
UNIT 4: INTERNAL CONTROL

2.1 INTRODUCTION

The Important consideration of internal control in this unit has three major objectives first, to explain the meaning of internal control, second, the significance of purpose and objective of internal control third, the characteristics of good internal control. In this Unit, students should able to know the broad classification of internal control as accounting and administrative control; and the major weakness of internal control. This unit tries to show the internal control over cash, Accounts Receivable (credit sales), payroll, and fixed assets.

2.2 DEFINITION

Internal Control is a process effected by an entity's board of directors, management, and other personnel that is designed to provide reasonable assurance regarding the achievement of objectives in the following categories.

- (1) effectiveness and efficiency of operations
- (2) Reliability of financial reporting, and
- (3) Compliance with applicable laws and regulations. alternative definition defined by AICPA (American Institutes for certifications of public accountants) as: Internal control referees to all coordinate methods and measures within an organization or within a system adopted to safeguard assets, check accuracy and reliability of accounting data, promote operational efficiency and encourage adherence to prescribed managerial policy.

Overall internal controls are also defined as operational checks and balances that prevent loss due to fraud, waste, abuse, and management of resources. The resources include: personnel, information, and capital.

2.3 PURPOSES AND OBJECTIVES OF INTERNAL CONTROL

The purpose of internal control can be explained in to two aspects:

- a) The management (client) concern and
 - b) The Auditors concern
- (a) **The client concern** – the reason an organization establishes a system of internal control is to attain objectives (goals). Generally management has six purposes in setting good system of internal control. These are to:
- (i) achieve reliability of accounting records.
 - (ii) safeguard assets
 - (iii) increase profitability
 - (iv) prevent and defeat frauds and errors
 - (v) prepare financial statements timely
 - (vi) discharge laws, rules & regulations
- (b) **Auditors concern:** The generally accepted auditing standard field work standard, number, (3) three states that a sufficient understanding of internal control is to be obtained to plan the audit and determine the nature, timing and extent of testes to be performed. Thus, the primary purpose of studying and evaluating of internal control system by external auditors is to determine the amount of audit work. It is assumed that good internal control provides more reliable financial data and statements.

The objectives internal control includes to:

- (i) control operations – to ensure efficiency and effectiveness
- (ii) control financial reports – To ensure the preparation of reliable financial statements
- (iii) control compliance – To ensure compliance of laws, regulations.

2.4 ESSENTIAL ELEMENTS OF SOUND (EFFECTIVE) INTERNAL CONTROL

Essential elements are components of strong internal control. They are used to evaluate the strengths and weakness of internal control system.

2.4.1. Competent, trustworthy personnel with clear lines of authority and responsibility

The most important element of any internal control is personnel. If the employees are competent (well trained) and trustworthy (TRUST), some of other elements can be absent and reliable financial information's will still result. Specific responsibility for performance of a given duties must be assigned to specific Individuals. Organizational structure defines how authority and responsibility are delegated and monitored. It provides a frame work for planning executing, and monitoring operations.

2.4.2. Segregation of Duties

It is Important for an organization to segregate (separate) the authorization of transactions, recording of transactions, and custody of the related assets. Independent performance of each of these functions reduces the opportunity for any one person to be in apposition both to perpetrate and to conceal errors or Irregular in the normal course of his or her duties. Example: first, if an employee can authorize the sale of marketable securities and has access to the stock certificates, the assets can be misappropriated. Second, If an employee receive payment from customers on account and has access to the accounts receivable subsidiary ledger, It is possible for that employee to misappropriate the cash and cover the shortage in the accounting records.

There are four guidelines for segregations of duties to prevent both intentional and unintentional errors and frauds.

- (a) *Separation of the custody of assets from accounting.* For example, If one person is responsible for store keeping (custody of inventory) and maintains inventory records, it is possible to ship (dispatch) some Items for his /herself and adjust the Inventory balance by recording a factious transaction.
- (b) *Separation of the authorization of transaction from the custody of related assets* – for example, If one person is assigned For authorization of payment transaction, and handling of cash it in creases the possibility of frauds.
- (c) *Separation of duties within the accounting section function:* Examples include: The recording in journals and related subsidiary ledgers and then keeping of control ledgers in principle should be separated. Recording in

sales journals and recording in cash receipts journal and Accounts Receivable control Ledger keeping should be separated. Accounts payable control clerk should not record cash payments journal.

- (d) *Separations of operational responsibilities from record - keeping.* For example, accounting functions should be separated from management department activities.

2.4.3. Documentation Procedures

Documents provide evidence that transactions and events have occurred. Several procedures should be established for documents. first, whenever, possible, document should be pre - numbered and all documents should be accounted for pre numbering accounting documents should be promptly forwarded to accounting to help timely recording documents should be produced in copies, they should be simple to understand, sufficient, and designed for multiple uses.

2.4.4. Authorization Procedures

Every transaction must be properly authorized. Properly authorization implies that concerned personnel should authorize (approve) each transactions at each step where transactions occurs. For example, the authorized person for paying cash is the cashier, for receiving, it is the store clerk, for permitting the transaction it is the manager etc.

2.4.5. Physical Control Over Assets and Records

Physical control relates primarily to safeguard asset from theft, deterioration, spoilage, etc. Accounting records and securities, (bonds, Debentures, Treasury stocks, cheeks, notes,) should be in well locked custody. Inventories should be protected by constructing from fire proof materials, well - ventilated room and locked doors, generally,

- Safes and vaults are necessary to store cash before the cash is deposited in a bank.
- Locked ware houses for inventories.
- Fencing of the organization.
- Locked storage cabinets for accounting records. etc; are necessary elements, of physical control.

2.4.6. Internal verification (Independent Internal Verification or Checking)

This element of internal control refers to the need of Independent checking process. Which involves, Reviewing, comparison, reconciliation of data, which are prepared by the other personnel, and the findings (discrepancies) should be corrected.

2.5 LIMITATIONS OF INTERNAL CONTROL

An internal control system should be designed and operated to provide reasonable assurance. That is an entity's cost of internal control system should not exceed the benefits that are expected to be derived. The necessity of balancing the cost of Internal controls with the related benefits requires considerable estimation and judgment on the part of management. Therefore the idea of reasonable assurance arises from two concepts: cost - benefit, and the inherent weakness: The cost - includes paying employees for implementing the system, constructing and acquiring facilities (safes, stoves) printing of vouchers, forms, etc. the benefits includes prevention of potential losses.

The inherent limitations include management override of internal control, personnel errors, or mistakes, and collusion.

- (i) **Management override of internal control:** an entity's controls may be overridden by management. For example, a senior - Level manager can require a low - level employee to record entries into the accounting records (because) that are not consistent with the substance of the transactions and are in violation of the organization's control. The lower - level employee may record the transaction, even though he or she knows that it is a violation of control, because of fear of losing he's or her job.
- (ii) **Personnel errors or mistakes** - The internal control system is only as effective as the personnel who implement and perform the controls. For example, employees may misunderstand instructions or make errors of judgment. They may make mistakes because of personnel carelessness, distraction, or fatigued.
- (iii) **Collusion** - the effectiveness of segregation of duties lies in the Individuals performing only their assigned tasks or in the performance of one person being checked by another. Collusion may occur, for example, an individual who receives cash receipts from customers collude (agree) with the one who records those receipts in the customers' records order to steal cash from the entity.