

## **S.Y.B.Com(Sem-III)**

### **Sub: Advanced Accounting-VI**

#### **Unit: 4 Internal Check, Internal Audit and Internal Control and Investigation**

##### **Internal Control System:**

Internal control refers to the set of principles, procedures, and practices companies define to ensure they keep a check on risk-causing factors and rectify the same to avoid losses or frauds. It plays a significant role in guaranteeing accountability of companies, which remain under controlled supervision for correctness and reliability. Internal controls can be preventative, detective, and corrective. As the name implies, preventative control is the procedure or measures used to prevent any suspected error or irregularity. Detective control, on the contrary, is the means adopted to identify the loopholes. Internal control includes internal check , internal audit and other controls regarding business activities.

The right controls can help to assure business continuity; prevent costly errors, irregularities, and fraud; and maintain the integrity of financial statements and accounting records.

They can also help:

- Increase transparency throughout the enterprise
- Promote accountability in every process and business unit
- Promote ethical behaviors
- Identify problems and take corrective action
- Improve employee and organizational productivity
- Maintain regulatory compliance
- Protect the organization's reputation and brand value
- Retain more customers and maintain a strong competitive position

## **Objectives of internal control are;**

1. financial reports are reliable,
2. effective and efficient operations, and
3. activities comply with applicable laws and regulations.
4. Safeguarding business assets from stealing and wastage.
5. Ensuring compliance with business policies and the law of the land.
6. Evaluating functions of each employee and officer to increase efficiency in operation.
7. Ensuring true and reliable operating data and financial statements.

### **Internal Check:**

The internal check is an arrangement of the duties of the staff members of the accounting functions in such a way that another automatically checks the work performed by a person. An internal check also reduces the number of transactional errors, since the second person can spot and correct them as part of her ongoing work.

In the opinion of Spicer 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 a transaction so that without collusion between two or more persons, fraud is activated and at the same time the possibilities of errors are reduced to the minimum.”

L.R. Dicksee defines an internal check as “such an arrangement of book-keeping routine that errors and frauds are likely to be prevented or discovered by the very operation of the book-keeping itself.”

An internal check has been defined by The Institute of Chartered Accountants of England and Wales (ICAEW) as; “the checks on -a day to day transactions which operate continuously as part of the routine system, where the work of one person is proved independently or in complementary to the work of another, the object is the prevention or early detection of errors or frauds.”

## **Characteristics of Internal Check System**

Certain qualities are needed to make an internal check system more effective and efficient. Such qualities are known as features of internal check system, which are as follows:

### **1. Division of Work**

No one should be allowed to have the right to perform the work from origin to end.

For example – a transaction of sale may have to be split into a display of article by staff, the preparation of invoice by another, the receipt of cash against the invoice by a third clerk, the delivery of article against the proof of receipted invoice by another clerk, checking of outward movement of an article against delivery order by a clerk and so on.

In big business houses, such specialized tasks increase the speed of work and automatically introduce internal checks.

### **2. Provision of Check**

An organization should set up such provisions so that work can be checked by another staff. An officer can check the work of one staff by transferring to the staff and again.

### **3. Use of Devices**

In this modern world, various devices can be used to do various functions like the use of time record machines, wage determination machines, etc. An organization should use machines that help to make work of internal check easier.

### **4. Self-balancing System**

An organization can use self-balancing ledger accounts, which help to make the work of internal check easier. Its effectiveness depends on its management.

### **5. Job Rotation**

No individual clerk should be allowed to occupy a particular area of operation for long. Familiarity with and exclusiveness in a position offer a person greater flexibility to attempt manipulation with the system.

## **6. Specialization**

Every staff may not have such specialized knowledge to maintain accounts properly. So, an organization should give the training to increase their skills so that internal checks can be made more effective.

## **7. Control**

There is more chance of frauds where there is direct contact between consumers or the public. So, a manager can keep eyes in those works so that the internal check system can be made more effective.

## **8. Authority Level**

There must be clear cut authority levels according to sanctions to various transactions. Commensurate to the authority vested, responsibility must be extracted. The existence of authority levels results in a review of the operations of subordinates.

## **Objectives of Internal Check**

1. To minimize the possibility of error, fraud, and irregularity.
2. To prevent the misappropriation of cash and goods.
3. To allocate duties and responsibilities to every clerk in the organization.
4. To ensure an accurate recording of all business transactions.
5. To enhance the efficiency of the clerk in the organization.
6. To exercise moral influence over the staff member.
7. To prepare a final account with ease and efficiency.

## **Advantages of Internal Check**

### **1. Moral Influence on Employees**

The system of internal check puts a morale check on members of staff and enables them to learn honesty, hard work, and straightforwardness.

### **2. Determination of Employees Liability**

The system of the internal check determines the responsibilities of employees. The member of the staff may be held responsible for any irregularity carried on by him.

### **3. Less Possibility of Frauds**

There is less possibility of fraud under the system of the internal check because errors and frauds can be detected at an early stage.

### **4. Increase in Efficiency**

The system of internal check ensures greater efficiency and speed because the arrangement of internal check is based on a division of labor.

### **5. Auditing Made Easy**

The system of internal check facilitates the work of auditors to a great extent by enabling him to rely on test checking.

### **6. Final Accounts Can Be Prepared**

In an internal check system, the 'Profit and Loss Account' and Balance Sheet is prepared without any loss of time.

### **7. Correct and Complete Records of all the Transactions**

The system of an internal check may also result in correct and complete records of all the transactions on each balancing of the books of accounts.

### **8. Detection of Dishonesty or Irregularity**

Any dishonesty or irregularity in the concern by the members of staff can be detected before they assume any complication.

### **9. Test Checking Possible**

Suppose the auditor finds the system of internal check satisfactory. Then by taking into mind, its defects or weak points he can take the help of test checking.

### **Disadvantages of Internal Check**

#### **1. Expensive**

The system of Internal Check is more expensive and time-consuming.

#### **2. Slackness in the Work**

This is also a serious defect of the system of internal check. The auditor may show slackness at work. He may rely on the system of internal check blindfold, which may affect the quality of audit work adversely.

#### **3. Not Suitable for Small Concern**

The system of internal check is not suitable for small concern as it may be uneconomical in small concern.

#### **4. Grouping among Employees**

If the employees of the concern join hand, they may keep the employer in the dark and may cause many irregularities defying any-detection thereof.

### **Internal Audit:**

The term internal audit has been defined as the independent appraisal of activity within an organization for the review of accounting financial and other business practices as a protective and constructive arm of management.

Professor Walter B. Meigs of America says, “Internal auditing consists of a continuous, critical review of financial and operating activities by a staff of auditors functioning as full-time salaried employees.”

As defined by The Institute of Internal Auditors (IIA), “Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

### **Objectives of Internal Audit**

1. To verify the correctness, accuracy, and authenticity of the financial accounting and statistical records presented to the management.
2. To confirm that the liabilities have been incurred by the organization concerning its valid and legitimate activities.
3. To comment on the effectiveness of the internal control system and the internal check system in force and to suggest ways and means improve these systems.
4. To facilitate the early detection and prevention of frauds.
5. To examine the protection afforded to the company’s assets and use of them for business purposes.
6. To identify the authorities responsible for purchasing assets and other items as well as disposal of assets.
7. To ensure that the standard accounting practices which have to be followed by the organization are strictly followed.
8. To undertake a special investigation for the management.
9. To assist management in achieving the most efficient administration of the operation by establishing procedures by complying with the company’s operating policies.

### ***Comparison between Internal control and Internal check:***

- Internal control uses to control the business activities while internal checks use to check the work accuracy.
- The scope of internal control is broader as compared to the scope of internal check.

- As it is an arrangement of controlling the business activities so it contains huge cost while internal check contains no cost.
- The main responsibility of internal control is to fix the unwanted stuff while the main responsibility of internal check is to prevent it from frauds.

## **Comparison between Internal check, Internal audit and Internal control system :**

### ***Difference # Internal Check:***

#### **1. Purpose:**

Safeguarding or minimizing errors and frauds in actions transactions and records, and profacting assets. So as to ensure the efficient running of business.

#### **2. Scope:**

Rather restricted to formulation and working of proper accounting and other operational systems and reporting or offering suggestions to appropriate internal authorities.

#### **3. Periodicity:**

Proceeds simultaneously with initiation of transactions and ends with recording thereof.

#### **4. Personnel:**

Internal staff with no specialized knowledge or skill but with clearly defined division of each work so that no one employee can be in complete control over completion and recording of any transaction—responsible to departmental/branch/unit-heads.

### ***Difference # Internal Control:***

#### **1. Purpose:**

Formulation and circulation of management principles and policies and effective and speedy execution thereof with the help of internal checking and internal audit activities.

#### **2. Scope:**



Wider in scope than internal check and internal audit as specified above.

**3. Periodicity:**

Spreads through the process of internal checks up to taking action on internal audit reports.

**4. Personnel:**

Top management personnel accountable to owners/stakeholders.

***Difference # Internal Audit:***

**1. Purpose:**

Detecting and reporting errors and frauds and irregularities regarding assets committed, if any detection and prevention activity-

**2. Scope:**

Limited to a continuous internal system of checking financial and non-financial operations and reporting to internal top management.

**3. Periodicity:**

Commences after transactions are completed and recorded.

**4. Personnel:**

Specially qualified and skilled audit staff as a part of internal personnel responsible to senior or top management.

**Auditor's Duties in relation to internal check :**

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 Weakness:** 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 work.

### **Investigation:**

Investigation is a detailed examination of accounts and enquiry into the state of affairs of the business or for a specific purpose. It involves the process of analyzing, collecting and presenting facts in a manner which enables the parties to know the essential facts regarding the matter under enquiry. Investigation covers more than one financial period and the program depends on each type of investigation.

### **DEFINITION**

- According to **Spicer and Pegler**, “The term investigation implies an examination of records for some special purpose”.
- **Taylor and Perry**, “Investigation involves and enquiry into the fact beyond the books of accounts into the technical, financial and economic position of the organization”.

### **OBJECTIVES**

The following are the objectives of Investigation:

- To ascertain the financial position and the earning capacity of the concern.
- To investigate when fraud is suspected by the proprietor.
- To investigate on behalf of Income Tax authorities for tax liability.
- To investigate for the purpose of lending money to a concern.
- To investigate for claims under insurance policy covering losses.

## **What is Auditing?**

Auditing is a systematic investigation of the fiscal declaration of an individual to provide an opinion about accurate and fair views. The term individual using here mentions to all groups whether it is income making or any liberal institution. The primary purpose of auditing is to explore and report the level of correctness and consistency of the financial statements of any object. Moreover, it confirms whether the unit analytically upholds the records of accounts, booklets, and receipts or not. The auditor completes the whole auditing process.

Auditing is a prevalent method for all the organization that is performing annually. Auditing is generally using in accounting to confirm the intensity and consistency of facts showing in the reports. Auditing completes anytime, and auditors keep some essential points in their mind while making a report that, first is the research of the financial statement is creating on satisfactory accounting strategies and it is a reliable presentation, second is relevant Rules are necessary to follow while preparing reports. The third is all substantial realities are openly revealing in the financial statements.

Auditing is performing in two ways either the internal auditor or external auditor. The internal auditor is a worker of the organization who is appointing by the management of the organization, while the external auditor is selecting by the government from the outside certified public accounting (CPA) firm. An audit spreads all accurate claims in the financial statements with a view of discovering their truth. An auditing period usually covers up the accounting year of the client. And the results of auditing are widely used.

## **What is Investigation?**

An investigation is the procedure of complete inspection of actions to get assured purposes. The act of investigation is the study to find out about a particular thing. It is the main issue in journalism to investigate many cases and thorough this process to prepare a report about the situation. An Investigation of any firm or business association point to complete systematized and essential review of the accounts books beside with past and present deal records of an individual. It is showing for a particular purpose to represent a fact and with the help of evidence, introduce a reality. The investigation is defining by the thing planning to achieve by the party on whose behalf investigation is assuming.

In the progression of the investigation, the most common thing that are employees, including in observation, inquest, penetrating, questioning, and assessment etc. The investigation method is performing by a professional team who has certification of definite facts according to the necessities of the association without any particular period. There is no lawful necessities to expose information in an examination. The investigation is merely exceptional, it is not commonly performing in all organizations, because it is not the regular procedure, and the results of investigation are useful only for the client.

The appointment of an investigator is conducting by managers, and it is not the natural process it only performing as per the need of the organization. They are experts in their profession. There is no such legal responsibilities with favor to the investigation. It can surprisingly happen at any time.

### **Differences Between Auditing and Investigation**

The following are the major differences between auditing and investigation:

1. The process of inspecting the financial statement of an entity and then giving an independent opinion on it is known as Auditing. A careful and detailed study of the books of accounts to discover truth is known as Investigation.
2. Auditing is a general examination while Investigation is critical in nature.
3. The evidence obtained from audit process are persuasive. Conversely, the nature of evidence obtained from Investigation process is conclusive.
4. Auditing is conducted every year, but Investigation is conducted as per the needs of the organization.
5. Auditing is performed by the auditor whereas an expert team does the performance of an investigation.
6. Auditing is compulsory for every company. On the other hand, the investigation is discretionary.
7. Auditing verifies the true and fair view of the financial statement while Investigation is performed to establish a fact.
8. The appointment of an auditor is made by the shareholders of the company. As against this, an investigator is appointed by the owners/management or one-third party.
9. The scope of auditing is general, which attempts to give an opinion on the financial statement of the company. On the contrary, the scope of the investigation is limited as it attempts to answer only those questions that are asked in the engagement letter.

## **Procedure for conducting Investigation in Auditing**

The following procedure are followed while conducting Investigation in auditing.

### **1. Determination of Nature and Scope**

The instructions of the client regarding the nature, scope and objective should be obtained in certain and unambiguous terms. If the instructions are vague, they may create confusion and problems during investigation. The instructions should cover the area of the investigation, the purpose of investigation and the period to be investigated.

### **2. Formulation of Investigation Programme:**

1. An investigation programme cannot be fixed and rigid. Actual investigation procedures at each stage have to be programmed, depending upon the various developments in the course of the investigation.

2. The finding of the previous steps will decide the further course of investigation. While formulating the investigation programme, the broad scope and limits are to be determined.

3. The list of records and documents to be verified are to be determined at this stage keeping in view the objective and purpose of the investigation.

### **3. Conduct of Investigation:**

A thorough investigation, i. e, examination of various records and documents, and examination of various persons of the concern, relating to the investigation area are to be conducted.

At every stage, the investigator may decide the further course of investigation based on the circumstances and various findings.

The investigator shall maintain, an exhaustive record of work done, evidences examined, important discussions held etc., as evidence for the investigation conducted. The record maintained by the investigator along with the supporting documents may form the basis for formulation of conclusion and preparation of the investigation report.

### **4. Investigation Report**

The investigator may correlate all his findings, analyze all the supporting documents and statements, thoroughly examine the investigation records and draw

conclusions. While doing so, he must have an open mind, free from pre-conceived notions.

### **Contents of Investigations Report**

The investigator may draft the investigation report. The report may contain,

1. The purpose and scope of Investigation.
2. The period covered by the investigation.
3. The terms of investigation with reference to the written instructions of the client.
4. The various limitations faced by the investigator that may materially affect the conclusion drawn should be mentioned.
5. The assumption forms the basis of investigation. The assumption should not defeat the very purpose of the investigation.
6. The investigation report should contain headings, with subheadings, charts, graphs, etc.
7. Conclusion of the investigator should be stated in clear and certain terms.
8. The supporting documents and data may be presented as appendices to report.

### **Investigation on behalf of An Intending purchaser of a running business:**

Some times any one person or firm wants to purchase the business. So it know the financial position and earning capacity of the business investigation is made on the behalf of the purchasers.

1. Obtain Profit and Loss account and the balance sheet and examine them.
2. Various heads of expenses and incomes to be arranged properly in trading and profit and loss account .

3. In trading account t the items of sales, purchases and closing stock to be verified in detailed.
4. Expenses as per profit and loss account to be scrutinized in detail.
5. Adjustments to be made in incomes and expenses as shown by the profit and loss account.
6. Examination of balance sheet items.
7. Where the business is to be purchased from a company, verify the share capital, rights of shareholders, dividend, memorandum of association, article of association and the market value of shares.
8. Prepare the investigation report soon after completion of investigation work.