

# Diploma in Financial Management & Accountability

- A joint initiative of TISS & FMSF

## Course Material



Audit

Paper - VII

Module - IV

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## Chapter 5

### INTERNAL CONTROL

#### 5.1. MEANING OF INTERNAL CONTROL

The system of internal control has been defined by International Auditing Practices Committee in the Internal Auditing Guidelines No. 6 as “the plan of organisation and all the methods and procedure adopted by the management of an entity to assist in achieving managements objective of ensuring, as far as practicable, the orderly efficient conduct of its business including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records and the timely preparation of reliable financial information.”

Thus internal control systems represent the broad control system instituted by the management to achieve the objective of :

- a) Orderly and efficient conduct of the business;
- b) Adherence to management policies;
- c) Safeguarding of assets;
- d) Prevention and detection of fraud and errors;
- e) Ensuring accuracy and completeness of the accounting records; and
- f) Timely preparation of reliable finance information.

Usually the control is entirely centralized with the owner and there is no significant delegation of duties. However, as the business grows in size, it soon reaches a stage, where the owner can no longer keep himself immediately informed about the detailed operations of his business. In such a case internal control becomes very important. The reliability of business operations can be judged by the effectiveness of internal control.

## 5.2. OBJECTIVES OF INTERNAL CONTROL

- a) Transactions are executed in accordance with management authorization.
- b) All transactions are recorded with appropriate amount and in appropriate account.
- c) To prevent the assets from unauthorized access, use or disposition.
- d) To prevent and detect fraud and error.

## 5.3. FACTORS AFFECTING INTERNAL CONTROL

The internal control environment may be affected by

- a) **Organizational structure:** The structure of the organization should be as far as practicable; it should prevent the individual from overriding the control system.
- b) **Management supervision:** Management is responsible for devising and maintaining the system of internal control. Management should review the adequacy of internal control on a regular basis to ensure that significant controls are operating effectively.
- c) **Personnel:** The proper functioning of any system depends on the competence and honesty of the person operating it. The qualification, selection and training as well as the personal characteristics of the person involved are important features in establishing and maintaining a system of internal control.

#### 5.4. ESSENTIALS OF A GOOD INTERNAL CONTROL SYSTEM

- a) Proper allocation of functional responsibilities within the organization.
- b) Implementation of proper operating and accounting procedures to ensure the accuracy and reliability of accounting data, efficiency in operation and safeguarding of assets.
- c) The quality of personnel is also very important. They should be competent and honest.
- d) The review of the work of one individual by another whereby the possibility of fraud or error in the absence collusion is minimized.

#### 5.5. INHERENT LIMITATIONS OF INTERNAL CONTROL

Due to some inherent limitation of internal control, objectives of internal control cannot be absolutely achieved. These limitations are as follows :

- a) Management's consideration that a control be cost - effective.
- b) The potential for human error.
- c) The possibility of deception of controls through collusion with outside parties or with employees of the entity.
- d) The possibility that the person having higher authority may override a control.
- e) The procedures may not work due to changes in conditions.
- f) Manipulation by the management in the preparation of financial statements.

## 5.6. EFFECT OF INTERNAL CONTROL ON THE WORK OF AUDITOR

The duty of safeguarding the assets of a company is primarily that of management and the auditor is entitled to rely upon the safeguards and internal control instituted by the management. For an auditor the examination and evaluation of the internal control is an indispensable part of the overall audit programme.

The auditor should study the accounting system and evaluate the operation of internal control to determine the nature, timing and extent of audit procedure. The review of internal control will enable the auditor to know:

- Whether it is possible to locate errors and frauds in the ordinary course of operations.
- Whether internal control system is adequate and really in operation.
- Whether internal auditing department is operating effectively.
- Whether any administrative control has a bearing on his work.
- Whether the control adequately safeguards an asset.
- Whether the transactions are recorded correctly.
- How reliable the reports, records and certificates by to the Management can be.
- The extent and the depth and examination that he needs to carry out.
- What are the areas where the control is weak and where it is excessive, and
- Whether worthwhile suggestions can be given to improve the control system.

Once the auditor has knowledge of internal control system he can formulate his entire audit programme. In the absence of knowledge about internal control, his audit programme may become unwieldy and cumbersome. The auditor should also see that after the installation of the internal control system, there is proper follow up by the management to ensure compliance. The system may not be in operation or may operate only partially. Therefore, the auditor should take care to see that the internal control system is in operation as devised by the management.

The review of internal control system will help the auditor to know the weakness in the system. He should bring to the notice of the management the weakness of the

system and to suggest measure to overcome those weaknesses. He should also make appropriate follow up to ascertain how far weaknesses have been removed.

Where internal control is weak in some areas, the auditor would use different audit procedure or he would extend certain tests to cover a large number of transactions. He may perform additional tests to bring him, the necessary satisfaction. For example, if the auditor finds that internal control over wages is so weak that there exists a possibility of dummy workers being paid, the auditor might include wages distribution in his programme in order to find out the workers who do not turn up for receipt of wages. Similarly, if the internal control over debtors is weak, he should get the balance confirmation exactly on the date of the year closing so that he may eliminate the risk of errors and frauds occurring in between the intervening period. Also, he may decide to have coverage of debtors by the confirmation procedure.

Thus it can be said that the extent and nature of the audit programme is substantially influenced by the internal control system in operation. The existence and operation of internal control system is of great significance in deciding upon a plan of selective checking i.e. test checking or sample checking.

#### **5.7. METHODS FOR THE PROPER REVIEW AND EVALUATION OF THE ADEQUACY OF THE INTERNAL CONTROL**

- a) **Narrative-record** - It contains a complete written description of the internal control system of the enterprise as found in actual operation by the auditor. The method of keeping a narrative record may be usefully employed in a small business where internal control system may be generally weak. The type and extent of narrative record will vary according to the requirements and individual judgement of each auditor. This method may be recommended in cases where no formal control system is in operation.
- b) **Check list** - A check list is a series of instruction and/or question which a member of the auditing staff must follow and/or answer. When he completes the instruction, he initials the space against the instruction.

Answers to, the check list instructions are usually yes, no or not applicable. This is again on job requirement and instructions are framed having regard to the desirable elements of control. Different check lists may be prepared for different clients and situation. For example, a checklist on purchases may contain the following:

- i) Are purchases centralized in purchase department?
  - ii) Are purchases made only from approved suppliers?
  - iii) Are purchases orders duly authorized?
  - iv) Are purchases based on competitive quotations from two or more suppliers?
- c) **Internal control questionnaire** - It is a set of questions designed to provide a thorough view of the state of internal control in an organisation. The questions are generally prepared in sections of distinct control areas and are often further segmented into subsections. Evaluation through internal control questionnaire now forms part of any properly organized audit. Weakness in internal control can be known by examining the answers to the question in the questionnaire and by testing whether the procedure or control stated to be operating is in fact operating. By this process the auditor would be better equipped to decide the extent and depth of checking required in various accounting areas and can pursue his work more objectively. He can decide upon a more intensive and extensive mode of checking in weak-control areas and can subject the rest to normal checking for deriving the necessary audit satisfaction.

The management of the concern under audit is normally expected to put replies against question in the questionnaire. These may be completed by audit staff on the job and are thereafter examined by senior in-charge. On the basis of experience gained, the points of lesser importance may be appropriately dealt with and questions inapplicable to the job eliminated. The standard audit programme may be modified in the light of knowledge gained by use of questionnaire. The questionnaire helps the auditor to prepare a report of deficiencies and recommendations for improvement.

- d) **Flow chart** - A flow chart is a graphic presentation of each part of the company's system of internal control. It is considered to be one of the most concise way of recording the auditor's review of the system. It minimizes the amount of narrative explanation and thereby achieves a consideration and presentation not possible in any other form. It gives a bird's eye view of the system and the flow of transactions.

#### SELF ASSESSMENT QUESTIONS

- i) What is the meaning of internal control?
- ii) Explain four key internal control measures for an organization.
- iii) What is the effect of internal control on the work of auditor?
- iv) Outline the system of internal control regarding the :
  - Cash transactions
  - Purchase of Capital Assets
- v) Design a questionnaire for evaluation of internal control system for the payments made by cheques.
- vi) What is the difference between Internal Audit and internal Control?
- vii) What is the method of proper review and the evaluation of the adequacy of the internal control system?