures. The accounting cycle begins with transactions, and these transactions are first set down as they occur on primary papers of one kind or another. The information thus recorded is assembled or classified and is either recorded in formal journals or is posted directly in summary form to ledgers. From the ledgers, statements are prepared which set forth and interpret the static and dynamic aspects of the company's financial operation. At each stage of the accounting cycle the forms and records are interwoven with procedures, and the effective utilization is always a result of the combination of the form itself and the procedure affecting its use. The composite picture of all forms and the procedures by which they are used constitutes the accounting system.

The accounting system as so portrayed is always, as we know, a means to an end—that of providing a proper historical record and of enabling the management to operate the business as efficiently as is possible and with the greatest legitimate net profit. More specifically, there are the objectives of information, protection, and control. With respect to information, it is the function of the accounting system to produce accurate and reliable financial information currently in the proper detailed form and with the least possible delay. As to protection, the system by means of its record of accountabilities charged and discharged provides for the minimization of loss from fraud or unintentional causes and waste from carelessness or inefficiency. The management's general responsibilities of stewardship and conservation of resources are thus protected. The accounting system accomplishes the control objectives by allocating responsibilities and bringing about compliance with instructions,

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procedures, and policies. A further objective applying to all of those previously mentioned, but particularly to that of control, is the objective of efficiency, or what one might term maximum utilization. It is a constant aim to carry on the accounting operations in a manner which will be most economical as to time and effort, and with the minimum of error—considering always the cost expended to obtain these results.

These aspects and objectives of the accounting system have been outlined because they are essential to a proper understanding of internal check. Our definition then takes on added meaning when we define internal check as any method or practice which promotes the realization of these objectives. For example, let us take the case of a storekeeper. If the proper perpetual-inventory records are not maintained, the loss of accountability constitutes a weakness of the accounting system along the line of protection. We may say that the internal-check system is defective because of this breakdown in the proper functioning of the system and because of its failure to establish value accountability. Or suppose that, while accountability is maintained in money value, information relative to physical units is not available so that the purchasing department cannot purchase properly. Here the system is not producing the proper information and the control of the purchasing activities is being disrupted. This likewise is defective internal check and a weakness to be remedied. Both faults represent shortcomings of the accounting system in realizing the objectives of information, protection, and control in an efficient manner.

III.

Each type of business transaction has its own special problems and features which relate to internal check. There are a few basic ideas, however, which

are common to all and which rank as controlling principles. To some extent these principles overlap, but despite this defect which can be assessed against any abstract classification, they merit careful consideration.

1. *That responsibility be fixed to as great an extent as possible.*

In operation of any kind which is to be efficient, responsibility must be clearly fixed. The same responsibility may be delegated downward several, or many times, but the chain must be continuous and responsibility must be established at every level. Accountability is a special form of responsibility, as that which exists in the case of the storekeeper or custodian of a petty-cash fund.

The quality of the system of internal check is measured by the degree to which the accounting forms and procedures establish these responsibilities or accountabilities, and the extent to which documentary evidence is built up relative to their creation and discharge.

Fixing of some responsibilities, as for example, the signing of checks in accordance with a corporate resolution furnished to the bank, is more or less forced upon the corporation, but there are many other cases often ignored. For example, when goods are purchased various activities are carried on—the purchase, the receipt of the goods, storing of the goods, approval of the invoices, payment of the invoice, sale of the goods, delivery of the goods, extension of credit, the collection of the account, etc.—and at each stage one or many responsibilities may be involved and must be properly assigned to individuals.

The extent to which such responsibility is fixed is an important measure of the quality of internal check and within reasonable limits is a basic prerequisite to satisfactory internal check.

2. *That accounting and operation be separated.*

Wherever possible it is desirable that a man should not establish the accountability for his own operations. A cashier should not receive money and also perform accounting duties in the general books. Likewise, a store manager being controlled under the retail inventory plan would not be permitted to calculate and set down the retail values in the records which establish his accountability. Such a situation would make it possible for fraud to be practised and in any case would not present the means of ascertaining errors or of maintaining the necessary alertness for the efficient operation of the activity involved.

3. *That no one person be in complete control of an important part of a business transaction.*

This principle is interrelated with the previous one and duplicates it to some extent, but goes farther and refers to a splitting up of activities even within the accounting or operating phases. The more people that can be introduced into a transaction—at least up to the point where there is duplication of effort and confusion because of too many participants—the better assurance is obtained of effective operation. In the first place, fraud is less likely to occur, because collusion between individuals is then necessary and, while that is never an impossibility, the natural fear and hesitancy of suggesting fraudulent action to an associate is ordinarily sufficient to control this tendency. Secondly, the natural pride of individuals to avoid a poor showing with respect to their particular part of the procedure generates an alertness which is wholesome and makes for efficiency. Finally, if one person makes an error in the handling of his part of the transaction, that error will come to the attention of the person handling the next part of the transaction. The philosophy here is essentially

one of checks and balances and is an essential part of all systems of good internal check.

IV.

Just as there are basic principles of internal check, there are general factors of attainment which are applicable to all types of transactions and which play an influential rôle in determining the effectiveness of the system of internal check. They represent, so to speak, the general mechanism of attack on the problem in the light of the principles previously mentioned.

1. *The accounting system.*

(a) Double-Entry System. The rôle of a double-entry system of accounting, while it makes a substantial contribution to internal check, is likely to be exaggerated in this respect. The necessity of effecting a balance under this system, which insures to a certain extent that both sides of a business transaction are given recognition, undoubtedly brings to light many errors and omissions. It does not, however, give any assurance that the correct accounts on the debit or credit side have been charged or credited, and the system does not automatically come to a halt if an entire transaction is omitted. Moreover, it gives no positive protection against fraud or manipulation of accounts. It serves, therefore, as a useful framework and assists somewhat in the detection of error, but its limitations beyond this point must be definitely recognized.

(b) Accounting Forms and Procedures. In the design of accounting forms, considerable aid can be given to the promotion of good internal check. The first requisite is that they be as simply and logically set up as is possible, so that they can be used with the least possible effort and with the minimum chance of error. This is particularly true with regard to laying out the blanks or columns whereby the proof of accuracy of the data on the form is to be established.

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The design of the forms must also be considered in the light of the person who is to use them—his intelligence and background—and the conditions under which the form is to be prepared. The consideration of the procedures relating to the use of the form will determine the provision for approval and verification blanks, and the form and its procedure must at all times be considered together in relation to the general objectives of the entire accounting system.

(c) *Controlling Accounts.* The control of subsidiary ledgers of all kinds through controlling accounts is another important means of promoting the effective operation of the accounting system and of attaining good internal check. Here again the device is not a complete insurance, inasmuch as it will not automatically detect the posting to a wrong account in the subsidiary ledger without some supplementary means of control, but it does contribute materially to the detection of error and fixing of proper responsibility.

(d) *Use of Mechanical Equipment.* In recent years great advances have been made in the development of mechanical equipment of all kinds. These devices in many cases, such as cash registers, check-signing machines, and the like, directly serve the purpose of prevention of dishonesty in addition to their other advantages of economy of time and effort. Take, for example, the case of a tabulating machine using punched cards. While the purpose here is not directly fraud prevention, insofar as it results in better and more prompt analysis of data with a minimum of error, the device promotes the general effectiveness of the accounting system and is a part of the internal check.

2. Clarity of instructions.

Instructions are issued for the operation of the accounting system and also, by department heads and higher executives, regarding other matters. While there are obvious limitations to the

preciseness with which instructions can be written or orally expressed, instructions should be made as clear as possible. Likewise, policies can usually be set down in documentary form and are of great assistance in giving to the employees general notice of the action wanted. The extent to which instructions and policies are reduced to writing and expressed in an understandable manner has a direct effect on the orderliness and efficiency with which the operations involved are carried on. A lack of such proper documentation not only results in a lack of uniformity, but also creates indecision and confusion which causes delay and weakens company morale in general.

3. Personnel factors.

The accounting system with its forms and procedures is carried on by individuals and its efficiency is largely conditioned by this human factor. It is not enough to lay out on paper the technique of the system; it is equally important to study carefully the rôle of the individuals who are to operate it and to consider the ways and means by which their activities can be made more effective.

(a) *Selection and Training of Employees.* The starting point is the proper selection of the employee. The objective is to secure an employee of good health, high character, attractive personal qualities, education suitable to the post being filled or the post it is desired eventually to fill, and finally aptitude for the type of work to be done. Great advances have been made in scientific selection of employees by personnel specialists, but many concerns do not yet approach the problem in a sufficiently long-range manner; instead employees are obtained as is most convenient and without proper consideration of qualifications. The result is necessarily a loss of time and money through a high turnover and a loss of efficiency.

The employee, once selected, must be properly trained if he is to work efficiently. Failure to plan and organize this training often results in the new employee's being dependent on his immediate associates, who may or may not have the ability to impart the necessary training and who, even though properly qualified, may or may not feel disposed to cooperate with him thus. The result is defective operation of the accounting activities, waste of time and effort, and a low level of attainment of the information, protection, and control objectives.

(b) *Working Conditions of Personnel.* Closely related to the efficiency of the personnel are the conditions under which the employees work. This, in its broad sense, includes physical conditions such as sanitation, light, heat, and equipment of all kinds, and other conditions such as rules, attitudes, and policies. Such conditions are basic in influencing the level of efficiency of the employee and, equally important, in developing the proper attitude. All of these underlying factors which affect the efficiency of the accounting activities are positive factors in the attainment of a good system of internal check.

(c) *Rotation of Employees.* We have seen that one basic principle of internal check was that one employee should not be in complete control of an important part of a business transaction. An important means of furthering this principle is the rotating of employees at various intervals. While such a shift usually involves administrative difficulties, it has the double advantage of serving as an insurance against a long-run program of fraud or manipulation, and of broadening the training of the personnel in general. Such shifts, furthermore, in bringing a new mind to each job often serve to develop improved ways of doing things, and the general state of change encourages a healthy alertness. A special form of this rotation

on a more limited scale is the requirement of annual vacations and the replacement of the employee during this period. This provides the minimum opportunity of appraising the employee's work, of avoiding long-run fraud, and of acquainting the employees with the various types of work in the organization.

4. Bonding of employees.

The bonding of employees is in part purely an insurance matter, but it is also a factor in attaining good internal check. As an insurance item, it simply means that the employer has paid a certain premium for which he secures protection against loss from fraud or embezzlement on the part of his employees—at least as long as he complies with the provisions of his contract with the insurance company. Knowledge on the part of the employees, however, that they are bonded and their realization of the serious consequences which will result from fraudulent action serves as a powerful impetus to honest and careful operation. It is, therefore, most desirable that the employee bonded be aware of the fact that he is bonded if these further psychological gains are to be secured. This purpose is accomplished to some extent by the fact that the employee must fill out a bond application when the company first obtains his bond.

5. Organization factors.

A basic principle of internal check is that responsibility be fixed to as great an extent as possible, and the securing of this condition is a matter of organization. Likewise, the organization must be so designed and set up that accounting is separated from operation where possible and that no one person is in complete control of any important part of a business transaction. Organization, which is concerned with the assignment of duties and allocation of responsibilities, is accordingly a major factor in obtaining good internal check. Under a

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good organization setup, accounting matters and matters relating to accounting flow smoothly and systematically along the proper lines, and information is available at any stage from records of one kind or another and the individuals who operate them. Defects in organization, on the other hand, cause error, confusion, and delay, and break down the effectiveness of the system's operation in all directions.

(a) **Organization Discipline.** It is one thing to have a scientific organization scheme laid out on paper, and still another to get it to operate effectively. The maintenance of effective operation of a good system once established lies in the alertness and discipline of the persons who are a part of the organization. This means that every executive and officer, from the top rank down through the rank and file, must maintain an alertness and discipline commensurate with his rank and ability. In other words, each individual at every level of authority must be aware of his own responsibilities and enforce the observance of responsibility of at least the next ranking individual below him. The failure to do this generates laxity, which is contagious and is one of the most serious obstacles to good internal check. Particularly dangerous is a lack of sympathetic coöperation by officers and executives who are somewhat removed from the accounting routines and who, because of their failure to understand the significance of these matters, are inclined to regard them as useless form. Such action undermines the organization discipline and creates serious obstacles to effective operation.

(b) **Follow-up of Error or Unsatisfactory Conditions.** Closely related to the organization discipline is the procedure for control of errors, discrepancies, variations downward from standards, and unsatisfactory conditions in general. Such situations present opportunities for the preservation of good internal check and its constructive

improvement. First of all, there is usually the prima-facie evidence that someone has been negligent or inefficient and, while this initial presumption may often be incorrect, the event serves as a starting point to ascertain whether or not this is really the case. Should the initial presumption hold, it calls for suitable action in some form, at least to the point of making it known to the offender that the fault is a matter of knowledge to higher authority. But a larger field of constructive effort exists in a study of the conditions which made the error possible. What is it about the system in force which permits errors or unsatisfactory events of this nature to occur? What, if anything, in the light of the cost thereof can be done to eliminate or minimize it. The follow-up of these matters will not only develop improvements in the system in general, but will serve as one of the most potent psychological forces. The errors or other unfortunate incidents, instead of undermining the system, can be turned about as offensive tactics to the development of improvements and increased efficiency.

AUDITING

As a final factor of attainment of good internal check it is appropriate to discuss safeguards. Assuming that a good system of internal check has been devised and has been put into operation, we have seen that there are then forces at work such as organization, discipline, and follow-up of errors which serve as a continuous impetus to the efficient operation of the system. Nevertheless there exists the human tendency to relax and to depart gradually from the original standards of procedure. It is necessary, therefore, to develop a program of more or less independent and detached safeguards which will serve as tests or indexes of whether the internal check is being properly maintained. Such a program may consist of activities within or without the company,

but the general characteristic is that they are supplementary to the normal routine and to the expedients which are developed as a part of the regular operation of the business. It is at this point that we embark into the field of auditing. Such activity is designed to ascertain whether the system as devised is properly functioning, and at all times it has the further objective of evaluating the adequacy of the system itself.

1. *Test checks by company executives and officers on a part-time basis.*

The simplest type of program, and one carried on in smaller businesses, is where the executives or other company personnel make spot checks of one kind or another. For example, an executive or some other employee engaged in saleswork may at irregular intervals physically verify an inventory which is under the control of a given individual. Or a test check may be made as to whether sales invoices are being priced correctly. Such programs have been known to be very effective and, when carried on in a small business by a capable and energetic executive, represent a very satisfactory solution to an otherwise impossible problem. The limitations of this program, however, are that it is admittedly a sideline and is very likely to be neglected, especially when other matters are at all pressing. Many such programs are started with the best of intentions and then gradually break down because of the pressure of current operating matters.

2. *Outside service agencies.*

A very common procedure—particularly in the retail field—is to employ outside agencies to visit the stores and to report on conditions there existing. Some of these agencies concern themselves primarily with detection of fraud, and the representative makes cash purchases as a test to see whether the sale is properly recorded on the cash

register or reported in the regular way. Other agencies report on the appearance of the store and salespeople, the manner in which the representative was treated, and other matters of interest to the company headquarters. Some of these agencies operate on a national basis and others exist only in particular localities. The writer knows of one group which travels about the country, notifying its clients beforehand of its itinerary, and inviting assignments while in a given area.

3. *The outside audit.*

The professional auditor, as a part of his regular auditing activities, has contributed to the attainment of a good system of internal check in two major ways. In the first place, his contact with the company during the course of his audit may develop findings which lead to the discovery of unsatisfactory practices, and he is able—to some extent, at least—to note defects of internal check. These may be called to the client's attention in the desired manner, together with suggestions or recommendations as to the preferred procedure. Secondly, the very fact that an outside audit is made has a certain psychological value in promoting honest and efficient operation on the part of the personnel.

The smaller the organization and the more intimate the outside auditor's relationship is with the client, the more effective will be the services of this kind rendered. The larger the organization grows, the more difficult it becomes for the outside auditor to maintain the close contact with his client necessary to appraise the more detailed phases of internal check. It is of course true that the outside accountant may be engaged on a special basis to study the internal check and system features, and in such a case better results are obtainable. It is clear that the system activities carried on in the course of a regular annual audit must necessarily be limited in scope.

4. *The internal auditing department.*

Where an organization has grown very large and where the nature of its operations warrant, a separate internal-auditing department becomes an important means of attaining and safeguarding a good system of internal check. Such a department, when properly organized, is a detached group of full-time specialists, not burdened with operating responsibilities, and has to a greater extent than the outside auditor sufficient time to carry on the detailed activities necessary to appraise the system of internal check. In addition, it has the advantage of an intimate knowledge of the company's operations and the industry of which it is a part. While such a department performs a variety of other services to management, certainly one of its most important activities has to do with internal check. This is true with respect to appraising both the system which has been set up and the manner in which it is operating. In the large modern corporation, this safeguard to internal check is likely to become increasingly significant, and the desirability of properly coördinating this group with the outside auditor more apparent.

V.

The purpose of this paper has been to discuss the nature and basis of internal check, and not to deal with the detailed application of internal-check principles to specific phases of the accounting system or its operation. The interpreta-

tions of the term itself have been varied and in many cases narrow, and in the light of modern accounting activities the need exists to define its scope more clearly. The term, internal check, suggests, unfortunately, mechanical aspects which are too limited and exclude the qualitative aspects of all phases of the financial and accounting activities. It has also been the approach of many writers to associate the term exclusively with the prevention and detection of fraud. Certainly these are, and always will be, important matters of concern to the accountant and auditor, but the term should not be restricted to these activities only. The end sought in the case of all accounting activities is the maximum efficiency of providing information, protection, and control, and any phase of the system or its procedures which relate to this efficiency are part of the field of internal check.

Discussion of the general principles of internal check and the related factors of attainment provides the needed background and serves as a starting point from which applications can be made to every phase of the accounting system's operation. It is in that way only that positive gains can be derived. The importance of such applications and the relationship that exists between internal check and the general efficiency of the accounting system are such that the subject deserves the most careful consideration on the part of all students of accountancy and accounting practitioners. It is to that end that the present paper is directed.