

## CHAPTER X

### INTERNAL CHECK AND CONTROL

#### 1. Fraud

An ever pressing problem confronting business is fraud. Fraud is a false representation of facts made with a knowledge of its falsehood or recklessly without belief in its truth, with the intention that it should be acted upon by the complaining party, and actually inducing him to act upon it.

In business the prevention of fraud in the books of accounts is more to be desired than to induce its detection. It will be very remote possibility to eliminate fraud altogether, irrespective of devices so far developed. But material curtailment is possible by judicious application of the principles of internal check.

The accounting system must be designed and installed in such a way that misappropriation of cash and other properties of the clients could be exceedingly difficult if not altogether impossible. The more difficult it is for an employee to be able to cover his tracks, the less should be the danger from commissions of fraud of this character. The

assurance of a relatively quick and automatic uncovering of fraud of this type serves as the most valuable deterrent.

No system can be absolutely air-tight as to fully eradicate fraud. It is quite impossible to device any system which will absolutely prevent fraud. The most that can be hoped for, is an introduction of a system of internal check which will make it as difficult as possible to carry out dishonest practices.

## 2. System of Internal Check

A system of internal check may be defined as the coordination of a system of accounts and related office procedures in such a manner that the work of one employee independently performing his own prescribed duties checks continually the work of another as to certain elements involving the possibility of fraud. Internal check is principally a method whereby an internal audit of the books and records is carried out continually by staff employees separately performing their duties. Briefly, the phrase is a technical one used to describe a situation where more than one employee is responsible for recording a transaction completely; no part of the accounts or procedures should be under the absolute

and independent control of any one person.

### 3. Purpose of Internal Check

The purpose of internal check is to establish a means of conserving and protecting the assets of the business. In other words, all assets that accrue to the business must all be received and accounted for while the parting of all assets from the business must be legitimate, properly authorized and accounted for. Internal check in the business establishes audit and minimizes fraud.

A few of the procedures for internal check and control are outlined below.

#### With Respect to Cash Receipts

All cash receipts must be properly receipted. The official receipts must be pre-numbered, and all numbers even if voided must be accounted for. This alone cannot be expected to prevent fraud. A dishonest cashier can easily misappropriate funds if he is to be the cashier and bookkeeper at the same time.

Here are some of the necessary precautions to observe in order to prevent commission of fraud:

1. Two or more bonded employees, not connected with the accounting department, should be assigned to open all incoming mails and list all checks and money orders received. The list shall be prepared in four copies; one to accounting department; one to the cashier (together with the cash); one to the treasurer, and one for the file.

2. No single individual in the accounting department should be allowed to handle transactions relating to both cash receipts and cash disbursements.

3. The cashier should not have access to the cash receipts journal, accounts receivable ledger, and statements concerning customers' accounts.

4. All cash receipts should be deposited daily in a bank account.

5. Each day's receipts should be segregated and deposited intact and a carbon copy of the bank deposit slip kept readily available for audit purposes.

6. The employee who prepares the monthly bank reconciliation should be different from the cashier but preferably one from the accounting department who does not keep the cash books.

7. Receiving cashier should not be permitted to open incoming mails.

With Respect to Cash Disbursements

As a general rule, all cash disbursements must be evidenced by an authorized voucher. Other precautionary measures to be taken against fraudulent disbursements of cash are:

1. A person other than the one who signs checks should reconcile bank accounts.

2. All checks presented for signature should not only be accompanied by approved vouchers but also by other supporting papers like the purchase order, purchase invoice, material receiving report, etc.

3. An individual who distributes the pay envelopes to employees should not be the same person as the one who prepares the payroll checks.

4. The operating bank accounts should be maintained on an imprest method.

5. Petty Cash expenses should be paid from the petty cash fund which should also be on an imprest basis.

6. The cashier should under no circumstances be allowed to approve vouchers for payment, nor be permitted to sign checks.

7. Disbursements, except for petty cash, are made by checks.

8. Checks must be pre-numbered, fully accounted for, and should be in the custody of the treasurer.

9. Checks should be signed shortly before payment and never too much in advance.

10. Vouchers should be pre-audited by a voucher clerk who has neither a purchasing or disbursing function.

11. Vouchers and invoices are perforated or mutilated as soon as paid.

12. Payroll and advances to employees must be authorized by the comptroller only.

13. Disbursements for purchases shall be supported by original purchase order, authority to purchase, and original vendor's invoices, authority to ship goods from vendor, and the original material received report with acknowledgment of receipt of the articles purchased as per specifications and authorization.

14. No check should be drawn payable to bearer.



15. A major officer should sign vouchers for disbursements covered by invoice.

With Respect to Accounts Receivable

The person handling cash should not have access to the accounts receivable ledger. Other precautionary measures are:

1. One or more general ledger control accounts should be maintained over accounts receivable records. The person responsible for preparing the monthly trial balance of accounts receivable should not be allowed access to the general ledger or general journal.

2. All allowance and deductions allowed to customers should be evidenced by a credit memorandum duly approved by one or more individuals not concerned with the accounting department.

3. No account should be written off as bad debt without the written consent and approval of the board of directors or some members of the executive staff not affiliated with the accounting department.

4. Persons in charge of customers ledger must not be given access to the incoming mails and should not be ordered to mail the customers' monthly statements.

5. Complaints and other communications from customers are sent to the treasurer directly from the mail desk.

6. Monthly reports of past due accounts are prepared for the treasurer,

7. The control over returns and discounts and other credits to customers are to be maintained by the treasurer and comptroller.

With Respect to Accounts Payable

The general rule is that all accounts payable should be evidenced by an unpaid approved voucher. Other precautionary measures are:

1. A member of the accounting department should verify the mathematical accuracy and extension of all invoices and check the quantity, quality and prices noted in vendor's bill with the purchase order and material received report before the voucher is made for approval.

2. Whenever possible, disbursement checks should be drawn by a person other than the one assigned to prepare the voucher.



3. No invoice should be vouchered for payment without being supported by an approved copy of purchase order and material received report.

#### With Respect to Purchases

All purchases should be evidenced by a purchase order. Furthermore:

1. Purchase order should be made only upon receipt of duly approved purchase requisition.

2. Purchase requisition shall be made only when the stock reaches the minimum requirements or when out of stock.

When the amount of purchases are large, vendors may even be asked to submit bids. The bids or quotations must be opened by a committee or group of persons not connected with the purchasing department. The bids are listed and scheduled. The lowest bidder is not always awarded the contract. The bidder to be awarded should be a reputable vendor who can be able to meet the requirements and to comply with the contract.

#### With Respect to Sales

Sales should always be evidenced by a duly approved sales invoice which must be pre-numbered.

All the numbers shall be accounted for even if voided. Other precautionary measures are:

1. Use of cash register for cash sales.
2. Approval of all credit sales by the Sales Manager or by the Credit Department.
3. Preparing sales invoices in multiple copies to be distributed to the shipping and accounting departments, etc.
4. Periodic tests to determine whether or not the instructions given to the sales clerk and shipping clerks are being carried out.
5. Preparing shipping invoices for all goods that have already left the stores.

With Respect to Stores

No article should leave the storeroom except to fill a duly approved issue requisition. Other precautionary steps to be observed are:

1. Use of stock cards.
2. Use of Material Received Report
3. The person keeping the stock cards should not be given access to the storeroom.

4. Periodic inventories are taken and the results compared with the balance appearing on the stock card.

#### 4. Other Forms of Internal Check

Other forms of internal check worth mentioning are as follows:

1. Use of accounting machines.
2. Grant of vacation to employees or rotation of their duties.
3. Routing supporting documents through different channels, each one having a separate record of same.
4. Providing for controlling accounts. If both records are posted, one with totals and the other by details, the discrepancies can be detected promptly.
5. Counter signature by some responsible employees on certain transactions needing approval.
6. Bonding employees who are assigned to handle important transactions.
7. Internal Audit at irregular intervals.

## 5. Limitations of Internal Check

Bonding an employee is a device to prevent losses through fraud. This and all others are but a means for harassing dishonest employees in committing fraud even when strongly tempted.

A good system of internal check may be designed, but some employees may fail to follow the procedure prescribed. Hence, the efficacy of internal check is diminished. There is, ofcourse, no better substitute for the personal honesty of the employees,