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CONTENTS **PAGE**

MODULE 1

UNIT 1: DEFINITIONS OF INTERNAL CONTROL

CONTENTS

1.0 INTRODUCTION

Welcome to this course on Internal Control. In this course, it is designed to help business owners and operators understand the need for internal controls and develop simple systems to put in place in their businesses. Whether a business is a sole trader or has many employees, introducing internal controls will ensure that the business runs more efficiently, resources aren't lost and there are fewer unpleasant surprises.

Organizations especially small businesses are the most vulnerable to fraud because they often don't have effective internal controls. You could also paralyse your business trying to cover every possible contingency. However, by removing opportunity and motivation for fraud and theft, and ensuring you have systems in place to discourage errors and identify mistakes and anomalies quickly, you are able to discourage fraud in the first place and, if that fails, you can take corrective action to minimise losses.

Good internal controls help you manage resources and make sure operations are efficient and effective. Owners/managers of businesses hold the key to the fight against internal control failures and must be attentive to the concept and issues of internal controls to maximise the business potential and minimise the risk of fraud, error and loss.

Thus, this course has been designed primarily to develop your awareness of a good internal control system and the techniques used to minimize the risk of fraud, error and loss.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- define the term internal control
- outline the points to note in internal control definition
- list the major objectives internal control is designed to achieve

3.0 MAIN CONTENT

3.1 Definition of Internal Control

The internal control system is concerned with the control operative in every area of corporate activity. It is defined according to ICMA as "the whole system of controls, financial and otherwise, established by the management in order to carry on the business of the enterprise in an orderly and efficient manner, ensure adherence to management policies, safeguard the assets and secure as far as possible the completeness and accuracy of the financial records".

3.2 Points to Note in Definitions of Internal Control

The individual components of an internal control system are known as controls. The important points to note in this definition are as follows:

1. The internal control system is established by management.
2. The controls are designed to achieve four major objectives. These are:
   a. To enable management carry on the business in an orderly and efficient manner.
   b. To ensure that management policies are adhered to throughout the organization.
   c. To ensure that proper custody is maintained over the valuable assets of the enterprise.
   d. To ensure that all authorized information is recorded accurately and correctly.

These objectives are better known through the explanation of the following key terms: orderly management of business; adherence to policies; proper custody of valuable assets; and authorization of information.

3.3 Who is in Control?

Management is responsible for internal controls. Walking through the five components of control explains why.

a) Management has the most influence on the control environment for a department.
b) Management sets business objectives; helps employees understand the objectives, and can encourage employees to discuss the risks to achieving them.
c) Management establishes the activities needed to ensure everyone is carrying out its directives.
d) Management is responsible for facilitating communications and information flow within a department.
e) Finally, management provides day-to-day supervision.

Thus, if management buys into the COSO definition, they should also buy into the idea that controls are one of their key responsibilities.

Auditors can facilitate this buy-in by explaining to management what internal control means and focusing in COSO's role as a "framework" that embraces many other controls and management mechanisms. Auditors should also explain that controls exist to help achieve basic objectives, like serving the customers, selling goods, and protecting assets.

Finally, internal auditors need to fully understand that management and employees working in an area are the "experts" in the business of that area and will always know more about what goes on than the internal auditors who periodically visit it. If internal controls are truly effective, all five components of COSO are working even when the auditors are not working.

4.0 CONCLUSION

In this unit, you have learnt about the term 'internal control', important points to note when defining internal control and the objectives for which internal control is designed to achieve.

5.0 SUMMARY

If risk of fraud, error or losses is to be reduced, then there must be effective internal control system in place. Organizations must put in place an adequate internal control and must take into cognizance the objectives the internal control put in place is designed for.

6.0 TUTOR-MARKED ASSIGNMENT

1. Define the term 'internal control'?
2. Itemized the objectives of putting in place a good internal control system.

7.0 REFERENCES/FURTHER READING

CPA (2007) Internal Control for Small Business Melbourne-Australia: CPA Australia Limited

UNIT 2: TYPES OF INTERNAL CONTROL

CONTENTS

1.0 INTRODUCTION

The internal control of assets (and liabilities) in any organization should be thoroughly done to reduce inherited fraud. The internal control should cover control of valuable assets, objectivity in recording their historical costs, integrity on the part of the recording personnel, supervision control, authorization of records and activities should be acknowledged by means of signatures, initials, rubber stamp etc.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- state the acronym for types of internal control
- explain each letter of the acronym
- list other categories of internal control
- explain the other types listed

3.0 MAIN CONTENT

3.1 Types of Internal Controls

Management may decide on any type of suitable internal control(s) for the organization. According to the guidelines issued by the Institute of Chartered Accountants of England and Wales (ICAEW) on Internal Control, the types of internal control are mnemonically put as **'PAPAMOSS'**. The Acronym is a list of some of the types of controls that may be found in many enterprises. The meaning of the acronym **'PAPAMOSS'** is highlighted below.

'**P**' Physical controls over assets
'**A**' Arithmetical and Accounting Controls
'**P**' Personnel Controls
'**A**' Authorizations and Approvals
'**M**' Management Controls
'**O**' Organizational Controls
'**S**' Segregation of Duties
'**S**' Supervisory Controls

a. 'P' **Physical controls over assets:** These are those procedures and measures set up to secure proper custody over valuable corporate assets. They prevent unauthorized access to these assets. All assets of an organization should be safeguarded at all times especially the valuable and portable assets such as cash, stock and motor vehicle. Security of assets should be designed to ensure that access to assets is limited to authorized persons and no asset is stolen without notice.

b. 'A' **Arithmetical and Accounting Controls:** These controls, which are predominant in the recording function, ensure that all transactions occurring during the period have been authorized, and that they have all been correctly and accurately recorded and processed. There should be a system of checks on the arithmetic accuracy of the accounts kept in respect of transactions e.g. extraction of balances, to check the accuracy of all postings during a given period, establishment of control accounts of creditors and debtors and the preparation of Bank reconciliation statement etc. This example also includes checking the arithmetical and accuracy of calculations and maintaining and checking control totals.

c. 'P' **Personnel Controls:** no matter how well a system is designed, its efficient and effective functioning will depend on the operators. Controls are therefore necessary to ensure that personnel have capabilities commensurate with their responsibilities. Theses controls, known as personnel controls, provide a framework for ensuring an efficient selection and training procedure for staff. There should be qualification system to ensure that a capable staff is allocated to a particular duty and is sufficiently motivated to ensure effective and efficient performance of his duty with complete integrity.

d. 'A' **Authorizations and Approvals:** These are those controls, which specify the persons responsible for authorizing and approving transactions and the limits of such authority. All transactions should be authorized and approved by responsible officials before the organization is financially committed. Such authority should be clearly specified in writing and the limit of authority or responsibility clearly defined.

e. 'M' **Management Controls:** These are those controls characteristically executed by top management on a periodic basis as against a daily basis. Conceivably, they include periodic reviews of management accounts and comparison thereof with budgets and other special reviews. Some writers call management controls overriding controls. It is the responsibility of management to establish control for day-to-day operation of the affairs of the organization and this will include supervisor controls, internal audit functions, review of management accounts and comparison of actual result with budget and other review procedures.

f. 'O' **Organizational Controls:** These are those controls, rules, regulations and procedures which:

- Specify the organizational plan (structure)

- Define roles and allocates responsibilities; and
- Identifying lines of reporting for all aspects of the enterprises' operations.

Responsibilities should be allocated to staff according to experience and proficiency and the line of reporting should be clearly indicated. It is of importance that an organization has an organizational chart showing all lines of reporting.

g. 'S' **Segregation of Duties:** They are those controls, which ensure that separate individuals or groups of individuals carry out the main functions of an organization of authorization, executive, custody and recording. It is believed that the separation of these critical duties will minimize the inherent risk of fraud or errors and increase the element of checking within the system. This is to ensure that no one person is responsible for all aspects of a transaction. In other words, the job should be arranged in such a way that the work of one person is complementary to that of another or independently checked by another person so that fraud and error may be minimized or early detection maximized. Involvement of more individuals reduces the risk of accidental error and deliberate fraud.

h. 'S' **Supervisory Controls:** These are controls over day-to-day activities of the organization, which ensure that the work of less experienced staff are reviewed and controlled by independent, more senior and experienced staff. This is part of the internal check. The checker should have a thorough knowledge of the job.

3.2 Other Categories/Types of Internal Control

In addition to the above control (PAPAMOSS), the other categories are:

i. **Acknowledgement of performance:** This is the control that specifies that for each activity performed, the person that performs the activity must acknowledge in writing that he performed the activity. The level of acknowledgement varies from simply signing-off with date or doing it with brief comment on the activity carried out. It is expected that somebody will not acknowledge a performance he is not sure of. Persons performing data processing operations should acknowledge their activities by means of signatures, initials, rubber stamp etc. For example, if invoice calculations have to be checked, the checker should initial each invoice. Acknowledgement of performance not only allows blame to be ascribed but also has a powerful psychological effect. Audit clerks usually initial the audit programme when they have completed part of the work. Even audit clerks reluctantly confirm in writing that they have examined a thousand credit notes when they looked at only one hundred.

j. **Budgeting Controls:** These are controls that set targets for activities, volumes and other financials of the organization. Targets are set for the number of new customers for the marketers, for expenses, sales, production, stock levels, purchases, fixed assets acquisition etc. These targets act as goal motivation for the employees. They also form reasonable basis for assessing staff efforts. A common control technique applied in business is the use of budgets, which can be defined as a quantitative plan of action. Budgets having been agreed can be compared with actual performance and differences investigated.

3.3 Inherent Limitations

No internal control system, however elaborate, can buy itself guarantee an efficient administration and the completeness and accuracy of the records. This is so because of the following reasons:

(i) Two or more dishonest persons working in collusion can override the efficacy of the best possible controls;

(ii) Authorization controls can be abused by those in whom the authority is vested;

(iii) Management is in a position to override controls set-up by it.

(iv) Pressure exerted from within and outside the organization can influence the integrity and competence of staff;

(v) Human errors doe to errors of judgement and interpretation, misunderstanding, carelessness, fatigue or distraction can undermine the effective operation of internal controls.

Because of these inherent limitations in even the most effective internal control system, it will not be possible for the auditor to rely solely on its operations as a basis for his opinion on the financial statements or process. In some organizations, the auditor may be unable to determine whether all the transactions have been reflected in the accounting records unless there are effective internal controls.

3.4 Components of Internal Control

Internal control consists of five inter-related components or activities. There are five steps, or components, in COSO's internal control framework, all of which are management's responsibility to perform. These internal control components are presented as a pyramid, with control environment as the base, risk assessment and control activities the next levels up, information and communication near the top, and monitoring at the peak.

3.4.1 Control Environment

The control environment contains informal, and often intangible, soft controls, such as ethics, integrity, management philosophy, and commitment to competence, as well as more formal controls like organizational structure and assignment of roles and responsibilities. The control environment consists of those factors that set the tone of an organization and thereby influence the control consciousness of people in the organization. The factors reflected in the control environment, some have been mentioned above include the followings:

(i) Integrity and ethical values;
(ii) Commitment to competence;
(iii) Board of directors or audit commitment activities;
(iv) Management's philosophy and operating style;
(v) Organizational culture;
(vi) Assignment of authority and responsibility; and
(vii) Human resources policies and practices.

The control environment is the foundation for the other components of internal controls, providing discipline and structure. All of the other components of control depend on the solidity of this base. It provides an atmosphere in which people conduct their activities and carry out their control responsibilities.

3.4.2 Risk Assessment

Management sets both entity-wide objectives and activity objectives, identifying and analyzing the risks that these objectives will not be achieved. All entities, regardless of size, structure, nature or industry are subject to business risk. Business risks affect each entity's ability to survive, compete successfully within its industry, maintain its financial strength and positive public image and safeguard the overall quality of its products, services and well being of its people.

The decision to be in business is a decision to accept risk. There is no practical way to reduce risk to zero. Management and the board of directors decide what risks to accept and the extent and methods to be applied to monitor and mitigate the risks. Because economic, industry, regulatory and operating conditions continue to change, mechanisms are needed to identify and deal with the special risks associated with change.

During a risk assessment, management identifies and analyzes risks to the achievement of its objectives and forms a basis for determining how the risks should be managed. Management should have identified and initiated measures to mitigate the important risks, based on their probability and impact, before the auditors begin an audit. The auditors should then evaluate the risk assessment process.

3.4.3 Control Activities

The mechanisms management establishes to ensure that their directives are carried out, including the activities identified to mitigate risks, are control activities. These controls depend greatly on the activity under consideration. A great deal of activity-specific knowledge is required to determine what the controls should be. COSO's control framework presents a risk control matrix that analyzes activity-level objectives, risks and controls. This matrix is but one method of establishing control activities. Other methods or ways of establishing control activities includes:

a) Flow charting;
b) Analyzing the completeness, accuracy, authorization, timeliness of transactions;
c) Safeguarding of the input, processing, and output (IPO) of transactions; and
d) Strength, weaknesses, opportunities and threats (SWOT) analysis.

4.0 CONCLUSION

Internal control in an organization should include physical control over assets, arithmetic and accounting control, personnel control, authorization and approval control, management control, organization control, segregation of duties, supervisory control, acknowledgement of performance and budgeting. It is therefore important for organizations to understand these controls very well and their expectations and proper documentation.

5.0 SUMMARY

In this unit, you learnt different types of internal control, its acronym and other types of internal control like budgeting and acknowledgement of performance. I hope these types of internal control will help build up for the next unit - Importance of internal control system.

6.0 TUTOR-MARKED ASSIGNMENT

1. Write in full the acronym “PAPAMOSS”.
2. Explain the types of internal control you know.
3. Mention other types of internal control apart from ‘PAPAMOSS’

7.0 REFERENCES/FURTHER READINGS

Albert, L. N. and Cenker, W.J. (2003) *An assessment of the newly defined internal audit function,* Managerial Auditing Journal, *University Press ISSN 0268-6902* 17(3):130-137

Papastathis, P. (2003) *The Modern Internal Control in Businesses and its applications in them*, A, Athens

UNIT 3: IMPORTANCE OF INTERNAL CONTROL SYSTEM

CONTENTS

1.0 INTRODUCTION

Losses through fraud and embezzlement by associates and employees at all levels-property, corporate and ownership levels -contribute to cost pressures in an organization. It is therefore compulsory for organisations to carry out effective and efficient internal control in an organisation when the importance is considered.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- highlight the importance of internal control system
- explain the importance highlighted

3.0 MAIN CONTENT

3.1 Highlights of Importance of Internal Control system

The following is a highlight of the importance of internal control system. The importance is highlighted below.

(i) Management of risks

(ii) Report facilitation

(iii) Effective financial control

(iv) Risk control

3.2 Explanation of Highlighted Importance

i. <u>Management of Risks</u>

An organisation's system of internal control has a key role to play in the management of risks that are significant to the fulfillment of its business objective. A sound system of internal control contributes to safeguarding the shareholders investment and the company's assets.

ii. <u>Report Facilitation</u>

It facilitates the efficiency and effectiveness of internal and external reporting, and assets compliance with laws and regulations.

iii. <u>Effective Financial Control</u>

Effective financial controls (including the maintenance of proper accounting records) are an important element of internal control. They help to ensure that the organisation is not unnecessarily exposed to avoidable financial risks and the financial information used within the business and for external publications is reliable. They also contribute to the safeguarding of assets, including the prevention and detection of fraud.

iv. <u>Risk Control</u>

An organization's objective, its internal structure and the environment in which it operates are continually evolving and as a result, the risks it faces are continually changing. A sound system of internal control therefore depends on a thorough and regular evaluation of the nature and extent of the risks to which the organization is exposed. Since profits are in part, the reward for successful risk taking in business, the purpose of internal control is to help manage and control risk appropriately rather than to eliminate it.

4.0 CONCLUSION

The importance of internal control system contributes to safeguarding the shareholders investment and the company's assets, ensures assets compliance with laws and regulations, maintenance of proper accounting records, and managing and controlling of risk appropriately rather than to eliminate it. It is necessary you know this in order to know the essence for which internal control system should be designed.

5.0 SUMMARY

In this unit, you have learnt the importance of internal control system, as well as how to highlight and explain them. These are reasons why organizations can see the benefits in establishing a sound internal control system.

6.0 TUTOR-MARKED ASSIGNMENT

1. Highlight the importance of internal control system.
2. Explain the points highlighted in question one.

7.0 REFERENCES/FURTHER READING

Bounton, W. C. and KellWalter, G. (1996) *Modern Auditing*, 6th edition, John Wiley and Sons, Inc.

UNIT 4: FEATURES OF INTERNAL CONTROL SYSTEM

CONTENTS

1.0 INTRODUCTION

The nature of the control operating within any commercial organization is determined by the organizational structure of the organisation as this determines the basis and type of controls that are likely to be put in place in such organisation. This unit is designed to enable you know the characteristics of a good internal control system. It is designed to make you know those necessary things that must be featured in a good internal control system before you can adequately carry out internal control in an organization.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- know the factors determining internal control system
- mention and explain the features of internal control system
- explain the relationship between internal control and statutory audit

- know the content of management reports on internal control conducted
- know what internal check is and what it includes

3.0 MAIN CONTENT

3.1 Factors Determining Internal Control System

One basic feature that is common to all internal control systems is the separation of duties. The principle ensures that the three basic functions of authorization, custody and recording are given to different people to avoid a situation where a single person can process a transaction from the initiation stage to the recording stage.

A good organization structure should be evidenced by organizational charts and written job descriptions showing authorities, duties and lines of reporting. For a good audit practice the auditor should obtain a copy of all organizational charts so to familiarize him with the level of authority and lines of reporting existing in the client's organization as the control weaknesses inherent in a system are likely to be disclosed by such charts. At any rate, the features of internal control will depend among other factors on:

1. The nature and size of the business conducted,
2. The number of administrative staff involved.
3. The materiality of transactions concerned
4. The importance placed upon the internal control system by the management.
5. The Management style of the entity, particularly the trust placed on the integrity of the key person and the latter's ability to supervise and control his/her subordinate staff.

3.2 Features of Internal Control System

However, the following are the features of internal control system;

1. A whole system: Internal control can be seen as single procedures or as a whole system. The whole system is more than the sum of the parts
2. Established by the management: Internal control systems are established by the management directly or by means of external consultants, internal audit, or accounting personnel.
3. Ensure adherence to management policies: An effective internal control system will enable an organization to implement its plans and policies as laid down by the management
4. Safeguarding the assets of an organization: An effective internal control system guards and protects the resources of an organization. It ensures that the financial resources of an organization are not misappropriated or embezzled, and also ensures that the physical assets of an organization are not misused.
5. Accuracy of the records: An internal control system enables the records of the organization to be complete and accurate. It also ensures that the books of account are not tampered with by unauthorized persons.
6. Financial and other controls: Internal control makes use of financial control such as the use of control accounts. It also makes use of other control measures such as physical access restriction to computer terminals.

3.3 Internal Control and Statutory Audit

With the complexity in business environment, internal control forms the basis of modern auditing as it is neither desirable nor reasonable for an auditor to carry out hundred percent checks of all the transactions entered into by a client during the course of the financial period. The internal control system in an organization (with its strengths and weaknesses) provides the auditor with reasonable number of evidence which enables him express an opinion on the client's financial statement after its proper evaluation.

Otherwise, the work of an auditor will be so boring, uninteresting and quite discouraging with the attendant heavy burden on the client. While it is the responsibility of management to set up and maintain the internal control system, it should be clearly stated that the annual audit exercise is not a substitute for effective management control.

3.4 Reports to Management on Internal Control Systems

It is the management's responsibility to prepare financial statements and institute control systems in operation to forestall the occurrence of frauds and errors. It is the auditor's responsibility to assess the effectiveness of a client's control system so as to determine the extent of reliance to place on the controls. During the course of an audit, the auditor may come across weaknesses in the client's system which may undermine the completeness, accuracy and validity of the client's transactions.

In this regard, the auditor has a professional duty to provide constructive criticisms of the client's system in a formal report to the client's management known as the Management Letter (ML) or Letter of Control Weaknesses (LCW) or Domestic Report (DR).

This letter should not only highlight the weaknesses that come to the auditors' attention during the audit, it should also highlight the likely consequences of such weaknesses and the: auditor's recommendations to improve the system in the future.

The fact that the auditor reports to management on control systems does not diminish the management's responsibility from instituting effective control systems and neither does it prevent the auditors from considering the effects of such weaknesses on the auditor's tests and procedures.

It is a good practice to follow-up all management letter points on subsequent audit visits so as to ensure that the auditor's recommendations have been implemented. If the auditors establish that the weaknesses are still in existence, it is customary to write a fresh management letter, drawing attention to previous weaknesses earlier highlighted. This in effect implies that as long as a weakness remains in the client's system, references should always be made to it in new reports written to the client's management.

3.5 Internal Check

Internal check is part of the internal control system. It has been defined to mean those routine day-to-day controls over transactions which are designed to minimize the risk of errors and irregularities. Internal check includes:

1. Controls designed to ensure that the duties of authorization, execution, recording and custody are not done by one employee.
2. Supervisory controls exercised by middle and lower level management over the work of subordinates.
3. Arithmetical and accounting controls designed to ensure the accuracy, completeness and correctness of records and especially those controls to ensure that the work of one person is independently proven by that of another in the normal course of his work.

4.0 CONCLUSION

The features of any internal control system should include a whole system, established by the management, ensure adherence to management policies, safeguarding the assets of an organization, accuracy of the records, and financial and other controls. These features are as a result of determining factors such as the nature and size of the business conducted the numbers of administrative staff involved, the materiality of transactions concerned, the importance placed upon the internal control system by the management and the management style of the entity.

5.0 SUMMARY

In this unit, I discussed features of internal control system, its determinants, internal check and the responsibilities of management and auditors on internal control reports.

6.0 TUTOR-MARKED ASSIGNMENT

1. What are the factors determining internal control system

2. Mention and explain the features of internal control system
3. What is the relationship between internal control and statutory audit?
4. What are the responsibilities of management and auditors on internal control reports?
5. What is internal check? and what does it comprise of?

7.0 REFERENCES/FURTHER READING

Cook and Wincle (1976) *Auditing,* Philosophy and Technique, pp. 136.

Mara, A. (1991) *Internal Control, Cost Analysis, Pricing in Hotels,* The Technological Education Institute of Athens.

MODULE 2

UNIT 5: INTERNAL AUDIT

CONTENTS

7.0 References/Further Reading

1.0 INTRODUCTION

Internal audit is an independent appraisal function within an organization for the review of activities, in order to review the accounting systems and related internal controls. In this unit, I will examine the definition of internal audit, functions, elements, internal audit reports and programmes, e. t. c.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- define internal audit
- mention the functions of internal audit
- discuss the elements of internal audit
- explain the term internal audit report
- discuss the audit of internal control system
- compare the internal control questionnaire with the internal control evaluation questionnaire
- discuss on internal audit programmes and working papers

3.0 MAIN CONTENT

3.1 Internal Audit Defined

Internal audit is an element of the internal check system set up by the management of an enterprise to carryout a review of the accounting and internal check system. The internal audit assigned staffs that make up the internal audit department.

The internal audit is an independent appraisal function within an organization for the review of various activities as a service to all levels of management. It is a form of control to measure, evaluate and report upon the effectiveness of other controls, financial and otherwise as a contribution to the effective use of the resources within the organization.

3.2 Functions of Internal Audit

1. Review of accounting systems and related internal controls.
2. Examination of financial and operational information for management.
3. Review of the economy, efficiency and effectiveness of operations.
4. Assistance in the implementation of new accounting system.
5. Review of the implementation of corporate policies, plans and procedures.
6. Special investigation.

3.3 Essential Elements of Internal Audit

1. **INDEPENDENCE:** Internal auditing is carried out by independent personnel. Internal auditors are employees of the firm and their independence is not always easy to achieve. However, it can be assisted by;
   - Having the freedom to arrange its own priorities and activities
   - Having unrestricted access to record assets and personnel
   - Freedom to report to higher management and where it exists to an audit committee
   - Internal audit personnel who have no conflicts of interest or any restrictions placed upon their work by management
   - Internal audit personnel who have no non-audit work
2. **TRAINING:** All internal audit staff should be trained
3. **STAFFING:** The internal audit department should be adequately staffed in terms of numbers, grade and experience.
4. **RELATIONSHIPS:** The internal auditors should foster constructive working relationship and mutual understanding with management, external auditors, and any review agencies.
5. **DUE CARE:** The internal auditor should behave as much as an external auditor in terms of skill, care and judgment. He should be up to date technically and have personal standards of knowledge, honesty, probity and integrity as much as an external auditor.

6. **SYSTEMS CONTROLS:** The internal auditor must verify the operations of the system in the same way as an external auditor i.e. by investigation, recording, identification of controls and compliance testing of the controls.

3.4 Organization of Internal Audit Department

Internal Audit being a management tool will be whatever the management wants to make it in order to achieve their objective. Ideally, Internal Audit Department should be headed by a Chief Internal Auditor or better still a 'Director of Internal Audit" who should be on the same level with all other departmental heads if he is to command respect. The Chief Internal Auditor or the Director of Internal audit as the case may be, should report directly to the MD/CEO/Management Board but not to any of his peers as the main job of the Internal Auditor is to appraise and report on the activities of other departmental heads.

Therefore, for effectiveness and to enjoy a reasonable degree of independence, the head of Internal Audit should report to the apex authority of the organization. The other members of the team which may include the Principal or Senior Internal Auditor, Internal Auditor I or senior Executive Officer and Internal Auditor II or Higher Executive Officer, etc. have been provided by the Accountancy profession because of the training of accountants which includes a lot of analytical techniques. Nowadays, all these have changed. The emphasis is placed on the supportive role to management rather than checking the accuracy of accounting records and business transactions.

Though for the purpose of proper coordination, it is advisable that Internal Audit department should be staffed with those knowledgeable in accounting and book-keeping. Meanwhile, just as other departments or functional areas within an organization, the internal audit department should have 'its own crop of Managerial, Supervisory and Clerical Staff with properly defined reporting line. Audit department should not be seen as an extension of Bursary or Treasury Department but a separate unit.

3.5 Scope and Objective of the Internal Audit Function

The scope and objective of the internal audit function is dependent on its terms of reference as stated by management, the size and nature of the enterprise, the number and experience of the internal audit staff and skill and competence possessed by the internal auditors. Internal auditors are found however to operate in the following broad areas:

1. Review of accounting and internal check system on behalf of the management.
2. Review of the economy of production and many accounting controls.
3. Review of implementation status of management policies, plans and budgets.
4. Review of management accounts and report on behalf of management.
5. Special investigation.

3.6 Internal Audit Report

Unlike the statutory auditor's report, the internal auditors report need not follow the reporting standard or guidelines as there is no regulatory body that regulates the conduct of internal audit. However, it must follow the normal pattern of report writing which comprise of heading, introduction, paragraphs, the main body of the report dealing with observations and findings, recommendations for corrective measures and conclusions.

This report is addressed to the management or whoever is responsible. Internal audit report is the medium by which the internal auditors views are conveyed to the Board of Directors and the management. It covers the evaluation of the internal control system, accounting systems, periodical reports on the activity of each functional area (dealing with their efficiency and compliance with the management policies and objectives) and reports on the results on special investigations and enquiries.

For internal audit report to achieve its goals of assisting management efficiency, its contents and recommendations must be given adequate attention by the management and followed by the necessary corrective actions. Meanwhile, management must also provide necessary equipment to the internal audit department and they should make sure necessary corrective action is taken by the management based on the recommendations in the internal audit report. It may be necessary to write a follow-up report which should be copied to a higher level of authority than the one reported on for compliance directive. Hence, it is recommended that the Chief Internal Auditor or Director of Internal Audit should not occupy any level lower than that of the functional managers and should report directly either to the Chief Executive Officer or to the Audit Committee in the case of a public company.

3.7 Audit of Internal Control System (system based audit)

When an auditor decides to place reliance on a client on the internal control system, he will have to (i) ascertain it, (ii) record it, and (iii) evaluate it. This audit approach involves the use of compliance tests. Compliance tests provide audit evidence that internal control procedures are being applied as prescribed.

3.7.1 Ascertainment

For a new client, ascertain the internal control in operation through enquiring from management, inspection of records and observation. For an old client, update the internal control system to reflect current situation.

3.7.2 Recording

For practical purpose, record the internal control system through narrative notes, internal control questionnaire and flow charts.

(i) Narrative Notes

These are narrative notes describing the internal control system of an organization. This method has been widely criticized in the sense that when badly written, identification of the control with the system may not be possible from the note. However the criticism may be overcome by adopting a disciplined approach in writing the system notes.

(ii) Internal Control Questionnaire (ICQ)

This is an elaborate set of questions covering every facet of the internal control system of an organization. It entails framing the questions in such a way as to call for descriptive answers. The preparation of an ICQ involves the following steps:

a. Divide the system into appropriate section(s).

b. Questions should be framed in a way to require detailed description of the system.

c. Ask questions that identify relevant controls.

ICQs are usually completed by attendance and care should be taken when completing the questionnaire so that the answers given relate to what is actually happening and not what the client's staff feel the auditor wants to hear. Examples of internal control questionnaires on:

(a) Salaries

- What is the procedure for engaging new employees?
- Who are responsible for salary preparation and payment?
- What are the procedures for ensuring that employee who received salary actually worked for such remuneration received?
- How is the incidence of ghost workers avoided?
- What happens to unclaimed salaries?
- What is the identification procedure during salary pay-out?

(b) Purchases

- When is an order for goods raised?
- Who initiates an order for goods?
- What is the procedure for ensuring authorization of order?
- How is order price being determined?
- What is the procedure for ensuring compliance of goods supplied with order?
- How does the company ensure that only goods ordered are delivered and paid for?

This questionnaire intends to establish how good a client's control system is. Where there are weaknesses in the system, the auditor is advised to review:

(a) The errors and frauds which are likely to exist.

(b) The materiality of such errors and frauds in the client's financial statements.

(c) The substantive audit tests to perform to detect such errors and frauds.

In designing an ICQ, the auditor should take into account the following:

(a) A blank ICQ should be designed for each new client only if the size and the nature of operation is complex. For a small business, the controls can be assessed by putting across questions to the client and carefully noting the replies. In addition, it is advisable to perform a physical observation of procedures.

(b) The useful life of an ICQ should not exceed 5 years,' meaning in effect that the ICQ should be updated when necessary. It is advisable to compile an ICQ from the scratch when there is a sudden change in the client's systems, for example, where a client changes from a manual system to a computerized system.

(c) The ICQ should be compiled by an experienced member of the audit team at a pre-arranged meeting, putting across relevant questions to the client's staff about the operations.

(d) The questions should be designed in such a way as to require simple Yes or No answers. A "YES" answer indicates a potential strength and a "NO" answer indicates a potential weakness in the system.

(e) The answers to the questions in an ICQ should be corroborated by the auditor on a test observation basis, so as to ensure that controls do exist in practice.

Advantages of Internal Control Questionnaire

1. It ensures that all important questions are asked.
2. All the features of the system are highlighted and tested.
3. It is specifically designed for identifying areas of weaknesses.
4. It assists the auditor in understanding the system.
5. It provides a check list of what to do for the auditor.

6. It assists the auditor to draft a management letter.

Disadvantages of Internal Control Questionnaire

1. It does not by itself evaluate significant areas of weakness.
2. It can inhibit the exercise of initiative of the user.
3. The expenses and time involved in the preparation may not be justified.
4. Internal control questionnaire may encourage mechanical replies.

(iii) Flow Charts

This is a diagrammatical representation of internal control system showing:

- Movement of documents
- Sequence of operations
- Check procedures built into the system
- Segregation of duties.

Techniques of Flow Charting

The following principles should be followed when preparing a flow chart for effective communication

a. Where standard flow chart symbols are not used, a key should always be provided.

b. Flow lines should move vertically from top to bottom.

c. Operations should be shown in strict chronology order and sequentially numbered.

d. Narrative description should be minimized and shown on the extreme left hand column.

e. The title and name of the person responsible for each operation should be shown in a responsibilities column.

f. It should be simple, clear and unambiguous for easy understanding.

3.7.3 Evaluation

Evaluate the control to determine whether they are satisfactory in principle by using **internal control evaluation questionnaire (ICEQ)**. The result of evaluation process determines the volume and nature of audit work to be done in expressing opinion on the financial statements.

Although, ICEQ is similar to internal control questionnaire, the difference lies in the fact what while ICQ requires detailed set of answers, ICEQ deals with YES or NO answer only. The questions are normally in two fold, the "key question" which goes straight to the heart of the matter and the "subsidiary question" which influence the answered question. Below are examples of internal control evaluation questionnaire (ICEQ) on:

(a) Salaries

- Can employees be paid for work not done?
- Are time clocks supervised by a responsible official?
- Are time records and piece work sheets checked before processed for accuracy and authorization?
- Are time records and piece work sheets controlled by persons independent of the payroll department?
- Are proper controls exercised over adjustments, lateness, sickness and absenteeism?
- Are adequate safeguards operated over cash payment and unclaimed salaries?

(b) Purchases

- Can goods or services be ordered without being authorized?
- Are purchase orders/requisitions prepared and approved by responsible officials?"
- Are there any limits of authority operating over ordering of goods and services?
- Are purchase orders pre-numbered and, numbers accounted for?
- Are purchases orders valued and compared with existing budgets and other management policies?
- Is segregation of duties being exercised over purchase orders?

In modern auditing, practicing firms now use evaluation questionnaires to evaluate the materiality of client's control systems rather than focusing on the establishment of controls in practice.

In designing the ICEQ, the objective is to ensure that there are effective key controls to forestall the occurrence of frauds and errors in operation.

As stated earlier, the questions in an ICEQ require YES or NO answers, where a "YES" answer indicates strength and a "NO" answer indicates weakness in the system.

Where the auditors become aware of weaknesses in the system as a result of the ICEQ assessment, they should establish the existence of compensating controls to counter balance the situation.

3.8 Comparison of Internal Control Questionnaire with the Internal Control Evaluation Questionnaire

3.8.1 Similarity

The objectives of the two (i.e. both instruments) are the same, that is, to evaluate the system of controls

3.8.2 Differences

1. Internal control questionnaire incorporates a number of detailed questions without attempting to distinguish their materiality. The internal control evaluation questionnaire on the other hand isolates control objectives within the area under review.
2. The answer "NO" in an internal control questionnaire indicates a weakness while "NO" indicates a strength/compliance in an internal control evaluation questionnaire and vice versa.

3.8.3 Advantages of Internal Control Evaluation Questionnaire (ICEQ) over Internal Control Questionnaire (ICQ)

1. Materials and non-material errors are highlighted.
2. It highlights only the key controls.
3. It enhances the drafting of a management letter.
4. It points the attention of audit staff to matters fundamental to controls in the areas under review.
5. A completed internal control evaluation questionnaire will assist the auditor in determining the nature and extent of his tests and procedures.

In the process of evaluation, auditors carry out work-through tests to ascertain the correctness of the system. A Work-through test is the tracing of transactions from inception of the records to the conclusion. Auditors also conduct compliance tests on the controls before finally reporting on the weakness in the internal control system to the management by writing a management letter or what is otherwise known as a domestic report.

3.9 Internal Audit Programmes and Working Papers

For effective internal auditing, an internal auditor's approach should adopt a reasonable measure of standardization for effective monitoring and control with a little flexibility which allows for the use of initiatives when circumstance warrants. To this effect an internal audit programme, can either be a standard one or a special audit programme. Standard audit programmes are those developed to meet the need of every circumstance while special audit programmes are developed for a specific situation. Experience has shown that where the system of internal check is adequate, less time is normally devoted to routine checkings involving the use of standard audit programme but more time is spent on constructive work which aids management in its tasks of managing the business profitably and this calls for an informal approach with the use of initiatives on the part of the internal auditor.

The use of standard audit programmes however, has the following **merits:**

1. It provides the internal auditors with a framework for their activities along logical lines.
2. It indicates the minimum level of test checking which is regarded as necessary on the assumption that the system of internal check is adequate.
3. It provides immense help to the external auditor in designing their audit programmes so as to remove unnecessary duplication of work.
4. It encourages the achievement of a balanced audit at each accounting point and also a balanced audit throughout the whole of the organization.

5. It allows for the movement of staff from one assignment to the other without loss of continuity.

The use of standard audit programmes also has demerits. The **demerits** are as follows:

1. Standard audit programmes tend to destroy initiative by allowing the internal auditor to carry out the content of standard audit programme and no more.
2. When completely adhered to, it turns the work of internal auditor to a mechanically routine work.
3. It sometimes causes a sense of frustration in the mind of internal auditors when anxious to explore certain accounting features which standard audit programme may not allow.
4. It makes the extent of audit to become known or predictable to accounting personnel. Hence, the moral check imposed by audit is therefore lost.

Meanwhile, it should be borne in mind that an audit programme should not be a substitute to personal judgment and it should normally be regarded as a guide.

As in statutory audits, the internal audit **working papers** are the evidences of work done and steps taken by the internal auditor as a basis for his report. The working paper shows the details of work done by the auditor to enable him form an opinion on the accounts or set of account he is required to report on. For this reason, therefore, great care should be taken in the preparation, indexing and preservation of his working paper. **A good working paper should have the following features:**

1. Check List: these are of those work (things) done on the audit, that is, things needed for the completion of audit work.
2. Clear and neat exposition of the make-up of figures, accounts, reports and summaries.
3. Complete but concise narratives of the work done in preparing the schedule.

4. Cross reference to other current schedules and to earlier papers or reports and ease of retrieval by standard sequences and good indexing.
5. Details of personal and third party verifications.

Audit working papers could be **permanent** or **current** working papers.

The **permanent working paper** contains information of continuous importance to the organization. The contents of permanent working papers are:

1. Copies of certificate of incorporation and of the company auditor’s appointment and engagement letters.
2. Memorandum and articles of association of the company.
3. Organization's major accounting policies.
4. Organizational structure or management set up.
5. List of directors and their interest.
6. List of shareholders with more than 10% holdings.
7. Nature of the client business, registered office and branch network and their addresses.
8. Copies of the financial statements to date.
9. Names and addresses of company's professional advisers.
10. First Audit Planning Memorandum written for the company.
11. Statement of important ratios of the company.
12. Description of accounting and internal control system.
13. List of authorized signatories for the company and the signatures.
14. Specimen copy of all transactions document e.g. form voucher, goods delivery note, goods received note, payment voucher and petty cash voucher etc.

The **current working paper** contains current information and its contents are:

1. Schedule of major items in the financial statement.
2. The audit programme.
3. Letter of internal Control weakness.

4. Extract of board meeting decisions/extract of the minutes of board meetings held during the year.
5. Current copy of audit planning memorandum
6. All correspondence with the company on current audit
7. Letter of representation
8. Copy of letter of comfort from a lawyer on impending litigation against the company. (Otherwise called letter of attorney)
9. Reply to all circularization
10. List of all audit queries and their disposition
11. A copy of current audited Financial Statement.

3.10 Control Objectives and Detailed Controls in Various Areas of Business

I. Cash Receipt by Post

<u>Control Objective</u>

- All receipts through the post must be properly accounted for.

<u>Detailed Controls</u>

- Procedures should be established to ensure that cheques and cash sent through the post are not intercepted e.g post office box key should be made available to authorized officials only.
- A responsible person should be authorized to open all the post office boxes independent of the cashier.
- Post must be opened in the presence of at least 2 persons.
- All cheques or any other reportable instruments received through the post should be restrictively crossed "Account Payee Only".
- A memorandum cash book or post list should be made listing all cash and cheque received through post. The list should include information such as the payer, cheque number, date received and the amount.
- The memorandum cash book or post list should be signed by the persons present as an acknowledgement of the correctness of the details included.

- There should be a reconciliation of the pay in slip with the memorandum cash book. The reconciliation should be carried out by an independent person.

II. Cash Collections (Credit Sales)

Control Objectives

- All cash due to the company are collected
- All cash collections are properly accounted for
- All cash is collected by authorized persons only
- Cash collections are correctly and completely recorded

Detailed Controls

- Cash collections should be restricted to authorized persons only.
- All cash collected must be issued with official receipt and customers should be enlightened of the need to collect receipts evidencing payment.
- Receipts should be properly controlled and must be sequentially pre-numbered; receipt booklet should be issued to properly authorized personnel.
- Periodic review by specified personnel to ensure that all transactions in the receipts booklet are properly accounted for.
- Cash collected should be properly safeguarded. For example by the provision of a safe.
- Where cash is collected by field agents including insurance agents, salesmen etc, and adequate provision must be made to ensure that all collections are properly accounted for.
- Sales agents should be issued with delivery notes at selling prices to enhance accountability.
- A daily cash summary of all collection should be prepared and an independent reconciliation of the daily cash summary with details of the receipts and bank pay in slip should be carried out.

III. Cash Payment

Control objectives: to ensure that:

- Payments are made for only goods and services rendered.
- Payments are made to the right supplier in the correct amount.
- To ensure that payments are properly authorized.
- Cheques are signed by authorized persons.
- Payments are properly and correctly recorded.

Detailed Controls

- A responsible person should authorize invoices for payment. Such authorization should be made only after ensuring that the transaction is in order, goods or services have been received and that the invoice is arithmetically correct.
- An authorized person should be responsible for signing all cheques.
- Invoice approved for payment must be supported by all documents including purchase orders, goods delivery note, goods received note e.t.c. and the document must be checked before cheques are signed.
- All paid invoices must be properly stamped 'PAID' to avoid them being presented for payment more than once.
- Adequate custody must be established over cheque books. Controls in the area include ensuring that cheque booklet is issued to only authorized persons.
- A daily summary of cheque payments should be prepared and independently reviewed with the details of bank statements and cheque stubs.

IV. Banking of Cash Collections

Control Objective

- To ensure that all cash collected are banked promptly and are intact.

Detailed Controls

- Bank pay-in-slip should be prepared by a person who has no access to cash.
- All cash and cheques collected should be banked intact and promptly preferably every other day.
- Consideration must be given to the provision of adequate security for cash in transit e.g. the use of security organizations.

- There should be an independent reconciliation of bank pay-in-slips with record of cash collection.

V. Bank Balances

Control Objectives: to ensure:

- The correctness of balances shown by the bank statements as well as the cash book.
- That banking transactions are proper and bonafide.

Detailed Controls

- Bank reconciliation statements should be made by a person independent of those with previous contact with the cash or those in charge of recording cash transactions.
- Adequate arrangements should be established to ensure that bank statements are not intercepted by unauthorized person and that the bank statements are sent directly to the independent person in charge of preparing the reconciliation.
- All rejected cheques must be properly investigated to determine the reasons for their rejection.
- All reconciling items must be properly investigated in order to ensure that they are in order. Such items include un-presented cheques, direct credit and bank charges.
- A confirmation should be obtained from the bank periodically.

VI. Wages and Salaries

Control Objectives: to ensure that:

- Salaries and wages are paid in the correct amount.
- Salaries and wages are paid to bonafide staff in respect of goods produced and services rendered.
- All deductions from salaries and wages are authorized and promptly paid over to the right authorities.
- Salaries and wages are properly and correctly recorded.
- The wages payout procedures are adequate.

Detailed Controls

- A record of all personnel including name, position, effective date of employment, gross pay, authorized deduction and other relevant particulars should be maintained by the personnel department.
- Employees' monthly pay should be reconciled with the production records and time records where applicable
- Salaries and wages should be prepared by an independent person in the accounting department.
- The wages sheet should be properly reviewed for correctness by an officer before authorization.
- Monthly salaries and wages should be compared with those for prior periods and any significant variation must be properly investigated and accounted for.
- There should be a proper analysis of wages and salaries into the different monetary denomination for bank collection purpose.
- Adequate regard must be given to security measures to safeguard cash collections from the bank.
- Wages should be bagged by a person other than the person in charge of preparing the payroll.
- The time and place of payment of wages and salaries must be made known to all staff in advance e.g. in a large factory.
- All payments should be made in the presence of supervisors who should identify staff or alternatively identity cards should be presented on collection of payment by staffs.
- All collections on behalf of any staff must be supported by proper authorization.
- Uncollected wages must be properly safeguarded and recorded. They must also be properly investigated and returned to the bank after the expiration of a specified period of time.
- All deductions in respect of pension fund and income taxes must be paid over promptly to the appropriate authorities.
- A record of salaries and wages should be prepared by a person independent of those with previous connections to the wages

procedures. Such records must be reviewed for completeness and accuracy.

VII. Buildings

Control Objective

To determine whether the figure is fairly stated

(a) Steps in Control

- Obtain detailed schedule of building stating balance brought forward, additions, disposals and balance carried forward.
- Check cost to ensure arithmetical accuracy.
- Agree opening balance to prior year audited accounts and working papers.
- Vouch addition and ensure that they were authorized and bonafide.
- Ensure that additions represent capital expenditure and have been correctly recorded.
- Review disposal and ensure that they are bonafide and have been correctly recorded in the books.
- Vouch disposal proceeds to the cash book or accounts receivable.

(b) Existence: Inspect building to ensure existence. Where the auditor cannot inspect the building physically, he can rely on the following: rates, electricity bills, rental income, repairs on building and ground rent. Where the value of a particular building is material, it is very important for the auditor to inspect it either by contracting the inspection to professionals or asking his regional office to do the job on his behalf.

  - Obtain and review documents evidencing ownership (certificate of occupancy) and ensure that the building belong to the company.
  - Obtain and review lease agreements to ensure that the company has lease hold interest over the buildings.
  - Ensure that buildings are free of outside interest e.g. by being mortgaged.
  - Confirm that buildings held by third parties on behalf of the company are held free of interest.

(c) Valuation of buildings

i. Constructed buildings: direct material, direct labour and fixed overhead

ii. Purchased buildings: Purchase cost.

iii. Lease hold buildings: Capital sum paid for the lease and should be amortized over the life of the lease

Note: ensure compliance with SAS 3

Verification of building revaluation

- Ensure that revaluation is carried out by professionals that are independent, competent, experienced and have integrity.
- Ensure that assumptions made are reasonable
- Ensure that all surpluses on revaluation have been posted to revaluation accounts.
- Obtain and review the assumptions in carrying out revaluation.

The following factors should also be noted

- That revaluation surplus are posted to revaluation account and shown as part of shareholders equity.
- That provision has been made for deferred tax where necessary i.e. where you think building is going to be sold in the nearest future.
- That building are properly presented and disclosed in the financial statements.
- Obtain a representation letter from the management.

VIII. Plant and Machinery

Control Objective

To determine whether the figures are fairly stated

Detailed Controls

- Obtain a schedule of plant and machinery stating among others balance brought forward, addition and disposal in the year.
- Check cost to ensure arithmetical accuracy
- Agree opening balance to prior year audited accounts and working papers, plant and machinery register and the general ledger.
- Vouch additions during the year and ensure that they are bonafide.
- Ensure that additions include only capital expenditure items.

- Vouch disposals and ensure that they have been properly treated in the book and that they are bonafide.
- On a test basis verify the existence of plant and machinery through physical inspection.
- Review documentary evidence of ownership, such as invoice, licenses e.t.c and ensure that the assets belong to the company.
- Review for plant and machinery that have been pledged to third parties in respect of obligations to them.
- Ensure that adequate provision for depreciation in respect of plant and machinery account for the year on a basis consistent with prior year and which are acceptable.
- Obtain a letter of representation from management
- Ensure that all material fact and information regarding plant and machinery are properly disclosed in the financial statement.

IX. Debentures

<u>Detailed Controls,</u> In respect of debentures from previous years:

- Obtain details of debenture balances outstanding as at the end of the year.
- The details should also state the balance brought forward, additions and repayment during the period
- Ensure that debenture interest is paid as at when due to debenture holders.
- Ensure that the portion of debenture repayable during the period has been paid.
- Where there is a provision to set aside an amount annually to a debenture redemption reserve funds, ensure that such an amount is properly set aside.
- Obtain a letter of representation from management.
- Ensure that debenture balances are properly stated and other information necessary for a proper understanding of the financial statement are disclosed.

<u>Detailed Controls,</u> In respect of debentures taking during the year:

- Review the minutes of directors meeting and ensure that they are authorized.
- Review the company's memorandum and article of association and ensure that the debenture is not ultra vires the company and with the power of directors.
- Where the loan is not ultra-vires the company, but directors have no power to enter into such loan agreements, ensure that a resolution has been passed by the share holders in a general meeting authorizing the loans.
- Obtain the debenture deed and review the terms regarding interest, security and the repayment of capital.
- Ensure that the debenture agreement has been properly registered as a security in accordance with CAMA 1990.
- Vouch receipts to cashbook.

X. Current Liabilities

<u>Detailed Controls</u>

- Obtain details of creditors as at the end of the year showing opening balances and closing balances.
- Check the accuracy of the schedule obtained
- On a test basis, select some purchase orders and vouch them to goods receipt note, received suppliers invoice and credit entries in the suppliers account.
- Select some suppliers balance and trace credit purchase during the year back to relevant purchase order.
- The objectives of step 3 above is on one hand to ensure that all purchases are recorded and on the other hand to ensure that all entries in the suppliers account represent purchase transaction that actually took place during the year.
- On a test basis, vouch payment to suppliers during the year to cash book.
- Circularize creditors balance.
- Obtain a letter of representation from management.

- Ensure that creditors' balances are properly stated in the financial statement.

XI. Bank Overdraft (Bank O/D)

Detailed Objectives

- Obtain details of overdraft outstanding as at the year end.
- Review the minutes of directors meetings and ensure that additional overdraft taken during the year is properly authorized.
- Review overdraft agreement and ensure that all the terms including interest and repayment of principal had been adhered to by the company.
- Review and determine whether any asset has been offered as security for bank over draft and if this is so, whether the fact is disclosed in the financial statement.
- Obtain confirmation from the banks regarding balances outstanding as at the end of the period.
- Obtain a written representation from management as at the end of the period
- Ensure that bank over draft is properly stated and material fact properly disclosed in the financial statement.

XII. Taxation

Control Objective: to ensure that:

- The figure is fairly stated

Detailed Controls

- Verification of tax balances
- Obtain details of the taxation account in the general ledger.
- Agree the opening balances to last year audited account and audit working papers.
- Obtain the clients tax computation for the year and review it to ensure that it has been properly prepared. Where the client has not prepared a tax computation, the auditor should prepare one and ensure that the amount provided in the financial statement and charged for the year is fairly stated.

4.0 CONCLUSION

The internal audit is an independent appraisal function within an organization for the review of activities. It includes independence, training, staffing, relationships, due care, and systems controls. Internal audit being a management tool will be whatever the management wants to make it in order to achieve their objectives. Ideally, Internal Audit Department should be headed by a Chief Internal Auditor or better still a 'Director of Internal Audit" who should be on the same level with all other departmental heads if he is to command respect. The scope and objective of the internal audit function is dependent on its terms of references as stated by management, the size and nature of the enterprise, the number and experience of the internal audit staff and skill and competence possessed by the internal auditors. Unlike the statutory auditor's report, the internal auditors report need not follow the reporting standard or guidelines as there is no regulatory body that regulates the conduct of internal audit. However, it must follow the normal pattern of report writing which comprise heading, introduction, paragraphing, the main body of the report dealing with observations and findings, recommendations for corrective measures and conclusions.

5.0 SUMMARY

In this unit, I discussed internal audit and its functions; essential elements of internal audit; organization of internal audit department; scope and objective of the internal audit functions; internal audit report; audit of internal control system (system based audit); comparison of internal control questionnaire with the internal control evaluation questionnaire; internal audit programmes and working papers; as well as control objectives and detailed controls in various areas of business.

6.0 TUTOR-MARKED ASSIGNMENT

1. What is internal audit?
2. Mention four functions of internal audit
3. List and explain five elements of internal audit

4. Explain three things an auditor will have to do when he decides to place reliance on a client's internal control system
5. Differentiate between internal control questionnaire (ICQ) and internal control evaluation questionnaire (ICEQ)
6. List and discuss three documents for recording internal control system
7. Write short notes on the following:
   i. Organization of internal audit department
   ii. Scope of the internal audit functions
   iii. Internal audit report
8. What are the advantages of internal control evaluation questionnaire (ICEQ) above internal control questionnaire (ICQ)
9. Define a working paper and discuss the types.
10. Mention the control objectives and detailed controls of the following areas of business:
    i. cash receipt by post
    ii. cash payment
    iii. bank balances
    iv. buildings
    v. debentures
    vi. bank overdraft

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UNIT 6: RELATIONSHIP BETWEEN INTERNAL AUDITOR AND THE EXTERNAL (INDEPENDENT/STATUTORY) AUDITOR

CONTENTS

1.0 INTRODUCTION

The interest of internal auditors is derived from their position as staff of the organization, and accordingly would want the system to operate efficiently and effectively. The external auditor on the other hand is interested in the internal control system so far as its effectiveness can assist in reducing the level of audit test on the transactions and balances processed through it or included in the financial statements. The scope of the Internal Audit function is determined by management. Whereas the scope of the external (statutory) auditors work is determined under the statute in which he was appointed.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- know the similarities between internal auditor and external auditor
- differentiate between internal auditor and independent/statutory auditor

- assess the effectiveness of the internal audit department

3.0 MAIN CONTENT

3.1 Similarities between Internal Auditor and External Auditor

1. Common interest in the accounting and internal check controls: The internal and external auditors both have vested interest in the accounting and internal check control. The interest of the internal auditors is derived from their positions as staff of the organization, and accordingly would want the system to operate efficiently and effectively. The external auditor on the other hand is interested in the internal control system so far as its effectiveness can assist in reducing the level of audit test on the transactions and balances processed through it or included in the financial statements.

2. Similarities of Techniques or Methods

Both auditors adopt similar techniques and methods in recording and evaluating the system as well as carrying out their audit tests in recording the system. Both auditors would use a combination of three techniques: Narrative or System note, Internal Control Questionnaire and Flowcharts.

Audit tests are of two types depending on their objectives. These are **compliance test** on the internal control systems and **substantive test** on the transaction and balances included in the accounts and the financial statement

3. Independence

Both auditors are after independence from those whose work, they are reviewing. In this regard, the internal auditors report to the highest level of management and procedures are normally established to ensure that their remuneration, promotion and employment are not determined by middle level management.

4. Both auditors have common interest in the continuous effective operation of such system.

5. Both auditors have common interest in the adequate flow of management information.

6. Both auditors have common interest in the safeguarding of asset.

7. Both auditors have common interest in ensuring compliance with statutory and regulatory requirements.

3.2 Differences between Internal Auditor and Statutory Auditor

i. Scope

The scope of the Internal Audit function is determined by management. Whereas the scope of the external (statutory) auditors work is determined under the statute in which he was appointed.

ii. Approach

The approach adopted by the external (statutory) auditor is dictated by his statutory objective of forming an opinion and reporting on the financial statement whether they present a true and fair view. The internal auditor approach however is designed to ensure the effectiveness and efficiency of operation of the organization.

iii. Responsibility

The internal auditors are responsible to management to whom they report, whereas the statutory auditor is primarily responsible to the shareholders to whom he reports.

iv. Appointment and Qualification

The internal auditors are appointed by management, whereas the external auditor is appointed by the shareholders usually at the Annual General Meeting. In addition, internal auditors need not possess any professional qualification. The external auditor on the other hand must be professionally qualified with a certificate permitting him to practice in Nigeria or any other country. Notwithstanding these, the statutory (external) auditor may rely to a large extent on the internal auditor in determining the strength of the internal control and assessing the general reliability of the accounting records.

3.3. Assessing the Effectiveness of the Internal Audit Department

The external auditor should be concerned with the following in making his assessment of the effectiveness of the internal audit department:

a. The degree of independence accorded the internal audit department in performing his functions

b. The qualification and experience of the internal auditor and the staff working with him

c. The depth, direction and timing of the tests and the audit evidence from which conclusions were drawn by the internal Auditor.

d. The extent the management implements the recommendations and suggestions of the internal auditor's reports.

With all these critically looked into and logically concluded the external auditor may reduce the level of his checking and tests but such reliance does not exempt him from liability inherent in the reliance.

4.0 CONCLUSION

In this unit, you have learnt about the similarities and differences between internal auditors and external auditors. You have also learnt the factors to be considered in assessing the effectiveness of internal audit department.

5.0 SUMMARY

The similarities between internal auditor and external auditor are similarities in techniques or methods, independence, common interest in: continuous effective operation of such system; adequate management information flow; accounting and internal check controls; and asset safeguarding. While the differences between internal auditor and statutory auditor include the scope, approach, responsibility, appointment and qualification.

6.0 TUTOR-MARKED ASSIGNMENT

1. What are the similarities and differences between internal auditors and external auditors?
2. Mention factors used in assessing the effectiveness of internal audit department.

7.0 REFERENCES/FURTHER READING

Bounton, W. C. and KellWalter, G. (1996) *Modern Auditing*, 6th edition, John Wiley and Sons, Inc.

UNIT 7: ASSESSMENT AND EVALUATION OF INTERNAL AUDIT FUNCTION

CONTENTS

1.0 INTRODUCTION

The degree of independence of the internal auditor, technical competence of the internal audit staff, relevance of the scope and objective of the internal audit function, exercise of due professional care by the internal auditor in the conduct of his work, and quality of internal auditor report and extent to which management act upon them are factors to be considered in evaluating the internal audit function.

2.0 OBJECTIVE

In this unit, you are to learn the factors to be considered in evaluating the internal audit function.

3.0 MAIN CONTENT

Factors to be considered in Evaluating Internal Audit Function

The external auditor should evaluate the internal audit functions to determine the extent to which he can rely upon their work. Factors to be considered during this evaluation include

(i) Degree of independence

(ii) Technical competence

(iii) Scope and objective of the internal auditors

(iv) Due professional care, and

(v) Internal audit report.

These evaluation factors are discussed below:

1. Degree of Independence: Internal auditors should be independent of those whose work they are reviewing and reporting upon. In order to ensure this independence, internal auditors should report to the highest level of management and should not be put in a situation where their employment, promotion and remuneration are determined by middle-level management. They should not have any functional responsibility and should be free to communicate with the external auditor who should be in a position to obtain all internal auditors' reports required for his audit.

2. Technical Competence: Internal auditors should be sufficiently competent in order to be able to discharge their internal auditing responsibilities. Evidence of technical competence will include membership of a professional body or the possession of relevant experience.

3. Scope and Objective of the Internal Auditors: The external auditor should consider the relevance of the work of the internal auditors to his overall audit objective of expressing opinion on the financial statement.

4. Due Professional Care: The external auditor should consider the extent of the audit work. The audit work must appear to be properly planned, recorded, controlled and reviewed. Evidence of the exercise of due professional care will include the existence of an Internal Audit Planning Memorandum, the existence of proper documents, audit working papers.

5. Internal Audit Report: The external auditor should consider the quality of internal auditor report and the extent to which management responds to and acts upon these reports.

4.0 CONCLUSION

The effective evaluation of internal audit function is based on the independence of the auditor, due professional care, technical competence, scope of his assignment and the quality of his internal audit report.

5.0 SUMMARY

In this unit, five factors of evaluating the internal audit function were discussed.

6.0 TUTOR-MARKED ASSIGNMENT

What are the evidence of technical competence of an auditor and his evidence in the exercise of his due professional care?

7.0 REFERENCES/FURTHER READING

Albert, L. N. and Cenker, W.J. (2003) *An assessment of the newly defined internal audit function,* Managerial Auditing Journal, *University Press ISSN 0268-6902* 17(3):130-137

UNIT 8: TECHNIQUES OF RECORDING IN HOSPITALITY ADMINISTRATION

CONTENTS

1.0 INTRODUCTION

Business transactions in hospitality administration can be grouped into major revenue centers, minor revenue centers and recreational centers. There must be issue supporting schedules or departmental income statements for each revenue center. Sales and matching principle must be adhered to. Guest checks should be pre-numbered, tinted and have duplicates. Moreover, it should be kept in locked storage, in numerical order. Guest ledger includes individual records for each of the hotel's registered guests or an accumulation of guest and master folios. The opening machine totals for paid and paid-out must be the same figures that appear on the previous shift's cash report as the closing machine totals for paid and paid-out.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- group business activities into different revenue centers

- ensure internal control for food and beverage sales
- know the function of accounting personnel and front office
- understand the guidelines for recording activities by cashier

3.0 MAIN CONTENT

Business Transaction: Hospitality businesses usually engage in the exchange of goods, property or services for cash or a promise to pay.

Revenue (sales) - Expenses = Income

3.1 <u>I-Revenue Centers:</u>

1. Categories of revenue centers

(i) Major revenue centers (i.e. Rooms, Food & Beverage)

(ii) Minor revenue centers (Telephone, Gift shops, Newsstand, Valet, Laundry, Barbershop or beauty salon)

(iii) Recreation centers

2. Revenue centers and financial reports

- Issue supporting schedules or departmental income statements for each revenue center.
- Separate food & beverage revenue center into two: Food schedule and Beverage schedule.
- Might use more than one account for Food and also for Beverage.
- If the sales volume and expense items are not significant, they might be pooled to a single financial reporting category called <u>other operated departments</u>
- The functions associated with some minor revenue centers may be leased to a Concessionaire, and hence appear on hotel's schedule of rental and other income.

3. Fundamental revenue concepts

- Sales and the matching principle
- Upon depository receipt, cash a/c shall be debited and unearned revenue, deposits or credit balances shall be credited.

(a) Revenue accounts

i. **<u>Room sales</u>**
Room allowances (Contra revenue account)

ii. **<u>Food sales</u>**
Food allowances (Contra revenue account)

iii. **<u>Beverage sales</u>**
Beverage allowances (Contra revenue account)

(b) Other income-- Food and Beverage department
iv. **<u>Telephone sales</u>**

Telephone allowances (Contra revenue account)

Other accounts for income earned by the hotel (ex: interest income, dividend income, rental income, concessions income, commissions' income, vending machines income (less the cost of merchandise sold), and foreign exchange income)

- Net revenue = gross revenue - allowances
- Gross profit = net revenue - cost of sales (merchandise items)
- Gross profit = Net Revenue (ex: for room revenue)

3.2 <u>II-Internal Control for Food and Beverage Sales:</u>

1. Guest Check (also called Server's Checks): This initiates the Food & Beverage order taken from the guest, and represents the invoice given to the guest.

- Guest checks should be pre-numbered, tinted and have duplicates. Moreover, it shall be kept in locked storage, in numerical order.
- Used checks, unused checks versus void checks!
- Post to dinner, the server must price and total the guest check (applicable for manual systems), unless the point-of-sale equipment can automatically perform the addition.
- Later, the cashier receives payment or makes the guest sign his/her guest check and deposits everything to the cashier.
- At the end of the shift, the cashier's cash drawer and supporting documents are accounted for (i.e. cash, credit card vouchers, food charges, and any miscellaneous paid-outs). Later, they are reconciled against cash register reading using a daily cashier's report

- Beverage sales in a lounge, a bar… presents a harder job for internal control
- Some basic internal control procedures for beverage sales are listed as follows:
  (i) Require the bartender to ring each sale as it is made
  (ii) Require the bartender to insert each paid check into a locked box
  (iii) The cash register drawer shall never remain open even for a small period of time
  (iv) Servers are not allowed to first pay the bartender in cash and collect later from customers
  (v) Bartenders should not be allowed to take register readings or reconcile their own cash at the end of their shifts

2. Guest charge privileges: These very privileges are allocated to guests who have provided an imprint of a valid credit card or were given a direct billing privilege at registration. In this case, all guest charges are recorded as debits in their respective guest, or master folios.

3.3 III-Accounting Personnel and Front Office Functions:

- Guest ledger includes individual records for each of the hotel's registered guests or an accumulation of guest and master folios.
- Guest ledger accounting (i.e. front office accounting) includes the accumulation of guest charges, credits and payments along with outstanding balances.
- Guest ledger versus city ledger
- The accounting department is responsible for:
  (i) Recording the results of front office activities
  (ii) Maintaining the city ledger
  (iii) Accounting for credit card receivable
  (iv) Paying vendors
  (v) Handling payroll
  (vi) Preparing financial statements (i.e. consolidated income statement and balance sheet)

(vii) Budgeting

Other accounting functions

The internal auditor should be responsible for:

- Entering all room charges, separating room taxes from room revenues and insuring that all vouchers have been accounted for and properly posted to each guest folio.
- Preparing the front office room status report and reconcile it with the housekeeper's report for any room discrepancy
- Verifying Food & Beverage charges made to guests and charged to their rooms with the daily Food and Beverage sales reports. This duty is conducted, also, for all other revenue centers.
- Guest folio errors (whether overcharges or undercharges) shall be corrected by the internal auditor using either a correction or an allowance voucher and posted to a separate allowance journal.
- Preparing a summary report of the up-to-date amounts owed to the hotel in both guest ledger and city ledger accounts

3.4 IV-Some Guidelines for Cashiers:

- The opening machine totals for paid and paid-out must be the same figures that appear on the previous shift's cash report as the closing machine totals for paid and paid-out
- At the close of the shift, the cashier should subtotal paid and paid-out for the current shift, and record the closing figures in the machine's totals column
- If at any stage, cashier accidentally miss-keys any transaction, adjustments can be made to the machine

Net cash received = cash paid-in (closing) - cash paid-in (beginning)

Net cash paid-out = cash paid-out (closing) - cash paid-out (beginning)

Net cash sum of cashier's shift = net cash received - net cash paid-out

- The cashier should extract the net cash sum from the cash drawer, and secure the money in the general cashier's safe deposit box until deposited in the Bank

- At the end of any shift, the cash drawer should contain exactly the same amount as it did when the cashier opened his/her shift.
- If any cash overage or shortage occur, the cashier must recheck the cash report and search all the transaction records for possible miss-keyed entries

4.0 CONCLUSION

Hospitality business administrators should ensure that guidelines are given to cashiers after grouping their activities into different revenue centers. Accounting personnel must also perform their functions in ensuring the implementation of internal controls for food and beverage sales.

5.0 SUMMARY

In this unit, I discussed the practical aspect of recording in hospitality administration. Ways of ensuring internal control of food and beverages sales, guidelines for cashiers in recording and the functions of accounting personnel were discussed.

6.0 TUTOR-MARKED ASSIGNMENT

1. Write the techniques of recording and functions in hospitality administration under the following headings:

(a) Guidelines for Cashiers (b) Accounting Personnel and Front Office (c) Internal Control for Food and Beverage Sales (d) Revenue Centers

7.0 REFERENCES/FURTHER READING

Albert, L. N. and Cenker, W.J. (2003) *An assessment of the newly defined internal audit function,* Managerial Auditing Journal, *University Press ISSN 0268-6902* 17(3):130-137

UNIT 9: PROBLEMS OF INTERNAL CONTROL SYSTEM

CONTENTS

1.0 INTRODUCTION

No internal system however elaborate it maybe can by itself guarantee efficient administration, completeness and accuracy of records, nor can it be a proof against fraudulent collusion especially on the part of those holding position of authority or trust. It is important to reiterate that the essence of having internal control systems in operation is to reduce the possibilities of errors and frauds in operation.

2.0 OBJECTIVE

At the end of this unit, you should be able to understand the limitations/problems of internal control systems.

3.0 MAIN CONTENT

Limitations of Internal Control Systems

The limitations of internal control systems are as follows:

Human errors: Where an official does an operation repeatedly over a period of time, stress and fatigue may set in sometimes with an attendant error being committed.

Collusion: Two or more officials may collude with one another, thereby, beating the control systems put in place by the client.

Abuse of authority: A responsible official in a position of authority may abuse his powers to commit fraud.

Lack of motivation: Where officials are not well compensated, they would not discharge their functions with integrity, thus creating an avenue for fraud.

The essence of carrying out compliance test on an internal control system is to limit the auditor's substantive testing. The auditor cannot rely solely on the operations of the internal control system as a basis for his opinion on the financial statement.

4.0 CONCLUSION

The problems of internal control systems are due to human errors collusion, abuse of authority, and lack of motivation.

5.0 SUMMARY

In this unit, I discussed the limitations of internal control systems.

6.0 TUTOR-MARKED ASSIGNMENT

1. List and explain the problems of internal control systems.

7.0 REFERENCES/FURTHER READING

CPA (2007) Internal Control for Small Business Melbourne-Australia: CPA Australia Limited

MODULE 3

UNIT 10: INTERNAL CONTROL OF STOCK IN HOSPITALITY ADMINISTRATION

CONTENTS

1.0 INTRODUCTION

As in nearly all hotel departments, Food and Beverages outlets of a hotel can operate under any [of the three systems which are manual systems, semi-automated system and fully automated system.

2.0 OBJECTIVES

At the end of this unit, you should be able to know:

- the various system of stock control
- how each system works

3.0 MAIN CONTENT

3.1 Manual System of Stock Control

In small organizations where the manager or the owner is available in nearly all hotel operations, manual systems are preferred. This is because there is no need for an investment in computers, though a lot of human errors, as far as control is concerned, might be observed. The forms that must be used in a manual system are:

Captain order

This form is a written format of the guest order. This is an internal control document prepared in three copies by the waiter/waitress. A copy is sent to kitchen for food production, a copy to service bar for the drinks to be prepared and the last copy to the cashier for opening a guest check. On the captain order, no monetary information is included. The order of the guest, the table no., the waiter ID, and number of guest(s) only filled. Captain orders help to control the relation between the waiter, kitchen, service bar and cashier.

Guest check

By recording food and beverage item prices on the captain order, the cashier prepares the guest check. If any cancellations or an addition from the initial captain order occurs, the cashier should make the necessary changes. As far as payment is concerned, the guest might opt for: (i) Charging to his room; In this case, the waiter shall insert the room number and take the guest signature on the guest check, or (ii) Cash, Credit Card, Bank Check or personal check. In this case, the waiter shall get the due amount from the guest; bring the collection to the cashier, who shall prepare the necessary legal document for sales along with the various internal control vouchers needed. In manual systems, cash register machine is used for this purpose. To illustrate, the cashier rings up the sale on the cash register and gives the guest the cash register bill.

At the end of his/her shift, the cashier should take the “Z” report from the cash register, attach it to various guest checks opened, the captain orders, and the total cash received in that very shift. Later, it is the responsibility of the Hotel Manager or Accounting Managers to verify the total shown on the cash register tape against the total cash receipts and the total computed from the serially numbered guest checks. While doing so, the unit prices recorded on the guest checks have to also be verified from the price list.

3.2 Semi- Automated System of Stock Control

In larger organizations, maintaining internal control by observation and one to one verifications is not applicable. In cases where business owners want to benefit from computerized systems but cannot afford financially to set up a fully automated system, it is better to make use of an individual Posting Machine for the various F&B outlets' operations. In such systems, there is no need for the verification of unit prices on the guest checks as the computer automatically posts the prices.

The other advantage is, as the guest check printed from the posting machine is facing the legal requirements, there is no need to use cash register machine or to create another legal document. At the end of each shift, the cashier shall count the cash receipts and compare them with the total generated from guest checks. The accounting department does the verification. In semi- computerized accounting systems there is no interface with the other hotel departmental systems. This is one of the biggest disadvantages of this very system since it involves extra control work for other departments and functions. For example, the internal auditor must control and post all the data again to the Front Office system. This is time consuming and subject to numerous posting errors. In practice, this might generate significant late charge amounts, and hence might affect seriously the financial position of the hotel.

3.3 Fully Automated System of Stock Control

In big organizations, manual or semi-automated systems cannot be applicable because of the huge amount of the number of transactions, their control, and the large amount of money associated to them. In fully automated systems, in order to maintain an adequate internal control and information flow, the individual computers must be electronically connected to each other. The major advantages of the system are: (i) on-line information is available; (ii) no need for re-entering data; and (iii) minimum internal control requirement.

4.0 CONCLUSION

The internal control of stock can be done by manual, semi-automated or fully automated systems.

5.0 SUMMARY

In this unit, I discussed the systems of internal control of stock in hospitality administration.

6.0 TUTOR-MARKED ASSIGNMENT

1. List and explain the various systems of internal control of stock.

7.0 REFERENCES/FURTHER READING

CPA (2007) Internal Control for Small Business Melbourne-Australia: CPA Australia Limited

UNIT 11: CASH DISBURSEMENT CONTROL IN HOTEL MANAGEMENT

CONTENTS

1.0 INTRODUCTION

The hotel industry is the only business where the guest enjoys the benefit of credit facility right from the time he comes to the hotel and where the business man whose primary objective is to collect revenue when the transaction is over is deprived of that and gets benefit only on or after the departure of the guest and that too sometimes after a period of 30-40 days in normal course. This results in the blocking of money and hence creates a situation of greater risk. It demands higher investment and hence it is important that the hotel takes some definite and concrete steps to ensure that the guest accounts will be settled in full at the agreed time therefore protecting the hotel from bankruptcy due to bad debts.

The hotel should control the credit of its guest to also ensure a healthy cash flow. Cash flow means the money which moves in and out of the business. The term credit control refers to the various measures taken by the hotel to ensure that the guests settle their accounts in full either themselves or through someone else on their behalf (which may be a credit card company, airline company, corporate office, a travel agent or person) within a specified period of time.

2.0 OBJECTIVES

At the end of this unit, you should be able to know:

- the credit control procedures
- cash control activities
- how to control hotel funds
- the Cash Internal Control chart in an hotel

3.0 MAIN CONTENT

3.1 Credit Control Procedures

Various steps are to be taken by different front office personnel at different stages of the guest cycle that will help in credit control. Credit control procedures used for different guests at the front desk during check-in are:

(i) <u>Guest paying by credit card:</u>

A Guest is required at the time of check-in to present his credit card

- Credit card is imprinted
- Name on the card is tallied with the name on registration card
- Check expiry date of the card
- Check the hotlist to check that it is not blacklisted
- Check that the hotel accepts the type of credit card presented by the guest

(ii) <u>Guest paying by travel agent voucher:</u>

A Guest presents travel agents voucher at the time of check in. These are prepaid vouchers which are then tallied with the record copy the travel agent has sent to the hotel in advance at the time of reservation. The receptionist will then attach this voucher to the guest registration card and then send it to the cashier who will open the folio and mark the instruction as required on the folio.

(iii) <u>Guest checking in with tour groups:</u>

Groups are usually prearranged and preregistered and the credit procedure is established between the tour operator and the hotel prior to arrival. The cashier in such a case will open a master folio in case of group charges. The

POS cashiers are informed not to make any credit sales transactions to any group member for their personal incidentals/expenses and charge cash for the same.

(iv) <u>Guests from Airlines:</u>

There are two types of guests sent by the airlines:

Stay over guests: These guests are provided with PSO {Passenger Service Order} or MAO {Meal and Accommodation Order} which detail the services and facilities that will be provided by the hotel to such guests and the airline will pay for the same. The folio in this case will be signed by the guest at check out and the bill is forwarded to the airline company for payment.

Crew: These guests have to sign their bills on checkout which are forwarded to the airline for payment. Services and facilities which are provided by the hotel and paid for by the airline are mentioned in the contract which the airline makes with the hotel.

(v) <u>Guests having all their charges billed:</u>

Look through the billing instructions given at the time of reservation to check what charges are covered by guests and what charges are paid by the company. If the room charges are to be billed to company and other incidentals are paid by the guest himself such as laundry, food etc. confirm with the guest at the time of check in itself how he will pay his incidentals and the same instruction must be marked on the folio. In such cases a split folio is used where charges are charges are distributed into two {between company/organization and individuals} one for rooms and the other for incidentals.

(vi) <u>Guest with scanty baggage:</u>

These guests are not allowed to purchase anything on credit. All payments are to be settled in cash unless well known to the hotel. An advance/deposit is taken from them at the time of check-in to be adjusted against room and incidental charges. The registration cards, folio and arrival notification slips will have APC {All payments cash}. A credit limit is also fixed in case of well known guests with scanty baggage and the moment his outstanding balance reaches the limit the internal night auditor prepares a slip which tells the guest to deposit some cash before making any new credit transactions.

(vii) <u>Walk-in/chance guests:</u>

To avoid any possibility of a skipper and hence loss of revenue, the hotel will usually ask for an advance payment or deposit at the time of check-in. The deposit should be enough to cover the room charges and incidental charges.

3.2 Cash Control

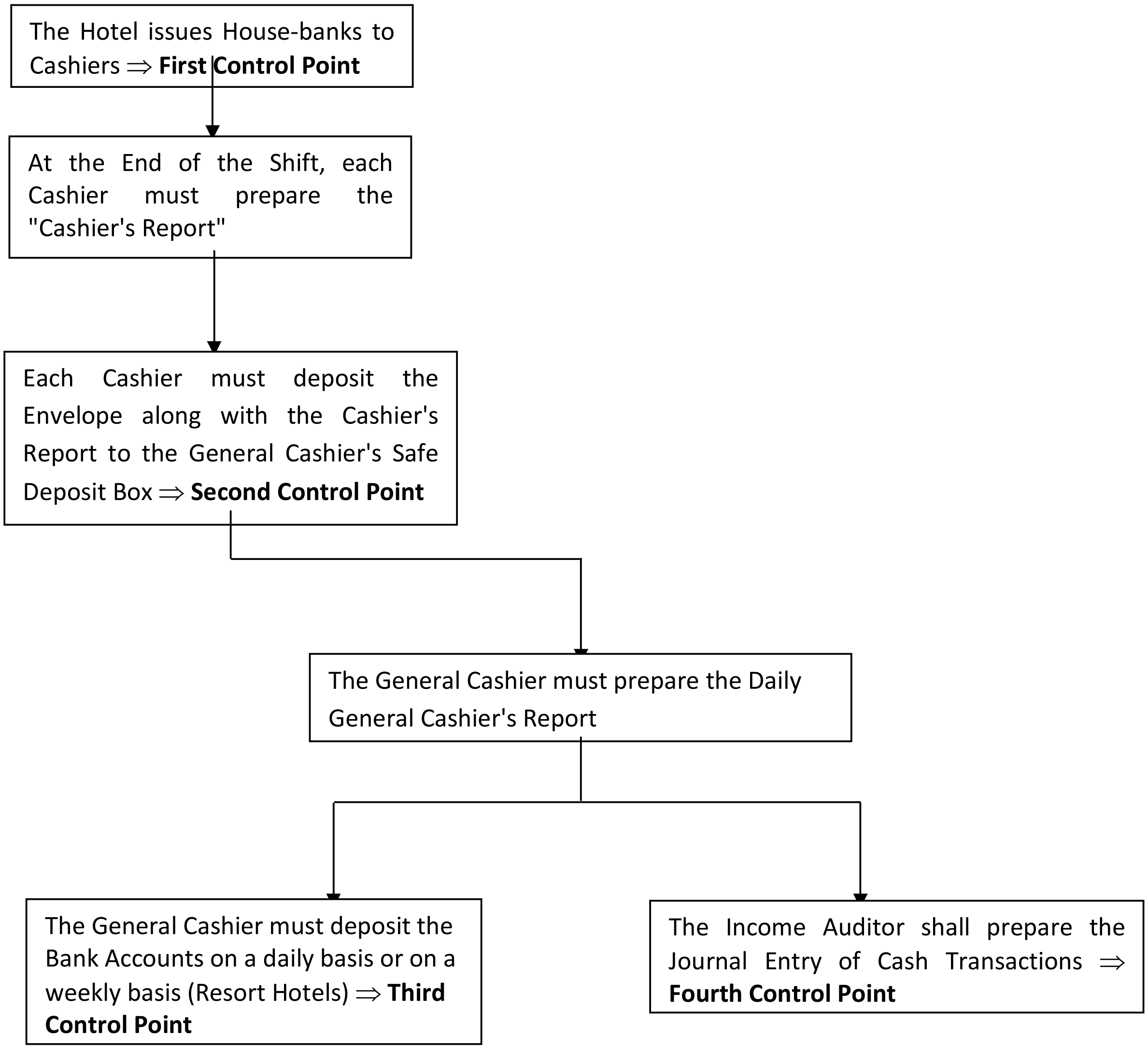
All cash must be kept under lock and key and under the supervision of the cashier. The cash/bank float given to the cashier is also controlled and a check is kept on the same. The cashier should take proper precautions when dealing with foreign currency. Whenever the guest pays in cash the cashier has to make a cash receipt and hand it over to the guest. The cash collected everyday should be sent to the bank for deposit. Cash control is important from the point of view of hotel as credit sales are usually discouraged.

3.3 Protection of Hotel Funds

- Cashiers should make frequent money drops to have minimum cash in hand.
- Cash drawers should be accessible to only one cashier at a time and should be kept closed when not in use.
- Alarm systems should be installed in all areas of the hotel where cash transactions take place.
- A consistent system for handling bank deposits and money pickup should be developed and followed.

Staff handling money like the cashier, security etc should be appointed only after strict scrutiny and cross checking with their previous employers. They should be rotated from time to time and a new combination of staff should be used. They must also be trained to react in emergency situations.

Cash Internal Control Chart:



4.0 CONCLUSION

Cash disbursement control in hotel management can be done in three ways. This involves ensuring credit control procedures, cash control and protection of hotel funds. The credit control procedures covers: guest paying by credit card, guest paying by travel agent voucher, guest checking in with tour groups, guests from airlines, guest with scanty baggage, and walk-in/chance guests.

5.0 SUMMARY

The internal control chart involves first control point (The hotel issues house-banks to cashiers). Here, at the end of the shift, each cashier must prepare the "cashier's report". Second control point, here, each cashier must deposit the envelope along with the cashier's report to the general cashier's safe deposit box. Third control point, here, the general cashier must prepare the daily general cashier's report and the general cashier must deposit the bank accounts on a daily basis or on a weekly basis (resort hotels) and finally fourth control point, here, the income auditor shall prepare the journal entry of cash transactions.

6.0 TUTOR-MARKED ASSIGNMENT

1. Write short notes on the credit control procedures to be put in place for the following:
   i. Guest paying by credit card
   ii. Guest paying by travel agent voucher
   iii. Guest checking in with tour groups
   iv. Guests from Airlines
   v. Guest with scanty baggage
   vi. Walk-in/chance guests
2. What are the necessary steps to be taken for the protection of hotel funds?
3. Draw and explain the cash internal control chart

7.0 REFERENCES/FURTHER READING

CPA (2007) Internal Control for Small Business Melbourne-Australia: CPA Australia Limited

UNIT 12: PETTY CASH CONTROL IN HOSPITALITY MANAGEMNT

CONTENTS

1.0 INTRODUCTION

Petty cash transactions are to be authorized accordance with established policies. Petty cash transactions are to be correctly analyzed and recorded. The officer in charge of petty cash should not have access to other company funds. Petty cash should be maintained on an imprest basis.

2.0 OBJECTIVE

At the end of the unit, you should be able to know the control objectives and the detailed controls of petty cash in hotel management.

3.0 MAIN CONTENT

3.1 Control Objectives of Petty Cash

The control objectives are to ensure that:

- All petty cash transactions are authorized bonafide and in accordance with established policies.
- Petty cash is properly safeguarded.
- Petty cash transactions are correctly analyzed and recorded.

3.2 Detailed Controls of Petty Cash

The detailed controls of petty cash are:

- The officer in charge of petty cash should not have access to other company funds.
- Petty cash should be maintained on an imprest basis.
- All petty cash payment must be properly authorized by a responsible person and must be in accordance with laid down policies.
- All petty cash disbursements must be properly analyzed and recorded in an analyzed sheet.
- Petty cash reimbursement should be made only after the petty cashier has properly accounted for all payments made during the period e.g. by supporting documents to duly authorized petty cash voucher.
- Payment to suppliers involving material amounts should not be made out of the petty cash voucher fund and in any case policies should be established to ensure that the types of payments and the limits of their amounts are clearly communicated to the petty cashier.
- Proper custody must be provided for petty cash voucher balances e.g. by the use of cash sales.
- There should be a surprise cash count by an independent person e.g. the internal auditor. During the surprise cash count, the independent person should ensure that cash balance in the safe is in agreement with the record in the petty cash voucher book. In addition petty cash voucher should be examined for proper authorization and to ensure that the transaction is in accordance with established policies.
- Cash advance should be properly accounted for.

4.0 CONCLUSION

The control objectives and detailed controls are to be taken into consideration in the control of petty cash in hotel management.

5.0 SUMMARY

In this unit, I discussed the necessary steps an officer in charge of petty cash should take for the control of petty cash in hotel management.

6.0 TUTOR-MARKED ASSIGNMENT

1. List three control objectives of petty cash in hotel management
2. Mention five detailed controls of petty cash in hotel management.

7.0 REFERENCES/FURTHER READING

CPA (2007) Internal Control for Small Business Melbourne-Australia: CPA Australia Limited

UNIT 13: ACCOUNT RECEIVABLES CONTROL IN HOSPITALITY ADMINISTRATION

CONTENTS

1.0 INTRODUCTION

Accounts receivable is an important asset of any business. Any delay or failure to collect due accounts, can result in cash flow shortages and profit erosion.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- know necessary steps in the control of account receivables
- know risks involved in financing using account receivables
- mention the types of risks involved when financing with account receivables in hotel management.
- know the components of Account Receivables and Inventory Financing (ARIF) lending structures.

3.0 MAIN CONTENT

3.1 Account Receivables Control

The following are the controls to be taken into consideration.

- Ensure credit and collection policies are in writing.
- Conduct credit checks on new credit customers.
- Regularly age accounts and have an independent review of the report.
- Ensure credit purchases are recorded as soon as the transaction occurs.
- Separate the accounts receivable function and cash receipting.
- Have transactions, such as non-cash credits and write-off of bad debts, cross-checked.
- Have a well-documented and strict policy for the follow up of overdue accounts.
- Review credit balances on a regular basis.
- Have numerical or batch-processing controls over billing.
- Ensure cross-checking of early payment discounts and penalties on overdue accounts.
- Ensure mailing of accounts cannot be tampered with.
- Prepare trial balance of individual accounts receivable regularly.
- Reconcile trial balances with general ledger control accounts.

3.2 Risks of Accounts Receivable and Inventory Financing

From a supervisory perspective, risk is the potential that events, expected or unanticipated, may have an adverse impact on an organisation's capital or earnings. The OCC has identified nine categories of risk: credit, interest rate, liquidity, price, foreign currency translation, transaction, compliance, strategic, and reputation. While Accounts Receivable and Inventory Financing (ARIF) have all these risks, this discussion/unit will focus on (i) Credit, (ii) Transaction, and (iii) Compliance risks.

3.2.1 Credit Risk

Credit risk is the current and prospective risk to earnings or capital arising from a debtor's failure to meet the terms of any contract with the organisation or otherwise to perform as agreed. Credit risk arises any time organisational funds are extended, committed, invested, or otherwise exposed through actual or implied contractual agreements, whether reflected on or off the balance sheet.

Like other types of commercial lending, ARIF's most significant risk is credit risk. ARIF borrowers typically exhibit higher default risk than other commercial borrowers. Credit risk is present in every part of the lending cycle — initial credit evaluation, underwriting, loan approval, loan administration, and, if necessary, debt liquidation.

3.2.2 Transaction Risk

Transaction risk is the current and prospective risk to earnings and capital arising from fraud, error, and the inability to deliver products or services, maintain a competitive position, and manage information.

3.2.3 Compliance Risk

Compliance risk is the risk to earnings or capital arising from violations of or nonconformance with laws, rules, regulations, prescribed practices, or ethical standards.

3.3 Types of Accounts Receivables and Inventory Financing

There are various types of accounts receivables and inventory financing (ARIF) practised. Three categories are defined as follows:

- **(i) Blanket Receivables Lending** — Asset-types other than accounts receivable and inventory that are often included in the collateral pool. Advances are not tied to borrowing-base formulas. Controls are minimal, and monitoring of the collateral is informal. Collateral valuations may be based on financial statements.
- **(ii) Factoring:** This arises where lender purchases receivables outright, with or without recourse. Although any loan with a lien against current assets, such as a blanket receivables loan, is technically ARIF,

here we are primarily concerned with arrangements in which lenders closely monitor and control collateral.

(iii) Accounts Receivable and Inventory Financing Structures

Since ARIF loans can be structured in many different ways, lenders should understand what structure is best suited to the characteristics of the borrower's business. For example, should the loan be long-term or seasonal? Should it be "fully followed" or "desk-followed"? The purpose of the loan, the anticipated source of repayment, the creditworthiness of the borrower, and the cash operating cycle of the business will help determine the structure of an ARIF loan. ARIF lenders will sometimes extend loans secured by fixed or other assets. They may even make unsecured loans. These loans may be separate agreements or part of complex "structured" loan agreements. The term "structured finance" is used to describe an arrangement that has more than one layer or type of debt. ARIF lending structures commonly include revolving credit, permanent working capital, seasonal operating advances, over-advances, and term debt.

Permanent Working Capital: Permanent working capital loans, which fund business operations, new growth, acquisitions, and other general purposes.

Seasonal Operating Advances: For many businesses such as apparel manufacturers and retailers, demand is seasonal. At certain times of the year, they require additional working capital. Before a peak-selling season, apparel manufacturers borrow to finish goods and build inventory levels. As inventory is sold, receivables increase until payments become due. Retailers often borrow to increase store inventory before heavy selling periods, such as holiday or tourist seasons, and repay after those seasons. A borrower may also need temporary inventory financing when a key supplier offers a special promotion. "Seasonal" credit advances are tied to the operating cycle of the specific business, the product of the borrower, or both. Lenders can structure a seasonal operating advance as a single-maturity note or a sub-limit option within a revolver. However, loans drawn under a revolver may not be specifically identified as seasonal. To distinguish the seasonal and "permanent" portions of a line, Auditors should perform an operating cycle analysis and review historical line; usage and repayment patterns. Auditors should also review quarterly financial information to evaluate working asset account volumes and borrowing levels. For borrowers that expect to grow, lenders and auditors should review pro forma balance sheet and income statements. Significant deviation from pro forma usually warrants further analysis and may signal a potential problem.

Lenders expect borrowers to repay seasonal advances in full by the end of the seasonal business cycle, normally by converting the supporting collateral into cash. Failure to repay seasonal advances on time may indicate a significant credit weakness. To assess whether a credit weakness exists, auditors should review trends in the borrower's sales and profit margins; trade cycle trends, including trends in receivables, inventory, and payable turnover ratios; and overall operating cash flow relative to debt service and ongoing operating requirements. Auditors should also determine the reason for any departure from historic borrowing patterns. If a borrower's financial performance is clearly weak, the loan should receive an adverse risk rating, even if collateral protection seems adequate. Unless reversed, financial deterioration often decreases underlying collateral values and increases exposure to loss. Exceptions to an adverse rating should be rare and would be appropriate only when the collateral is of high quality and the debt is substantially below the borrowing base or the loan was advanced under bankruptcy approved DIP (debtor-in-possession) financing.

Over-advances: Over-advances are loan advances that exceed the borrowing base. Although over-advances normally have the same priority lien status as other loan advances, they represent increased credit risk because collateral protection is reduced. Like any other new extension of credit, an over-advance should be approved in accordance with the bank's loan policies. Even when properly approved, frequent or longstanding over-advances are a sign of credit weakness. The credit approval documents of many ABL units and some secured lenders explicitly state when and under what conditions the lender will permit an over-advance. Such documents should stipulate the amount, frequency, duration, and period of the year when over-advances are permitted. Over-advances should be modest in amount and frequency; most important, they should have a defined repayment plan. Most lenders do not allow over-advances in excess of 10 percent of the borrowing base. Lenders should also do their best to verify that the borrower is using the proceeds as designated rather than masking obsolete inventory or slow sales. Lenders commonly permit over-advances for "Seasonal Inventory Buildup", i.e. borrowers may have brief periods during their normal operating cycle when inventory buildup exceeds sales. In these situations, the lender may temporarily increase the inventory advance rate to accommodate an over-advance. For example, lawn and garden equipment manufacturers may require additional credit availability during the winter months when sales are slow and inventory is accumulated for spring shipments.

4.0 CONCLUSION

Include in the account receivables controls are to ensure that credit and collection policies are in writing, conducting of credit checks on new credit customers and regularly age accounts and have an independent review of the report. From a supervisory perspective, risk is the potential that events, expected or unanticipated, may have an adverse impact on a bank's capital or earnings. Hotels are not also left out but the major risks of account receivables and inventory financing affecting them are credit risk, compliance risk, and transaction risk.

5.0 SUMMARY

In this unit, I discussed, account receivables control, risks of accounts receivable and inventory financing (credit risk, transaction risk, compliance risk), types of accounts receivables and inventory financing lending (blanket receivables lending, factoring, and accounts receivable and inventory financing structures).

6.0 TUTOR-MARKED ASSIGNMENT

1. Mention five controls to be taken into consideration in account receivables.
2. Explain three risks inherent in Accounts Receivable and Inventory Financing (ARIF)
3. Mention three categories of accounts receivables and inventory financing (ARIF) lending.

7.0 REFERENCES/FURTHER READING

CPA (2007) Internal Control for Small Business Melbourne-Australia: CPA Australia Limited

UNIT 14: CONTROL OF EMPLOYEES' REMUNERATION IN HOSPITALITY ADMINISTRATION

CONTENTS

1.0 INTRODUCTION

Control of employees' remuneration can be done through the control of a good payroll system. Many payrolls, even small ones, are now automated, so it is easier to commit fraud or errors if the internal controls are not tight and the procedures are not set or followed.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- know necessary steps in the control of employees' remuneration
- ask questions relating to an employee
- find out more about your organizational employees
- know how fraud is encouraged by staff in tipping off the auditors, owners or accountants of hospitality business.

3.0 MAIN CONTENT

3.1 Employees' Remuneration Control

The steps to be taken into consideration when putting in place adequate control of employees' remuneration are as follows:

- Ensure passwords are not handed to other staff members when the person in charge is on holiday or sick.
- If an electronic payroll is used, ensure supervisors change their password often.
- Ensure any payroll summaries are in the same typeface as the system's printer to avoid possible fraud.
- Review bank account deposits to ensure that each pay goes to a different bank account.
- Where possible, segregate payroll preparation, disbursement and distribution functions.
- If possible, the payroll officers must not calculate their own pay.

3.2 Questions of checklist about employees of an organization

1. Are all employees hired by you?
2. Are individual personnel files maintained?
3. Is access to personnel files limited to you or a designated manager, who is independent of the payroll or cash functions?
4. Are wages, salaries, commission and piece rates approved by you, the owner?
5. Is proper authorization obtained for payroll deductions?
6. Is gross pay determined using authorized rates and:
   (i) Adequate time records for employees paid by the hour?
   (ii) Piecework records for employees whose wages are based on production?
7. Are piecework records reconciled with sales records?
8. Are salespeople's commission records reconciled with sales records?

9. If employees punch time clocks, are the clocks located so they may be watched by someone in authority or are there security cameras in the vicinity?
10. Are time records for hourly employees approved by a supervisor?
11. Would you be aware of the absence of any employee?
12. Is the clerical accuracy of the payroll checked?
13. Are payroll registers reviewed by you?
14. Do you, the owner, approve, sign and distribute payroll cheques?
15. If employees are paid in cash, do you compare the cash requisition to the net payroll?
16. Do you maintain control over unclaimed payroll cheques?
17. Is annual leave required to be taken regularly?

3.3 Investigating organizational employees

In a small business, you are very reliant on your employees. They are your representatives with customers, suppliers and competitors. Take the time to hire the right persons/people for the job and your style of management, as the costs of hiring and training can be the equivalent to three months' wages. This is not an easy process. Unfortunately, some people do falsify their employment records to get a good job – it is more common than you think. When taking on a new employee, always take the time to check their employment record, ring the previous employers and don't just rely on written references. Check out any claimed education credentials that are essential to the operation of the job/business, undertake regular annual performance reviews with staff, ensure adequate training is provided, clearly outline responsibilities and expectations, keep lines of communication open with employees by ensuring that:

1. Employees are well motivated because resentment increases when the owner enjoys success without passing it on to employees.
2. You are sensitive to employees' hopes and expectations.

3. You don't misplace trust – one person in a small business usually bears an inordinate amount of financial responsibility. Review your office staff.

3.4 Ensuring Staff feedback

Finally, develop a process for staff to report breaches in internal controls and report suspicious behaviour. Ensure that staff know your door is always open and their concerns are welcome, not a nuisance. Most fraud is detected by staff tipping off the auditors, owners or accountants. This culture can be encouraged in organisations by:

1. Having in place a whistle blowing procedure
2. Protecting the identity of whistleblowers, if practicable
3. Protecting whistleblowers from being victimized
4. Investigating breaches as quickly as possible and taking firm disciplinary action when necessary
5. Rewarding staff for reporting breaches in internal controls or outright fraud (as well as for innovative ideas), perhaps with a gift voucher or similar, for every useable suggestion

It is important that staff feel that it is their duty and responsibility to report such matters as it is their livelihood, as well as yours, that relies upon the financial integrity of the business.

4.0 CONCLUSION

A good payroll system is a method through which employees' remuneration can be controlled. In a small business, you are very reliant on your employees. They are your representatives with customers, suppliers and competitors. Take the time to hire the right person for the job and your style of management, as the costs of hiring and training can be the equivalent to three months' wages. It is important to also let staff feel that it is their duty and responsibility to report/blow whistles as it is their livelihood, as well as yours, which relies upon the financial integrity of the business.

5.0 SUMMARY

In this unit, I discussed, employees' remuneration control, questions of checklist about employees of an organization, investigating more about organizational employees and ensuring staff feedback.

6.0 TUTOR-MARKED ASSIGNMENT

1. List the necessary steps in the control of employees' remuneration
2. Write ten (10) questions to ask relating to the control of an employee.
3. Mention four practices that are expected of staff in tipping off the auditors, owners or accountants of hospitality organisations.

7.0 REFERENCES/FURTHER READING

CPA (2007) Internal Control for Small Business Melbourne-Australia: CPA Australia Limited

REVIEW QUESTIONS

1. Define internal control systems.
2. Mention the types of internal controls in practice.
3. What are the internal control objectives of personnel policies?
4. List some management controls.
5. When are physical controls especially important?
6. List some physical controls
7. How can theft of cherubs in the post be prevented /detected?
8. How can teaming and lading be prevented?
9. List suitable controls over a petty cash system.
10. List some possible wages fraud.
11. Barca pays Arsenal, a cousin of Maldid who is an employee of Barca, for goods not supplied. How could this be engineered and how can it be prevented?
12. List the benefits of a stock control system and how the benefits are achieved.
13. How can the accuracy of a fixed asset register be assured?
14. Define internal audit system.
15. Discuss four differences between internal and external auditors.
16. Discuss the factors to be considered before placing reliance on the work of internal auditors.
17. Mention eight areas of cooperation between internal and external auditors.
18. Mention the two methods of evaluating internal control systems.
19. What are the benefits of ICEQ over ICQ?
20. Discuss the limitations of internal control systems.