Internal Control and Auditing Techniques

Internal Control

The American Institute of Public Accountants has defined internal control as the plan of organization and all the co-ordinate methods, and measures adopted within a business to safeguards its assets, check the accuracy and the reliability of its accounting data, promote operational efficiency and encourage adherence to prescribed managerial policies.

The Institute of Chartered Accountants of England and Wales defines internal control as "internal control means not only internal check or internal audit, but the whole system of control financial and otherwise, established by management in order to carry on the business of the company in an orderly manner, safeguard its assets and secure as far as possible accuracy and reliability of its records".

Objective of internal control

- To minimize, if not completely eliminate, wastage and inefficiencies in business operations and to safeguard the assets of the business.
- To ensure high degree of accuracy and reliability of accounting data and promote operational efficiency.
- To measure how far the policies of the management are being implemented, and
- To evaluate the efficiency of performance in all aspects of business activities and to highlight the weaknesses.

Steps/Measures/Techniques of Internal Control:

A. INTERNAL CHECK

Internal check is a system enforced in business under which the recording of business transactions is arranged in such a manner that the work of one staff member will automatically be checked by others in the course of recording of transaction itself.

Thus, under internal check system the staff duties are so arranged that no one person is allowed to record every aspect of the transactions and the entire work is distributed among the various members of the staff in such a manner that the work of one person is automatically checked by Others.

Objectives of internal check

- To reduce chance of fraud and errors that may be committed by any member of the staff and make it more difficult. If any fraud is to be committed two or more persons must collude together.
- To detect fraud and errors easily and correct them promptly.
- To exercise moral pressure among the members of the staff.

• To allocate duties and responsibilities of every person in such a way that he can be taken to task for any lapse on his part.
• To increase overall efficiency of the members of the staff by assigning duties based on the principle of division of labour.

5.6.7 Distinguish between internal check and internal control

Ans. Point	Internal check	Internal control
1. Meaning	It is a system of allocation of responsibility, division of work and methods of recording transactions, whereby the work of one employee is checked continuously by another.	It is the system of control established by the management in order to carry on business in an orderly and efficient manner, ensure adherence to management policies, safeguard assets and completeness of records.
	It is a part of Internal Control.	It includes Internal check and Internal audit.
2. Relation	It is arrangement of book-keeping and Olerical duties.	It includes the essence of Internal check and internal audit.
3. Essence	Checks are automatic and continuous.	It includes the implementation of Internal check and Internal audit.
		It includes Internal check and Internal audit.

B. INTERNAL AUDIT

Internal audit is described as the verification of the operations within the business by a specially assigned staff. It is an important tool of management to evaluate the correctness of records on a continuous basis in an organisation.

The term internal audit has been defined as "an independent appraisal of activity" within an organisation for review of operations as a basis of service to management. It is a managerial control which functions by measuring and evaluating the effectiveness of other controIs.

According to Howard F. Stettler, "internal auditing is an independent appraisal activity within an organisation for the review of operations as a service to management."

Objectives of internal audit

The main objectives of internal audit are as under:-

- To verify the correctness and authenticity of the financial records and statistical records presented to the management.
- To ensure that the standard accounting practices are strictly followed in the organisation.
- To facilitate early detection of errors and frauds.
- To ensure that all the transactions have been carried out under a proper authority and by persons authorised for the same in the business.

External audit/ Statutory Audit

The external auditor should, as part of his audit, evaluate the internal audit function to the extent considers that it will be relevant in determining in nature, timing and extent of his compliance and substantive procedures. Depending upon such evaluate, the external auditor may be adopt less extensive procedure than would otherwise be required.

Differences between internal audit and statutory audit-

The following are the points of differences between internal audit and statutory audit:

Internal audit	Statutory audit
1. Internal audit is the arrangement within the organisation to verify on continuous basis the correctness and truthfulness of the transactions by the salaried staff.	Statutory audit is the examination of the books of accounts of the business by an external auditor and to report that the profit and loss account and balance sheet are drawn according to provisions of law and the financial statements reveal the true and fair view of the results of operations and financial state of affairs of the business.
2. Internal audit is not compulsory.	Statutory audit is compulsory in case of business houses incorporated under the Companies Act and other acts.
3. Internal audit is carried out by the staff appointed by the business enterprises. It is not necessary that the internal audit staff should possess the qualification prescribed for professional auditor	Statutory audit can be carried out only by those who are qualified for appointment as per the provision of the Companies Act and other acts.
4. Being an employee of the organisation internal auditor is answerable to the management. His duties, responsibilities etc. regarding	The rights, duties, responsibilities and liabilities of auditors are governed by the provisions of law. The auditor is independent of management.

Auditing Techniques:

1. Posting Verification
2. Vouching
3. Confirmation
4. Physical Examination
5. Reconciliation
6. Testing
7. Analysis of Financial statements
8. Scanning
9. Inspection
10. Observration

• **Posting Verification** – Verification of items by one source to another source – To establish the authencity and consistency of recording process

• **Extension Verification** – Multiplying two or more accounts to prove the accuracy of the total

• **Vouching** – An examination of all original evidences – To proving the accuracy of the entries in the books of accounts •

Confirmation – To ascertain the correctness of the figures and validity of the client's record – With the third party

Testing – Selection of representative items from the records and examining them for reaching on conclusion about the trend

• **Analysis of Financial Statement** – Uses various Financial Ratios horizontally and vertically

• **Physical Examination** – Includes inspection, counting, identification and measurement of quantity – May observe the process of stocktaking

• **Reconciliation** – Reconcile two or more related items if they are not agree or match with each other

• **TESTING** – Selection of representative items from the records and examining them for reaching a conclusion about trend of activity. – Items must be sufficiently representative of whole data.

• **Analysis of Financial Statements** – Financial ratios – Horizontal and Vertical comparison – Relationship with Industry averages

Documentary Examination – Same as Vouching in nature – To examine the adequacy and reliability • Scanning – Make a wide search to find out which of the entries are regular, consistent and logical

• **Observation** – Observe the various policies and procedures or plans followed by the client • Flow Charting – To describe graphically the issue of transactions through different stages

• **Inspection** – Arrange an inspection of the client's office, plant, branches etc. – To obtain the understanding of plant layout, manufacturing processes, product, control and safeguard of inventories etc. – Should inspect before examination and review

Others techniques.

• Enquiry • Computation • Management Representation • Sampling Techniques • Compliance Techniques • Substantive Testing • Analytical Review • Computer Assisted Accounting Techniques

• Obtaining Management Representation • Important evidence in form of – summary of oral discussions with management – Written representation from management • Should be addressed to the auditor contain Specified information • Its procedure must be agreed with client in early stage of audit.

VOUCHING

Meaning: Vouching means the examination of documentary evidence in support of entries to establish the arithmetic accuracy. When the auditor checks the entries with some documents it is called vouching.
Vouching is the acid test of audit. It tests the truth of the transaction recorded in the books of accounts. It is an act of examining documentary evidence in order to ascertain the accuracy and authenticity of the entries in the books of accounts.

According to **Dicksee** "Vouching consists of comparing entries in the books of accounts with documentary evidence In support thereof."

Voucher
Any documentary evidence supporting the entries in the records is termed as a voucher. Any document, which supports the entries in the books of accounts and establishes the arithmetical accuracy, is called a voucher.

Examples of vouchers:
A bill, a receipt, an invoice, goods received note, salaries and wages sheets, goods inward and outward register, stores records, counterfoil of a cheque book, counterfoil of pay-in-slip book, bank

statement, bank pass book, delivery challans, agreements, a material requisition slip, copy of purchase order, minute book, memorandum and articles of association, partnership deed, trust deed, prospectus etc. are the examples of vouchers.

IMPORTANCE OF VOUCHING

- Ensures genuineness of the transactions
- Enables to know transactions
- Helps to know relevance of the transaction
- Facilitates proper allocation of capital & revenue, expenditure
- Detects frauds and errors
- Decides authenticity of transactions
- Ensures proper accounting
- Compliance with law
- Ensures proper disclosure

The special considerations to be borne in mind by the auditor in the course of vouching

1. Date of the voucher
2. The name of the party
3. Tick and audit rubber stamp
4. Authorisation by the authorised person
5. Revenue stamp of Re. 1 if it exceeds Rs.5000/-
6. Transaction relates to business
7. Revenue and capital
8. Amounts in words and figure
9. Account head
10. No assistance of member of clients staff to be taken for checking receipts
11. Not to accept receipted invoice
12. Missing vouchers

13. Important documents
14. Vouching of cash transaction
15. Proper filing
16. Signature of payee

<u>Auditing Procedure:</u>

TEST CHECKING

Meaning

Carrying out detailed check of each and every transaction of a large business shall be time consuming for the auditor. In auditing the accounts of a business, every single copy is not usually checked by the auditor; what is usually done in practice is that a representative number of Entries of each class are selected and checked and if they are found correct, the remaining entries are taken to be correct. This is known as Test Checking.

In those organizations, where satisfactory internal check system is in existence, the auditor need not carry out detailed checking. He may adopt Test checking. It is a system of sampling employed by the Auditor for the purpose of reducing the volume of detail checking involved in the audit. If, in Test Checking, he finds that the records checked by him are correct then no further detail checking need be carried out.

SURPRISE CHECKS

To avoid audit procedures from becoming routine, mechanical and predictable, surprise checks are desirable. Surprise checks involve visits by auditor to the client's office/factory without prior intimation. The element of surprise is in respect of both time and scope. Items checked during such surprise checks are selected without prior notice to the client's staff.

Such checks are very effective in case of verification of cash, stock, investments, verification of books of prime entry. It helps in ascertaining whether the system of internal control is operating efficiently and thus prevent and detect errors and frauds in accounts.

AUDITING IN DEPTH

Taylor and Perry have defined Auditing in Depth as: “the examination of the system applied within a business entailing the tracing of certain transactions from their origin to their conclusion, investigating at each stage the records created and their authorization”.

VERIFICATION AND VALUATION

Spicer and Pegler have defined verification as “it implies an inquiry into the value, ownership and title, existence and possession and the presence of any charge on the assets”. Verification is a process by which an auditor satisfies himself about the accuracy of the assets and liabilities appearing in the Balance Sheet by inspection of the documentary evidence available. Verification means proving the truth, or confirmation of the assets and liabilities appearing in the Balance Sheet.