



## Learning Objectives

- To understand the meaning, objectives, advantages and disadvantages of Internal Check system.
- To Analyse the Auditor's duties with regard to Internal Check System.
- To Evaluate the Application of internal check system with respect to Cash and Trading transactions.

## 1.1 Introduction

In business concerns there are chances of misappropriation and manipulation of accounts. In order to overcome such irregularities and to prevent or minimise the occurrence of errors and frauds, a checking system is designed to have a check on the irregularities. Such a check which operates continuously as part of the routine system is called as Internal Check. This chapter highlights the principles of good internal check system and explains in detail the procedure of internal check with regards to cash and trading transactions.

## 1.2 Meaning Of Internal Check



The term internal check refers to allocation of duties to the employees in an organisation in such a way that the work of one person is automatically

### Internal check system when cash is withdrawn from bank against a cheque

Firstly, the Cheque is produced at the counter where the clerk issues a token and enters the token number on the back side of the cheque and in the token book.

Secondly, the cheque is then passed on to the ledger clerk who verifies the credit balance in the account of customer and makes the debit entry therein for the amount of the cheque.

Thirdly, the cheque is sent to an officer, who compares the signature on the cheque with the specimen signature of the account holder and passes it for payment.

Lastly, the cheque is sent to the cashier who makes the payment against the token and records it in the cash register.

Thus, withdrawal of cash from a bank account is undertaken by four different persons such that work of one person is checked by other person in order to avoid the occurrence of errors and frauds. The system of internal check is exercised in such a way that no individual person does the entire work and the process is as follows.



and independently checked by the other person from the beginning to the end. It denotes such an arrangement of duties among the staff that the work performed by one individual is independently checked by another in the routine course, such that errors and

frauds are prevented or discovered. Under the system of internal check, care is taken to ensure that no one person handles a transaction completely from beginning to end and the work of every person is in the ordinary course checked by another person.

### Internal Check System on Account of Cash Sales

Firstly, Sales Department makes an entry in the Sales Register for name of the customer, date of sale, quantity and amount of sale and issues a Sales Invoice.

Secondly, The store keeper in Stores Department makes an entry for material issued in the stores ledger.

Thirdly, at the factory gate the gate keeper makes an entry when the goods are sent out or delivered.

Fourthly, in Accounts Department the person records the sale transaction based on sales invoice.

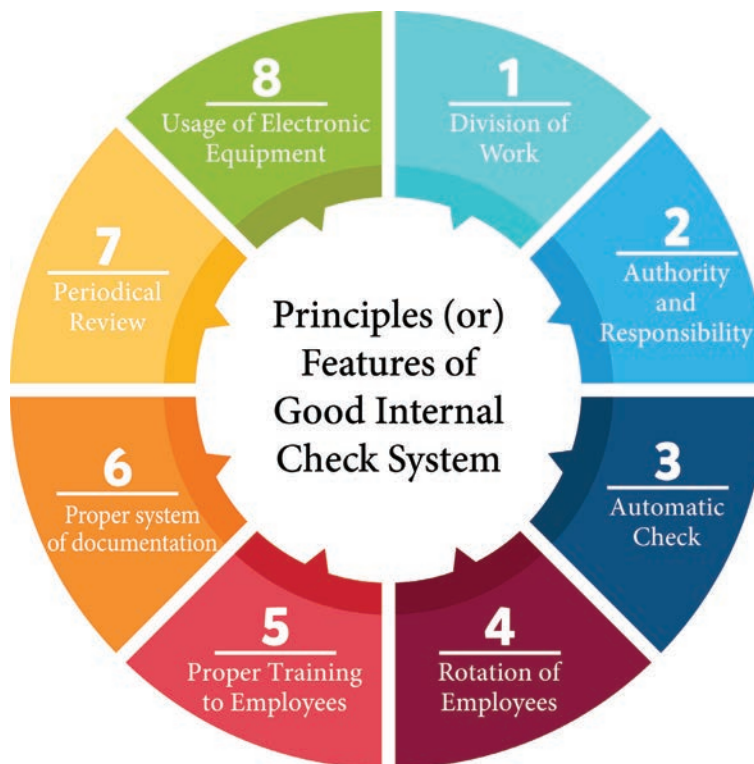
Finally, the cashier on receipt of cash makes an entry in Cash Book and issues receipt acknowledging cash received.

Thus, the transaction is passed through five different persons from different departments, and hence the work of one person is automatically checked by the other person in order to avoid errors and frauds.

### 1.3 Definition

- **L.R. Disksee** defined Internal Check as, “Internal Check is an arrangement of accounting routine that errors and frauds are automatically prevented or discovered by the very operation of book-keeping itself.”
- According to **F.R.M Depaula**, “An internal check means practically a continuous internal audit carried on by the staff itself, by means of which the work of each individual is independently checked by the other members of the staff”.
- According to **Speicer and Pegler**, “A system of internal check is an arrangement of staff duties whereby no one person is allowed to carry through and to record every aspect of the transaction, so that, without collusion between two or more persons, fraud is prevented and at the same time the possibilities of errors are reduced to the minimum”.

### 1.4 Principles (or) Features of Good Internal Check System



1. **Division of Work:** Division of work refers to dividing the total work among various staffs in such a way that no single person is allowed to perform the work from the beginning to the end. The work should be allocated to the employee based on the capacity of each person.
2. **Authority and Responsibility:** Authority, duties and responsibilities of each person should be clearly defined and there should not be any overlapping or duplication of duties and responsibilities.
3. **Automatic Check:** Work allocated to the staff should be in such a way that the work

performed by one person is automatically checked by another person.

4. **Rotation of Employees:** A good system of internal check should provide transfer or rotation of employees from performing one work to another at frequent intervals.
5. **Proper Training to Employees:** An effective system of internal check should carefully select the employees to the organization. The employees should be properly trained and clear instructions should be given to them to perform their work in an effective and efficient manner.
6. **Proper system of Documentation:** Internal check system should provide

for proper system of filing vouchers, correspondences etc. in a systematic manner.

7. **Periodical Review:** The system of internal check should at frequent intervals (be reviewed) and suitable changes should be introduced.
8. **Usage of Electronic Equipment:** The system of internal check should provide for usage of labour saving electronic devices such as calculating machines, personal computers, time recording clocks, book-keeping machines etc. The proper training should also be given to the employees for using these devices.

**Example:** picture showing the flow of internal check system in a textile showroom.



## 1.5 Objectives of Internal Check

The objectives of internal check are as follows:

1. **Early Detection of Errors and Frauds:** The main objective of internal check is to detect and prevent the occurrence of errors and frauds at an early stage. This is possible as the work of each and every person is independently checked.

2. **Minimization of Errors and Frauds:** It is one of the primary objectives of internal check. As the work performed by each individual is checked by another person, there is a check on errors and frauds. Hence, the possibility of errors and frauds are minimised to a greater extent.
3. **Division of Work:** Internal check provides for proper division of work based upon each and every persons

skill, ability, specialisation and effectiveness.

4. **Fixation of Responsibility:** The total work is divided into smaller units and assigned to different persons. Each and every person knows what is expected from him/her and he/she will be held

responsible for any errors or fraud which takes place in it. Internal check provides clear determination of responsibility.

5. **Reliability of Records:** The system ensures that the books of accounts and other records maintained provides reliable source of information.



## 1.6 Advantages of Internal Check

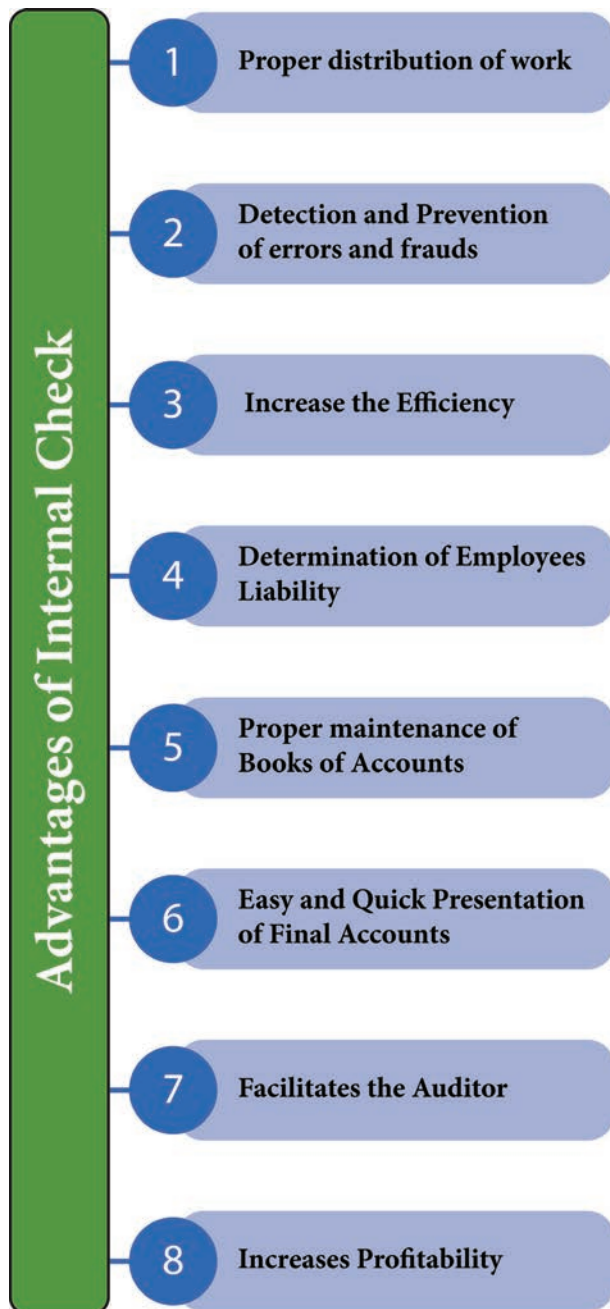
The main advantages of Internal Check are given below.

1. **Proper Distribution of Work:** Internal Check helps in proper distribution of work among employees based on their qualification and experience. It enables the employees to perform the work efficiently.
2. **Detection and Prevention of Errors and Frauds:** The main object of internal check is to minimize the occurrence of errors and frauds, as no individual

person does the work from the beginning to the end and the work of one person is checked by another person.

3. **Increases Efficiency:** A good system of internal check, increases the efficiency of work of employees as the right work is allocated to the right person taking into account his skill and experience.
4. **Determination of Employees Liability:** Internal check system clearly determines the responsibilities of the employees. Hence, the liability of the employees can be easily fixed due to irregularities or negligence caused by the employee.





5. **Proper Maintenance of Books of Accounts:** Internal check system helps to maintain proper records and ensures accuracy of the entries in the books of accounts.
6. **Easy and Quick Presentation of Final Accounts:** Internal check enables quick presentation of final accounts i.e., Profit and Loss Account and Balance Sheet immediately after closing of the accounting period.

7. **Facilitates the Auditor:** When there is an effective internal check system the statutory auditor can rely on the system. He can avoid detailed checking of transactions. He can select limited sample of transactions. This enables him to finish the audit work within time.
8. **Increases Profitability:** Overall efficiency and economy of operations leads to increased earnings for the owners of the enterprise.

## 1.7 Disadvantages of Internal Check

The disadvantages of internal check are given below.



1. **Expensive:** The system of internal check is more expensive and time consuming.
2. **Not Applicable for Small Organization:** This system is not applicable for small organization where there are only few employees. Only large organization having number of departments and

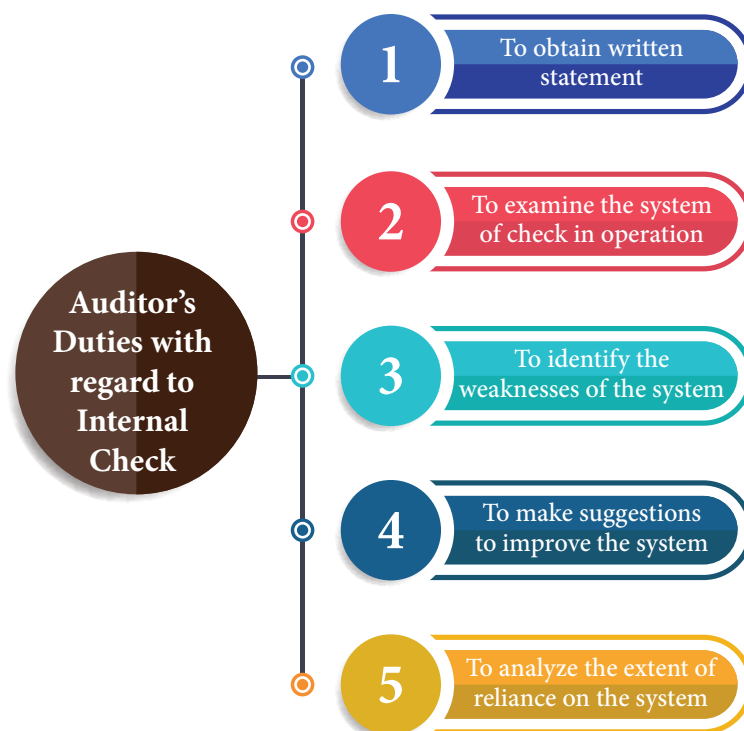
complexity of jobs can get benefit of this system.

3. **Monotonous for the Workers:** As same work is done by the employees continuously the job becomes boring and the employees lose their creativity.
4. **Risky for the Auditor:** When the auditor relies on the system of internal check and does not conduct tests he will be charged for negligence.

5. **Disorder in Work:** If the system is not fully organized and if there is any failure in the system, it creates disorder and confusion hence, chances of errors and frauds increase.

6. **Chances of Collusion:** Though internal check system prevents errors and frauds but in reality there may be chances of collusion between two or more employees to indulge in frauds or malpractices.

## 1.8 Duties of an auditor with Regards to Internal Check System



The system of internal check in an organisation determines the scope of work of a statutory auditor. The duty of an auditor is to verify the effectiveness of the system of internal check in operation. However, the auditor should perform the following work in this regard.

1. **To Obtain Written Statement:** An auditor should obtain a written statement about the working of the internal check system from the business concern.
2. **To Examine the System in Operation:** The auditor should carefully examine

the existence and operation of the internal check system.

3. **To Identify the Weaknesses:** The auditor should identify the weakness of the system which will result in occurrence of errors and frauds taking place.
4. **To Suggest for Improvements:** If the system of internal check is ineffective, the auditor should make suggestions to strengthen the system of internal check.
5. **To Analyse the Extent of Reliance:** The auditor should carefully analyse the extent to which he can rely on the effectiveness of internal check. If the system of internal check is effective, he can check sample transactions thus devoting his attention on other important audit areas.

## 1.9 Internal Check - Cash Transactions

Checking of all cash transactions should be given utmost importance because employees tend to involve in fraudulent activities by misappropriating cash and manipulating accounts in an organisation. Hence, the auditor should verify the system of internal check in operation with regard to cash receipts and cash payments, which is explained in detail below –

### 1.9.1 Internal Check-Cash Receipts

There should be proper system of internal check as regarding cash transactions as the employees tend to misappropriate cash in an organisation. Cash receipts

may be misappropriated in the following manner:

- Cash receipts may not be entered in the cash book. Cash received may be understated by preparing duplicate receipts for amount less than what is actually received.
- Cash sales may be treated as credit sales.

The following system of internal check may be adopted as regards cash receipts.

1. All inward remittances should be opened by the cashier in the presence of a responsible officer.
2. On receipt of cash or cheque, it should be immediately entered in cash book or cheque received notebook.
3. All remittances (draft, cheque) must be crossed as 'account payee only'.
4. Cash and cheques received should be deposited immediately.
5. Bank pay-in-slips should be prepared by a separate person, who is not entrusted with the work of depositing cash in the bank.
6. Cash received after the banking hours should be kept in the locker of the business. The locker should be opened by the cashier in the presence of a responsible official.
7. Printed receipts should be issued for all remittances signed by the cashier and responsible official.
8. Unused receipt book should be kept under lock and key under the custody of the responsible official.
9. Cancelled or spoilt receipts should not be detached from the receipt book.
10. Cash balance should be physically verified by a responsible official by surprise check at frequent intervals.



### 1.9.2 Internal Check-Cash Payments

There should be an effective system of internal check with regard to all payments made by the concern in the form of cash or cheque or bank transfers. Cash payments may be misappropriated in the following ways:

- Payments may be made against fictitious vouchers.
- Payments may be made against inflated vouchers.
- Payments may be made without receipt of goods.
- Revenue expenses may be treated as capital expenditure.

Hence, a proper system of internal check is necessary. The following system of internal check may be adopted as regards cash payments.

1. The person in charge of making cash payments should not have any connection with the person responsible for receiving cash.
2. The person responsible for making cash payments should not have access to the books of accounts.
3. All the payments should be paid by way of crossed cheque.
4. After making payment against a particular bill or invoice, the voucher and the supporting bill or invoices should be stamped as 'paid' so that the same voucher is not passed again for payment.
5. Unused and cancelled vouchers and cheque books should be kept under the custody of a responsible person.
6. Person who is responsible for preparing the cheque should be clearly specified.

Before passing a bill for payment, it should be ensured that the goods have been received.

7. The bill for which payment is to be made should be sanctioned by the responsible official.
8. Confirmation of balances from the creditors should be made through direct correspondence.
9. Proper sanction should be obtained by directors from higher officials to make payment for transactions of special nature.
10. Bank reconciliation statement should be prepared to reconcile cash and bank balances from time to time.

### 1.10 Internal checks-Wages

Wages are very important item of expenditure. The system of internal check for wages should be devised in a planned and careful manner. There are great possibilities of frauds in a concern employing a large number of workers. A sound system of internal check for payment of wages may avoid errors and frauds which may be revealed from time and piece wages records.

The following system of internal check may be adopted as regards wages.

#### I. Maintenance of Wages Records

1. **Time Records:** It is a record maintained by the gate keeper who records the entry time and exit time of each worker. Foremen of each department also maintain records for time spent by an employee. When wages are paid on

the basis of time spent by a worker, the record maintained by the gate keeper and record maintained by foremen of each department are summarised for payment of wages.

2. **Piece-work Records:** This record is maintained by the foremen who records the actual work done by each employee. Each person is provided a job card who records the work done by him. Finally, the record maintained by the foremen and job card are used in determining wages.
3. **Overtime Records:** Overtime should be sanctioned in advance by a responsible person. Employees should be issued overtime slips bearing the name and number of worker. Such slips should be issued and initialled by some responsible official. At the end of the week such slips should be sent to the wage office.
4. **Pass-out Records:** The workers should not be allowed to leave the factory without the written permission. For this, a pass-out slip is issued to the worker by same authority. Such slips are handed over to the gate keeper. The wage office should also be given copy of it.

## II. Preparation of Wage Sheet:

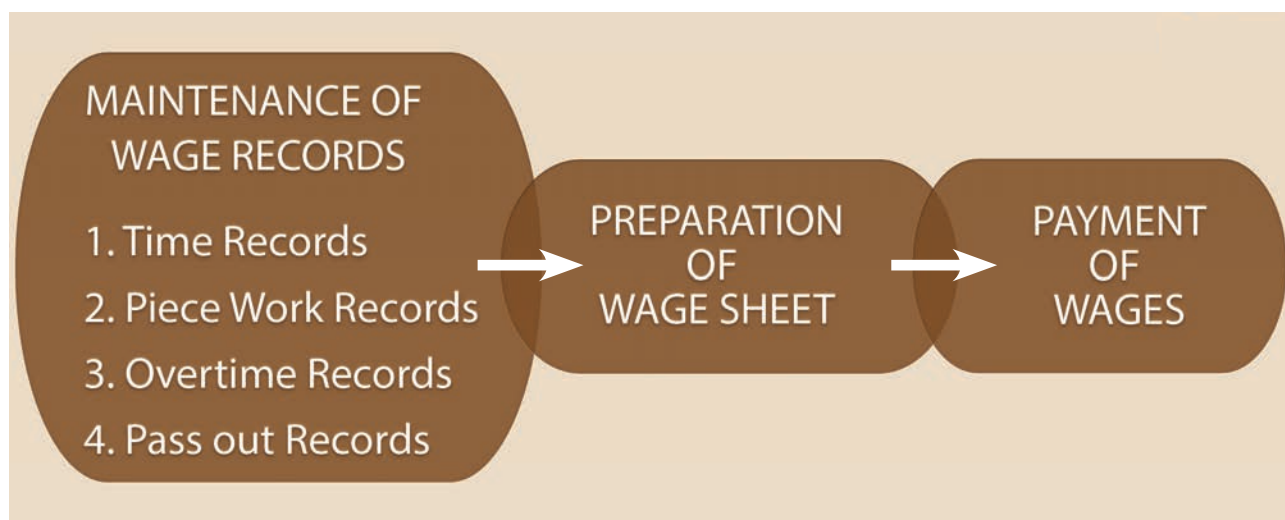
The wage sheet should not be prepared by one clerk alone. A set of clerks should compare the records maintained at the gate and the wage office and enquire about differences, if any. The following points should be taken into account.

1. **Base:** The wage sheets should be prepared with the help of attendance register, overtime slip and pass-out slip.

2. **Separate Sheets:** Separate wage sheets should be used for time-workers and piece-workers.
3. **Checking:** The wage sheet should be inspected and counter signed as correct by the works manager and foreman.
4. **Signature:** The wage sheet should be counter signed by those employees who has prepared it.
5. **Approval:** Each and every wage sheet should be approved by factory manager or managing director.

## III. Payment of Wages:

1. The person who is in-charge for payment of wages should not have connection with the preparation of wages sheet.
2. Each worker should be asked to receive his wages personally in the presence of his foreman to identify him.
3. No payment is made to someone on behalf of a worker who is absent.
4. Wage payment should be made by cash department, not by other persons.
5. The amount of wages for each employee should be placed in an envelope bearing the name and number of person.
6. Special arrangements should be made for payment to the absentees.
7. Exact amount of money should be drawn from the bank for payment of wages.
8. Advances to workers should be discouraged and if it becomes unavoidable, they should be given through the petty cashier.
9. If casual workers are also employed in the factory a separate record should be maintained for them.
10. Undisbursed wages should be deposited immediately into the bank.



## 1.11 Internal Check Trading Transactions

### 1.11.1 Internal Check-Purchases

The following system of internal check may be adopted as regards purchases.

1. A purchase department should supervise and control the entire purchase transactions of the organisation.
2. The procedure for purchases should start with issuing purchase requisition, making enquiry about the terms and conditions of purchases from different suppliers.
3. Purchase requisition should be in a printed form and serially numbered. They should be given to all the departments in the organisation.
4. On receipt of requisition from various departments, the purchase department should send enquiry letter to the suppliers.
5. The purchase department, after verifying the quotation should place an order with the supplier.
6. All the purchase orders should be signed only by the Purchase Manager or any responsible person on his behalf.
7. Goods should be received by a responsible official and entered in the Goods Received Note and the same should be recorded in the stock register/stores ledger.
8. On receipt of invoice from the supplier, the purchase department should check the invoice with the goods received note and verify the rate, discount, quality and quantity of goods.
9. Goods received should also be entered in the stores ledger and entries should be made in the bin card.
10. The accounts department should verify the purchase invoice with the goods received note and purchase order before making payment.
11. After making payment, the accounts department should affix a rubber stamp on the invoices in order to avoid duplication of payments.
12. At frequent intervals a responsible person should check the entries in the purchase book with supplier ledger account.



### 1.11.2 Internal Check-Purchase Returns

1. When goods are returned to the supplier it should be entered in purchase returns book.
2. A credit note should be obtained from the supplier for each return of goods and the note should be attached to the invoice.
3. The purchase department should check such advice note with invoice and enter in purchases returns book.
4. When only part of the goods are returned to the supplier, the goods which are accepted alone should be entered in the stores ledger.





### 1.11.3 Internal Check-Sales



Sales are the most important source of revenue in a business and hence the possibilities of errors and frauds taking place are greater. Frauds may be committed in the following ways:

- Sales may be omitted from recording in the sales book.
- Fictitious sales may be accounted.

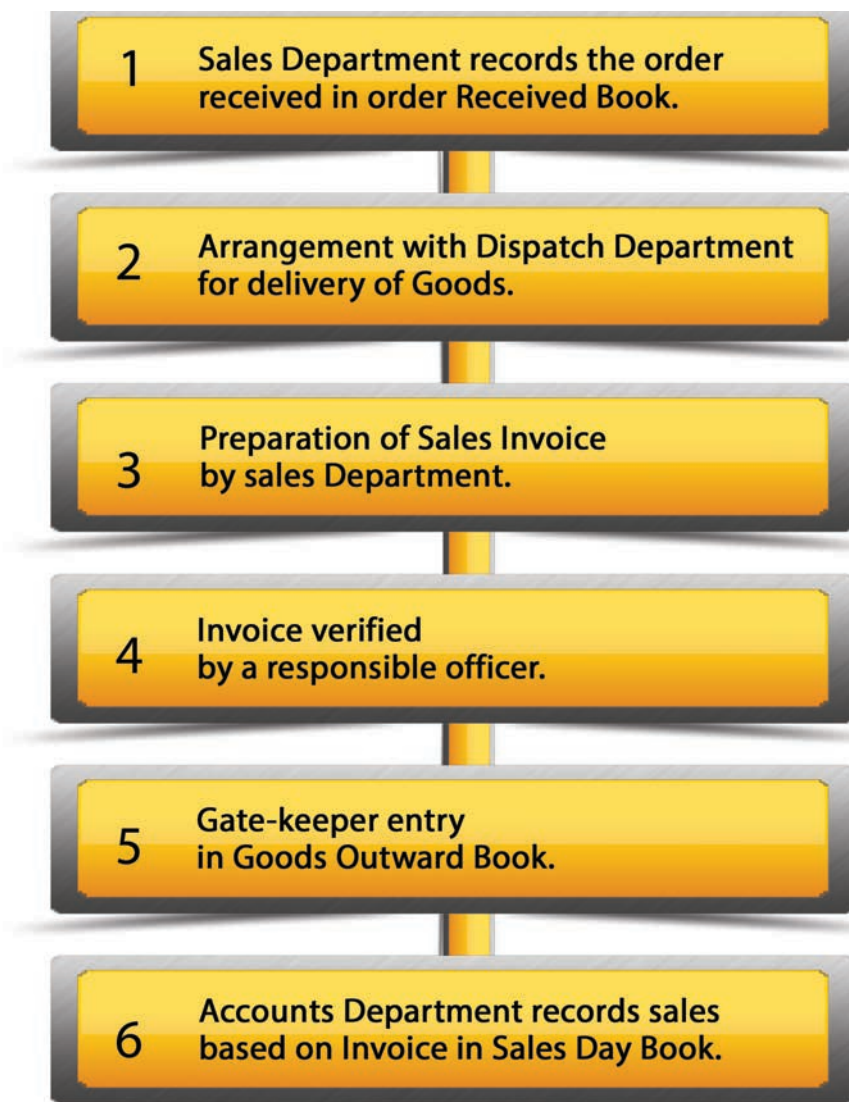
- Sale of fixed assets may be treated as sale of goods.

In order to overcome the occurrence of such type of frauds, an effective system of internal check as regards credit sales is necessary which may be in the following manner.

1. On receipt of order from the customers, it should be numbered and the particulars entered in the order received book.
2. The order copy should be handed over to the dispatch department who makes necessary arrangements for delivery of goods.
3. When the goods ordered are ready for delivery the dispatch department should inspect the goods with the order copy and enter the details of goods delivered in the dispatch memo.

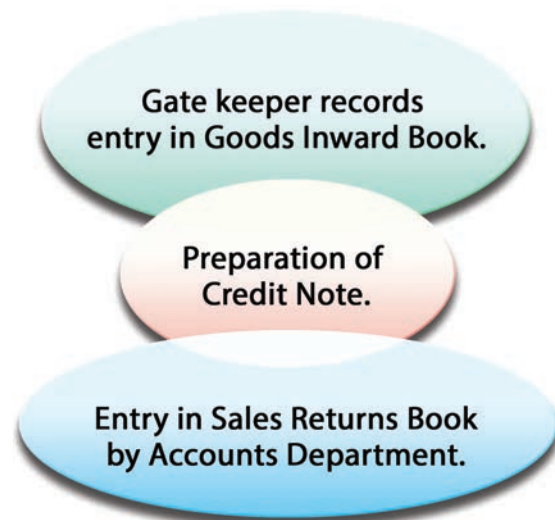


4. The invoice should be prepared based on the dispatch memo in three copies, one copy should be sent to the customer, second copy to the accounts department and third copy will be retained by the sales department.
5. A responsible official should check the particulars in the invoices and also confirm that the terms and conditions in the order have been duly followed and finally he should put his initial on the invoice.
6. The gatekeeper should record particulars of the goods leaving the premises in the goods outward book.
7. The persons who are responsible for preparing the invoices should not be allowed to post the entries in the customer's accounts.
8. At frequent intervals, the balances in the customers' accounts should be verified with the confirmations received from the customers.
9. A responsible official should verify that only sale of goods are accounted in sales day book and sale of assets are not accounted.
10. A responsible official should deal with customers enquiries, overdue accounts and writing off bad debts.

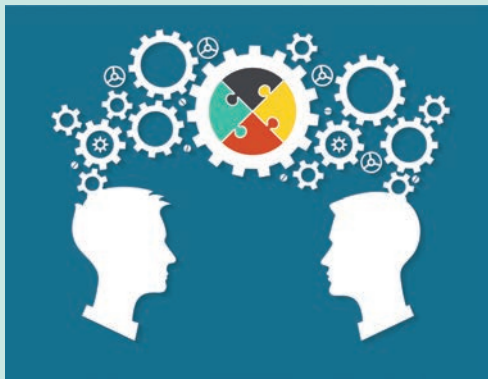


#### 1.11.4 Internal Check-Sales Returns

1. The goods returned by customer should be entered in the sales return book and reason for the return should also be recorded.
2. The gatekeeper should also enter the goods received in the goods inward book.
3. A credit note should be prepared, duly checked and initialled by a responsible official.



#### STUDENTS ACTIVITY



1. Visit an Industry, discuss with Accounts Manager regarding internal check system followed for cash receipts and cash payments.
2. Visit an industry, with prior permission to verify internal check system followed with regard to purchase and sale transactions.
3. Set up a model bank in your class room and discuss the procedure for deposits, withdrawals and sanctioning of loans.

#### SUMMARY

Internal check refers to allocation of duties to the employees in an organisation in such a way that the work of one person is automatically and independently checked by the other person. The main object of internal check is to detect errors and frauds, to provide for division of work, fixation of responsibility, liability of records. Internal check is based on the principle of division of work, automatic check, rotation of employees, proper training to employees, periodical review and usage of electronic equipments. The drawback of the system are expensive, creates confusion and disorder in work. Internal check is exercised in case of cash transactions i.e., cash receipts and cash payments and trading transactions i.e., purchases and purchase returns, sales and sales returns to detect misappropriations of cash and goods.

## KEY TERMS

- **Internal check:** The term internal check refers to allocation of duties to the employee in an organisation in such a way that the work of a person is automatically and independently checked by the other person.
- **Division of work:** The total work divided among various staffs based on their skill and expertise.
- **Purchase Returns:** When goods are returned to the suppliers.
- **Sales Returns:** Goods returned by customers.
- **Invoice:** Invoice is a statement. It is prepared by the seller of goods. It contains the information relating to name and address of the seller and the buyer, the date of sales, price and quantity of goods sold.
- **Debit note:** A debit note is a commercial document issued by a buyer to a seller. Debit note is the source document to the purchase returns journal.
- **Credit note:** A credit note is a commercial document issued by a seller to a buyer. Credit note is the source document to the sales return journal.



## EVALUATION



### I. Multiple Choice Questions

1. A system in which the work of one person is automatically checked by another person is called as \_\_\_\_\_.
  - a. internal check
  - b. internal control
  - c. internal audit
  - d. interim audit
2. Objects of internal check are \_\_\_\_\_.
  - a. to minimise errors and frauds
  - b. to prevent errors and frauds
  - c. to allocate duties and responsibilities
  - d. all of the above
3. A good internal check system \_\_\_\_\_.
  - a. to reduce the liability of an auditor
  - b. reduces the work of an auditor
  - c. reduce the responsibility of an auditor
  - d. All of the above
4. The system of internal check is based on the principle of \_\_\_\_\_.
  - a. division of labour
  - b. unity of command
  - c. unity of direction
  - d. authority

5. Internal check is a kind of \_\_\_\_\_.
  - a. complete audit
  - b. division of work
  - c. partial audit
  - d. final audit
6. \_\_\_\_\_ is a valuable part of internal control
  - a. internal audit
  - b. internal check
  - c. test check
  - d. routine check
7. While making payment for purchases \_\_\_\_\_ are to be checked by a clerk.
  - a. account sales
  - b. invoices
  - c. cash receipt
  - d. none of these
8. When goods are returned to suppliers, a \_\_\_\_\_ should be obtained from them.
  - a. debit note
  - b. credit note
  - c. account slip
  - d. none of these
9. Goods returned by customers will be entered in \_\_\_\_\_.
  - a. goods inwards book
  - b. purchases returns book
  - c. goods outward book
  - d. above all the books
10. Internal check system is useful to \_\_\_\_\_ business concerns.
  - a. small scale
  - b. large scale
  - c. medium size
  - d. all the above

**Answers 1.(a), 2.(d), 3.(d), 4.(a), 5.(b), 6.(b), 7.(b), 8.(b), 9.(a), 10.(b)**

## II. Very short answer questions

1. What is meant by internal check?
2. What are objects of internal check?
3. What is meant by Overtime records
4. What is piece wage records?

## III. Short answer questions

1. Define "internal check"?
2. Mention the principles of internal check system?
3. What are the objects of internal check?
4. State the procedure of internal check as Records Sales Returns.
5. Explain the duties of an auditor with regard to internal check system.

## IV. Essay type questions

1. What are the advantages and disadvantages of internal check?
2. Explain a system of internal check as regards payment of wages?

3. Explain a system of internal check as regards cash receipts?
4. Explain a system of internal check as regards cash payments?
5. Explain the system of internal check as regards sales?
6. Discuss the features of a good internal Check System.
7. Briefly explain internal check procedure with reference to Purchases and Purchase Returns.

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