



### Learning Objectives

- To understand the meaning, definition and objectives of internal control.
- To understand the advantages and disadvantages of internal control.
- To understand the principles of good internal control system.
- To evaluate the auditor's duty of internal control.
- To analyse the methods of evaluating internal control system.
- To identify the differences between internal check and internal control.

### POINTS TO RECALL



In the previous chapter, we have studied meaning and importance of internal check system and application of internal check system with respect to cash and trading transactions.

## 2.1 Introduction

Internal control is the overall control environment established by management of an enterprise for effective and efficient monitoring and control of its operations. It aims at adherence to management policies, safeguarding of assets of the enterprise, proper accounting and record of the business transactions. Internal check and internal control are vital components of the control system.



The auditor should properly understand and assess the internal control system to determine the degree of reliance to be placed on it and accordingly to plan the nature, timing and extent of audit procedures to be performed by him. If the internal control is found to be effective, the auditor may resort to selective verification. However, when internal control system is weak auditor has to verify the transactions in detail.

## 2.2 Meaning

Internal Control refers to the process of control exercised by the management either financial or non-financial to ensure proper accounting of business transaction and reliability of records. Internal control

has a wide coverage which includes checks and controls exercised to ensure efficient and effective functioning of the business organisation. In other words, it is a process implemented by the management to provide the following:

- i. Proper accounting and reliability of records,
- ii. Effectiveness and efficiency of business operations, and
- iii. Compliance with laws and regulations.

The scope of internal control system is vast. It comprises both administrative control as well as accounting control.

### 2.3 Definition

- **Auditing Practices (SAP-6) of Institute of Chartered Accountants of India:** “Internal control system refers to the whole system of controls, financial or otherwise, established by the management in the conduct of a business

including internal check, internal audit and other forms of control.”

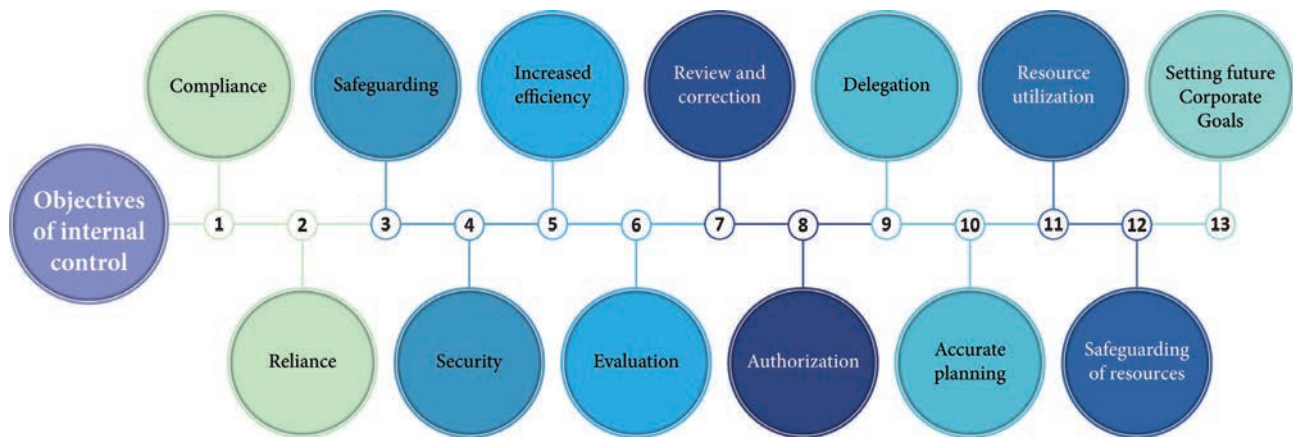
From various definitions, the following points emerge:

- Internal control is a system of control or practice put in place by management.
- Controls are established over financial and non-financial areas of business.
- Controls take the forms like internal audit and internal check.

### 2.4 Objectives of Internal Control

Each organization must have a system of internal control in place for achieving the preset goals. Other than accomplishing the desired goals and objectives of the organization, this system plays a very important role in any organization. The main objectives of internal control are as follows:

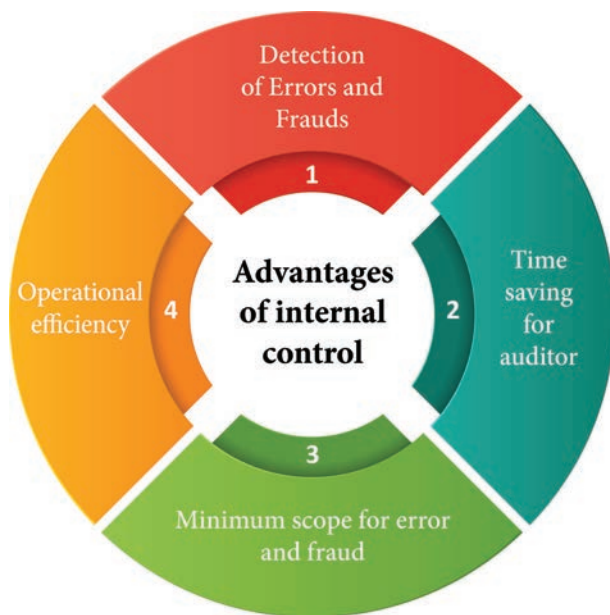




1. **Compliance:** To have compliance with law and accounting practices that is generally accepted and followed in the country. The accounting process also needs to be in compliance with these.
2. **Reliance:** To increase the reliance on the internal systems, accounting practices should be followed by the organization, so that the chances of frauds are reduced.
3. **Safeguarding:** To safeguard the organization's accounts, employees and assets by formation of fool-proof policies, rules and regulations.
4. **Security:** To provide security to customers, employees and property of the organization. Physical security systems like security guards, locks and anti-theft devices are used for providing protection.
5. **Increased Efficiency:** To assist in human resource and performance management, and to keep proper control over business activities to achieve maximum levels of efficiency.
6. **Evaluation:** To evaluate the accounting system for proper authorization of transactions.
7. **Review and Correction:** To review the working of the business, locate weak points in operations and to take corrective measures for proper working.
8. **Authorization:** To provide proper authority for purchase, sale, valuation, verification and possession of assets.
9. **Delegation:** To provide for division of duties among the employees where all staff members work cohesively.
10. **Accurate Planning:** To ensure that the auditor's and the accountants of the organization make all the financial reports correctly and to ensure that financial planning is done accurately.
11. **Resource Utilization:** To ensure that all the resources, i.e., men, material, money and machines of the organization are optimally used.
12. **Safeguarding of Resources:** To protect the resources of the organization against mismanagement or fraud and to ensure that the company's activities are in accordance with laws and regulations.

13. **Setting future Corporate Goals:** An efficient system of internal control helps the organization in goal setting. However, the organization should have certain policies, rules and regulations in place to achieve the preset goals.

## 2.5 Advantages of Internal Control



An audit control system can give the following advantages:

1. **Detection of Errors and Frauds:** Internal control systems are structured in such a way that work done by one employee in a process is checked by another without knowledge of the former. In such an environment, any fraud committed is brought to light unless there is collusion among fraudsters.

2. **Time Saving:** Auditor can test check or sample check the transactions to ensure reliability, and accuracy of entries in the books. Hence, he can complete his audit work and prepare financial statements within the prescribed time.

3. **Minimum Scope for Errors and Frauds:** Each employee does only a limited work assigned to him, moreover, consciousness of his work being independently checked by another keeps him to be always alert at work. In such a context, chances for commission of error or fraud are lesser.

4. **Operational Efficiency:**



It facilitates fixation of accountability, error – free work performance, accuracy reliability and authenticity of entries and eradicate inefficiency, fraud, theft, etc. Moreover, this system enables the management to assess the performance of employees. All these collectively contribute to enhance the operational efficiency of organization as a whole.



## 2.6 Disadvantages of Internal Control



An audit control system can give the following limitations or disadvantages:

1. **Organizational Structure:** Deficiencies in organizational structure make internal control ineffective.
2. **Size of the Organization:** Small organizations have very low levels of internal control, which are almost negligible due to more interference by owners and management.
3. **Unusual Transactions:** The internal control procedures normally fail to keep a check on unusual transactions.
4. **Costly:** The implementation of internal control procedures and processes involves incurring costs in terms of time, effort and resources.
5. **Abuse of Power:** Members at the top-level management may override or interfere with control.
6. **Collusion of two or more People:** It may lead to internal controls being over- ridden.
7. **Obsolescence:** Control system may become redundant with passage of time if not updated with change in the size and nature of business.
8. **Human Error:** Internal control fails as there are possibility of human errors.
9. **Frequent follow-up measures:** Follow-up procedures need to be frequent to ensure its effectiveness, which is extremely time-consuming.

## 2.7 Principles of Good Internal Control System



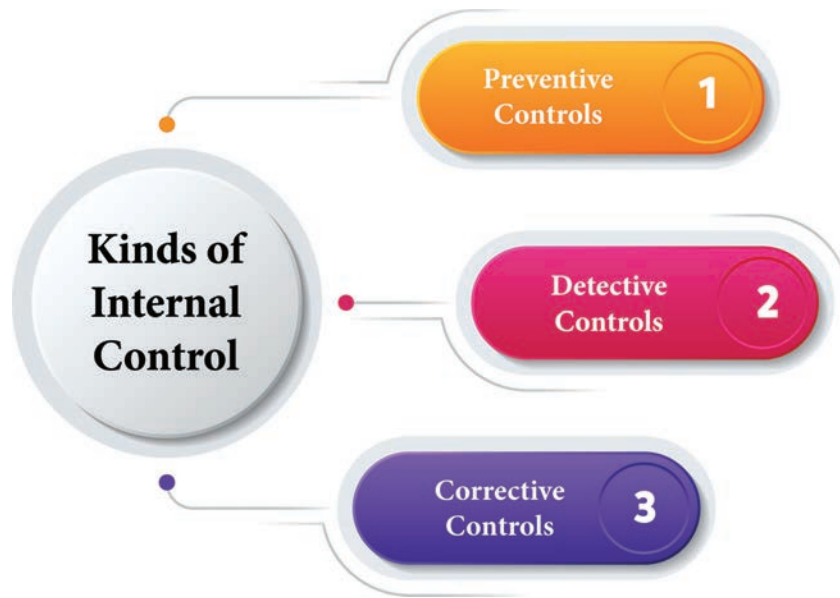
An effective or good system of internal control should have the following principles: -

1. **Well-designed Accounting System:** Internal control should provide for a well designed accounting system. The financial and accounting activities must be separated. For example, person who

is responsible in handling cash (cashier) and the person who accounts cash (accountant) should be done by two different persons.

2. **Competent Personnel:** In any internal control system, personnel are the most important element. When the employees are competent and efficient in their assigned work, the internal control system can be worked and operated efficiently and effectively even if some of the other elements of the internal control system are absent.
3. **Division of Work:** This refers to the procedure of division of work properly among the employees of the organization. Each and every work of the organization should be divided in different stages and should be allocated to the employees in accordance with their skill and expertise.
4. **Separation of operational responsibility from record keeping:** If each department of an organization is being assigned to prepare its own records and reports, there may be a tendency to manipulate results for showing better performance. In order to ensure reliable records and information, record-keeping function is separated from the operational responsibility of the concerned department.
5. **Separation of the custody of assets from accounting:** To protect against misuse of assets and their misappropriation, it is required that the custody of assets and their accounting should be done by separate persons. When a particular person performs both the functions, there is a chance of utilizing the organisation's assets for his personal interest and adjusting the records to relieve himself from the responsibility of the assets.
6. **Supervision:** Directors should review the company's financial operations and position at regular and frequent intervals. Comparison with results for previous periods indicates discrepancies that call for further examination. Where budgetary control is in use, attention will be drawn to material variances and explanations required. From time to time, special reviews of particular items such as stocks, or the operation of the wages department, should be undertaken.
7. **Sound Practice:** Sound practices of administration require that established procedures, policies and delegation of responsibility should be open to all employees of the organisation. This helps in avoiding doubts, attempts to shift responsibility for unsatisfactory performance etc.
8. **Internal Audit:** Internal audit is a part of the whole system of internal control. It should operate independently of the internal check and in no circumstances; it should divert any one of responsibilities placed on him. It is the examination of accounts of a business concern by its employees specially appointed for the purpose. It is an independent appraisal of activity within an organization for the review of accounting, financial and other business practices.

## 2.8 Kinds of Internal Control



The type of internal control system to be employed in an organization depends upon the requirements and nature of the business. Generally, there are three types of Internal Control in an organisation preventive control, detective control and corrective control. These types of controls are essential for an effective internal control system. From a quality standpoint, preventive controls are essential because they are proactive and emphasize quality. However, detective controls play a critical role by providing evidence that the preventive controls are functioning as intended.

1. **Preventive Controls:** Preventive controls are designed to discourage errors or irregularities from occurring. They are proactive controls that help to ensure departmental objectives are being met. Examples of preventive controls are:

- **Segregation of Duties:** Duties are segregated among different people to reduce the risk of error or inappropriate action. Normally, responsibilities for authorizing transactions (approval),

recording transactions (accounting) and handling the related asset (custody) are divided.

- **Approvals, Authorizations, and Verifications:** Management authorizes employees to perform certain activities and to execute certain transactions within limited parameters. In addition, management specifies those activities or transactions that need supervisory approval before they are performed or executed by employees. A supervisor's approval (manual or electronic) implies that he or she has verified and validated that the activity or transaction conforms to established policies and procedures.

- **Security of Assets (Preventive and Detective):** Access to equipment, inventories, securities, cash and other assets is restricted; assets are periodically counted and compared to amounts shown on control records.

2. **Detective Controls:** They are designed to find errors or irregularities after they have occurred. Examples of detective controls are:

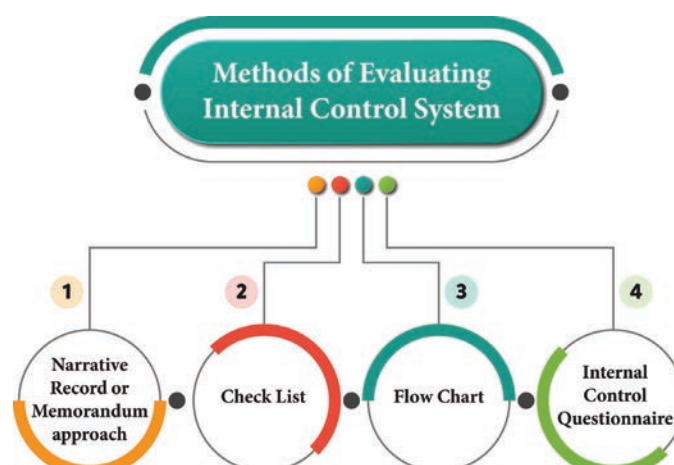


- **Reviews of Performance:** Management compares information about current performance to budgets, forecasts, prior periods, or other benchmarks to measure the extent to which goals and objectives are being achieved and to identify unexpected results or unusual conditions that require follow-up.
  - **Reconciliations:** An employee relates different sets of data to one another, identifies and investigates differences, and takes corrective action, when necessary.
  - Physical Inventories
  - Audits
3. **Corrective Controls:** Corrective controls target at the correction of errors and irregularities as soon as they are detected.

## 2.10 Auditor's Duty in Evaluating the System of Internal Control

1. **Understand the System:** The auditor should understand the control system by discussing with personnel at various levels in the organisation. He should also refer to organisation charts and manuals for this purpose.
2. **Determining the Reliability:** The management installs and maintains an adequate internal control system taking into account the nature and size of the business. It is the duty of an auditor to establish a basis or degree of reliance on the system of control.
3. **Determining the Adequacy:** The auditor should apply various compliance tests in order to determine the adequacy of internal control system.
4. **Review and Evaluation:** Auditor should critically review and evaluate the internal control system to determine the efficiency of its operations. If there is a good system of internal control the work of an auditor becomes easy.

## 2.9 Methods of Evaluating Internal Control System





The following are the methods of evaluating internal control system:

1. **Narrative Record or Memorandum**

**Approach:** It is a complete and exhaustive descriptive record of the system. It is appropriate in circumstances where a formal control system is lacking, like in case of small businesses. Gaps in the control system are difficult to identify using a narrative record.

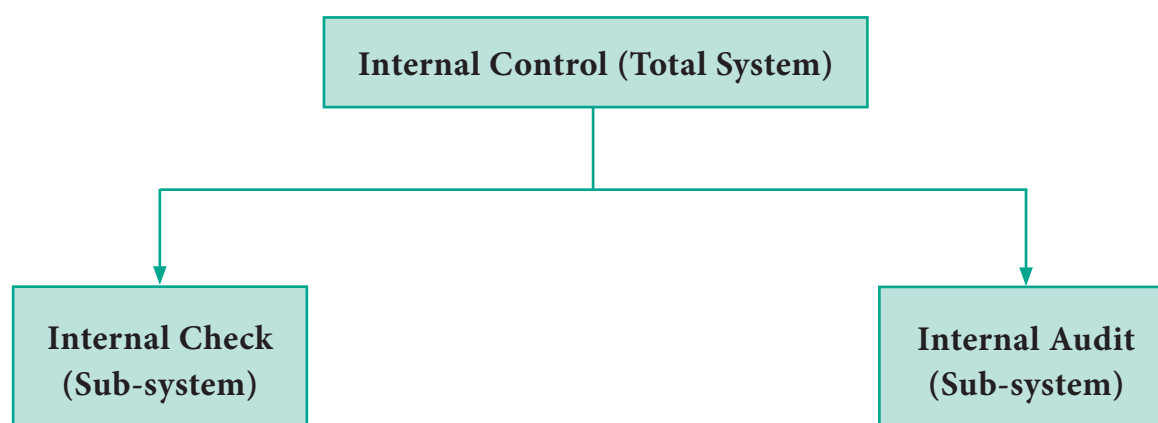
2. **Check List:** It is a series of instructions that a member of the audit staff is required to follow. They have to be signed or initialled by the audit assistant as proof for having followed the instructions given. A specific statement is required for every weakness area.

3. **Flow Chart:** It is a pictorial representation of the internal control system depicting its various elements such as operations, processes and controls, which help in giving a concise and comprehensive view of the

organization's working to the auditor. A complete flow chart would depict the process of raising documents, personnel involved in doing so, the flow of documents through various departments, maintenance of records, flow of goods and consideration, and dealing with results. The internal control evaluation process becomes easier through a flow chart as a broad picture of all the controls involved can be gauged in a glimpse.

4. **Internal Control Questionnaire:** This is the most widely used method for collecting information regarding the internal control system and involves asking questions to various people at different levels in the organization. The questionnaire is in a pre-designed format to ensure collection of complete and all relevant information. The questions are formed in a manner that would facilitate obtaining full information through answers in "Yes" or "No".

## 2.11 Differences between Internal Check and Internal Control



The Points of distinction between internal check and internal control are as follows.

S.No	Basis	Internal Check	Internal Control
1.	Meaning	A system of allocation of responsibility, division of work, and methods of recording transactions, whereby the work of an employee is checked continuously by another.	It consists of all the methods and procedures adopted to assist in achieving the objective of efficient conduct of business. It includes internal check and internal audit.
2.	Scope	It operates in routine to double check every part of a transaction at the time of occurrence and recording of the same.	In internal control systems, work of one person is automatically checked by another.
3.	Objective	Its objective is to ensure that no employee has exclusive control over any transaction or group of transactions and their recording in the books.	Its object is to ensure adherence to management policies, safeguarding of assets, prevention and detection of frauds and errors, accuracy and completeness of accounting records.
4.	Point of Time	Methods of recording transactions are devised where work of an employee is checked continuously by correlating it with the work of others.	In internal control system, checking is done simultaneously with the conduct of work. Every transaction is checked as soon as it is entered.
5.	Thrust of System	The thrust of internal check system is to prevent errors.	The thrust of internal control lies in fixing of responsibility and division of work to avoid duplication.
6.	Cost Involved	It is a part of internal control and a method of division of work, therefore does not add to the cost.	The system proves to be costly in case of small businesses because more number of employees are engaged.
7.	Report	The summary of day to day transactions work as report to the senior.	Internal control provide for built in MIS reports.

Picture showing a sequence of food serving in a function.

Discuss whether it is internal control or internal check.



## STUDENTS ACTIVITY



1. Discuss the internal control system for cash deposits and withdrawals in a bank.
2. Visit a company and discuss with stores manager regarding internal control system followed for material management.
3. MOCK Bank: Set up a model bank in your classroom and discuss the procedure for deposits, withdrawal and sanctioning of loans.
4. If you are residing in a gated community, discuss about the security system followed in your campus.

## SUMMARY

- **Internal control** is the overall control environment established by management of an enterprise for effective and efficient monitoring and control of its operations. It aims at adherence to management policies, safeguarding of assets of the enterprise, proper accounting and record of the business transactions. The type of internal control system to be employed in an organization depends upon the requirements and nature of the business. Generally, there are three types of Internal Control in an organization namely; preventive, detective and corrective controls.

## KEY TERMS

- **Internal Control** –A system refers to the whole system of controls, financial or otherwise, established by the management in the conduct of a business including internal check, internal audit and other forms of control.
- **Preventive Controls**– It is designed to discourage errors or irregularities from occurring.
- **Detective Controls**- It is designed to find errors or irregularities after they have occurred.
- **Narrative Record** - It is a complete and exhaustive description of the system. It is appropriate in circumstances where a formal control system is lacking, like in the case of small businesses.
- **Flow Chart** - It is a pictorial representation of the internal control system depicting its various elements such as operations, processes and controls, which help in giving a concise and comprehensive view of the organization's working to the auditor.
- **Internal Control Questionnaire**: It is the most widely used method for collecting information regarding the internal control system and involves asking questions to various people at different levels in the organization. The questionnaire is in a pre-designed format to ensure collection of complete and all relevant information.



## EVALUATION



### I. Multiple Choice Questions:

1. Internal control is
  - a. Part of internal check
  - b. A part of internal audit
  - c. Whole system of control employed by management
  - d. Examination of reliability of transaction
2. Which of the following is used for evaluation of internal control?
  - a. Internal questionnaire approach
  - b. Flow chart method
  - c. Narrative approach
  - d. All of the above
3. Representation of the entire control system in diagram under evaluation system.
  - a. Flow chart method
  - b. Narrative approach
  - c. Internal questionnaire approach
  - d. All of the above



4. Under which of the following methods the auditor evaluates control by observation and writes down?
  - a. Oral approach
  - b. Narrative approach
  - c. Flow chart
  - d. Questionnaire method
5. Check list contains the instruction to be followed by the \_\_\_\_\_.
  - a. Internal auditor
  - b. External auditor
  - c. Audit assistants
  - d. Employee of the organisation
6. An auditor should study and evaluate internal controls to
  - a determine whether assets are safeguarded
  - b Suggest improvements in internal control
  - c Plan audit procedures
  - d express and opinion
7. A flow chart, made by the auditor, of an entity's internal control system is a graphic representation that depicts the auditor's.
  - a understanding of the system
  - b understanding of fraud risk
  - c documentation of assessment of control risk
  - d the auditor and his audit assistants
8. Internal Control Questionnaire contains the questions need to be followed by the \_\_\_\_\_.
  - a Employer
  - b Employee
  - c Auditor
  - d Banker
9. The effectiveness of internal control system determines the extent of checking done by the \_\_\_\_\_.
  - a. Management
  - b. Auditor
  - c. Accountant
  - d. None of the above
10. Proper segregation of duties reduces the opportunities in which a person would both
  - a. establish controls and executes them
  - b. records cash receipts and cash payments
  - c. perpetuate errors and frauds and conceals them
  - d. record the transaction in journal and ledger.

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

## II. Very Short Answer Questions

1. What is internal control?
2. Define internal control
3. What is meant by narrative approach?
4. What is flow chart method of evaluation?
5. What is internal control questionnaire?
6. What is check list?

## III. Short Answer Questions

1. State the objectives of internal control.
2. What are the kinds of internal control?

## IV. Essay Type Questions

1. What are the advantages and disadvantages of internal control system?
2. Explain the principles of good internal control system.
3. Discuss the methods of evaluating internal control system.
4. Differentiate internal control from internal check.

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