

# INTERNAL AUDIT CONTROL

BY

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Associate Professor of Accounting, School of Business Administration  
The University of Texas



*Submitted in partial fulfillment of the requirements for the  
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**PART I**  
**INTRODUCTION**

## CHAPTER I

### INTRODUCTION—STATEMENT OF THE PROBLEM

#### **Why Internal Auditing**

The development of business organization to its present size and complexity has brought in its wake a demand, previously unheard of, for summarized and detailed information as to internal operations and company properties. This information obviously is to be used by executives and departmental heads as a basis for judging future policies of the company. It is important, therefore, that these reports be prepared promptly and reflect accurate data if they are to serve any useful purpose. The securing of satisfactory internal factual data is generally acknowledged as an accounting function. The passing of judgment as to the accuracy of accounting information is decidedly an auditing function. The efficient executive, however, cannot wait until the end of the fiscal year to find out whether the information he has been using as a basis for his actions is accurate. He must have confidence in current manufacturing and distribution costs, in current shipping reports, and in monthly statements of profit and loss and expense analysis, otherwise the cost of securing all this detailed information is a complete loss. To develop means whereby current transactions, the raw materials of accounting reports and statements, are verified at the source, if not while the transaction is occurring then shortly thereafter, is the primary function of internal auditing.

Besides this function of preventing and detecting errors tending to make inaccurate departmental and other reports, internal auditing has also for its purpose the preventing and detecting of embezzlement on the part of company employees.

#### **Financial Crime**

Losses occurring in business houses, banks, institutions, and municipal corporations through dishonest employees seem relatively insignificant until one stops to remember the frequency with which such headlines as the following are constantly returning to the front pages of our daily newspapers: "Commission Merchant Forced to Dissolve Because of Bookkeepers' Peculations," or "County Official Kills Self After Audit," or "Bank Officer Indicted for Misappropriating Cash and Securities."

A study of one metropolitan newspaper for the year 1930 revealed that over one hundred of the three hundred and sixty-five daily issues carried stories of financial fraud of one kind or another. That there are tremendous losses to the American public from financial crime is attested to by the statements from officials of fidelity and surety companies. Estimates of yearly losses from embezzlement and forgeries range from \$175,000,000 to \$300,000,000. Chairman William B. Joyce of the National Surety Company estimated the yearly losses from embezzlement alone to be \$125,000,000.<sup>1</sup>

The following succinct record of amounts paid by surety companies covering losses by theft and embezzlement from 1916 to 1928, inclusive, taken from the 1930 *World Almanac*, shows conclusively that despite the efforts of legislators, corporation officials, and accountants, fraud in accounts and embezzlements is growing apace:

Year	Losses Paid	Percentage
1916.....	\$ 1,866,775	100.00
1917.....	1,921,388	102.93
1918.....	2,472,385	132.44
1919.....	3,704,717	198.46
1920.....	4,406,923	236.07
1921.....	8,672,024	464.55
1922.....	9,308,503	498.64
1923.....	10,311,258	552.36
1924.....	12,141,011	650.37
1925.....	13,033,417	698.18
1926.....	14,038,000	751.99
1927.....	16,746,103	897.06
1928.....	16,675,359	893.27

No doubt a certain amount of these increased losses paid is due to a larger volume of business transacted by the companies. It is to be noted, however, that the ever-increasing losses have caused the companies to be more careful in the selection of risks. In spite of this care the companies have had to pay out an increasingly larger percentage of the premiums paid in. In 1917 the companies paid back to insurers—in reimbursement of losses—25 cents out of each dollar received in premiums; in 1918, 28 cents; in 1919, 32 cents; and in 1923, 34 cents.<sup>2</sup> One of the large surety companies in 1924 stated “the company is today

<sup>1</sup>*World Almanac*, 1930, p. 297.

<sup>2</sup>Letter Bulletin No. 2 of the American Institute of Accountants, p. 4.

handling twenty-five fresh defalcations every working day as against thirteen two years ago."

### Causes of Increasing Crime

It is very doubtful that the percentage of dishonest men is any greater today than twenty years ago. Nor can one be led to the conclusion that business men or employees of business concerns who today perpetrate fraud are more clever than those of former days. While it is true that occasionally a trusted clerk may be employed whose past record, if investigated, would prevent his employment, yet it is the contention of the majority of authorities who have investigated embezzlement cases that the so-called natural-born thief seldom secures a position of trust with a concern of any standing. The ordinary defaulter is an honest man who becomes dishonest after he obtains employment.

The usual causes of defalcations are stated generally as the lure of speculation, demands of extravagant living, drink, bad associations, and spite. Undoubtedly, the first two, gambling and extravagance, have been the immediate major motivating causes. The employee who takes the company's money for gambling on horse races, the market, or otherwise does not consider himself a thief. He is so thoroughly confident that he is going to win that he merely "borrows" from the cash drawer for a day, week, or month. Should he be successful, he expects to replace the cash. There is no way of ascertaining just how many men have "borrowed" and won in this manner, seen the error of their way, and forever abstained from such dishonest practice. In the majority of cases, however, the winning has been so easy that the defaulter works the same scheme, loses, and is forced to "borrow" additional sums, taking the chance foolishly to hide his misdoings under the veil of secrecy by failing to record transactions, by juggling his accounts, or by deliberately manipulating the records. In the end his scheme, irrespective of how crafty it may be, becomes top-heavy; the man, wearied from trying to keep up appearances, gives himself up or is caught by outside accountants. Often the slightest kind of thing, such as a questionable act or remark, will make some one in the organization suspicious. The follow-up of this suspicion often reveals the business crook.

The real reason for the increasing financial fraud is not, however, that men are today any differently motivated than they were formerly, but it is the fact that business conditions today offer more *opportunities* for manipulation, misrepresentation, and fraud than did those

of our fathers and grandfathers. It is an old adage that opportunity makes the thief. On this basis there is no doubt but that there should have occurred a great many business thefts, for the opportunities have been many and obvious. American business as a whole has developed rapidly by virtue of the growth of individual business units which often started small only to find that almost over-night they had reached enormous proportions. Generally speaking, it has been the quick growth in number of transactions handled, the growth in the size of business units, and a general aversion on the part of the American business men to so-called "red-tape" which has prevented the accounting records and the system of accountability for individual businesses from keeping pace. The major executives have been so absorbed in increasing production, expanding the market, cutting down overhead, and meeting competition, that accountability for funds and property has too often been taken for granted. In other cases, such as for example many of our smaller banks, ignorance or complete indifference on the part of many of the directors has resulted in a laxness in accounting and auditing.

Thus it has resulted that the laxness in accounting systems and the failure to revise and amend the office and store procedure has given rise to greater opportunities for embezzling. Edward C. Lunt in his book *Surety Bonds* makes the statement that "a certain bank embezzler, now languishing in jail and deeply penitent, attributes his downfall to the laxity of his superior officers. He says that he fought hard to overcome temptation and even prayed at his desk sometimes for strength to resist an unusually attractive opening." In a large number of cases of embezzlement this principle of "contributory negligence" has been violated by the employer because he has failed to exercise due diligence in the introduction of proper safeguards. Mr. F. W. Lafrente is authority for the statement that "almost every loss resulting from dishonesty on the part of the principal on fidelity bonds brought to my attention is the *result of some omission in accounting supervision* which is perfectly obvious after the loss occurs."<sup>3</sup>

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<sup>3</sup>"Defalcations" in the *Journal of Accountancy*, April, 1924, p. 260. Note: The italics is the author's.

### Accounting versus Accountability

A system of accounts and a system to determine accountabilities are two different things, but how often are the two things confused: the former is for information, the latter for protection. A system of accounts and records may be logical, perfectly classified, and capable of setting forth clearly the supposed financial condition and yet fail utterly as a method of preventing error and dishonesty. The business man may consider that he has protection from fraud and error because he has had a good system of accounts installed, only to find to his chagrin at a later time that his accountant has been pilfering his cash, or that his lieutenants have been borrowing his securities.

A system of accountabilities is based on the principle of accounting for values entrusted and hence must take cognizance of all those methods which will cause a charge to be made against the person entrusted and a discharge when the value is parted with by him. This system requires not only that the subordinate entrusted render an account but likewise that the account be supported by proof. The proof may be in the nature of an automatic internal check or a deliberate check. The proof may be made periodically, such as semi-annually or annually, or it may be made at the time the transactions occur. As a basis for accountability, then, the account stands out as the framework, but requires in addition "the best attainable evidence of each entry, proving that the accounting person has done his duty."<sup>4</sup>

### Definition of Internal Audit Control

A proper system of accountability can be secured only by a proof of the accounts which requires a comprehensive method of auditing. But auditing refers to a determining of past accountability, and it must be admitted that the longer the period between audits the greater is the danger that error and fraud will go undiscovered. The embezzler considers that during the long intervals between audits he will have a better opportunity to replace his "borrowings," thereby lowering his coefficient of risk.

It is at this point that an internal auditing system operates most effectively because it requires that a verification be made immediately or within a very short

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<sup>4</sup>*Journal of Accountancy*, June, 1909, p. 89.

period following the transaction of the business. A system of internal audit control therefore may be considered to include all those devices, methods, procedures, and practices within an establishment tending to prevent and discover error and fraud in accounts. More specifically, a good system of internal audit control will consist of an adequate internal-checking arrangement coupled with a program of internal auditing. Internal check methods are aimed principally at prevention of fraud and error and deal with matters of office routine together with a scientific distribution of duties. The internal audit will include a program of continuous examination, analysis, review, and verification of business transacted by members of the staff of the concern. It carries the idea of a detailed or complete audit made as quickly as possible after the transactions have been recorded. But what are the classes of error and types of fraud which may occasion such elaborate accounting and auditing machinery?

#### **Causes and Classes of Accounting Errors**

There is an old proverb which says, "he who makes no mistakes does nothing, he who does nothing makes no mistakes." While it is an aim of accountancy to get as near perfection as possible, the fact remains that, due to the tremendous amount of recording necessitated by modern business, errors in bookkeeping do occur frequently and variously. However, before any progress can be made towards reducing accounting mistakes, some sort of classification should be drawn up. Mistakes in accounts may occur because of:

1. Inadequate training and experience on the part of the employee.
2. Carelessness, indifference, or stupidity of the clerks.
3. Downright dishonesty of employees and officers.
4. Failure of the system to provide adequate controls and proper supervision.

Probably the great majority of errors are due to the first two causes. It is generally considered that honest, intelligent, efficient, and experienced help is difficult to get and more difficult to keep. In the larger concerns, however, where performance tests are given to prospective clerks, where training periods before regular employment are required, and where supervision is rigid, errors due to these causes may be materially reduced.

Accounting errors may be classed as unintentional and

deliberate. They may be further divided as errors of omission and errors of commission, which may be further divided as clerical mistakes and errors in applying the correct accounting principles. Expressed in outline form, with illustrations, this classification may be set up as follows:

### Accounting Errors

#### I. *Unintentional*

##### A. Errors of Omission

1. Clerical mistakes—honest failure to include all items on a sales ticket
2. Of accounting principle—failure to record depreciation on fixed assets

##### B. Errors of Commission

1. Clerical—posting to wrong customer account
2. Principle—debiting inadvertently an asset instead of an expense account

##### C. Compensating errors—overfooting of asset or expense account offset by overfooting of liability account

#### II. *Intentional*

##### A. Error of Omission

1. Clerical—goods delivered but not billed
2. Principle—failure to write off worthless accounts

##### B. Errors of Commission

1. Clerical—debiting sales returns and allowances when customer pays cash on account, and withholding the cash
2. Principle—arbitrarily writing up goodwill.

In the majority of cases, unintentional errors are due to carelessness and ignorance. On the other hand, intentional or deliberate errors often smack of dishonesty.<sup>3</sup>

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<sup>3</sup>Just when an error is intentional and when unintentional often becomes a question of fact to be decided by a court or some other official body. The following excerpt taken from the November 3, 1929, issue of the *New York Times* seems of interest in this connection:

#### "Jailed a Year for \$1.30

Berlin-German judicial severity, traditionally characteristic of pre-war days has not entirely subsided under the republic. This was shown when Gustav Schroeter, for 26 years a servant of the government first in the army and since 1920 in the postal service, was sentenced to a year in prison for a discrepancy of \$1.30 in his books.



Not only may an employee endeavor to cover up his trickery by fraudulent manipulation, but also the management may attempt to bolster up a weak financial position by deliberately overstating assets or understating liabilities.

### Results of Errors in Accounts

Errors in accounts will manifestly, if left incorrect or unadjusted, result in an erroneous statement of operations and financial condition. The result almost invariably is either an overstatement or understatement of net worth with an offsetting overstatement or understatement of assets or liabilities. Eventually these errors will be discovered by outside accountants or by the company's own clerical force. Before they are discovered, however, untold damage may have resulted from policies based on inaccurate internal statistics secured from the accounting records.

Another effect of unlocated mistakes may be that an honest clerk who inadvertently made the mistake may discover that it has gone undiscovered. Having located the weakness in the system he may, if motivated by a subsequent desire, make the same mistake a second time, but with the intent to enrich himself at the expense of the employer.

### Classes of Fraud in Accounts

A standard dictionary defines *fraud* as "deception with the object of gaining by another's loss." From the standpoint of accounting, fraud has been said to "consist of all acts, dishonest or deceitful, the object of which is to deprive some person or corporation of property without knowledge or consent of the other."<sup>8</sup> Fraud in accounts generally is divided into two groups:

1. The first includes all those cases in which there has been a wrongful retention or misappropriation of that which has been received or held in trust on behalf of an employer, to whom it belongs and to whom it ought to be accounted for. The term given to this class of fraud is *embezzlement*, although such terms as *misappropriation* and *defalcation* are used with a less degree of accuracy. This type of fraud is committed by cashiers, treasurers, bookkeepers, storekeepers and other employees, even includ-

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The prosecution alleged that Schroeter had manipulated his accounts so that a deficit of \$3.80 which he had to refund, was reduced to \$2.50. The defendant insisted that the discrepancy was due to unintentional errors in bookkeeping."

<sup>8</sup>Bennett, *Fraud in Accounts*, p. 5.

ing officers of corporations and various institutions and societies.

2. The second includes all those cases in which false accounts and statements are prepared and issued with the intention of showing a better or poorer financial condition than is actually the case. Seldom are minor employees involved in such frauds except in so far as they take orders from officers of the concern or from those in authority, actually preparing the misleading statements but not responsible for them. Some of the reasons why false statements are prepared and issued are as follows:

- a. To secure a better credit rating at banks or from trade creditors
- b. In the case of an individual ownership, partnership and even a corporation, to influence unduly the sale of a business
- c. To "freeze-out" small stockholders by creating secret reserves, keeping duplicate sets of records, or in some other manner whereby these small stockholders will be discouraged and sell out at a figure less than the true worth of the stock
- d. To induce prospective investors to buy stock in the concern
- e. To cover up defalcations on the part of an officer or officers, or through collusion of officers and employees
- f. To cover up the results of poor management, or in case the manager gets a bonus on the basis of net earnings, to pad the earnings statement.

While this list is in no wise complete, it does serve to indicate the nature of some of the frauds coming under this group. Manifestly, since these frauds are usually committed by an officer or officers of the concern, little may be accomplished in a preventive way by a system of internal check. If the employee who is a party to the deceit takes issue with the perpetrating official, he may be asked to resign. Likewise, an internal auditing staff can do little if the officials to whom they report are dishonest. For this type of fraud, a program of internal audit control can do little or nothing unless the head of the auditing department is subject to and reports directly to the board of directors or to an executive committee of directors and has authority to investigate the acts of officers as well as other employees.

With regard to embezzlements, however, an adequate system of internal auditing can materially deter potential embezzlers from practicing their nefarious schemes, and if carried out efficiently, will locate misappropriation, defalca-

tions, and abstractions before they have grown to any sizable sums. As examples of some of the kinds of embezzlements which can and should be prevented by internal check or discovered by an internal auditing staff, the following are set forth:

I. *Methods Used with Cash Receipts*

A. Directly Abstracting Cash Receipts Making no Entry on Books from

1. Sales of merchandise
2. Sales of scrap or waste
3. Sales of containers, reels, etc.
4. Rents or miscellaneous incomes
5. Rebates, refunds, allowances, from freight overcharges, damages, etc.
  - a. By placing check (if a check) in cash drawer and taking out an equivalent amount of cash, depositing the check
  - b. By taking check to bank having it cashed, saying it is to be used for cash funds or petty cash
6. Interest received on bond coupons
7. Customers on accounts previously written off
8. Receipts on account withheld where customer was never charged (keeping record on loose sheets, "on the cuff," in mind, or elsewhere)
9. Receipts from fraudulent or unauthorized issues of notes payable or bonds payable, the liabilities for which are not recorded
10. Forged accommodation checks (in case of hotels), such checks at end of year being written as bad
11. Pocketing of hotel receipts, the cashier marking the account "skipper"
12. Withholding assessments (in case of a club)
13. Withholding deposits on leases
14. Refund checks from insurance policies canceled before expiration

B. Directly Abstracting Cash Receipts, Making False or Erroneous Entry on Books

1. Lapping
2. Overstating sales discount
3. Overfooting sales discount column
4. Crediting customer in full but charging an expense account
5. Underfooting cash sales column
6. Debiting sales returns or allowances instead of cash for collections from customers

7. Entering receipts from customers in cash book, but not including in footings, and offsetting by overcharging some expense or income account
  8. Withholding cash and charging an inactive account, or partner's personal account
  9. Withholding cash in cash of a savings bank or savings department of a bank, failing to enter cash on teller's list, but entering it on pass book, individual ledger cards, and changing inactive account when reconciling to agree with general ledger control
  10. Abstracting refunds made by virtue of wage overpayments
  11. Abstracting refunds made by virtue of deliberate overpayments of purchase invoices
- C. Indirectly abstracting cash—making false entries on books
1. Opening false accounts on books in confederate's name
    - a. Case of stock brokerage bookkeeper who debits customer for interest charged, but credits interest account for less and credits confederate's account for the difference
    - b. Same for commissions
    - c. Debit partner's account and credit fictitious account, then later having check drawn or stock bought to close out the credit balance in the confederate's account
  2. Using false loose-leaf records to insert for audit and examination purposes

## II. *Methods Used with Cash Payments*

1. Abstracting cash and underfooting purchase discounts (only when bookkeeper has access to cash)
2. Abstracting cash and showing fictitious expenses
  - a. Making out false cash or petty-cash vouchers
  - b. Raising petty-cash vouchers
  - c. Using petty-cash vouchers twice by changing data
  - d. Intercepting checks, charging asset account, such as a postage purchase account, but later relieving by journal entry supported by vouchers from mail clerk, either forged or previously used
  - e. Making fictitious interest payments
3. Abstracting cash and showing fictitious purchases—or using a previous invoice
4. Abstracting cash, overfooting payments and expenses (such as labor pay roll, etc.)

5. Cashing unclaimed dividend checks
6. Cashing unclaimed pay roll checks
7. Raising checks for cash and overfooting cash disbursement column—usually destroying checks or changing with ink eraser after check is returned from the bank
8. Raising checks after they have been returned by the bank to agree with erroneous entries made in the cash disbursement record
9. Forging signatures on checks
10. Padding pay rolls
11. Failing to drop from pay rolls employees dismissed or quitting
12. Colluding of paymaster and employees, splitting overstated earnings

### III. *Methods Used with Merchandise*

1. Diverting incoming merchandise before it enters storeroom (particularly where goods are boxed up and clerk does not check for quantity)
2. Appropriating merchandise by unauthorized requisitions
3. Appropriating finished or partly finished goods during process of manufacture
4. Making unauthorized shipments to confederates
5. Shipping more merchandise than was ordered
6. Rifling by an officer or employee of the storeroom at night
7. Appropriating supplies

### IV. *Methods Used with Securities*

1. Unauthorized sale of treasury stock, or bonds
2. Unauthorized loan of treasury stock, or bonds
3. Unauthorized pledging or hypothecation of company's securities owned
4. Theft of securities, charging other accounts, particularly inactive accounts. (Worked in case of a New York bank where head of purchase-and-sale division of bond department issued duplicate orders to buy bonds for customers in Philippines and Hawaii, charging their accounts for duplicate purchase but abstracting one bond and sending other on to customer)

### V. *Miscellaneous Methods*

1. Abstracting cash for spoiled checks redeposited—cashier placing check in his cash box, abstracting

- a like amount of cash and depositing check with day's cash receipts
- 2. Offsetting cash receipts against checks for working funds and not recording on books
- 3. Bribes
  - a. For selling at special prices or terms
  - b. Allowing unwarranted rebates, allowances, etc.
  - c. For purchasing at special prices, terms, etc.
  - d. For approving inferior goods
  - e. In placing advertising
  - f. In appointment of employees
  - g. In making investment of funds
- 4. Drawing unauthorized notes or drafts
- 5. Kiting transfers between banks, to cover up shortages in one bank account
- 6. Colluding with lawyer in collecting debtor accounts written off as uncollectible
- 7. Redemption of tickets, coupons, etc., formerly stolen by insiders.
- 8. Overissuing authorized stock by a treasurer, and withholding the cash—stock certificate book not available and issue of stock not put on record
- 9. Overcharging customer in case of hotel, say, on American plan by virtue of meals, pocketing the difference.

While this collection of methods which have been used in the past to defraud concerns is far from complete, it does give one an idea of what the systematizer and internal auditor are up against. The statement has often been made that no system is fool-proof against the clever embezzler or the desperate clerk; that irrespective of how complete the system of internal check, at some time or other the criminally-minded will find a weak link in the system and probably will make use of it. It is not the purpose of this treatise to set up an all-time, sure-fire, fool-proof system for preventing and discovering fraud in accounts, but it is felt that if the procedure yet to be outlined in subsequent chapters is carried out in practice, a very large amount of potential embezzling will be forestalled, and that errors will be materially decreased. Furthermore, it is believed that, should fraud and error be committed, they will be discovered and corrected expeditiously and before a great deal of harm has been done.

## CHAPTER II

### CLASSIFICATION AND EVALUATION OF METHODS OF INTERNAL AUDIT CONTROL

#### Definition of Control

The term control is used here to embody the idea of a restraint, a prevention. In internal auditing it takes the shape of a prevention of errors in accounts and a prevention of fraud on the part of those who may be held accountable. It is of French derivation from the word *contrôle*, which in turn is traced back to the Latin word *contrarotulum*, meaning "counter-roll." The idea of the necessity for a duplicate record as a way to discover if not to prevent peculation may have been the original concept of the term. Today, however, the term still stands but has been broadened to include in addition to duplicate records, any methods which will permit the proper setting forth of financial transactions and the safeguarding of properties which may have come into the hands of those employed in some economic unit whether it be an institution, a business, or a society. Internal audit control is to be distinguished from management or business control, the latter having for its avowed purpose the securing of an adequate return on capital invested and the preservation of its capital. Management control may make use of external as well as internal data so as effect a co-ordinating of activities, a synchronizing of functions, that will permit the company to operate as a unit instead of a number of independent parts. Internal audit control likewise has for its purpose the preservation of capital: but while management control expects to gain this end by operating at a profit thus having on hand at all times at least as large a net worth as was originally contributed, internal auditing control expects to preserve capital by setting up such methods as will provide the management with accurate information as a basis for its judgment and also by pursuing such methods as will prevent the loss of capital not only from operation but also from actual leakage.

Methods which in keeping with this concept of control have been proposed as a means of preventing and discovering errors and fraud in accounts include double-entry bookkeeping, use of records and checkable evidence,

controlling accounts, perpetual inventory records, mechanical devices, publicity, bonding, and personnel control.

### Double-Entry Bookkeeping

Many writers of double-entry bookkeeping textbooks have set forth as an advantage of this type of bookkeeping over single-entry the fact that if books are kept by the double-entry method there will be less likelihood of error and fraud entering into the accounts. This contention is no doubt based on the underlying principle of double-entry: namely, that there must be a debit for every credit, and *vice versa*. This idea of a *quid pro quo*, resulting in a maintained equilibrium, includes the converse that should there be no equilibrium when the accounts are cast up at the end of the day, week, month or year, then error has entered into the recording process. Furthermore, it is contended that, when such mistakes occur, they may be more easily located by tracing back such entries and matching up each debit and credit entry, should the error be in the journals or each debit and credit posting should the mistake have occurred in the ledger.

From the standpoint of preventing errors, there is some justification for the contention if the contender assumes that the bookkeeper is infallible in his account analysis, that he will invariably post to the account determined to be correct, and that he will not inadvertently place a figure in one column of a journal when it belongs in another; for in any of these situations there would still be an equilibrium but no absolute accuracy. The early writers on the subject would answer by saying that a deliberate check should be made of all postings. This answer would no doubt have been sufficient in the day of Paciolo or John Mair, but not very persuasive in this day of such numerous transactions. The expense of a complete duplicate journalizing and posting would be out of place in view of more economical ways of getting the same results.

But does double-entry, then, not reduce the chance of fraud in accounts? The answer is that double-entry does not of itself reduce fraud, but that it may provide the information which if intelligently handled may bring to light fraud already committed. For example, the employee may be pocketing cash received from customers to be applied to the payment of their accounts. The entry is made debiting Sales Returns and Allowances instead of Cash. Subsequently some one in the organization com-



compares the present year's sales returns and allowances with last year's and finds a large variation. Upon further investigation, it is discovered how the shortage occurred. Here one cannot say that the double-entry system prevented the peculation, neither did it do more than act as an accessory to the discovery. The best that double-entry can do is to provide the basis, or skeleton, for a scheme of internal auditing control. Standing alone, it is no protection against the misappropriation of property nor the prevention of error; but used in conjunction with other methods yet to be discussed, it does have a place in the scheme.

### **Uses of Records and Checkable Evidence**

To appreciate the advantages accruing from records and business papers made at the time the transactions occur, one has only to reflect a moment and consider how much more chance there would be of fraud and error if he were forced to forego their use. The sales ticket, the receipt, the railroad ticket, the waiter's bill, the purchase invoice, the bank check, and postal money orders are all examples of checkable evidence of accountability.

A case in point is one wherein there is a definite division of duties, as for example in a department store, where the sales clerk takes the money and passes it and the article sold over to a cashier-wrapper. No sales ticket is prepared since it is a cash sale, nor is an amount rung up on a cash register. Who can say that the sales clerk has passed all the money on to the cashier, or that the cashier has placed all the money received in the cash drawer and not some of it in his own pocket? What evidence is there that the proper amount has been charged to a customer for the article sold should the sale have been made on open account in the absence of a sales ticket? In a like manner, when a bank holds bearer bonds as collateral for loans or for accommodation to customers, what definite assurance has it that the officer to whom they were entrusted may not feel at liberty to use them as his own? Under the circumstances, there is no absolute protection; however, if a receipt is given to the bank's customer, this evidence of liability to the bank may also act as an evidence of accountability of the officer to whom it was entrusted and is to an extent a deterrent. This same idea of checkable evidence is ingeniously used in connection with issuance of postal money orders: the forms and blanks are so arranged and spaced as to figures and signs that tearing off the money order proper

makes a stub which automatically shows the amount of the order and hence serves as evidence of the amount of money which should have been received and reported to the cashier.

The conclusion with regard to vouchers and records of business transactions is then that while they will not in themselves prevent dishonesty and mistakes, they will largely reduce them. The very fact that a record is in existence which definitely shows what a person can be held accountable for will make him think twice before taking the chance of getting caught, especially if it is not within his power to destroy the evidence. Furthermore, the fact that he has destroyed the records, assuming he has had access to them, places him in a suspicious position.

### **Controlling Accounts**

The controlling account may from the standpoint of commercial accounting be considered a product of the late nineteenth century. Its popularity developed out of the necessity of having more than one man work on the ledger accounts at a particular time, the bulkiness of the general ledger, and the difficulty of securing proof of the postings with such a large number of accounts in one trial balance. The present-day large corporation books include in the general ledger many controlling accounts, such as trade debtors, investments, plant and equipment, factory ledger, inventories, accounts payable, delivery equipment, selling expense, administrative expense, and others, all of which are supported by subsidiary ledgers or other records showing the details.

Since the aggregate of figures in the supporting ledger must equal the balance in the controlling account, a quick method is provided of discovering that an error exists, so that a correction may be made while the transaction is fresh in mind. It has the additional advantage of localizing mistakes. For example, if a bank has 20,000 depositor accounts, distributed among five individual bookkeepers, should an error occur, it might be necessary to check all postings to the accounts on which changes were made during the day, up to the whole twenty thousand. If, however, five controlling accounts and five sub-ledgers are used, the controlling accounts will determine in which ledger the error is located and hence the work of getting it located is minimized.

### **Perpetual or Book Inventory Records**

While there are uses of perpetual inventory records other than as a method of internal check, it must be admitted that they do serve the purpose of keeping the storekeeper honest and more careful than if no such records were kept. Here is a clear case of the application of records as a basis for accountability, provided, of course, that the one to be held accountable for the stock does not keep the record.

A comparison of the physical inventory of raw materials, supplies, and finished goods on hand against the book inventory periodically will definitely bring to light inefficiency, waste, and dishonesty if it is existing in the department handling the goods. Such a record can also be used to advantage in a retail concern, if due allowance is made for honest error and a small amount of leakage, through the adoption of the retail inventory method of determining book inventory. Should the inventory as determined by the retail inventory method of a particular department vary greatly from the actual inventory as taken, an investigation to find the reason for the variation would be in order.

The fact that the storekeeper of the factory and the clerk in the retail establishment realize that a control is being exercised over the goods by means of a perpetual inventory will in a large measure prevent them from taking the chance of being caught in misappropriating the goods of the concern either by outright theft or through collusion with an outsider. Obviously, inventory records are more effective in preventing and discovering fraud and error when frequent physical inventories are taken and compared with the theoretical book figures.

### **Mechanical Devices**

During the course of the last generation, comparatively large numbers of machines and mechanical appliances have been invented and are now being employed in the internal check phase of accounting. Their use may not have in all cases been based entirely upon a desire to indicate the amount for which some cashier, clerk, or employee is responsible and for which he must account, but may in many instances have been put into service to accumulate totals which become the basis for entry of business transacted. The fact, however, that they do make possible a basis for determining accountability is justification for their consideration as a type of internal audit

control. A classification of such mechanical devices is as follows:

1. Registering Machines
2. Bookkeeping and Billing Machines
3. Auditing Machines
4. Miscellaneous Devices

*Registering Machines.*—Under the heading of Registering Machines, probably the most usual type one comes in contact with is the Cash Register. Its service as a control instrument comes about through its adding-machine feature, which records and accumulates the amount of cash for which the employee operating it is to be held responsible. Furthermore, the transactions rung up on the register are recorded in the presence of the customer, who may observe the amount of his payment as it is being registered. The effectiveness of this machine as an internal checking device depends upon the location of the machine, the extent to which customers are habituated to observing the amounts rung up, and a deliberate observation of the employee by an inside employer or outside detective.

The Taxicab Mileage Register in another of these registering machines which depend upon the assistance of the person being served to secure an effective check. Here again the register is not a fool-proof device as a preventive of fraud in those cases where there may be collusion between the driver and the passenger, or where the passenger is content to accept the driver's explanation that the meter is "out of order."

Other registering machines, such as the Street Car Fare Box, the Theater Ticket Register, the Subway Fare Box, the Food and Grocery Automat Machines, all work on the basis of payment before the service is rendered, and likewise hold responsible for cash the amounts as are secured from a reading of the recording device on the machines.

Another illustration of this principle of holding accountable an employee for an amount as recorded by a registering machine is in connection with bank receiving tellers, and particularly in the savings department. Here a machine is in use which prints in duplicate in such a way that when an entry is made in the pass book, a duplicate entry is simultaneously and inevitably made on a ribbon of paper enclosed in a locked box. At the close of the day, the enclosed tape is taken from the box and every entry thereon originally a credit to the depositor

becomes also a debit to the teller and hence an automatic check on the amount of cash received during the day's business.

*Bookkeeping and Billing Machines.*—Bookkeeping and billing machines have a place in an internal check program to the extent that they may be used so as to prevent errors in posting, to secure predetermined totals as a check against postings, and, where mistakes have been made, to set them forth quickly and clearly in order that they may be located before the day's business is closed up.

Some billing machines can be used not only to type the sales invoices, but also to permit the proof of extensions. This proof is secured by the use of a billing machine which accumulates the total of all the individual invoices typed. The total accumulated by the billing machine can be checked against a predetermined total, secured by multiplying the total number of items billed by the sale price.

Where the single posting system of bookkeeping machines is used, that is, where the customer's account, customer's statement, and a proof sheet are prepared simultaneously, accuracy of debit and credit posting is secured through the proof sheet, which collects each debit and credit as posted and sets forth totals when the tray is completely run. These totals may be compared with predetermined figures secured from recapitulations of the sales record (or billing machine totals), sales returns and allowances, and cash received on account during the day. While this procedure will assure the bookkeeper that his work has been accurate as to posting of debit and credit transactions, it will not prove that the respective debits and credits have been placed in the proper account. If this additional safeguard is wanted, it may be secured by the use of the Dual-Posting system. Under this system, which has found particular favor in bank bookkeeping and is often seen in the accounting departments of department stores, a run of the transactions with customers is first made on the ledger accounts, and a second run is set up on the customer's statement of account. The two may be compared and checked for accuracy by having the totals of each account called back, one person calling from the statement to another who watches the ledger account. The dual system is expensive, requiring two different clerks to keep one record, and will of course be used only where losses could easily occur through negligent posting to the wrong individual account.

*Auditing Machines.*—When one is first confronted with the idea of an auditing machine, he intuitively has a vision of a fool-proof robot, an automatic mechanical figure checker which requires only that one turn on the power, then sit idly by and permit the machine to roll out the figures correctly computed, accurately analyzed, and completely proved. Unfortunately, this idea of the so-called auditing machines must as yet remain a dream, for those machines which go by the appellation of “auditing machines” are hardly more than statistical and registering devices.

The National Analysis and Auditing Machine, made by the National Cash Register Company, is used primarily for analysis purposes. It takes the data as shown on some voucher such as purchase invoice, sales invoice, or expense-distributing voucher and prints two or more slips which may be used as a basis for posting to a card showing sales by salesmen, territory, and product, and to inventory sheets according to the product purchased or sold. It is of use as an internal checking device in that the data are controlled automatically when the voucher is recorded, so that it assures a complete tie-up of the detailed figures to be analyzed and the control figure, which is secured from a strip of paper in the machine known as the visible audit sheet.

Another of these auditing devices is made by the Langford Sales Audit Machine Company and consists of two machines, the first called a sales-record machine and the second a sales-audit machine. The sales-record machine is an ingenious device used by the clerk in making out the sale ticket, while the sales-audit machine takes the duplicate of the sales ticket and classifies the data thereon as an ordinary tabulating machine does.

In the two cases mentioned, it is obvious that the names attached to the machines are misleading according to the meaning of the word auditing as set forth in this discussion, but since they furnish a check upon the transactions analyzed, they can be made to fulfill a sort of auditing function in many businesses where they may be found adaptable.

*Miscellaneous Devices.*—The calculating machine, the slide-rule, the Hollerith and Powers tabulating machines, and the comptometer may find a place in an internal checking scheme mainly because it is through such means that an accurate double check may be secured on all manners of accounting computations with a minimum of expense. Likewise, the time-recording machines in the larger con-

cerns are an almost indispensable cog in the internal audit of pay roll.

### **Publicity**

The uses of publicity as a means of preventing and discovering peculations has had and still has a wide application. The ringing up and registering of trolley-car fares on a machine always in the front of the car facing the passenger, while now generally out of date, served a useful purpose twenty years ago. The railroad conductor of a few years ago was permitted to accept cash fares without giving a receipt of any kind, and as a consequence many dollars failed to find their way into the coffers of the railroad treasury. Today this same conductor is required to hand to each person paying cash fares a punched receipt, keeping the original for his own accounting of moneys received. It is true that not every person will pay particular attention to the punched slip, nor would every person if he discovered an error, such as the punching of a ten dollars fare for one dollar, report the discrepancy. The very fact that some person, be he passenger or company "spotter," may and probably will report the variation is enough to make the conductor hesitate in the business of misapplying the company's cash. The same influence is exerted by the ringing-up of cash on the cash register through which many a salesman is no doubt deterred from underreporting cash receipts by the lack of assurance in his own mind that his frailty will not find him out.

Publicity as an aid in auditing may be applied to advantage wherever donations are sought for and collected by charitable organizations, churches, memorials, and drives of various sorts. The question which comes to the mind of the donor in such cases is, did my contribution go for the cause or did some financial secretary or clerk intercept it on the way? One way to ascertain definitely whether all such donations have been fully reported and made use of is to publish a list of contributors. This publication may be printed in a newspaper such as the official organ of the organization or it may be simply filed at such place or places where it may be available to all donors for inspection. There is a general and warranted objection to the printing of names of donors in newspapers or other publicly circulated medium on the grounds that contributors are laid open to attack from other worthy and not-so-worthy campaigns for funds. Yet, no doubt, many lists of contributors to churches have been published for the use of the congregation without deleterious results. It must be noted, however, that unless the printed and circulated list is linked up with the

statement of accounts, by some one other than the book-keeper-cashier then the printing or circularization fails of its purpose.

An interesting case in which the publication of accounts resulted in the discovery of a forger and embezzler occurred just recently. A clerk in one of the state courts secured approximately \$150,000 over a period of a few years by means of issuing vouchers for witness fees where many of the witnesses' names were subsequently found to be fictitious. The fraud was uncovered because a state senator noted that the county he represented paid several thousands of dollars a year for witness fees while another county of approximately the same population paid a considerably smaller sum. The state auditor was asked to investigate and discovered the fraud. Had there been no publication of the accounts in this case, no doubt the embezzler would have continued his fraudulent bookkeeping.

Another case in which published information was used to catch a thief, this time an executive of a city of considerable size, is of interest in this connection. The city in question permitted the use of its auditorium to any person or organization upon the payment of a certain fee. An alert city auditor instructed his secretary to keep a file of all newspaper clippings showing the use of the auditorium. After six months, the auditor computed the amount which should have been reflected on the books of the city as revenue from this source. His computation was in excess of the book figure and further investigation revealed that receipts from one organization which had made considerable use of the auditorium had never been recorded. As it turned out, the losses were refunded to the city by the official who had misappropriated the cash, and a leakage was stopped which might have run into a considerable sum in the course of a few years.

### **Bonding Officers and Employees**

The taking out of fidelity bonds on employees as a method of internal audit control is included in this discussion because one often hears business men say, "we need no accounting system, no auditor, no 'red tape' to keep our men honest. If any of our employees should embezzle, we are protected by the surety company." No doubt, the knowledge on the part of the honest employee that he is bonded and that in order to maintain his standing in the community and his job he must never do anything which may prevent his securing bond in the future will in the majority of cases act as a preventive of fraud. Not so with the vicious man, the criminal at heart or the man who has got himself into



inextricable financial difficulties. Edward C. Lunt, President of the Sun Indemnity Company, is authority for the statement that "in the case of bank defalcations—at least 75 per cent of the losses paid by the surety companies on bank bonds are due to the fact that the principal has become hopelessly involved in speculation and has finally appropriated the bank's cash or securities in a desperate effort to extricate himself."<sup>1</sup>

The conclusion, then, with regard to surety bonds is that while they give protection to the employer for losses, they do not without additional safeguards offer sufficient protection against the prevention of fraud in accounts. Yet to round out a logical system of internal audit control, the bonding of employees and officers is an essential element.

### Personnel Control

The extent to which any system of internal audit control will function satisfactorily in a large measure depends upon the individual employees who operate the system. It is a truism that if only honest men are employed, no trouble is likely to arise in connection with their honesty. It must be remembered, however, that an individual's character may not be a constant factor, particularly if he is beset by temptations which on the surface appear to be sure of realization without his being caught. Likewise, where young men are employed without having had their characters seasoned by opportunities to defraud, no amount of selection is an absolute bar against fraud for the future. And yet, a careful selection of men who will be placed in jobs of responsibility, where they will have access to money, securities, and other property not their own, is surely to be preferred over no vigilance whatsoever.

After the individual has been employed he should not be forgotten by the personnel department; on the contrary, a study of his living conditions, his addiction to drink, gambling, and extravagance is a matter of importance to the employing concern. If an employee handling company funds is known to be betting on horse races, if he has an active account with a stock brokerage firm, or if he is seen around with a group of people whose mode of living<sup>2</sup> is

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<sup>1</sup>Lunt, *Surety Bonds*, p. 26.

<sup>2</sup>The following clipping taken from a 1930 edition of the *New York Times* shows where one close student of the subject places the blame: "Keeping up with the Joneses" is the pre-eminent cause of increasing embezzlement and defalcations by trusted employees, according to C. E. Millen, vice-president of the American Surety Company, after thirty years of study of defaulters. While

known to be beyond the salary paid him, then the company officials had better be careful lest one day they may find an employee missing and with him some of the company's cash and securities.

A recent case in point was that of a young bank clerk whose mode of living was quite generally known to be beyond his apparent means. Officers of a competing bank knew that this clerk had at times as much as \$50,000 deposited with their institution. Officers of the employing bank were cognizant of the fact that he was receiving daily calls from a local brokerage house. Neither of these sets of officers was sufficiently impressed with the unusualness of the situation to call attention of those who should have been interested to the bank's potential loss. The inevitable happened. The clerk was wiped out on a turn in the market, and, sensing certain discovery of his speculations, skipped out. The employing bank officers seemed surprised that one of their trusted employees had taken liberties with the bank's funds, and yet, overconfidence in this man's inherent honesty and a refusal to keep up with his personal living conditions practically make them accessories to his crime.

The way to thwart such fraud is to make some one in the concern responsible for keeping tab on each employee. The management can effect this check-up by co-operating with department heads, by securing information from outsiders, by getting information from banks with whom the employees do business, by studying the peculiarities of each employee, by changing employees in their various tasks, and by requiring that each employee take vacations periodically.

One cause for the rarity of bank defalcations in Great Britain is the practice of shifting clerks. No employee knows when he leaves his desk at the end of the day to what department he will be assigned on the following morning. By this practice a powerful control is exercised in the preventing of misappropriation through an effort to cover up. This section may be summed up in the words of the late Professor Charles E. Sprague: "To select a man

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discoveries of defalcations have been increasing sharply since the World War, Mr. Millen does not make any attack on prohibition as one of the main factors for the increase, although dissipation frequently accompanies the other causes.

"New automobiles, luxurious living, gambling in one form or another, and the extravagances of women dependent upon the employee are the main factors in most defalcations, according to Mr. Millen. The depression since the stock market break has brought to light many cases of dishonesty that otherwise might not have been discovered, he says."

known to be conscientious, to cultivate his self-respect by proper treatment, and never to require him to be false to others, these are safeguards tending to secure fidelity."<sup>3</sup>

### **Internal Check**

The foregoing methods of internal audit control will usually find a place in any systematic effort made to safeguard company property. It must be noted, however, that no one of them is within itself a fool-proof method either of preventing fraud or of discovering the wrongdoer. It is likely that there is no system, however air-tight it may seem, but will yield for at least a short period to the crafty cunning of the criminal mind. Our problem is the setting up of methods which will not leave opportunity for fraudulent accounting and which will deter the ordinary rational individual from taking that which does not belong to him. To this end, a centralized accounting department is needed, together with a systematic office procedure based on a scientific division of work among the employees. This procedure goes by the name of internal check and is fully discussed in Part II following.

### **Deliberate Internal Auditing**

As a further check on the honesty and efficiency of employees and in an effort to discover errors and fraud in accounts, a well-rounded system of internal audit control will necessarily have to include some deliberate internal auditing. To provide for this deliberate internal auditing, the large companies may need to maintain a trained staff of auditors, while the smaller concerns may simply require that a clerk not a part of the bookkeeping department perform certain auditing functions. A complete statement of the place and work of deliberate internal auditing and the internal staff auditor constitutes Part III of this discussion.

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<sup>3</sup>*The Journal of Accountancy*, Vol. 8, No. V, June, 1909, p. 87.

**PART II**  
**PRINCIPLES OF INTERNAL CHECK**

## CHAPTER III

### GENERAL PRINCIPLES OF INTERNAL CHECK

#### **Internal Check as a Phase of Auditing**

The public auditor, in planning the program of audit, always takes cognizance of the office personnel and records system in use as one of the factors determining the character of his audit work and procedure. Should his preliminary negotiations and investigation reveal that satisfactory records procedures are in use, he may limit his verification of detail transactions to certain samples, called test-checking. If, on the other hand, he finds an inadequate system of internal checks or a good potential system poorly functioning, he may find it necessary to verify all or practically all of the transactions occurring during the period under audit.

It is a definite relief to a public auditor to walk into his client's office and find that an intelligent effort has been made by the client's staff to effect some safeguard over transactions and their record by means of an internal checking arrangement. It is a relief in so far as it will permit him to ignore a very large part of the detail auditing which would be required in the absence of such checks. It is not to be inferred from this statement that the public auditor will take the bulk of the records of original entry on faith; for such is not the case. However, with an accounting system in which he has faith and with test checks on his own part, he can leave the job with a greater feeling of security that shortages have not occurred and are not likely to go long undetected should they occur. From this point of view, internal checking assists in and even takes the place, under some circumstances, of some auditing procedures. Since it may at times serve as a substitute for routine checking by public accountants, it deserves the consideration of those doing public auditing and should find a place in books on auditing practice.

#### **Internal Check as a Phase of Accounting Systems**

When the accountant is called upon to devise and install a system of accounting, he should have definitely in mind two requirements to which his system must conform. He must satisfy himself first, that it will furnish correct information, to the management, to the owners, and to interested

parties; and second, that the routine for handling transactions is so organized that no opportunities are left for inaccuracies or irregularities in the operating and accounting processes. Therefore, any accounting system in which no attention has been given to an orderly routine and division of duties as a procedure for safeguarding against speculation and errors can be considered as a system of accounts but hardly an accounting system. It is, therefore, essential that the specialist in accounting systems as well as the auditor be versed in principles of internal checking methods.

### **Internal Check—The Automatic Audit**

Internal check may be defined as that branch of internal auditing which depends for its effectiveness in preventing inaccuracies upon a scientific division of work among the employees so that one person's duties are complementary to or checked by another clerk. This division of duties may obtain in the operating departments as well as the accounting department of the business.

As an example of this automatic check in the operating department, the high-grade grocery establishment in some of the larger cities in which a central cashier is conveniently located may be considered. The customer will have his items of purchase collected by a clerk, who will determine the amount due from an adding machine list of the items. The customer takes the list to the cashier, who, after receiving the cash, marks the slip paid and returns it to the customer, who will in turn pass the paid slip back to the clerk. The merchandise purchases are then delivered to the customer. At the end of the day, another employee collects the paid slips from the clerks, totals them, and compares his total with the amount of cash received by the cashier. By this system, the grocery clerks have had no access to cash, and an automatic check has been secured on the amount of cash for which the cashier is accountable.

The same scheme is worked out in connection with many cafeterias in which a checker totals the amount due from food sales. The customer is given the charge slip, which must be presented along with the cash to the cashier before he can leave the establishment. The registering machine operated by the food checker gives a predetermined total of the amount of cash for which the cashier must account.

The double check on transactions may arise also from having the activities of one department co-ordinated with but independently proved by another department. As an

example, the case of a university in which considerable criticism was launched at the athletic department for its failure to check properly the issuance of athletic exhibition tickets is of interest. This weakness was remedied by a requirement that all such tickets be delivered by the printer directly to the auditor's office (the accounting department of the university). Here the tickets were counted and after being recorded were then passed over to the business manager of the athletic department, who, of course, made a second count to agree with the auditor's tally. After each game the athletic department turned over to the cashier of the university the tickets unsold and the money received. The cashier reported to the auditor's department a statement of cash received and tickets unsold which, when taken in conjunction with the accredited free list, gave a complete proof currently of the accountability of the business manager for tickets issued.

Another way in which internal check may be applied along with the automatic flow of transactions but before the transactions have found a resting place in the ledgers is to place clerks along the route whose sole duties will consist in recalculating and proving the computations and extensions as shown on the vouchers and other business papers, determining that the proper accounts have been debited and credited, and seeing that the transactions are adequately supported by these business papers. Generally, such clerks are a part of the personnel of the accounting department and are thus in position to prevent mechanical errors and errors of principle from getting into the accounts.

### **Basic Rule of Internal Check**

It is obvious that the larger the establishment, the easier it is to effect a scheme of internal check. With a large number of employees, each of whom is doing one detailed task, there is less chance for errors going undetected or fraud occurring. Other than through collusion, it is only when a clerk is allowed to handle property and to have access to the books in which such property accounts have been recorded that the opportunity is given him for withholding or misapplying the property and falsifying the record. Since this is the case, the first rule which must always be kept in mind is that individuals who are in the operating departments must not be allowed to keep the books of the concern. Stated in another way the basic rule of internal check is that the work of ac-

counting should be separated from that of operation. As specific application of this rule, the storekeeper should not be allowed to keep the record of stores inventory, nor should the cashier be permitted to keep the accounts-receivable record. What results from this rule is that the properties of the business are held by one person or department, while the records of such properties are kept or controlled by another department. Likewise, the records of the liabilities as authorized are kept separate from the department in which they secure authorization. The ultimate effect, then, of this separation of operating from accounting functions is to make the accounting system definitely and directly a method of internal check over the operating departments.

#### **Illustrations of Automatic Audit**

As a further elaboration as to how an automatic check is secured on transactions by virtue of the division of duties among employees, the following are illustrative:

1. One person receives money on account, but another credits the customer's account.
2. One person is responsible for all cash received, but another keeps the books in which the cash account is entered.
3. One person may make the cash journal entry for receipts and disbursements, but another must reconcile the cash book with the bank account and with the actual cash on hand.
4. Approval for the payment of invoices may be secured from one person in authority, but the check must be written and signed by a second person and countersigned by a third individual.
5. One clerk may prepare the pay roll, but others will place the money in the envelopes and deliver them to the employees.
6. One person may credit the customer accounts for returns and allowances of merchandise, but only after the authority for such allowances has been secured from some one in authority.
7. One person may make the sale, but another will charge the customer's account.
8. The credit department may decide whether an order is to be shipped, but the shipping department will actually ship the goods.



### **Internal Check in the Small Concern**

As has been stated above, the best results from an internal checking system will be secured in the larger organizations where the number of transactions is large enough to warrant having a clerk do one and only one detailed task. The cashier should be kept busy handling cash and should not be allowed to assist the bookkeeper or be required to keep the ledger. Likewise, each ledger clerk should be kept busy posting to the accounts in his ledger and should not be asked to fill-in at the teller's or cashier's cage. Under such circumstances, the routine work is so arranged that employees will be checking one another in such a fashion that errors are practically eliminated and fraud can come about only through ignorance or collusion of two or more of the employees.

But what can be done in those concerns where the business is not large enough to support a personnel adequate to effect this automatic check? There are in this country many small offices in which one man is obliged to act as both bookkeeper and cashier. Is it entirely impossible to secure any check on transactions at the source within such an organization? The answer is that the possibility of securing a check will depend upon the attitude the manager or owner will agree to take with regard to having a part in the scheme. If he is so supercilious as to refuse to take any active part in handling some detail, then the situation is hopeless. If, however, he is willing to do his part, the following procedure is indicative of what might be worked out in the smaller office:

1. He may open all mail personally or permit his secretary to do so, listing remittances before turning them over to the cashier, and stamping on the back of such checks received "for deposit only."
2. He will require that all cash receipts be deposited intact, daily.
3. He will make all payments by check, except for small amounts to be handled through a petty cash fund.
4. He will see to it that a cash and sales register under lock and key is in operation, and he or his secretary will check the registers daily with the bank deposits.
5. He will require the bookkeeper to prepare statements to customers and have them handed over to the owner for scrutiny and mailing.
6. He will receive and reconcile personally the bank statement.
7. He should verify the monthly statements of creditors and personally mail out the checks.

8. He will require that all general journal entries be approved by the owner or manager, and especially those involving sales returns and allowances and those writing off uncollectible accounts.

9. Finally, he will have books audited periodically by public accountants.

From the foregoing it can be ascertained that some sort of internal check can be secured even in the smaller businesses. Just how the principles of internal check are to be applied in an organization must obviously depend on the nature of the business conducted, the size of the businesses, the number of transactions effected and the type of internal organization.

### **Business Transactions and Internal Audit Control**

Proper accounting and auditing procedures do not just develop of themselves. Some conscious effort and much thought must be brought to bear on the situation at hand to effect a satisfactory set-up for the control of transactions. The transactions and internal transfers are the raw materials with which the accountant works. A business transaction may be defined as an exchange of values resulting in an increase or decrease in assets, liabilities, and proprietorship of the accounting unit. Business transactions come about through dealings of the business entity with other concerns and outside individuals. An internal transfer may be defined as a change of location or form of values within an organization. When raw materials have been taken out of the storeroom and placed in the factory for fabrication into finished goods, a transaction has not occurred, because the original values have not changed and only the location of the values has been varied. Likewise, when depreciation on machinery is taken, the loss in value of the machinery is merely transferred to the value of the finished product. However, when the finished goods are sold, a definite exchange of values has taken place and a transaction has resulted.

The major activities, two or more of which are applicable in any business, resulting in the consummation of transactions, are as follows:

*Purchasing.*—Under the heading of purchases will be found the purchases of merchandise for resale, raw materials, supplies, labor, sundry fixed assets, services, rent, and in fact, anything bought by the business. For purposes of administration, there is usually a division of the purchasing activities, the purchasing department proper handling the ordinary merchandise, materials, and supply

purchases, and the employment department handling the task of purchasing the services of workmen. The board of directors of the executive committee of the board may in many cases be responsible for the purchase contract with lawyers, lessors, engineers, and public accountants.

*Selling.*—The general activity of selling includes all sales of every nature, whether they be sales of merchandise or of services. In a public utility it becomes a sale of gas, electricity, communicative service, or other commodity. A factory will market its manufactured units, the retail establishment will reflect sale transactions of ready-made goods, and the hotel has its room service for sale. While the great majority of the sale transactions will be consummated by the sales department, unusual sales—such as sales of land, plant and equipment, or fixtures—may be handled by the general manager or by the board of directors.

*Cash Receipts.*—The receiving of cash by an establishment constitutes a most important part of the routine inasmuch as frauds involved in cash receipts withheld or delayed are more difficult to trace than those peculations of cash once deposited but later withdrawn. The major part of the receipts come from sales of services or goods for cash and from cash received on account from customers. There are, of course, other occasions when cash is received and should be accounted for, such as from the sale of securities, from the incurring of liabilities, increasing of capital stock, from the return of an overpayment, and from the disposal for cash of miscellaneous assets.

The cash receipts and sales transactions are closely related, as the one is the opposite of the other. Receipts of cash reflect an increase in monetary values, while the sales transactions give rise to a decrease in company assets through cash sales unless there is a corresponding increase in cash.

*Cash Disbursements.*—In the majority of concerns a more effective control is had over the payment of cash than in its receipt. This result is due to the fact that the greater part of the money disbursed is by check signed by an officer who is presumed to have made some investigation of the authenticity of the item. However, the cash disbursement transactions are not free from fraudulent practices, particularly where fictitious or forged purchase invoices are paid. The same relationship exists between cash disbursements and purchases as between cash receipts and sales, with the co-ordinate problem of determining that when cash is decreased some other value has been secured. The prob-

lem is larger, however, than simply proving that goods have been received, since cash may be disbursed for things other than goods.

### **Internal Transfers**

The failure to account properly for that limitless number of internal transfers and adjustments which occur within the business may have its effect not directly in the loss in value to the business, but in depicting an erroneous operating and financial position, which may indirectly be the cause of loss. For example, a failure to include depreciation of plant and machinery in the cost to manufacture finished goods may give a cost figure which when used as a basis for establishing a sale price will result unwittingly in a decrease in company values. It is therefore highly important that all internal transfers, the results of which will be reflected in the accounts, be subject to the closest sort of internal audit control.

The following seven chapters take up in detail the routine that should be followed and the procedure which may be adopted in order that a proper safeguard over the four major groups of transactions and internal transfers may be secured.

## CHAPTER IV

### INTERNAL CHECK ON RECEIPTS OF CASH

#### Importance of Subject

Theft of cash by employees and officers is no doubt the most usual type of embezzlement, holding a big lead over thefts of goods, securities, and other property. The peculiar nature of cash which permits of its easy transferability, its ready use as purchasing power together with the inherent difficulty of tracing it, make it the favorite object of the business crook. Cash is as liquid to the embezzler as it is to the business. Whereas the employee who steals bonds and merchandise may have to work with a confederate to convert these items into cash, the clerk who steals the company's currency and gold may more easily play a lone though dangerous game.

Cash irregularities may be divided generally into four groups:

1. Interceptions of unrecorded receipts
2. Abstractions of cash previously recorded but not deposited
3. Improper withdrawal of funds on deposit, and
4. Miscellaneous cash derelictions.

The first of this group, that of interceptions, is by far the favorite method used by the crook. "A recent study of one hundred and fifty-five instances of cash irregularities shows that seventy-two of the instances have to do with interceptions, while fifty were instances of improper withdrawal, seventeen were abstractions, and sixteen were miscellaneous."<sup>1</sup> If this study of cash irregularities is to be taken as a representative sample of what is taking place in the business world generally, namely, that approximately one-half of such irregularities are occurring through the interceptions of receipts, then a great deal more attention should be given to a study of how to overcome such irregularities than has been given in the past. It is not difficult to find the reason for this large percentage, since the interception of cash receipts is the easiest of accomplishment and the most difficult to discover. The problem is to set up such a routine for cash receipts transactions that what has

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<sup>1</sup>J. R. Wildman, "Favorite Methods of Business Crookdom," in the *Accounting Review*, Vol. IX, No. 2, December, 1925, p. 128.

been received by the business is actually shown by the records. Once a record has been secured of what should have been received, the internal auditor is in a position more easily to determine whether it has actually been received.

### **Sources of Cash Receipts**

Cash flows into the business from various sources, the main stream being from sales transactions, with smaller streams coming from conversions of company assets and through increase of company liabilities. Although a complete list of all such sources would be beyond the scope of this work, the following list is probably representative:

1. The sales of merchandise for cash
2. The collection of accounts and notes receivable from customers, a sale of merchandise having been made one or more days prior to the collection
3. The collection of charges for services, such as gas, electricity, and water
4. The renting of property or the lending of money
5. Bank loans, bond issues, or the sale of capital stock
6. The sales of scrap, waste, and non-merchandise items
7. The sales of special and miscellaneous assets
8. The return of cash where erroneous or excess payments have been made on purchases
9. The receipts of deposits as guarantees subject to withdrawal.

There are, of course, other sources of receipts not listed above such as fees and tuition in universities and colleges, collections of taxes and assessments in governmental and municipal corporations, dues and initiation fees in clubs, and donations in charitable organizations. While the exact methods of handling cash receipts in non-profit organizations may vary slightly in places from the methods used in businesses for a profit, the variation is not so great as to require a different discussion of the one from the other.

### **Receipts from Cash Sales**

In those businesses in which the person servicing the customer does not actually touch the cash, there is less opportunity for fraud than in those concerns where the customer receives the goods from and pays cash to the same clerk. For example, the bus driver receives no cash, but is required to carry a registering machine into which is placed the fare and for which he is held accountable. In a like manner, many soda-dispensing establishments require that the money be paid to the cashier,

who gives the customer a ticket which when presented to the dispenser is good for whatever he wishes to order up to the amount stated on the ticket. Several times during the day these tickets are collected and at the end of the day serve as a total to be used as a check on the amount of cash taken in by the cashier.

The reverse process, that of permitting the dispenser to give the ticket to the customer to pay as he leaves, is not so satisfactory because there is no guarantee that the customer will not walk out without paying. Should the clerk use a registering machine which throws out a ticket for the amount registered and which is used as a basis for paying the cashier, then a better check is had than if the dispenser is allowed to prepare the customer's order and to collect the cash for it.

In those types of business in which the sales person handles both goods and cash, the two main sources of fraud in cash sales are: (1) the sales person may fail to report or make any record of the sale, pocketing the cash, and (2) he may underreport the sales, pocketing the excess of actual sale price over the amount reported.

Business concerns following this procedure have developed two methods of safeguarding cash. The first provides for a cashier-wrapper and either an overhead carriage or a pneumatic tube system. The sales person makes out the sales slip either in duplicate or in triplicate and sends the package to be wrapped and the money received along with the original and one copy of the sales slip. The "clerk-wrap" registers the money, files the copy of the sales slip, marks the original paid, and returns it with the wrapped package to the salesman and hence to the customer. The second copy of the sales slip is retained in the sales book and is taken up by the sales auditor at the end of the day to be used, among other purposes, as a check on the "clerk-wrap" for cash received by him.

The second method, which provides for a similar procedure, is more generally used in department stores. This method requires that a central cashier be located conveniently to several sales departments. The salesman as before prepares the sales ticket in triplicate and passes the purchased goods over to the cashier-wrapper, who checks to see that the ticket covers the goods to be wrapped, notes the prices on the sales ticket, registers the amount, and returns the parcel direct to the customer. This procedure will not prevent the sales clerk from changing the price tags on merchandise after it is sold but before it is wrapped. If, however, the cashier is well informed

on prices of merchandise within his territory, he will note and report any variations on the sales slip from the correct price.

Where the sales clerk is allowed both to wrap the package and accept the money, a cash register should be in use which is supposed to prevent underreporting by placing squarely before the customer the amount registered. Where this combination cashier-sales-clerk method is in operation, a deliberate check is often secured by having an outsider make a purchase with the correct change and note whether the sale was rung up on the cash register. Where the percentage of mark-on is uniform in the department, another deliberate check may be secured by applying the percentage of gross profit which should have been made by the department. Usually this is a test check seldom made more frequently than twice annually, but useful under the circumstances.

### **Collections from Customers on Account**

Cash received from customers on account can enter the business in three ways:

1. It may be received through the mails, generally in the form of checks, drafts, or money orders.
2. It may be paid directly by the customer to the cashier.
3. It may be paid to a representative of the business authorized to receive funds, who will transmit such cash to the cashier or deposit it in an authorized depository.

The extent to which one or more of these methods is used depends on the nature of the business. A manufacturing or wholesale establishment generally receives the majority of its collections from trade debtors through the mails, although frequently such concerns have need of a cashier's window for collecting from local customers and from miscellaneous sources. In some types of business, such as real-estate concerns, installment houses, and public utility organizations, the bulk of the payments are made at the cashier's window. In other concerns, such as department stores and retail stores, the customers' payments are made more or less equally through the mail and at the store.

### **Handling Receipts Through Incoming Mail**

In those concerns where the cashier is allowed to open the incoming mail and receive and deposit the cash and checks without a prior list of such receipts having been



made, the way is clear for him to defraud the company through methods to be detailed later in this chapter. The system employed to defeat such fraudulent practices is what is known as the "check-list" method, which has its inception in the mailing division of the office. Such a division may be under the supervision of the treasurer, the credit manager, the sales manager, or the office manager. Preferably a minor executive should be given the task of opening all mail where remittances are included in the incoming mail. Under no circumstances, however, should the person opening incoming mail be given access to cash, as this freedom would allow him the opportunity of placing checks in the cash drawer and withdrawing currency or coins. If currency is received through the mails, then only bonding and the subsequent audit procedure yet to be outlined will give the necessary protection.

The essential feature of the check-list system is the preparation of a list of the names of all individuals or concerns sending money, together with the amounts received. As the mail is opened it is inspected and sorted in accordance with the contents of the envelope. The envelope, in case it includes a remittance, should be attached to the enclosure, since the envelope is often the only evidence of the identity of the customer. These remittances should then be listed on a sheet of one or more columns, the number of columns depending upon the amount of information required, and are inspected for the following details:

1. Is the check post-dated? If so, the fact should be noted on the sheet, with the date when deposit may be made
2. Is the check signed? If not, it should be deleted from the list and immediately returned to the customer for signature
3. Is the check made out to the receiving concern as payee? If the concern is not the payee, has it the proper endorsement? If not, then the check will be returned for endorsement
4. Does the written amount agree with the figure amount?

The check list prepared by the incoming mail division may under certain circumstances be used to save a considerable amount of time and effort through the preparation of an extra copy of the list for the accounting department. This copy would have a column in which would be listed the names of customers making payments

on their accounts and would serve as a posting medium for the subsidiary Accounts-Receiveable ledgers. This procedure would eliminate the necessity for having individual customers' names listed on the cashier's receipt records, the general cash-receipts records thereby showing daily receipt from mail collections in total rather than in detail.

To safeguard cash received in this way, the cashier should be required to make out under his signature a receipt in triplicate for all cash received on account. Where possible, it is a good policy to have the person making the payment also sign on a line marked "correct." The original is then passed to the customer, the first copy is detached to be sent to the accounting department for entry in the Accounts-Receiveable Ledger, and the second duplicate is retained for future reference. The cashier will make deposits in the bank as often as it is deemed necessary. Where possible, a person other than the cashier should make the deposit. However, no harm is likely to come from permitting the cashier to make the deposit provided the duplicate deposit slip is sent by the bank to the auditor or treasurer.

At the end of the day, the cashier prepares a daily cash report of receipts, to which should be attached all supporting papers, including duplicate receipts, cash-sales tickets, etc. This report is sent to the accounting department, where the control and detail accounts are respectively debited and credited.

### **Subsequent Audit of Receipts on Accounts**

The work of checking the records to determine whether all cash recorded has been deposited may be delegated to the treasurer's office or it may be done in the auditing division of the accounting department. Since it is an auditing function, it may be assumed that the auditor has received the copy of the deposit ticket and a copy of the list of mail remittances and has access to the duplicate receipt record retained by the cashier. Obviously then, a comparison of the check list against the deposit ticket will bring to light any peculations through a failure to deposit cash received through the mail. Where the cashier fails to prepare a receipt of cash paid at the window, the task is not so easy. The cashier may resort to fraudulent practices, some of which are:

1. Withholding receipts, but making proper entry on the cash receipts book

2. Withholding cash received, making no entry on books
3. Falsifying totals on daily cash report
4. Overstating sales discounts
5. Lapping.

Methods of auditing or detecting these are discussed in order.

### **Withholding Cash Received and Making Proper Entry**

The first of these practices will be found only when the cashier is desperate and plans to make one big coup and then disappear. If, however, the system of requiring that all cash received be deposited daily is operating, then such a person who is so depraved as to steal company cash in the face of positive discovery could at best steal no more than the day's receipts and the change funds. The following illustration is cited as an example of what may happen without proper safeguards:

"The chief accountant of a 175-room transient hotel was an old and trusted employee. His books were audited regularly each month and always found in good order. The restaurant business was small and the chief accountant did the work of the controller, general cashier, and bookkeeper; he personally made all deposits at the bank.

"Everything ran smoothly until one day, just about the time the auditors were due for the regular monthly audit, the chief accountant disappeared. Investigation revealed the fact that from the time of the last audit the chief accountant had failed to deposit the currency in the daily receipts, and deposited only checks received. To the extent of the checks deposited, he drew exchange checks, thus securing possession of all the receipts during the period involved. In addition, he held up all checks which had been drawn in payment of creditors and in this manner he avoided overdrawing the bank balance. His last act before disappearing was to take all the cash from his petty cash fund and house bank. In all, the defalcation amounted to a little over \$20,000.

"Only a desperate man would attempt a method which could be continued for so limited a time and which made discovery certain. The incident illustrates, however, the fallacy of allowing the bookkeeper to act as general cashier or to make the bank deposits. Where the hotel is too small to employ a general cashier, one of the cashiers should receive all cash and either deposit it himself or turn it over

to the manager for deposit. The duplicate deposit slip only should go to the bookkeeper.”<sup>2</sup>

### **Withholding Cash Receipts, Making No Entry**

With the collusion of the receivable ledger bookkeeper, the second scheme—that of withholding cash receipts and making no entry—may be worked for a short period. It may even be temporarily successful without collusion. The success of such a plan will depend on whether the cashier is able to prevent periodic statements from going to the customer or to vary such statements to conform to his speculations.

A number of methods have been devised to discover frauds of this type. One method is to have each individual ledger bookkeeper send his monthly statements together with a list of such amounts to the auditing department or, in the absence of such a department, to the credit manager. Here the totals of the list as prepared will be checked against the control as secured from the general ledger bookkeeper. It will also be checked against each of the statements to be sent, and, most important of all, such statements will be mailed by the individual doing the checking, to be sure that no statements are mislaid before they get into the post office. Should the auditing department receive replies from customers stating that they have already paid the items charged, then the auditor may be obliged to take further steps to satisfy himself as to whether the error is accidental or whether it resulted from the withholding of cash.

Another method, not quite so satisfactory but capable of giving some internal check on customer accounts, is for the credit department to receive a copy of each billing to customers made by the company. These duplicate invoices are then filed in a tickler file under the date when payment is due. As collections on account are received, a copy of each receipt passes through this department and the proper invoice is taken from the file and marked paid. Manifestly, those invoices not paid when due will be followed up by corresponding with the customer. If the customer answers that he has made payment on account and has evidence of payment, further investigation would then disclose what had become of the cash.

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<sup>2</sup>*The Alarm Clock* (published by Horwath and Horwath), March, 1928.

### Lapping

Another favorite method of fraud employed by the dishonest cashier, and one difficult to discover in the absence of proper safeguards, is that of lapping. This is a method whereby cash is abstracted from customer receipts, the credit to the customer being delayed one or more days. It often comes about where the cashier is permitted to receive, record, and deposit the money taken in. It can be worked with checks received as well as with currency, but is often limited to a few accounts where the customers remit currency. The following situation may be taken as an example:

Receipts—June 15		Cash Entered and Deposited, June 15	
From Edgar Brown, check..\$	350	From Edgar Brown .....	\$ 350
“ O. K. Bird, currency.	200	“ J. T. Cole.....	175
“ J. T. Cole, check....	175	“ P. Newman.....	525
“ P. Newman, check....	525	“ L. A. Kling.....	400
“ L. A. Kling, cash....	400		
<b>Total.....</b>	<b>\$1,650</b>	<b>Total.....</b>	<b>\$1,450</b>
Receipts—June 16		Cash Entered and Deposited, June 16	
From Robt. Shipp, check...\$	425	From O. K. Bird.....	\$ 200
“ Henry Roberts, check	350	“ Robt. Shipp.....	425
“ Mrs. S. Austin, check	250	“ Henry Roberts.....	350
“ F. B. Pheil, cash....	400	“ F. B. Pheil.....	400
<b>Total.....</b>	<b>\$1,425</b>	<b>Total.....</b>	<b>\$1,375</b>
Receipts—June 17		Cash Entered and Deposited, June 17	
From L. R. Smith, check...\$	640	From L. R. Smith.....	\$ 640
“ S. Steffler.....	350	“ Mrs. S. A. Austin....	250
“ Isaac Aaronson, cash	425	“ Isaac Aaronson.....	425
<b>Total.....</b>	<b>\$1,415</b>	<b>Total.....</b>	<b>\$1,315</b>

It is obvious how the cashier has worked the scheme. On June 15 he placed the \$200 collected from O. K. Bird in his pocket. The next day, he covered the \$200 by crediting Bird on the books but withdrawing \$50 of the cash paid by Pheil. He is now \$250 short; so he fails to give credit to Mrs. S. Austin. The next day he withholds \$100 of the currency paid in by Aaronson, which makes him \$350 short. He covers the Austin credit this day but delays crediting Steffler until a future date. Eventually such a fraud will break down under its own weight, but in the meantime a considerable amount of money may be missing. Of course, at the end of the month, if the cashier has not borrowed enough from outside resources to make good his shortage,

the embezzlement will be detected by the procedure stated above in connection with the withholding of receipts, making no entry. However, it should have been caught earlier and would be discovered if the internal auditor checked the cash-receipts book against the deposit ticket daily. For example:

Cash Receipts Book, June 17		Deposit Ticket, June 17	
From L. R. Smith, check...	\$ 640	Currency .....	\$ 325
" Mrs. S. Austin, check	250	Checks .....	350
" Isaac Aaronson, cash	425	Checks .....	640
<hr/>		<hr/>	
Total.....	\$1,315		\$1,315

He would immediately see that the currency of \$325 deposited represents no individual receipt for the day. Likewise, that the check of \$350 deposited does not appear on the cash-receipt book. Further investigation would quickly reveal how the cashier was covering.

#### **Falsifying Totals on Daily Cash Receipts Book**

The method of falsifying totals on the daily cash-receipts book is so crude as almost to admit of no consideration inasmuch as it requires the assistance of some one in the bookkeeping department to keep the controlling account from showing out of balance at the time of taking a trial balance with the receivable ledger. Furthermore, if the internal auditor foots the copy of the daily cash report, or the copy of the daily cash-receipts journal, the error is quickly discovered.

#### **Overstating Sales Discounts**

The method of overstating sales discounts, like the others discussed above, will seldom if ever be used by the cashier if he is cognizant that some one in the auditing department is making a deliberate check of his records. Probably the outstanding advantage of an auditing department is to put the employees on notice that their work is being closely examined and hence deter them from directing their attention to methods of fraud when their time and attention could be profitably used with regard to matters of business.

If, however, the cashier senses that no one is currently checking his cash-receipts book, he may take advantage of the opportunity by overstating customer discounts and pocketing cash for the difference. The scheme may be operated in two ways: either the amount of the discount taken may be increased, or a discount may be recorded when none was taken, the net effect being the same in either case.

Discovery may be effected by comparing deposit tickets

with the cash-receipt book should the overstatement have been made on a collection by check. If the abstraction is made from currency payments, then a scrutiny of the cash book by the auditor for each entry made is necessary.

Exceptional or suspicious discounts would be subject to further investigation. An additional check may be secured if all letters or statements accompanying the remittances have been sent to the auditing department, these to be used to check against the cash-receipts journal.

Should the cashier elect to overfoot the discount column with an offsetting underfooting of the cash-received column, even though correct entries have been made in the journal, he may rest assured that this manipulation will be discovered by the auditing department.

### **Receipts from Refunds and Allowances**

One very fruitful source of embezzlement occurs when an improper control is exercised over cash or checks received from refunds or allowances. Such refunds or allowances come about through overpayment of purchase or expense invoices, from claims against railroads for overcharges or breakage, through refunds of advances made on barrels, drums, or other containers, from insurance cancellation, damages, and the like.

As an example, there is the case of a concern which operated its own heat, light, and refrigeration plant where certain alkaline products were needed and which could be bought only in containers. The policy of the company selling this product was to charge \$20.00 for each container, the amount to be refunded when the containers were returned. The engineering department kept a record of the number of containers and when forty were empty—enough to make a carload—they were shipped to the firm for refund. The accounting records showed charges to the engineering department and credits to the creditor for the full amount of the shipments received, including the twenty-dollar deposits made on containers. The cashier upon receipt of each of the \$800.00 checks would place it in his cash drawer, abstract a like amount, and make no record of the refund. The following internal procedure would have revealed the fraud quickly:

1. All containers received and paid for on a deposit basis should have been set up in a separate general-ledger account instead of having been charged to the cost of the engineering department.

2. Each month the accountant should have secured a statement of the number of containers on hand.

3. When the engineering department made a return shipment of containers, the accountant should have been notified. Such a notice would put him on guard that a check and hence a credit to his container inventory account was forthcoming. A failure of the cashier to run the credit through his records within a short period would justify the accountant in turning the matter over to the company auditor.

Railroad claims and returns and allowances on purchases for which cash will be received should be set up in the ledger accounts and the railroad or the creditor account charged. Failure then to give proper credit to these accounts should be investigated. Almost invariably cash frauds involving refunds and allowances are perpetrated by an employee who is acting as both cashier and bookkeeper. Manifestly, the best way to prevent such fraud then is to separate these two positions.

#### **Collections in a Public Utility**

Probably no business has so tight a control over cash received as usually has the utility company in its local offices. After the various meter readers have completed their tasks and the office force have made their computations of amounts due for services and goods bought, the customer is billed on a specially constructed billing machine which automatically prints the amount four times. These four prints are shown by Illustration No. 1. Copies 1 and 2 are sent by the mailing division to be mailed to the customer, No. 3 is sent to the cashier, and No. 4 remains in the accounting department. When the customer pays the cashier, copy No. 3 is taken from the file in the cashier's office and along with copies No. 1 and No. 2 is marked paid. Copy No. 2 is detached and kept by the cashier, and No. 1 becomes the customer's paid receipt. At the end of the day, the cashier totals the cash, makes a summary daily cash report, and sends all collection coupons, copy No. 3, and other supporting data to the chief accountant for verification, and the cash to the chief cashier for deposit. A clerk in the chief accountant's office then goes to the office record file (copy No. 4) and from the data on copy No. 3 makes such notations as are necessary on this record. The office record copy is then taken out of the unpaid file, only those accounts which are delinquent being thus left in this file. Periodi-



cally, a representative is sent to call on all customers delinquent in their payments, and if the cashier has held out any receipts of cash, the withholdings will be discovered and proved by having the customer produce either

PUBLIC SERVICE CO.      February 1931							Cashier's Coupon Public Service Company			
Code and Rates on Reverse Side				Office Hours 8:15 A.M. to 5 P.M.						
Pres. Reading Date	Prev. Date	Meter Readings		Consump- tion	Code	Gross	Net	Code	Gross	Net
		Present	Previous							
Discount will Not be allowed unless paid within fifteen days of present reading date.										
No. 1							No. 2			

Collection Coupon Public Service Company February 1931				Office Record Public Service Company February 1931						
Code	Gross	Net	Code	Gross	Net	Pres. Date	Prev. Date	Meter Reading		
								Present	Previous	
No. 3								Partial Payments		
								Date	Amount	Bal.
No. 4										

FORM No. 1—Billing Slip

his cancelled check showing payment or his receipted bill, or both. Of course, adequate controlling accounts of unpaid bills are kept in the general ledger.

### Miscellaneous Receipts

The other types of receipts mentioned under sources of cash receipts above are more subject to deliberate audit, either internally or externally, than to internal check. In the case of interest on bonds owned by a bank, for example, a custodian of the securities, usually an officer of the bank, is charged with the securities under his control and is also charged with the collection of interest thereon. He is discharged when proper record has been made of the receipts of cash by the bank for such interest. It is the duty of the bank auditor, how-

ever, to determine whether the securities custodian has placed the receipts in the bank and not in his own pocket.

Sales of scrap, waste, and by-products should be controlled through operation of the perpetual inventory plan. Frequent physical counts, however, should be made to ascertain that the book inventory of such items is correctly stated.

Cash received from the sale of stock, the issuance of bonds, or bank loans should be traced by the auditor into the bank account. Likewise, transfers between banks, a frequent source of fraud by the treasurer, should be subject to the closest scrutiny of the internal auditor. Where the concern is not large enough to supply a clerk to perform this auditing function, then outside auditors should be called in more often than once yearly.

### **Organization for Control Over Cash Receipts**

The first step to be taken in the securing of a control over cash receipts is to discover whether the concern is so organized as to permit of a continuous, uninterrupted flow, unhampered by so-called "red-tape," of cash from the time it comes into the business until it reaches the bank. Should the existing organization be adequate for securing this control, the next step is to determine whether proper precaution and supervision are being exercised directly toward the continuation of an effective control. A concern may have the finest kind of accounting system installed, but unless it is being adhered to conscientiously, it can be of little assistance.

The first step, then, is to be assured that the department responsible for the receiving, handling, and depositing of funds is separated entirely from the department keeping a record of the receipts and a record of the amount supposed to be in the depository. This separation is secured in the majority of concerns by placing the cashiers under the supervision of the treasurer, whose duties with regard to cash receipts are as follows:

1. To receive all cash and checks from the mailing division
2. To consolidate cash from the various receiving divisions or departments
3. To receive directly all cash from collectors and traveling representatives
4. To keep a duplicate record of all such cash receipts as prescribed by the controller in the form desired by the general-ledger accounting section

5. To send a copy of the record as kept of cash receipts to the general-ledger accounting section for entry on the ledgers
6. To prepare duplicate receipts for all cash received from customers, a copy of which will be sent along with the daily report of cash received, and will serve as a basis for posting to the customer accounts in the Accounts-Receivable Ledger
7. To deposit intact daily all cash received during the day, attaching duplicate deposit ticket to the daily report of cash received and sending it to the accounting or auditing division.

In addition to separating the receiving division from the recording division, steps should be taken to distinguish the recording function from the auditing function. This can be done by placing responsibility on the comptroller for all recording and auditing. The comptroller, being unable personally to handle all the details, should have under him a chief accountant in charge of all recording procedure and an auditor in charge of verification procedures. The records kept under the supervision of the chief accountant will serve as a check on the cashier and treasurer and will assist the auditor in satisfying himself that the cash deposited was all the cash received by company employees.

The duties of the accounting department with regard to cash receipts are:

1. To post to the ledgers all debits to bank accounts for cash received and deposited
2. To post to the general ledger all credits arising by virtue of the cash received
3. To post to the customer accounts from letters of transmittal or duplicate receipts prepared by the cashier, all cash received from customers to apply on account
4. To check the incoming-mail clerk's record of remittances received against the daily deposit tickets
5. To audit the daily cash sales
6. To prove the cash receipts at the end of the month by reconciling the bank statement with the books.

To give a clearer picture of the inter-relation existing between the various divisions of the business which should be so arranged as to effect a control over cash receipts, a flow chart of receipts is shown below.

### **Explanation of Flow Chart for Cash Receipts**

Cash is seen to enter the business through three avenues: namely, through the mail, directly to the cashier's window, and indirectly to the cashier by way of sub-cashiers and cash registers.

Upon receipt of envelopes enclosing remittances, the mailing division under the supervision of an officer of the company prepares the check list, as explained above in triplicate, one copy for the auditing department, one for the credit department, and one to be retained in the originating division. The copy sent to the auditing department is used to assist in the daily proof of cash received and deposited, and the credit department's copy is used to bring the files of this department up to date. The letters of transmittal or remittance tickets enclosed are sent to the accounts-receivable division, there to be used to check off accounts shown to be paid. This preliminary checking off of paid items obviously has to agree with the subsequent posting to be made from cash-books records.

The checks and currency, if there are any, are sent then to the general cashier, who immediately issues receipts in triplicate, the original going to the payer, a second copy to be retained in the receipt book, and the third copy to accompany the daily cashier's receipt sheet. The cashier's daily receipt sheet is prepared in duplicate, a copy of which goes to the general-ledger bookkeeper, who makes postings to all general-ledger accounts affected. Attached to this copy is a set of duplicate customer receipts, which, after being reconciled with the accounts-receivable control credit for the day, are sent to the accounts-receivable ledger clerk for posting to the individual accounts in the subsidiary ledger. The cashier prepares the deposit ticket in duplicate, sending the deposit tickets and the cash for deposit to the treasurer's department.

The treasurer, assistant treasurer, or a clerk in the department delivers the day's cash receipts to the bank for deposit. The bank teller stamps one deposit ticket and returns it to the treasurer's representative. The other copy he initials and mails to the company auditor.

The proof of the day's cash is obtained in the auditing department, where a check of the items showing on the duplicate deposit ticket is made against the check list from the mailing division and the cashier's daily-receipts sheet.

DETAIL	MAILING DIVISION	TREASURER'S DEPARTMENT	CASHIER	GENERAL LEDGER BOOKKEEPER	ACCOUNTS RECEIVABLE LEDGER CLERK	AUDITOR*
A. Incoming mail, including remittances by check received in	where list is prepared in triplicate of cash and of checks received. 1. a) copy of list is sent to b) copy of list is sent to credit department 2. Cash and checks retained sent to 3) Letters of transmittal or remittance tickets to		1. Issues receipt in triplicate a) copy to payer b) copy to accompany daily cash sheet c) copy retained by cashier 2. Entries in cash receipt book or on daily receipts sheet a) copy to			
B. Receipt of cash and checks thru cashier's window					To assist in checking off the paid items	
C. Cash sales thru cash registers or sub-cashiers			2. Entries in cash receipt book or on daily receipts sheet 3. Prepares daily deposit ticket in duplicate and sends cash and deposit ticket to	where general ledger entries made, accounts receivable control credited for cash received on account	Postings to credit of individual accounts from cashier's receipt copy	
		where assistant treasurer or clerk in department deposits cash in bank, the teller signing duplicate and mailing direct to				where proof is made of cash by 1) checking mailing list against deposit ticket 2) Checking the daily cash receipts against deposit ticket
D. Bank statement						

\*In some concerns, this work may be performed by a clerk in the accounting department.

FORM No. 2—Flow Sheet for Cash Receipts

### **Conclusion on Cash Receipts**

The conclusions which result from the foregoing discussion may be summed up as follows:

1. Any internal checking scheme on cash receipts demands that some method be devised whereby a record will be prepared immediately for all money and checks received
2. That the duty of receiving moneys be turned over exclusively to the cashier, under the supervision of the treasurer
3. That the duty of keeping a record of such receipts shall be handled exclusively by the accounting department
4. That some one in the organization will function as auditor, whose duties will consist among other things of:
  - a. Comparing duplicate deposit slips against the daily cash book and incoming mail sheets
  - b. Verifying footings on cash-receipts journal
  - c. Verifying discounts on sales as recorded on the cash journal
  - d. Approving all non-cash credits to customer's accounts
  - e. Personally checking customer statements against ledger accounts and placing them in the mail
  - f. Taking charge of incoming mail if suspicions are sufficiently aroused that fraud is evident.

## CHAPTER V

### CASH DISBURSEMENTS

A study of fraud in accounts reveals that a large number of irregularities occur through an improper withdrawal of funds on deposit. Such a study may also show that many petty thefts occur from a rifling of the working funds, the special imprest funds, and the petty cash funds. It has been too often supposed that, because the firm required all payments to be made by check or through a petty cash fund, an adequate check was being maintained over disbursements. While it is true that such an arrangement is more satisfactory than the plan which permits of payments of expenses and purchase invoices out of the daily cash receipts, it cannot of itself do more than serve as a vehicle for the proper administration of funds disbursed. Checks may be fraudulently issued just as cash receipts may be fraudulently misappropriated. To prevent the issuance of unauthorized and improper disbursements, a systematic routing of all those transactions calling for payment is needed.

#### **Analysis of Cash Disbursements**

Some of the transactions which occasion the paying out of company funds may be listed as follows:

1. Purchase of goods, either finished or in the form of raw materials, supplies, and fixed assets
2. Purchase of labor
3. Purchase of other items constituting the bulk of the operating expenses
4. Purchase of securities and other income-producing property
5. Retirement of bank loans, bonds issued, and capital stock
6. Miscellaneous payments such as those resulting from lawsuits, dividend declarations, patent infringement, and the refunding of customer deposits.

#### **Liquidation of Accounts Payable**

Probably the cash-disbursement transactions which bulk largest in an industrial concern are those arising from the payments to trade creditors for raw materials and

goods bought. Such payments are almost wholly by check and are subject to fraudulent practices only when an adequate internal check on purchase transactions is not maintained. If it be assumed for purposes of this discussion that a voucher system is in use and that all vouchers are prepared by a voucher clerk in the accounting department, that receiving reports are attached to the voucher, that extensions, computations, and footings have been proved by a voucher auditor, and that the voucher has been approved by an officer (probably the controller or his assistant), then there is little likelihood that unauthorized payments will be made. However, to make the plan more fully protected, the disbursement cashier should have

DETAIL	ACCOUNTING DIVISION	CASHIER	TREASURY DEPARTMENT	AUDITOR
Purchase Invoice, after completing the usual purchase procedure, goes to	where Voucher-check is prepared, is signed by chief accountant or comptroller, then sent to	for number and name of bank on which to be drawn, then to	for signature; a) Voucher returned to	
	as a basis for posting to general and subsidiary ledger accounts, then passed on to	for entry in cash-disbursements journal 1. Original retained 2. Copy sent to		
Bank statement received by				where monthly reconciliation of bank statement takes place.

FORM No. 3.—Flow Sheet for Cash Disbursements

recorded and numbered the checks before they go to the treasurer for his signature. Even after the treasurer has signed the checks, they should not be sent back to the department from which they originated, but should be mailed directly from the treasurer's office by his secretary or sent to the outgoing mailing division for mailing to the creditors. Form No. 3, page 93, shows the routing of such disbursements.

It is to be noted that the disbursement procedure begins where the purchase procedure ends. That is, the invoices to be paid must have been received and matched up with the purchase requisition and the receiving report as to terms of payment, quantity, quality, and description



of goods bought. The invoice will have been checked as to computations and additions and the discount date noted thereon. Entry will have been made in the voucher register after a formal voucher to which has been attached all supporting data has been prepared. The time has arrived for the item to be paid. The purchase invoice with invoice audit block fully filled out or the voucher with supporting data is taken from the unpaid file and a blank check is filled in if it had not already been filled in when the voucher was prepared. The check is sent to the disbursement cashier for numbering, and frequently the name of the bank on which the check is to be drawn is placed thereon. The treasurer or his assistant signs the check and either remits it direct to the creditor or sends it to the mailing division for posting. The voucher proper is returned to the cashier for entry in his cash-disbursement journal. The papers are then returned to the accounting department to be used as a basis for posting to the general ledger and subsidiary records. At the end of the month or sooner these voucher records are available to the company auditor for further verification and reconciliation of the bank statement with the books.

As an indication of the way in which embezzlements in cash in bank have come about, and in order to show how an internal check would have forestalled them, the following cases are cited:

*Illustration No. 1.*<sup>1</sup>—The company was a fairly large concern in which it was thought that an adequate control was exercised over all departments of the business. There was, however, one weak link, by virtue of which the daring embezzler was able to secure approximately a hundred thousand dollars before he resigned.

The company's warehouse was in a different city from that in which the purchasing department and general offices were situated. The purchasing department's procedure prescribed that requisitions for all needed supplies and materials be sent to the purchasing department; however, because of general laxness, this practice was not always followed. Purchase orders were supposed to be prepared in the purchasing department from the requisitions. Practically all purchases were shipped direct to the warehouse, and all invoices were sent direct to the purchasing department.

Copies of the receiving reports, which were prepared

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<sup>1</sup>Adapted from a case in Haskins and Sells *Bulletin*, June, 1925, pp. 42, 43.

in duplicate at the warehouse, were forwarded to the purchasing department. Upon receipt of these copies, the purchasing agent approved the invoices for payment after verification and distribution had been made in his department. *The accounting department accepted the approval of the purchasing agent without further investigation*, and prepared vouchers for the treasurer to pay. The laxness in the system of internal control caused by assigning to the purchasing agent the authority to approve receipt of goods and approve invoices for payment gave him opportunity for fraud.

His plans for embezzlement showed an unusual amount of care and thoroughness. He opened offices in several buildings under the names of bogus companies and hired employees to attend to them. He opened bank accounts at various banks for these bogus companies. He had invoices printed with the names of the companies and had these invoices, representing false charges, sent for payment to the company of which he was the purchasing agent.

The embezzler forged receiving reports and attached them to the spurious invoices which he approved for payment. The fake invoices together with the forged receiving reports were then forwarded to the accounting department for entry and payment in accordance with the usual procedure. The distribution of the irregular vouchers was almost entirely to the general ledger account, "Warehouse Stock." Checks in payment of the spurious invoices were sent to the addresses shown on the invoices, and were received by the employees of the defaulter and deposited in the banks. The deposits were subsequently withdrawn by the purchasing agent.

In an effort to avoid attracting attention to his manipulations, the embezzler in a few cases actually had material shipped to the company's warehouse. Such material he purchased personally and had it shipped to the bogus companies, to be reshipped to the company he was defrauding. The manipulation was first discovered after the purchasing agent's resignation, when an employee in the accounting department noticed discrepancies between certain invoices and receiving reports received subsequent to the defaulter's resignation.

This case illustrates the possibility of fraud inherent in a situation where one man not only issues purchase orders, but also receives material requisition forms and approves invoices for payment. In this case, under a properly operated system of internal control, the manip-

ulations could not have been effected, because no receiving reports would have been on hand to substantiate the bogus purchases. Had the material-received forms been received and invoices been approved for payment by some one other than the purchasing agent, or some one under his control, he could not possibly, without collusion, have carried on his fraudulent operations undiscovered.

*Illustration No. 2.*—In a transient hotel of 200 rooms doing a large restaurant business, the steward found it advantageous to purchase various food items from farmers and vendors who frequently offered potatoes, vegetables, odd lots of fowls and turkeys, and other produce at considerable reductions, in order to avoid taking them back home.

In the absence of a cash fund in the receiving department, the storeroom clerk would make out a small cash-purchase voucher, and after having the farmer sign it, and the steward authorize it, he would take it to the cashier upstairs, and get the cash. On his way up, he would make changes on the voucher. If, for example, one bushel of sweet potatoes had been purchased, he would arrange the slip something like this:

1 sack potatoes	\$165
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It will be noticed that he did not use the word "sweet" to specify the kind of potatoes; he used "sack" instead of "bushel" and he did not use a decimal point in the amount. By adding an 0 to the 1 indicating quantity, placing "at \$1.65" after potatoes, inserting a point between 6 and 5 of the original amount and placing 0 after the 5, the clerk presented to the cashier this slip:

10 sacks potatoes at \$1.65	\$16.50
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The slip seeming to be genuine in all respects, the cashier would pay the amount and the clerk would pocket the difference. When changes like the above could not be made, it was easy enough to add another item or two to the bill and collect for the total. As receiving sheets were made out by this same clerk, it was a simple matter to alter them, as he had done the invoice, and thus show no discrepancy when the invoices were checked to the receiving records in the auditor's office. The alterations and additions to the receiving sheets were made, of course, after the steward had initialed them. In this manner, the clerk was able to double or treble his monthly salary.

This embezzlement was discovered when an analysis of

the food costs reflected an unexplained excess cost figure. A change of personnel together with the requirement that all cash payments be made direct to the farmer or vendors closed the gap.

Any number of cases are on record where fraud has occurred through a second use of a creditor's invoice. There are a number of variations of this method: sometimes the check is made out to a confederate; at others after the check has been signed the embezzler erases the name of the payee and places his own in, changing the name again when the check is returned from the bank. Probably the best way to defeat this scheme is to require that all invoices or vouchers be perforated or marked paid or cancelled in some manner to prevent their being used a second time. A variation of this method which requires the same procedure and secures the same results is through the preparation of false vouchers.

Still other frauds result from a laxity in handling spoiled checks. An illustrative case is that of the young bookkeeper who committed his first offense because of the opportunity granted him by an undelivered check. The facts are these: the manager ordered the bookkeeper to draw a check for \$800 to the order of the bank for the purchase of a bank draft. Before the delivery of the check to the bank, it was discovered that the required amount was only \$778.62, and the bookkeeper was told to enter the old check as a disbursement in his cash book and to draw a new check for the \$778.62, have it certified, and deposit the \$800 check. Both checks were charged to vouchers payable. Before the check to be deposited had been entered in his cash-receipt book, the bookkeeper remembered that there was more than a thousand dollars in currency which he was to deposit. Instead of entering the item in his cash-receipt book, he took the \$800 in currency from the drawer and substituted the \$800 check in place thereof. Now he realized that his vouchers-payable account was out of balance. This he adjusted by overfooting the voucher-payable column in the voucher register and spread the \$800 in the expense columns. Encouraged by his first fraudulent success which went undiscovered, he later waged a campaign to wrest funds from the business by padding vouchers, using duplicate invoices and making duplicate payments.

If the management was at fault in asking the bookkeeper to deposit the unused check, it was more at fault in permitting him to have access to cash funds, prepare checks, and keep the books. The check which started the bookkeeper on his road to jail should not have been deposited,

but on the contrary should have been voided without entry. However, if some one in the organization had rechecked the voucher register footings monthly, the fraud would have been turned up without further difficulty.

### **Pay Roll Disbursements**

Workmen may be paid either by check or in cash, out of a pay roll bank account or from the regular bank account, but irrespective of the method of payment there are a number of ways in which fraud may occur in the purchase of the services of labor in the absence of proper safeguards. The problem of a proper pay roll procedure is important enough to justify a separate discussion. Chapter VIII is devoted to this subject.

### **Payments of Operating Expenses**

As in the case of payments to creditors, vouchers for all expenses paid should be prepared in order that the person authorized to sign the checks may be appraised of what verification has been made of the items. Current operating expenses are seldom, if ever, placed in the ledger as a credit to the payee. Where a voucher system is not in use, the billings constitute the basis for the charge. As most of these invoices come through the mails, they should be sent to the department responsible for authorization before payment. The checks signed by the controller or his assistant with the invoices O. K.'d by the department head, may then be presented to the treasurer for his counter signature. In this way, the invoice is authorized by the department securing the benefit of the service, is verified by the account department, and is subject to a second verification in the treasurer's office. With the voucher system, the procedure would be about the same, the preparation of a formal voucher being the only significant variation.

Generally, the freight bills would be sent to the traffic department for rate verification, after which the accounting department should compare each bill with the receiving records to be assured that bills are not being paid on goods not received.

Salesmen's commissions and expenses should obviously be subject to the approval of the sales manager, and would be paid only after an independent audit in the accounting department of all data concerning such items.

One of the major oil companies was defrauded of several thousand dollars over a period of a few years through a failure to exercise a proper control over expense disbursements. If there is much oil leasing activity, many of the

large oil producing companies employ a clerk in the county clerk's office to send in a list of all oil leases recorded in that county. For this they pay a nominal sum for each lease so recorded and reported. One ambitious but unscrupulous clerk decided that he could increase his pay by reporting a number of bogus leases. This he did.

The procedure in the office was for the head of the production department to sign the bill so rendered as correct, for the bookkeeper to enter the item, and on the basis of this authorization for the treasurer to pay the amounts without further verification. The fraudulent practice was discovered when the disbursing officer noted the relatively large and increasing amounts which were being paid to this clerk. The speculation could have been avoided if the production department had required that the division superintendent, who was familiar with the leasing activity in his territory, verify and authorize the charge before it came to the general office for payment.

An interesting case was accidentally discovered in which the bookkeeper did not steal cash, but manipulated the accounts in such a way that he was supplied with free oil, gasoline, and repairs for a period of over five years. The company was a creamery operating a small fleet of trucks. This company was in the habit of permitting its office employees, six in number, the privilege of charging their individual personal purchases along with the gas and oil bought for company uses, the employees refunding the amount charged monthly.

The bookkeeper for the company, who was also the cashier, made use of this privilege. At the end of the month when the check was prepared for the garage bill, he would also distribute the charge to the various employees and to the respective company trucks. He did not, however, debit his own account for his purchases, but on the contrary distributed them over the various trucks. In this way he "saved" himself approximately \$2,500.

There are a number of weaknesses in this case. In the first place, the employees should not have been permitted the privilege of making their personal purchases through the company account; second, the bookkeeper was given too much latitude in his office duties; and third, a deliberate check should have been made of the bookkeeper's records. This check should have been made by some other employee in the office.

Where fixed charges such as rent, insurance, interest, salaries, and the like are paid periodically, the officer whose duty it is to sign checks should be supplied with a schedule of these charges as prepared by the controller and agreed

to by the general manager. These schedules should be prepared on columnar paper in such a way that it is possible to check off items periodically as paid. Changes made in these schedules should bear the initialed approval of the departmental officer responsible for the charge.

### **Liquidating Liabilities Other Than Accounts Payable**

Given an arrangement in which a clerk is permitted or required to keep the notes-payable register, draw the checks, and pay the notes at the bank, and then link this up with a dishonest clerk, and the result is almost a sure embezzlement. The method may be to issue false notes to an accomplice who later sends them through the bank for collection. Another way is to have a check drawn to a second bank, stating that it is to pay a note drawn by an out-of-town creditor who holds company notes, but instead of applying it on a note made by the company, to apply it on a note probably made by the clerk. To have an automatic check on notes payable, the following is suggested:

1. A clerk in the accounting department should keep the notes-payable register, controlled by a notes-payable account in the general ledger
2. A second person should prepare the checks, but only after a written authorization blank has been signed by a company official
3. A third person, preferably the treasurer or his assistant, should be required, to pay the note at the bank and get the cancelled note
4. The note should in every case be marked paid on its face or with perforations, and should be attached to the voucher paying it
5. As a final safeguard, the internal auditor should inspect all vouchers paying notes at least within thirty days from the issuance of the voucher.

### **Miscellaneous Disbursements**

Other disbursements, such as those for the purchase of securities, retirement of bonds, and payment of dividends, are subject to action of the board of directors. In all such cases, the internal auditor should see that the disbursement was sanctioned by official action of the board and that all details concerning the situation are at hand.

### **Transfers Between Banks**

Another type of check which requires close scrutiny is the one drawn to transfer funds from one bank to another,

the reason being that once the check is drawn what is to prevent its misuse by the person signing it.

An illustrative hypothetical situation is one in which the treasurer of a concern is authorized to make transfers frequently and in large amounts between the local bank and some forty-five other banks located in various parts of the country in which the company has funds. The transfers are effected by remittances either of checks drawn on one bank in favor of another or by drafts purchase at the home office.

The treasurer is heavily in debt and needs fifty thousand dollars. What will he do to get the money and how will he probably cover it? He would probably draw a check or checks on banks with large balances in favor of the local bank, such check ostensibly to be used for the purpose of buying drafts for deposit in outside banks. Instead of buying the drafts, he deposits the checks in the local bank to the credit of the company which he owns and controls. It is the practice of the company where transfers are being made to debit an account "Funds in Transit" and credit the bank on which the check is drawn. Accordingly this account is so debited for the fifty thousand dollars. But toward the end of the month the treasurer begins kiting to cover. He draws a check or checks on the local bank for the exact amount of his abstraction and sends them for deposit in the banks where the original transfers were supposed to have been deposited, taking care to mail them at such times as to reach the payee bank before the close of the month, but not to reach the local bank in time to be included in the monthly bank statement. These checks, of course, are not recorded, but an entry is put through debiting the payee bank and crediting the "Funds in Transit" account.

At the beginning of the next month, he covers the check on the local bank by drawing on another bank and continues this process, increasing the shortage all along the line.

This embezzlement will, of course, be prevented if the controller is required to countersign all checks and would be discovered if the auditor at the time of reconciling the bank statement with the books had noted that these transfer checks bore dates of from several days to a month prior to the dates on which they were shown by the bank as being deposited, during which time they remained inaccurately in the "Funds in Transit" account. Tracing and matching up the withdrawal and deposit would have effected discovery.



### Petty Cash Disbursements

Even in those establishments where the great majority of payments are made by check, it becomes necessary to make many small payments in currency and coin. These small payments may be more effectively controlled if one person is given a small cash fund out of which to make the payments, and if this person is held accountable for the cash or its equivalent, the receipt showing to whom and for what it was paid. Periodically the fund is replenished by a check drawn to the petty cashier, the receipts for past payments being attached to the voucher supporting the check disbursement. In this plan, the receipts will have been subject to the scrutiny of the voucher clerk, the voucher auditor, and the signing officer.

The opportunities for fraud in petty cash disbursements are few and cannot run into large sums. However, a failure to stop small leakages in petty cash may, if left undiscovered, result in demoralization of the employee to such an extent that he will begin wondering if he can collect larger sums without getting caught. The usual shortages in petty cash occur in the ways following:

1. The preparation of false vouchers, the signature of the payee being forged when such a signature is required. Often this fraud is committed by the cashier when he secures illegally the stationery of an outside firm in the habit of collecting small amounts from the firm
2. The changing of dates or amounts or both on petty cash vouchers previously used, and running through a second time
3. The raising of amounts on the bills paid. For example, if the laundry bill is \$4.25, the petty cashier may insert a 1 between the \$ sign and the 4, making the bill read \$14.25, and abstracting the ten dollars.
4. Overfooting of the paid bills when presented to the accounting department for reimbursement.

Inasmuch as no authorization is given before each payment, the petty cashier is in a better position to cover his shortages than is the clerk who prepares checks only after the routine procedure has been followed and proper authorization given. Some safeguard, however, may be obtained if the following suggestions are adhered to:

1. The imprest system of handling petty cash disbursements will not of itself give an automatic check
2. The petty cashier should not be allowed to have access to the filed vouchers

3. Upon reimbursement, each bill or voucher should be marked in some manner so as to prevent its use a second time
4. The vouchers should be closely examined by the voucher auditor before they are sent on for reimbursement. The person auditing these vouchers should be familiar enough with the details of the business to pass on the genuineness of vouchers and the amounts thereon. A rotating of clerks on this job will prevent such vouchers from being taken for granted as correct
5. The internal auditor should count the cash fund at irregular and unannounced periods.

### **Working Funds**

A working fund differs from both a petty cash and regular cash fund. It differs from petty cash in that it may be disbursed either by cash or through check or both. Furthermore, the amount of the working fund is generally much larger than the small petty-cash fund. Where a bank account is used with working funds, such a fund differs from the regular bank account in that it secures a reimbursement from checks drawn on the regular bank account, and has no other source of deposits. Collections from customers or other receipts are not placed in a working fund.

Working funds are found useful in plants and branches where the general office is located some distance from the plant or branch. Such a fund may also be used for a special purpose in the main office such as for pay roll or office salaries.

To effect a safeguard over such checking funds, two signatures should be required, probably the chief clerk's along with the plant cashier's. Also, upon reimbursement at the head office, the voucher presented should be carefully audited. Where the working fund is in cash, the procedure, as stated above with regard to petty cash, should suffice. In any event, the fund should be counted often by some one from the general office.

### **Cash Disbursements by Branches**

A more effective control over disbursements of branches may be secured by having an imprest fund located at the head office city than by permitting the branch cashier to operate a fund in the city in which the branch is located. A procedure for setting up and operating such a control system would involve, first, the establishment for the branch of a petty cash fund of approximately \$150, with

the requirement that all cash received at the branch be deposited, not subject to check by branch officers or employees, and, second, the setting-up of a "Branch Fund" of approximately \$15,000 in a bank in which the general office is located. In the operation of the system, the bank is instructed to honor checks drawn at company branches when properly signed and countersigned up to a maximum amount,—perhaps, \$500. Such checks are drawn only for current operating expenses and small local purchases, the head office taking care of all large payments.

The voucher checks are prepared at the branch in quadruplicate, the original check going to the payee, a copy being retained by the branch for reference, and the two other copies with all supporting data properly approved being sent daily to the home office. The home office runs an adding-machine total for each branch and for each day. A chronological record is made therefrom, and a continuous control on the total disbursements of each branch is built up. One set of copies is then filed in numerical order on post binders—one binder for each branch. These serve as a detailed record against which to compare the paid and cancelled checks when reconciling the Branch Fund bank account. The remaining copy and all supporting data serve as a basis for entry in the account books. These vouchers are audited and then placed on file. The bank is reimbursed by the home office out of its general bank account for the total of the branch fund disbursements each day, so that the fund is at its established amount. The advantages accruing from this procedure are as follows:

1. A small fund in one bank can be made to take care of a large number of disbursements which aggregate a sizable sum
2. Each branch has potentially the whole \$15,000 fund at its command, and yet the branch is closely restricted, audited, and controlled so as to safeguard the fund
3. Audit of all the branch funds can be made, with the exception of small petty-cash funds, simultaneously with other cash, and hence there is less chance of kiting going undiscovered.

### Summary

The general principle which the management through its representative, the auditor, must keep constantly in mind concerning disbursements of cash is that the com-

pany must receive value for each withdrawal of cash. It is not the auditor's function to determine whether the company received full value, but it is his task to observe whether responsible employees of the company have passed on this point. While the business of illegally securing company funds on hand or in banks is more difficult to cover up than other methods of embezzling, enough cases have been cited to show that where a proper system of safeguarding cash disbursements is not in operation, or where the system is not followed up to see whether it is functioning satisfactorily, serious losses may result from improper withdrawal of cash funds.

## CHAPTER VI

### INTERNAL CHECK ON SALES

The problem of controlling and safeguarding company cash has been discussed in the two previous chapters. Methods of obtaining a control over the purchases and sales transactions are yet to be treated. It is the purpose of this chapter to set forth the basic principles involved in the internal audit of those transactions which result in an increase of proprietorship through sales of goods bought, goods manufactured, and services rendered. These principles will be illustrated through a description of the sales routine as it applies to various types of businesses.

#### Possibilities of Fraud and Error in Sales

Many concerns demand the closest sort of control over cash and yet permit lax methods to develop within the selling activities of the business. While it is true that the peculiar characteristics of cash which permits it to drop out of sight easily makes it more susceptible to fraudulent practices than does the theft of goods, the fact remains that should goods be illegally disposed of, the net result is the same: namely, that the concern's net worth has been irregularly decreased. Likewise, where sale transactions are improperly controlled, a large opening is left for honest errors which may not result in a direct loss, although it does cause an indirect loss through a decrease of efficiency and hence additional expense, and often loss in patronage.

Errors in sales often occur from:

1. An improper pricing
2. Errors in extension and footings on invoices
3. A failure to ship all the goods ordered
4. A failure to ship the exact goods ordered
5. A failure to debit the correct customer account and to credit the proper customer for legitimate sales returns and allowances.

The opportunities for fraud in selling activities are few in number if the irregularities occurring from cash sales are eliminated. The following list is indicative:

1. Shipment of goods without authority to a bogus concern controlled by the embezzler or to a confederate, no offsetting charge being recorded
2. Donating merchandise to friends or undercharging them for goods or services bought
3. Padding selling-expense accounts
4. Accepting bribes in the placement of advertising space or in the purchase of advertising materials.

The first of these might occur in a wholesale house or a manufacturing establishment. The second fraud mentioned might obtain in any retail store. The other two are as much frauds in purchasing as they are frauds in selling and should be discovered by the same auditing methods that are used in connection with the purchase of other expenses. Where it is applicable, a perpetual inventory system should be installed to assist in the discovery of frauds in sales through its ever-present statement of what goods should be in stock. As a preventive of fraud and error in sales transactions, a well-organized internal checking routine should be developed and operated.

#### **Organization for Handling Charge Sales**

Legally, a sale is said to have taken place when title has passed, with delivery the chief determinant of this passing of title. From the standpoint of accounting, the time of delivery of shipment of the goods is taken as the date of the sale. The sales routine, however, must go behind delivery and begin with the receiving of an order from a customer, and hence from the viewpoint of the auditor the selling department originates the sales transaction. These orders may reach the sales department directly through the mails from customers, they may be phoned in, or they may be secured by traveling representatives. However, since the selling division does not actually deliver the goods, except possibly in retail stores, there are other departments through which the sales order must pass in order that an internal check on sales may be brought about.

The sales order, if it is to be a charge sale, must first be approved by some one authorized to grant credit. This person may, in a small concern, be the sales manager. It is more likely, though, that a credit department is separately set up to pass on credit sales. These credit sales may be passed on individually as they arise, or the credit manager may have given regular customers a line of credit, but in any event it is the credit manager's

responsibility not to pass sales orders where credit has already been granted to the maximum allowed.

Under the selling division there may be an order department, the chief function of which is to prepare such papers as will serve as an authorization for the release of goods for shipment. Incidentally, this department prepares and sends notifications to customers that their orders have been accepted, and it also initiates papers to be used for accounting for the sale and the collection of the records of the sale.

The stores department or the production department, as the case may be, upon proper authorization, delivers the goods to the shipping department for boxing, wrapping, and shipment.

It is in the shipping department that fraud may occur through unauthorized deliveries of goods. If there is in existence a separate stores or warehouse department distinct from the shipping room, there is little chance for unauthorized shipments unless collusion exists between employees of these two divisions of the business. No goods are delivered to the shipping department without an order from the sales department. This procedure is based on the assumption, however, that no goods will be delivered to the shipping department without an order from the sales department, and further that no goods will be shipped by the shipping department, even though delivered to it by the stores clerk, unless an order to ship has been received from the order division of the selling department.

Where the concern is small, with the stores and shipping departments combined, an internal check over goods sent from the concern may be secured by placing an employee, a gateman, at the place where goods are taken from the company warehouse or factory and placed either in trucks or railroad cars for delivery to customers. This gateman will keep a detailed list of all goods going out of the factory and the names of the concerns to whom such goods are being sent. This list will be sent to the accounting or auditing departments daily and will serve as a check against the customers' invoices issued during the day's operations. By this check, no goods will leave the factory without having been charged to customers.

The accounting department will function in the routine to the extent of actually billing the shipment and keeping proper records of the sales and charges to customers.

The question that arises in the mind of the person reviewing the accounting and internal checking system is,

are the duties as listed above being carried out separately and independently or is there overlapping of one department over another? The most carefully planned system is valueless unless it is being followed as planned. To be assured that the functions of each department are being separately performed, the internal auditor should investigate the routine periodically.

### **Internal Paper Work**

The basis of accountability for sales working through the principle of charge and discharge is effected through the use of checkable evidence. Hence when the stores clerk delivers goods to the shipping department, there should be some paper prepared which when signed relieves the stores clerk of his responsibility for the goods delivered. Likewise, the order clerk must have the written sanction of the credit manager before he is willing to order the release of goods. To carry out the routine involved in the acceptance of an order and the shipment of goods to buyers, it would be possible for each party involved in the procedure to prepare, have signed, and keep a paper which would show his individual discharge from responsibility. Such a procedure, however, would be inefficient and uneconomical in view of the fact that all such papers can be prepared in one or two strokes by a typist. To obviate this inefficiency, there have been devised two systems of preparing checkable evidence which will keep a record of the order as it passes through the successive stages of approval, filling, packing, shipping, billing, and accounting.

The first of these methods provides for the preparation of the sales order and the invoice billing at one typing. This method is considered satisfactory in those concerns where a few standard articles are sold and where the price is not subject to much fluctuation and does not therefore require much clerical work in the pricing and extending of invoices. This type of paper work is particularly applicable in some manufacturing concerns.

The second of these methods provides for the preparation of the sales order, followed by the billing of the goods after the work of the stores and shipping departments has been consummated. Such a scheme is effective in a manufacturing concern that produces on the job-order basis, where obviously the date of shipment is some time removed from the date of receipt of the order. It is also used by wholesale houses, in which the goods



must be assembled and combined for invoicing. In such circumstances often the articles ordered are not on hand and hence the preparation of back orders is necessitated. These two general methods are discussed and illustrated in the two sections following.

### **Sales Routine in a Manufacturing Establishment**

It may be assumed for purposes of illustration that the sales routine for a factory producing and selling shoes with sales of approximately ten million a year is being planned.

When an order is received from a customer, it is examined by the sales department as to quantities, quality of goods, prices, and terms. Next it is sent to the credit department for approval, and then returned to the order division of the selling department, where a serial number is given it.

The next step is the preparation of the order-invoice copies. Some concerns prepare three, others four, and still others may prepare as many as nine copies. The number of copies prepared is immaterial as long as the results desired are obtained. For this discussion five copies have been considered sufficient to be used, the function of each being as follows:

**First Copy.** The original, to serve as the sales invoice after the other procedure has been completed.

**Second Copy.** Duplicate invoice, to be held on file until completion of the order procedure and then sent along with the original to the billing division; later to go to the accounting department and there serve as the sales record.

**Third Copy.** Customer's copy, to be sent to the customer upon acceptance of his order and to serve as an acknowledgment of the acceptance.

**Fourth Copy.** Storeroom copy, to authorize the stores clerk to assemble the order and pack for shipping.

**Fifth Copy.** Shipping department copy, to be routed to the shipping room clerk and to authorize the shipping room clerk to make shipment.

In the preparation of these five order-invoices, the same serial number is shown on all of them to permit of a cross reference in tracing. Each copy is uniform in content as to the following items:

1. The order number and date
2. Customer's name
3. Name of salesman or if otherwise received, how received
4. How shipped
5. Date shipped

6. Quantity billed
7. Description of items to be shipped.

In one section of the copies is a place to show the separate information required. For example:

1. The sales invoice and the acknowledgment of the order will show the selling terms

SALES DEPARTMENT	CREDIT DEPARTMENT	STORES DEPARTMENT	TRAFFIC DEPARTMENT	SHIPPING DEPARTMENT	ACCOUNTING BILLING DIV.	DEPARTMENT RECORDING
Order received from customer or salesman, sent to _____	For terms, approval, etc.; returned to _____					
Order Division						
where five or more order-invoices blanks are prepared without prices as follows: 1) Sales invoice—held for completion of order procedure, then goes to _____ 2) Duplicate invoice 3) Acknowledgement copy—sent direct to customer 4) Store-room copy—sent to packing room where _____		goods are prepared for shipment, the goods going to _____				
5) Shipping-room copy goes first to _____		the copy to _____	where routing is determined, bill of prepared, then to _____	Goods are loaded, the car number and date of shipment being inserted on copy and returned to _____		where proper credit is made on inventory record
where price and extensions placed on copy #6 and sent along with copies #1 and #2 to _____					For billing #1 to customer #2 to _____ #5 returned to _____	bookkeeping department and serves as sales record
where it is placed in filled order file.						

FORM NO. 4—Showing Interrelations of Departments to Effect Internal Check on Sales

2. The duplicate sales invoice will leave space for the initials of those persons who passed on the credit, did the billing, and did the posting
3. The shipping copy will have space for the initials of those routing and shipping

4. The storeroom or packing copy will have spaces into which will be shown the initials of those clerks who assembled the goods, checked the assembling, packed the goods, and priced and extended the amounts.

The prices and extensions are placed on the sales invoice and duplicate invoice copies and the packing copy, but not on the other two. The storeroom copy is forwarded to the inventory section of the accounting department, where the perpetual inventory records are credited for issues. It is then returned to the order division for filing and future reference. Form No. 4 gives a graphic picture of the routine and tie-up of the various departments which assist in securing an internal check on sales transactions in a manufacturing concern.

#### **Routine in a Wholesale Concern**

As an illustration of the internal paper routine where the other procedure is separated from the billing procedure, the case of a jobbing concern with approximately two and one-half million dollars of sales annually, may be used to see how it differs from the combination order-billing routine as described above.

When an order is received in the office it is sent immediately to an order register clerk, who enters it on a register with spaces showing the date the order was received, the order number, the name of the customer, and the terms of sale. The date the order is filled and shipped is placed in the register subsequently. This registration is of advantage as a prevention against the loss of customer orders and also serves as a check on their movement through the warehouse and shipping department.

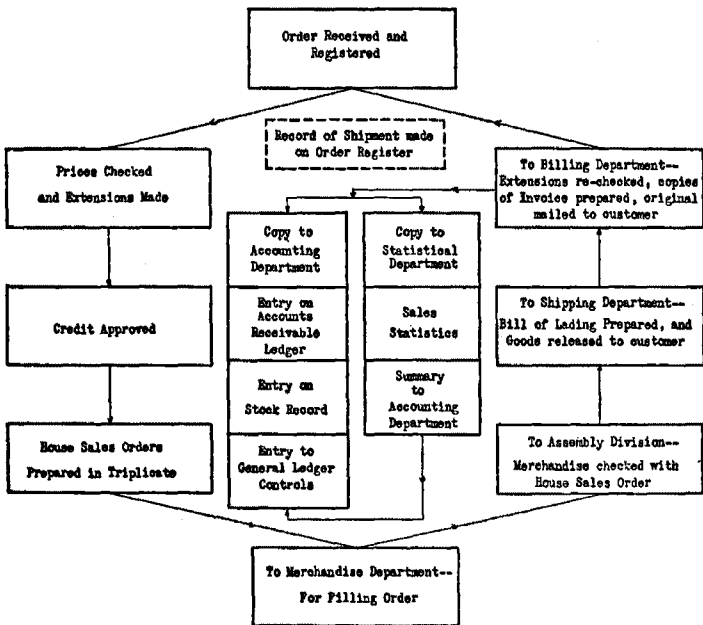
After the order is registered it is sent to the credit department for approval, unless it be for cash. Even C. O. D. sales should secure the approval of the credit manager, because of the possibility of loss should the shipment be refused. If the credit manager disapproves of the order, such a notation is made on the order register.

All orders, irrespective of how secured, should next be checked as to price. They may be checked by the sales manager, either general or territorial, or by a responsible price clerk. If there are any price differences between the salesman's order and the company price record, then these differences must be adjusted by telephone or telegraph before the house order is prepared.

Assuming the order is accepted, the next step is the preparation of the house sales-order blank, which may be

prepared in as many copies as are needed, the three essential ones being:

1. The original, to be used for authority to assemble and ship the goods,
2. The duplicate, to be sent to the customer as an acknowledgment that his order has been accepted and will be shipped as per his instructions, and
3. The triplicate, to be retained in the file for follow-up purposes.



FORM No. 5—Chart Showing Order and Billing Routine in a Wholesale Concern

The original is then sent to the stock room where the items mentioned are "picked" and "laid-out" for packing. The original may be used as a work sheet to accompany the order as it is being prepared in the various merchandising sections or slips for each department may be prepared, the original being sent to the assembly division of the shipping department against which the articles assembled are to be checked. Here a packing ticket showing the initials of the persons assembling and checking the assembling is prepared in duplicate, one copy being placed in the shipment, the other to accompany the bill of lading, which is next pre-

pared, the bill of lading and the original house order going to the billing division. The goods are then loaded and sent to the customer.

With these documentary evidences before him, the billing clerk then prepares the sales invoice, also in triplicate, the original going to the customer, a copy to the accounting department, and the other copy to the sales department for entry in the order register and for compiling sales statistical information. The accounting department posts to the subsidiary receivable and inventory accounts daily, while the statistical division at the end of the month sends the summarized sales data to the accounting department for posting to the controlling accounts. The internal auditor should see to it periodically that the controls reconcile with the detail records.

Form No. 5 is a simple diagram showing the routine of the order and the billing of sales transactions in a wholesale house.

### **Back-Order Sales Routine**

A back-order arises when it is discovered that goods ordered by a customer are not in stock. The routine for controlling back orders in a small wholesale company is relatively simple. In such a concern the combination packing-shipment clerk discovers the item or items to be out of stock and notes on an ordinary day book the name of the concern and the items out, and promptly notifies the purchasing department. When the goods are received the packing clerk prepares the back ordered goods for shipment, asks that an invoice be prepared and marks the items on the day book "shipped." While this procedure may be satisfactory enough in a small company it is, of course, unreliable in a large wholesale house.

Perhaps a better procedure would require that when the packing clerk upon assembling the goods for shipment finds that certain goods are out of stock, prepares an "out-slip" showing the name of the customer and the commodity short. This "out-slip" is sent to the buyer who in turn orders the merchandise at the same time notifying the customer of his action. The clerk filling the order marks on the packing copy form the items as back ordered and returns it to the order department. The partly filled order is of course sent through for billing. The "out-slips" are filed either alphabetically or according to the commodity, the latter method being more satisfactory. When the goods and checked invoice are received from the vendor, the buyer checks his "out-slip" file for items received, and sends the

slip, properly noted as to instructions, to the order department. A new set of order forms is prepared and run through. This procedure succeeds in assuring the filling of back orders with the least possible delay.

### **Sales Returns and Allowances**

Where goods are returned because of defects, improper shipments or for other reasons, the receiving department sends up a notice that such goods have been received, and asks for advice. Such returns are first to be approved by the sales manager, and then the billing clerk is authorized to prepare a credit memorandum in triplicate, one copy going to the customer, another copy going to the accounting department for credit to the customer and as a debit to the stock account, and the other copy going to the statistical department. In a like manner, allowances must be approved by the sales manager before credit is given the customer.

### **Large Retail Store Procedure**

The basis of an internal audit of sales in a retail store is the sales books, which are controlled by the sales-audit section working under the controller. These books are numbered serially, and every slip in each book is also numbered serially, in order to permit a reconciling of all sales slips with the sales book and a tracing of all missing slips. The first step in the procedure then is for all sales books to be received from the printer by the sales-audit section. These books are next passed out daily to the various departments handling sales transactions as follows:

1. To selling departments proper,
2. To returned sales and adjustment department,
3. To cashier, if he is permitted to receive cash on account from customers,
4. To those permitted to handle advance sales, usually section managers.

In addition to these sale slips, if the policy of the store permits goods to be taken out on approval, the sales-audit section passes special slips on which memorandum sales transactions may be reported.

In the selling departments it may be assumed that central cashiers are conveniently located so as to prevent delay to customers. These cashiers may be located in booths built up above and around the selling departments so that after the sale is made and the sales ticket prepared the merchandise and tickets may be passed up to the wrapper and cashier, respectively. If the sale is for cash, the cash is

rung up on a cash register, the slips are marked paid, and one copy is given to the wrapper to place in the package wrapped while the other is placed in a slot especially prepared to receive such slips. Should the sale be on account, then the cashier places the slip in a telephone connected with the credit department. The cashier states over the telephone the name and address of the customer, and the sales ticket is stamped by the credit department through a device which operates in the instrument. This ticket is placed in a separate compartment from the cash tickets, and the customer's copy is passed over to the wrapper to go along with the goods sold. Should a negative reply be printed on the sales slip by the credit department, then the customer is politely asked to step up to the credit department for confirmation of the sale, the sales department meanwhile holding the article.

At the end of the day's business, the cashier prepares a total of all sale slips separated as between charge and cash and these are forwarded to the audit section. Likewise, all sales books used during the day are collected in the audit section. A clerk from this section reads the amounts on the cash registers as a check against the amount of cash as reported received by the head cashier.

The stage is now set for a tie-up of the sales transactions. The sales slips turned in are first separated to see that none are missing, and second, to see that the totals agree with the clerk's tally. The cash slips are then reassembled and totalled, this time according to cashiers. This total of the cash sale slips is then checked against the cashier's daily summary reports and, if a cash register is used, against the register total. When this routine is followed, the audit section is in a position to keep track of all cash receipts and charge sales, thus making fraud difficult even when collusion exists. Likewise, unintentional errors in sales may be located and corrected within twenty-four hours after the error is made.

The audit section also maintains a control over C. O. D. sales and advance sales collections in the same manner. Its procedure here is to check the C. O. D. sales against reports of money collected and packages returned. Transactions arising through the adjustment department, including returned sales and allowances, should also come under the scrutiny and verification of the sales-audit section.

### **Room Sales in a Hotel**

The method of controlling and auditing room sales in the American transient hotels operated on the European plan

is uniform enough to justify a short description of the procedure as it applies to a 500-room hotel.

The sales transaction begins with the arrival and registration of the guest, the register serving as the original record. The register is to the hotel what the sales ticket is to the retail store. The form of the register for audit purposes is immaterial, although for administrative purposes the individual register card serially numbered is superior to either the bound-book register or the sheet register. As the card is filled out by the guest, it is passed over to a typist, who types off on the proper form the original and a copy of a guest account, and at the same operation prints a card for the room rack. The guest account as typed will show the guest's name and address, room number, room rate, and date of arrival. This account sheet then goes to the bill clerk, who, by means of vouchers from other sections of the hotel collects charges for meals, valet service, telephone, and telegraph to be posted to it.

The rates as placed on the account by the bill clerk for the room should be the amount which the management has fixed for the room and should be varied only when there is good reason sanctioned by the assistant manager or managers. Some of the reasons which will necessitate a variation from the room-rate schedule are as follows:

1. Guest may change rooms during his stay, thus requiring the preparation of a room-rate change slip
2. Guest may remain only during the day, and hence take the day rate
3. Special rates may be given to celebrities, such as movie actresses, internationally known athletes and others, the difference being charged as advertising
4. Complimentary rooms are often allowed to visiting proprietors or managers of other hotels.

If the case requires the giving of special or complimentary rates, it should be handled as a regular sale transaction, the correction being made by the issuance of an allowance memorandum signed by the proper authority.

Late in the evening—about midnight—a clerk prepares from the list of guests on the room rack a sheet on which is printed each room number with space left for recording the number of persons occupying the room and the rate for each room. This is known as the room-count sheet, usually prepared one sheet for each floor, and serves when totaled and summarized as the basis for entering the total sales for the day.

As this room-count is liable to have included errors,



the night clerk should check it by comparing all registrations, changes, and departures with the room rack, to be assured that no occupied rooms were left off and that no rooms are included as occupied when the guests have departed.

The night auditor may secure a better check by comparing the room rack with the guests' open accounts, which should be in agreement, or he may compare the room-count sheet with the guest ledger.

A further check on room sales is secured from the housekeeper's report, which is a report prepared each morning of all rooms occupied the night before. This report goes directly to the controller.

In the morning, the front office sends to the controller the transcript sheet, closed guest-accounts cards, list of accounts placed on new cards, cash-receipts sheet, and summary of cash receipts and disbursements. The list of cash register readings prepared by the night auditor is sent to the controller, as well as the housekeeper's report. With this information at hand, the controller is prepared to make the daily deliberate audit of sales. This he will do as follows:

1. See that the first register-card number of today's business is the one following the last card of yesterday's business
2. Check all arrivals from the card register to the room-count sheet to assure himself that each guest has been charged
3. The departures should be checked off on the room-count sheet
4. Compare the room-count sheet with the housekeeper's report to be assured that no rooms were omitted from the records when such rooms were actually occupied
5. Report any discrepancies to the manager or assistant manager as soon as possible in order that the front office records may be cleared
6. Prepare a daily tie-up of sales as follows:

Amount of Room Sales for Previous Day	XXX
Plus:	
New Arrivals during day (amount)	XXX
Changes during day (amount)	XXX
Total	<u>XXX</u>

Less:

Departures during day (amount)	XXX	
Changes during day (amount)		
(reductions)	<u>XXX</u>	<u>XXX</u>
Difference being amount of room sales		
for the day		<u><u>XXX</u></u>

### Restaurant and Dining Room Sales

Probably no business in the past has been so full of petty thievery as have the food-sale concerns. The class of people, mainly transients, were employed and, in the absence of proper internal checks, small frauds which often amounted over a period of time to large figures were very prevalent. In the last fifteen or twenty years this condition in the larger and better establishments has been controlled through the hiring of a better grade of personnel and the inclusion of checking systems. There are a number of different checking systems in operation, differing in some details, but having the following characteristics in common:

1. Consecutively numbered sales checks are used by the waiters on which to record customer sales. These are sent to the checker by the controller, the checker passing them out to the waiters in lots of twenty-five or more as they come on duty. Each waiter is required to sign for the checks in the "waiters' signature book"
2. The presence of a food checker who is stationed between the kitchen and dining room, whose duties are to examine all dishes, stamp the guest check, and maintain an independent record of sales. This record may be secured by the use of a cash register. Often a machine is used which will stamp the amount of the charge on the guest check simultaneously with the registering on the machine
3. The use of a cashier who receives all waiters' checks and if cash is received rings up the amount on a cash register. Charge sales are separately listed and sent immediately to the bill clerk in the front office for posting to the guest's account. All waiter checks are listed on sheets prepared to record the number of each waiter, the sales-check number and are distributed as to food, beverages, and the like. If the sale is to be charged, the name and room number of the guest are placed on the sheet

4. An auditor is employed to:
  - a. Account for all waiters' checks issued and returned
  - b. Check the sales as shown by the food checkers record against the waiters' checks as recorded on the cashier's sheet
  - c. Check all charges against the guests' accounts
  - d. Ascertain whether cash as shown by cash-sale slips has been turned over to the head cashier for deposit.

#### Sales in a Public Utility

As an illustration of the internal checking procedure on income in a utility, the case of a natural gas operating company in a community with a population of about 75,000 may be considered. The income of such a concern is derived mainly from three sources:

1. Sale of natural gas,
2. Sale of appliances, and
3. Service revenue.

The bulk of the income is secured from gas sales, the other two sources being incidental, but essential. The gas is purchased wholesale at the city limits, where it is metered as it comes into the mains of the city. It is also metered out to consumers, the difference being the leakage. The meters located on the consumers' premises are read monthly, the reading becoming the basis for the sale transaction. The city is divided into forty-two zones, requiring the services of seven men who do nothing but read these meters. The men are routed in such a way that one reader does not read meters in the same zone on successive months, the placing of readers being at the discretion of the chief accountant.

Zone books are prepared in the office and are passed out to the readers each morning as they come to work. They must also be returned to the office each night as the readers report in. A separate meter sheet is prepared for each consumer, to be used for two fiscal years, and showing the following information:

1. Name and address of consumer
2. Location on premises of meter
3. Meter number, size, date set and date removed
4. Deposit made on meter, if any
5. Date read and reader's number
6. Number of cubic feet shown on meter register
7. Consumption each month.

The data shown are filled in by the readers, with the exception of the consumption, which is calculated by a clerk in the accounting department. As the computation of consumption is completed on each zone book, it is passed to another clerk, who totals the consumption and applies the rate, the resulting figure going to the chief accountant to serve as a predetermined figure against which to check the accuracy of the billing.

The zone books are next passed over to the billing clerk, whose machine is so arranged as to collect fifteen different sets of totals, the usual totals required being: previous month's billings, merchandise sales, service charges, gas consumed both in quantities and amounts, and miscellaneous charges. After the billings are completed and the summary figures secured, they are passed to the chief accountant for checking against the controls. As each zone's billings are balanced they are placed in the mail.

Service income such as that coming from repairs and installations is controlled by having a clerk prepare a work order, two copies of which go to the shop superintendent. The superintendent issues a mechanic's order, which is returned to the superintendent when the work is completed. The superintendent then fills out a copy of the work order showing the time spent on the job and sends it to the accounting office. Here the amount of charge is computed and billed along with the gas consumed, the chief accountant keeping a control over total service charges. Periodically, the accountant should check the completed orders as received against the copy left in the work-order clerk's book, to determine whether all work orders issued have been completed and charged.

### Summary

From the foregoing discussion of sales procedure, it may be seen that while the various elements of any particular case are different from other cases requiring individual consideration and solution, it has been found that the fundamental principles of internal check on sales are the same. These summarized are:

1. The system must provide for a routine which will permit of a record to be made promptly of every transaction involving a sale
2. The same person must not be permitted to deliver the goods sold, receive the cash, and make the record
3. The routine should be so organized that each employee having a part in it will initial or sign the

accompanying data so as to place responsibility and determine accountability

4. There should be a definite separation of the work of the credit department and the accounting department
5. Registering machines should be used wherever the work permits. However, it must be remembered that such machines will not without further assistance provide an adequate check
6. Wherever adaptable, a perpetual inventory should be made a part of the system
7. Returned sales and allowances, and bad debts written off should not be passed unless approved by an executive
8. Wherever advisable, daily reconciliations must be provided by a clerk having no part in the transaction or by an internal auditor.

## CHAPTER VII

### INTERNAL CHECK ON COMMODITY PURCHASES AND EXPENSES

#### **Purchasing and Internal Check**

Many articles and several books have been written on the subject of buying procedure and the subsequent control of goods bought. Much of this writing has been duplication, but a great deal has been the result of direct researches into actual cases. Perhaps the mere mechanism of purchasing has been overemphasized. Undoubtedly, many systems entirely unsuited to the particular needs, have been incorporated in business concerns. It must, however, be true that some sort of purchase procedure is essential and workable. It is also true that the fundamentals underlying the placing of buying orders, the receiving of goods, and the approving of invoices are the same in practically all concerns. But no system, however successful it may be in one concern, can be placed in operation in another organization without due regard to the size and personnel of the organization, the nature of the business, and the methods peculiar to that line of trade. It is not the purpose of this chapter or any of the previous or subsequent chapters to set up a standardized system or routine which must be followed to the letter of the law. This discussion, however, does have as its aim the statement and description of such methods as have been successful under some circumstances, such circumstances not always stated in detail, and to discuss critically some typical procedures which may be adapted to most enterprises after the requisite modifications have been effected.

A system which provides good purchase procedure is pretty likely to give a good internal check on purchases, and wherever such procedure does not permit the development of internal check methods, the purchase procedure is probably highly undesirable. This correlation is true because purchasing routines have been developed consciously with the idea of control over goods bought, together with the least amount of confusion, expense, and error.

#### **Development of the Purchasing Function**

The corner merchant who does his own ordering, receiving, selling, and accounting is not concerned with internal

checking systems, inasmuch as all the steps carried out by such a system are performed by him personally. It is only as his business grows that he is obliged to relinquish some of the duties which he formerly performed. As the concern grows larger and larger and as it becomes increasingly necessary that the purchasing transactions be carried out by employees to whom the authority of purchasing and receiving goods has been delegated, the routine must provide for some means whereby responsibility for this creation of the company liabilities is secured and can be traced. With the development of purchasing as a delegated function, there arises a corresponding need for internal check.

### **Types of Purchases and the Purchasing Agent**

The kinds of things bought which result in the creation of liabilities to the company purchasing and subsequently the payment of company cash are:

1. Finished goods for sale
2. Raw materials for fabrication
3. Supplies for use
4. Services necessary to carry on operations
5. Fixed assets.

While it is true that a purchase involves a contractual relation in which the company through its delegated authority is one of the parties, it does not follow that in the present-day corporation the same person will act for the company in each of the above purchase transactions. Wherever it is convenient, as much of the purchasing activity as possible should be vested in the purchasing agent, and in any event the first three types of purchases listed above should be handled through this department. The principal function of the purchasing agent is to place orders at the most advantageous price and terms for goods that he has been requested to buy. His department is seldom, if ever, the starting point of a purchase transaction, as most of the demands for materials and supplies originate in other departments.

### **Steps in the Purchase Routine**

The steps usually found in the purchasing routine through the correlation of which an internal check on purchases may be secured are:

1. Preparation and receipt of the purchase requisition
2. The work incident to and the actual placing of the purchase order

3. The receipt of the goods ordered
4. The approval of the invoice for payment.

If these four steps are indifferently controlled, or if one person is allowed both to place orders and to receive goods, there is a good chance for fraud and error to creep in. If however, each part of the procedure is so separated that different employees are carrying out the various steps, then in the absence of collusion an internal audit of purchases may be said to be in operation.

The first step will not be universally followed inasmuch as some concerns, such as hotels and retail stores in which the department head is the buyer, may not find it practical to route each request for purchase through a central purchasing department. It is not practical for instance, in a hotel, where a steward must buy in the morning for delivery perhaps before noon, in which case the issuance of a "request to purchase" and a subsequent formal purchase order would be just so much red tape. True, such a procedure would give a more effective check, but the exigencies of the case make this routine impractical. In many retail stores where buyers are sent to a local market or abroad to buy, and where style, personal buying power, and quality of merchandise are such large factors, the preparation of a request to purchase is out of the question. In the wholesale and manufacturing concern this first step is essential and salutary. The other three steps should obtain in any business, whether it be a utility or a hotel, a producer of finished goods or a retailer of merchandise.

Even in those concerns wherein the use of the purchase requisition is not considered worth while, a memorandum sheet to be used as a confirmation of the purchase can be prepared, which sheet will for all intent and purpose of internal check give the same results as a purchase requisition. These several steps are first discussed after which their application to a number of different types of concerns is developed.

### **The Purchase Requisition**

Actually the request to purchase is more in the nature of a reminder to purchase than a demand that the goods be bought, and has little to do with internal check other than to designate the person or department originally responsible for the purchase. Its main reason for being is that it helps systematize the purchase procedure in providing a convenient means for formally notifying the office as to the needs of the respective department heads and for following up the goods until they are received. It has a greater use



in a manufacturing business than in the wholesale and retail establishments, where the majority of demands for goods originate in the buyers' departments.

The purchase requisition, when used, should be made out in duplicate and often in triplicate, showing the following information:

1. Description of items wanted
2. Quantity and quality of commodities desired
3. Names, probably suppliers, and estimated cost
4. Date goods are required
5. Reason for order, or use to which goods will be put.

If three copies are prepared, the original and first copy will go to the purchasing agent. The second copy will be retained for tracing purposes in the department originating the request. After the goods have been ordered, the copy of the requisition sent to the purchasing agent is returned to the requester, the copy retained in the originating department then being destroyed as of no further value.

The request should originate outside of the purchasing department. If the store's record is kept in the cost division, then the request will come from the store ledger clerk in this division when he finds that his stock has gone below the minimum required to be kept on hand. Requisition for equipment and special materials will come from the departments requiring these articles. Wherever a cost clerk is not employed, the factory superintendent or the department foreman may issue requests for goods not generally carried in stock. At any event, the purchase request should be in writing and should be prepared by some one not in the purchasing department proper.

### **The Purchase Order**

That plan which provides for a central purchasing division and a uniform routine for routing and following up purchase orders in the office so that responsibility for each invoice may be obtained is what is generally known as the purchase-order system. The purchase and receipt of goods is an operating function which must be controlled in order that error and fraud will not enter into the procedure. Purchases handled through the purchase-order system can be checked and approved for payment by a separately functioning department more readily than purchases handled by any other method.

The system begins with the preparation of the order and consists of a set of copies, the exact number depending upon the size of the concern, the type of organization, and the

methods pursued. These order forms are made out on some manifolding device. At least three copies are required, and some concerns prefer as many as five. The routine diagrammed in Illustration No. 6 shows five copies, to be used as follows:

1. The original purchase order—becomes the vendor's copy authorizing the shipment
2. Duplicate—to be kept in the buyer's office and filled numerically thus making a permanent purchase-order file
3. Triplicate—placed alphabetically in an unfilled follow-up file pending the receipt of the goods and the invoice
4. Receiving copy—sent to the receiving department to be filed pending the receipt of the goods and as the receiving department's authority to accept the goods when they are received
5. Store division copy—sent to the inventory clerk in the cost division who records on his "Balance of Stores" ledger cards that the goods have been ordered.

Other copies may be prepared if desired, such as an additional copy to the vendor, who, upon accepting the order and filling in the price thereon, returns the order as an acknowledgment of the acceptance. This copy may go to the invoice clerk to be used as a check of prices against the regular incoming invoice. An extra copy may be sent to the accounting department to be checked against the invoice, and then to be filed in a tickler according to the probable due date for convenience in checking the cash-discount dates.

In the case of a dining room or restaurant of a hotel, it is impractical to issue purchase orders. Here the steward should make a list of all telephone orders in duplicate, a copy going to the receiving clerk as a check against the goods delivered. While this method of purchasing is open to certain abuses, if deliberate audits are made often by the restaurant manager as to prices and by the auditor as to quantities and food costs, there is little likelihood of the steward's stealing for a very long period of time.

### **Fraud in Purchasing**

There are three places in the purchase routine where fraud may enter. These are:

1. In the purchasing department
2. In the receiving department
3. In the accounting department.

Cost Division, or prepared by department heads. Three copies prepared as follows:

- 1) Original
- 2) Copy
- 3) Copy kept by requestor for tracing. Destroyed when the second copy is returned.

Puts purchasing machinery to work.  
Purchasing agent may secure bids, determine vendor and place the purchase order preparing the following:

Purchase Order

- 1) 1st copy to vendor
- 2) Duplicate kept in a permanent numerical order file
- 3) Duplicate kept in follow-up file alphabetically
- 4) Copy to receiving department
- 5) Copy to Cost Division

Filed alphabetically to await receipt of goods

To record on "Balance of Stores" sheet in "Orders" Column

Vendor ships goods. Vendor sends invoice; is received by incoming mail division, where invoice is stamped, registered, and sent to

Goods Received

- A) Goods checked in
- B) Clerk puts quantity and quality of goods received on copy of purchase order
- C) Prepares receiving report copies as follows:

- 1) Copy to
  - 2) Copy to
  - 3) Copy retained and filed according to receiving report number
- Goods placed in bins with record made on bin cards. Initial both receiving report copies; send 1st copy to

where receiving report is checked against original purchase order and vendor's invoice this date then sent to

send 2nd copy to

For entry in "Balance of Stores Ledger" in "Received" column, then to

A) Where Voucher Auditor

- 1) Compares purchase order against requisition
- 2) Compares original report with copy secured from stores and receiving departments
- 3) Compares quantities on original receiving report with invoice
- 4) Verifies footings, extensions and discounts
- 5) Sees that all spaces on invoice have been filled out
- B) Voucher Clerk prepares formal Voucher Check
- C) Entered in Voucher Register
- D) Sent to

Who makes a general review of all

If it be assumed that an internal checking arrangement is properly functioning with definite responsibility for ordering, receiving, and approving goods, then there is only one way in which the purchasing agent or employees of the purchasing department can defraud the company, and this is through receiving of bribes. These bribes may be of several types and may be received in a number of different ways, but almost invariably they come about through the purchasing from one concern at prices or terms less beneficial to the purchasing company than could be secured elsewhere.

As a deterrent against this type of fraud, competitive bids may be of some assistance. To prevent competitive bidding from becoming a useless gesture, the following safeguards should be observed:

1. One responsible person should send out the requests for bids
2. All bids should be required to be written and sealed, and when opened they should be tabulated by a different person from the one sending them out
3. All bids received should be kept, and at least the list of bids should be attached to the voucher. If the lowest bid failed to get the business, then ample reasons should be given for the bid accepted

Wherever it is the policy of the concern to permit the receiving report to go directly to the purchasing agent, the purchasing agent may with the use of a dummy company prepare fictitious receiving reports, forge the receiving clerk's initials, and pass the invoice through for payment. A slight variation of this method of fraud would come about where the purchasing agent would have his dummy concern actually ship a few articles. The agent would then prepare an invoice for a large number of units, change the receiving report over the receiving clerk's initials to agree with the invoiced units, and run it through for payment. This type of fraud will be prevented if the receiving report is routed directly to the accounting department, where it will be checked against the vendor's invoice before it is passed to the purchasing agent.

Fraud in the receiving department might be caused from bribing the receiving clerk to accept inferior materials in place of those desired. This fraud, however, is not likely to take place if a separate storeroom is maintained or if the production department definitely ordered

materials of a certain quality required for certain definite productive orders. In some department stores a representative from the department ordering passes on the quality of the goods bought, at the same time that they are checked-in by the receiving clerk.

Diversion of assets by the receiving clerk is not an unknown method of embezzlement. It is more likely to occur when the receiving clerk is aware that no check is made of his receiving report or wherever the invoice is sent directly to the receiving department. Under the latter circumstance, in the absence of a separate storeroom clerk he may mark the invoice O. K., send part of the goods into the storeroom, and take the remainder for himself.

In a large metropolitan hotel, the receiving clerk kept his brother-in-law's butcher shop supplied with beef, ham, etc., until the food cost accounting system showed a leakage to be evident. Failing to find discrepancies in the records the management employed a detective to watch the receiving room. Had there been no food-control system, the brother-in-law's butcher shop might still be doing a low-cost business. This speculation would probably have been discovered earlier had there been a separation of the duties of storekeeper and the receiving clerk.

Fraud in connection with purchase invoices in the accounting department where the voucher and often the check is prepared has been discussed in connection with cash disbursements, Chapter V, above.

### **The Receiving Department**

The purpose of the receiving department is to receive merchandise and supplies purchased and distribute them to the proper division of the business, and to handle in a like manner the goods returned by customers. The duties of the receiving clerk are to receive shipments; to unpack and check contents; to deliver them to the storeroom or department requiring the goods received; to keep receiving records; and to report to the accounting department and purchasing department the number of items received, the condition of the shipment, and the quality of the goods received.

The receiving department should be separated from the shipping department for obvious reasons. If the concern is not large enough to support two separate departments, then different employees should be assigned to the functions of receiving and shipping.

It is seldom possible in the mercantile business to have a receiving clerk who is familiar enough with the different grades of many kinds of goods to pass on quality and damage. This inspection is more of a merchandising function than a checking function. In the manufacturing business, the production department should inspect the raw materials purchased, to prevent the acceptance of inferior materials. A further check on poor quality materials bought may be secured from an inspection of the finished product. Likewise, complaints from dissatisfied customers as to the quality of finished goods would lead the production department to check up on the raw materials bought and hence would result in detecting the bribery or inefficiency of the receiving clerk.

#### **Routine in the Receiving Department**

The receiving clerk has on file a copy of the purchase order for each shipment anticipated. With the exception of the goods returned by customers, he should not accept goods unless he has on hand a copy of the related purchase order. Such unauthorized packages invariably result in confusion where the regular routine has not been followed, and to prevent the recurrence, the proper official should be notified that shipments of this type are coming to the receiving department in order that he may take steps to stop this unauthorized practice.

Upon the vendor's delivery of the goods, the receiving clerk signs a receipt for them to the transportation company. His next step is to inspect the package and note whether it is in good order. He then makes notations on his receiving record, which may be a bound register book or a copy of the purchase order. The three usual methods of checking-in goods are:

1. Checking against the invoice
2. Complete blind check
3. Partial blind check.

Checking against the invoice is the method used in many small concerns. It has the advantage of saving time, because it is easier to identify the articles as listed on the invoice. Furthermore, if there are discrepancies, they can be located and reported immediately. There are, however, certain distinct advantages which probably outweigh the advantages of this method. These are that the checking may be done haphazardly and carelessly. An indifferent receiving clerk may make only a partial count

or no count at all. Also, the invoices sent to this department are often mislaid or lost, with consequent confusion, clogging of the receiving room, and often loss of discounts.

The complete blind check is the system employed when the receiving clerk secures a copy of the purchase order with no information other than the name of the concern, the order number, and the date when shipment may be expected. It does not show what articles are expected in the shipment or the number of units. Upon receipt of goods the receiving clerk lists the article, its description (as best he can give it), and the number of units received, on the purchase order copy or on a separate receiving slip. This receiving report is later checked against the invoice in the accounting office or the purchasing department. This method is seldom used, because of the uneconomical aspect of having the clerks unfamiliar with what they are looking for. It consumes too much time, and the purpose of it is often defeated through the placing by many shippers of a copy of the contents fully described in the shipment.

The partial blind check is a combination of the two methods described to the extent that the good features of both are included without the disadvantages of either. The itemized copy of the purchase order with quantities omitted is sent to the receiving clerk. He makes the count blind and fills in the quantities on the purchase order copy. The purchase order filled in by the receiving clerk is then passed on to be subsequently checked against the invoice received from the vender.

Often a special receiving report is prepared in triplicate, two copies going along with the materials to the storeroom or the production department, the third being retained in the receiving department. Of course, the stores clerk also receipts the receiving department for goods taken over, thus giving the receiving clerk a discharge from further responsibility for such goods as are received from transportation companies.

The stores department then initials the two copies of the receiving report, sending one copy to the purchasing department and the other to the accounting department.

### **Approval of the Invoice**

The purchasing procedure is now complete. There remains, however, the important task of determining whether it has been carried out correctly and honestly.

If by the routine the accounting department secures a copy of the receiving report initialed by the stores clerk, there is no objection to allowing the invoice to remain in the purchasing department until the receiving report comes through. This arrangement permits the purchasing department to compare the receiving report against the invoice after the invoice has been checked against a copy of the purchase order. The purchasing department is then in a position to pass on the prices and quality of goods, leaving the matter of computations and extensions for the accounting department.

The purchasing department should then send the checked invoice on to the accounting department where a second check should be made. The invoice should be compared with the receiving report and the purchase order on file to check quantities. The invoice should next be subjected to a checking of computations, extensions, footings, and discounts. Here it should be ascertained also that all clerks having a part in the procedure have initialed or signed the various papers, so that responsibility may be traced. A voucher clerk should then prepare the formal voucher, stamp the supporting papers in such a way as to prevent their use a second time, and send the voucher to the controller for signature. The controller or his assistant should make such an examination of the papers as he considers necessary, noting particularly whether the proper accounts have been charged, whether discounts have been taken when due, and whether the routine has been carried out as planned. Not until he has done so should he sign the voucher and pass it to the treasurer for payment.

If the receiving clerk is not required to prepare separate receiving reports, but uses a copy of the purchase order as the basis for his report, the invoice as well as the purchase-order receiving report should go directly to the accounting department. With this check the purchasing agent is not left in a position to forge or vary the receiving reports, as he does not have access to them until after they have been audited by the accounting department.

### **Voucher System**

The voucher system as used in the specialized sense is a system which provides for the accumulation of documentary evidence preparatory to making a disbursement of cash. The audited voucher carries along with the



formal documents all the data from purchase order to receiving report, including also the vendor's invoice and the initials of all those employees having a part in the ordering, receiving, storing, and accounting for the expenditure. This method obviates argument as to responsibility, leaves small chance for duplicate payments, and allows less opportunity for the presentation of false invoices or other frauds except through collusion. Wherever the formal voucher is used, these unpaid audited vouchers become the accounts-payable ledger and are paid through the treasurer either by a check attached to the voucher or by separate check, neither of which has any advantage over the other for purposes of internal check.

Wherever the formal voucher is not used, and the keeping of an accounts-payable ledger is necessitated, the invoice becomes the master working sheet of the transaction, as it passes from one department to another. On it are placed the initials of all those having a part in the routine, and to it are attached all related papers as evidence of the expenditure. Hence it may be said that this scheme secures the same results as are secured from the preparation of a formal voucher, the significant differences being those pertaining to bookkeeping routine rather than to internal auditing.

#### **Variations in Procedure**

In some concerns the proposed purchase must be approved by the financial executive before the requisition is sent through. If a budget is in operation, any proposed purchases of any size must, of course, be approved by the budget officer or budget committee.

Often materials and supplies cannot be delivered to a warehouse or central receiving station. When such materials must be delivered direct to the field, the field superintendent must accept responsibility of seeing that such goods are checked in, counted, and reported to the local storekeeper. A special field ticket should be prepared with as many copies as may be necessary, and this takes the place in the regular purchase routine of the receiving clerk's report. Under no circumstances should the purchase invoice be sent to the field superintendent for approval, as this procedure would cause many invoices to be misdirected or lost and hence the approving and accounting for invoices to be delayed.

### **Partly Filled Purchase Orders**

It is no uncommon occurrence for the vendee to notify the purchasing department that certain items ordered are temporarily out of stock, and stating the date when the vendor may expect to receive these back-ordered goods.

When this occurs, the purchasing department will mark on the second and third copies of the original purchase order the items to be received late. In this department there should be prepared also in duplicate a purchase order supplementary to the original, one copy of which will be sent to the receiving department and the other retained in the follow-up file. The receiving department copy serves not only as an independent order to receive goods, but also is used to notify the department that goods to be received on the original purchase order will be lacking the items noted in the supplementary order. In this way, little or no confusion will result from what might otherwise have been considered short shipments.

### **Local Purchases**

Local purchases should be handled through the central purchasing department just as outside purchases. However, there are at least two cases in which this procedure would not be entirely practical. One is when the operating company is some distance from the general office and minor purchases of from \$10 to \$25 must be secured from local merchants quickly. The other is when department heads, though they are located at the general office, are allowed to make certain purchases from local dealers because the formal requisition-purchase-order procedure would be cumbersome and uneconomical. The method employed under such circumstances is to permit the department head to issue a local purchase order, a copy of which goes to the accounting department. Such purchases are delivered direct to the department head ordering and not to the receiving department. This method fails to secure an internal check on the actual receipt of such goods, but it does throw the responsibility of receiving directly upon the department head. The department heads so purchasing are notified that they are being held responsible and are therefore likely to exercise care in handling such transactions. Of course, the accounting department should check the monthly statements from vendors against the local purchase orders. Likewise, the internal auditor, realizing that here is a weakness in the system, should take special care to see that fraud and

error are turned up, should he have any intimation that such are occurring.

### **Purchases of Services**

If the amount involved is taken as the criterion, then the purchases of materials, merchandise, and labor services constitute the bulk of the purchasing activity. There are other purchases consummated in the ordinary concern however, which must be internally controlled and audited. Some of the more usual expenses resulting from these services are:

Factory and office supplies	Water, gas, and electricity
Fuel	Telephone and telegraph
Freight and express	Professional services
Postage	Insurance
Salesman's traveling expenses	Taxes
Other traveling expenses	Interest
Advertising	Rent

The significant characteristic of most of these expenses is that they are not run through the regular purchase procedure. With the exception of the first two items, fuel and supplies, these services are not tangibly received and reported by an established receiving department. Many of them are not subject to the purchase-order procedure which functions from the viewpoint of internal check so well with raw materials and merchandise bought. Because of this general lack of a proper internal automatic audit it becomes increasingly necessary that more deliberate checks of these expense items be made by the auditing department. Since discussion is given of deliberate auditing of expenses in subsequent chapters, little need be said here other than to state what should be done at the time the expense is incurred in order that a proper verification can be made.

When factory supplies such as waste, sweeping compounds, and the like are purchased in large quantities, they may be handled through the same routine as applies to the regular purchases of the business. The same may be said of office supplies such as stationery, pencils, and ink. Such items may be kept in the stores department and requisitioned out as needed.

Postage, on the other hand, may be controlled by the requirement that the treasurer's office keep the stock of stamps and deliver them to the mailing section as needed.

Daily each department wishing to send out company mail may prepare a ticket showing the amount of postage required and send this ticket to the outgoing mailing section. These tickets may be recapitulated monthly and be used as a basis for charging each department for postage used. They should also be used by the internal auditor for checking against the amount of stamps purchased by the treasurer and issued to the mailing division.

Insurance and advertising placed should be routed through the central purchasing department. A copy of newspaper and magazine ads should be made a part of the voucher.

Such items as electricity, water, and gas should be checked by having employees make separate readings of meters occasionally, such independent readings to be attached to the utilities invoice.

Often professional fees may be checked by a comparison of the itemized statement, if supplied, against the contract entered into, such, for example, as the accountant's engagement memorandum or the architect's or engineer's specifications.

Freight and express bills should have the approval of the traffic department, and rent may be verified by a checking against the lease contract.

The significant point in connection with all the expense items discussed above is that the bills rendered by the payee should have the approval of the department responsible for the purchase and that these approved invoices be so filed with all supporting evidence in such a way that a periodic scrutiny, the oftener the better, can be made by the management operating through its authorized agent, the internal auditor.

## CHAPTER VIII

### INTERNAL CHECK ON PAY ROLL TRANSACTIONS

#### **Importance of Subject**

Of all the financial transactions carried on by a concern, probably none has in the past been more effectively controlled than salary and wage payments. In the small businesses the record of time-workers or pieceworkers was found in the hands of the proprietor or manager. Often these records were jealously guarded in order that the wage scale or salaries paid would not be widely disseminated. Something of the same attitude yet obtains in the very large concern where a private ledger is kept in which is recorded among other things the officers and office pay roll. Oftentimes, the office pay roll is in the keeping of a confidential clerk, none other than the officers having access to it. In many cases, the treasurer himself has complete control over office and store pay rolls, the bookkeeper getting his figures in lump sums for posting rather than from detailed pay rolls showing names of individual employees and their salaries. Obviously, wherever one man is entrusted with both the preparation and distribution of the pay roll, there can be no internal check. Under such circumstances, the only way that the management may be sure that fraud is not creeping into the office pay roll is through a deliberate verification made either by the internal auditing staff or by an outside accountant.

The secrecy surrounding the office and officers' pay roll does not obtain in the factory or field pay rolls. Neither can an officer afford to give his entire time to the pay roll alone. Even if an officer did handle all the detail involved in pay roll procedure, a satisfactory internal checking system would not be in effect. As stated above, a large amount of attention has been given during the past twenty-five years to the proper control of factory pay rolls. The development of large-scale business, the massing of large numbers of workmen within the confines of one factory, and the inevitable peculation which have gone in the wake of poorly controlled pay roll procedures have required that steps be taken to prevent losses from improper pay roll disbursements. Perhaps the main con-

sideration has been the securing of accurate records for costing purposes with prevention of fraud a secondary matter. At any rate, numerous devices are at hand which when used along with an adequate organization of the various divisions concerned have given and can give a proper control over wage payments.

It is not the purpose of this chapter to set forth any revolutionary schemes, but merely to describe established pay roll practice and to criticize apparent weaknesses in order that one may compare that which is worth while with those pay roll procedures which from the standpoint of internal check are inadequate.

### **Payment By Check Versus Payment in Cash**

In just what form payments will be made to employees is a matter for each concern to decide for itself, and will depend entirely upon local circumstances and conditions. Wherever a large number of foreigners are employed who know little of the English language and less about banking facilities and banking service to depositors, the pay roll will be made in currency and hard money. Some few labor unions, too, require that their members be paid in cash. There are advantages and disadvantages in the payment either of cash or by check. The usual disadvantages claimed for cash payments are:

1. Dangers from pay roll robberies during transportation of cash from bank and also after its distribution to employees
2. Extra amount of time required in counting money received from the bank, sorting it, and placing in envelopes
3. Possibility of mistakes in placing money in envelopes
4. Failure to secure a permanent record of the amounts paid to each employee.

Dangers from pay roll robberies may be offset by protective insurance; and the disadvantage of extra time in counting and sorting is no doubt overemphasized. In the case of the fourth disadvantage, as listed above, a record may be secured from each employee in the form of a receipt slip at the time or immediately before the envelopes are passed out.

The advantage claimed for checks—namely, that they serve as receipts—is probably overrated, because many of the employees cannot sign their own names. On the other hand, the disadvantages attributed to check pay-

ments—that the employee has trouble cashing his check—is overcome by the maintenance of a cash fund in the cashier's office for the express purpose of cashing such checks. Furthermore, the checks of a factory of any standing can always be cashed at the places of business where the employee is personally known. If necessary, the local bank may be encouraged to keep a window open for a few hours after closing in order to accommodate these factory employees.

From the standpoint of internal check, there is no particular preference of one method of payment over the other, with the possible exception that a better automatic control is exercised over unclaimed checks than can be secured over unclaimed envelopes. When a special pay roll bank account is used, the unclaimed wage checks are represented at all times by the balance in the separate pay roll account in excess of the nominal balance carried to maintain the account. Regardless of the payment method adopted, a considerable portion of the pay roll routine will be identical.

### **Fraud in the Pay Roll**

Wherever there is a satisfactory internal check on wage payment in operation, less fraud in pay rolls is likely to result. Most frequent frauds found in practice wherever an inadequate system is in effect or the system for one reason or another is not functioning come about from the placing of fictitious names on the pay roll ("padding"), from falsifying the amount of earnings by falsifying footings, by altering pay roll checks, and by withholding unclaimed pay. These fraudulent pay roll methods are separately discussed.

*Padding.*—The method of manipulating the pay roll which has been most extensively used by defaulters in the past is called padding. It is perpetrated by the placing of fictitious names on the roll, the person having charge of the pay roll forging the receipts; by the placing of the names of friends or acquaintances on the roll and having them present themselves, sign the roll, then split with the pay clerk; and by the deliberate failure to drop from the roll an employee who had severed connections with the company.

*Falsified Earnings.*—When the work of paying and pay roll preparation are done by one employee, he may change the rates on the pay roll proper and pocket the

excess over what is actually due workmen and the amount reported due them.

*Falsified Pay Roll Footings.*—The falsifying of pay roll footings is likely to occur only when the pay roll clerk is allowed to handle both the pay roll and the money distributed. When the paymaster advises the treasurer of the amount of cash needed, what may prevent him from asking for \$300 or \$500 more than the actual requirements? It sounds strange even to assume that no further safeguard would be made over company funds, but cases are definitely on record wherein the management had so much faith in the trusted employee that even the thought of checking his work never came to mind.

*Altering Pay Roll Checks.*—An interesting embezzlement was unearthed after it had been going on for a period of about five years in a Southern city which could under no circumstances have occurred if the internal checking arrangement employed for other transactions had been as well developed for pay roll. The facts are these: The cashier was given the additional duty of preparing the pay roll and distributing it to the employees. After the pay roll was prepared, it was presented along with a check made payable to "Pay Roll" to the manager for his signature. The cashier made it a practice to write in the figure amount on the check but left the writing in of the spelled money amount to be done by a protectograph after the signing. The general manager would scan the pay roll for rates, would test the extensions and footings, and after noting the names of men on the pay roll would sign the check, realizing that the amount shown on the check was the amount correctly stated on the pay roll sheet. He then passed the check back to the cashier for cashing at the bank and distribution into the envelopes. The cashier upon regaining possession of the check would raise some figure on it. For example, if the pay roll called for \$2,415, he would change the check to read \$2,465, or if the check called for \$2,335, he would raise it to read \$2,835, and pocket the difference. The total loss, which was found to be approximately \$20,000, was discovered incidentally only after the employment of public accountants who were asked by the local bank to make a balance-sheet audit for credit purposes.

This loss should never have grown to such proportions; in fact, the embezzlement should have been discovered the first week it was worked.



*Withholding Unclaimed Pay.*—The fraud of withholding unclaimed pay may be found in those concerns with high labor turnover. Either the paymaster or the cashier may be the embezzler. If the unclaimed envelopes are left in the hands of the paymaster, he may issue forged receipts. If the envelopes are returned to the cashier to be held until called for, provision must be made to prevent the cashier from lapping unclaimed pay from one week to another.

### Steps in Pay Roll Routine

Before any progress can be made to prevent pay roll frauds, a study should be made of the procedure in use. This study resolves itself into a determination of the routine through which the pay roll passes from employment of men to the disbursement of cash to them. It is through the correlation of these steps that an internal checking scheme is secured. The steps are as follows:

1. Hiring employees, keeping employment records, and preparing employment advices. This is the work of the employment department
2. Reporting the time of the employees. In this, the department responsible may have the assistance of time clocks and other mechanical devices. This work is performed by the timekeeping department under the supervision of the accounting or auditing department, since timekeeping is an intermediary auditing function
3. Approving the time or labor reports. This is a supervisory function, such approval coming from the foreman or supervisor in charge of the employees whose time is being reported
4. Preparation of labor costs. This is the daily record which accounts for each man's time in terms of work done
5. Entering labor costs on regular cost records. This work is usually performed by the cost division of the accounting department
6. Calculation of each employee's pay and compiling of the pay roll proper. This is the work of the pay roll department
7. Checking the pay roll from time records and labor reports. This work is in the nature of a pre-audit of the pay roll and is done in the accounting department
8. Preparation of pay roll voucher check. This is the

work of the voucher department of the accounting section

9. Signing of the voucher check. This act is done by the comptroller and treasurer
10. Paying employees by disbursing cash and securing receipts from employees.

### **Internal Check Through Correlation of Steps in Routine**

Chronologically, the employment department plays the first part in the pay roll routine. The employment manager is responsible for the purchase of labor services, just as the purchasing agent is responsible for the ordering of commodities. In the larger concerns, the foreman does not employ laborers, but notifies the employment department to employ them. The foreman makes known his requirements by issuing an advice known as a "help wanted slip." This slip is prepared in duplicate, the copy retained in the employment department, serving as an authority to hire. After conferring with the foreman about the men to be hired for the respective jobs, the employment department prepares in triplicate an "employment notice," on which is shown, among other things, the man's name, department sent to, beginning rate of pay, and the like. One copy goes to the timekeeping division, one goes to the pay roll section, and the third is retained in the employment division of the business as a permanent history of the laborer's connection with the company.

Should a workman be given a raise or a reduction in pay, it should originate with the foreman upon the superintendent's approval. This change necessitates the preparation of two copies of a "change-in-rate" slip, one of which is sent to the pay roll department. If this procedure is followed, there is always at hand a satisfactory file of information concerning employees to which an auditor may go should he have the slightest suspicion that there is fraud in the pay roll.

As stated above, the duty of keeping an accurate record of time worked belongs to the timekeeping department, which reports to the head of the accounting department or auditing department.

The timekeeper is responsible for seeing that men report in and out properly. In this he may be assisted by some automatic time-recording device so as to be assured that each man reports for himself and no one else. From the recorded information he prepares a daily

report by departments showing the number of men checked in and the number of hours worked by each man.

In addition to keeping a record of attendance time, the timekeeping department must assume responsibility for securing "job" time. By this is meant the time which each workman puts on each task to which he is assigned. One method of securing this "job" time is for the employee to have handed him each morning as he goes to work a daily ticket on which he records the number of hours and minutes spent on each task. These tickets must be O. K'd by the departmental foreman before being turned over to the timekeeper. Often, instead of having each employee fill out his own slip, it is prepared by the foreman or perhaps a department time clerk. In whatever way these man-job tickets may be prepared, they must have the approval of the operating department head and be sent daily to the timekeeping department.

The next duty of the timekeeping department is then to reconcile the attendance time for each employee with the "job" time as reported daily. Finally a timekeeper's report is prepared of the attendance and job time and is sent to the pay roll department, where it serves as the basis for preparing the periodical pay roll.

A variation of this procedure is for the task time sheets of individuals to be sent directly to the cost division of the accounting department and there reconciled with the attendance report of the timekeeper.

As soon as possible after the completion of the day's work, the time reports are delivered to the pay roll office, which immediately upon their receipt are examined to ascertain if all were received and properly prepared. Then follows the task of entering the compensation rates and the extension of earnings. Frequently this work of entering and extending rates is done in the timekeeping department, particularly where daily entries are made on the cost records; thus there is left to the pay roll department only the duty of preparing the pay roll and of finally paying the man. However, where daily wage costs are not required and hence daily extensions on wages are not needed, the pay roll department may not only prepare the roll, but may also determine the amount due each employee. Wherever the extensions are made, they should be calculated by experienced clerks as a precaution against errors. It is highly desirable that all calculations be checked by a second clerk.

After the pay roll has been compiled, it may be turned over to another employee in the pay roll department for checking; however, a better practice would be to send it to

the auditing department, where one of the auditors would make a pre-audit of the roll before payment. This would consist in test-checking the rates of pay against the official employee rate cards, footing the pay roll, comparing timekeeper's daily reports against the pay roll, and checking the distribution to job orders or departments. Although it is worth while to have the auditing department make this verification before wages are paid, it may be better to have the pre-audit made by the voucher auditor in the accounting department, leaving the final deliberate check to be made by the auditing department after the pay roll has been paid, as then a more complete tracing can be made of the entire completed routine. If this procedure is followed, it will be impossible for the pay roll department to pad or overfoot the pay roll, because the pre-audit would discover the discrepancy from a check of the roll against the employment record and the timekeeper's report. Of course, if there is collusion between the paymaster and the timekeeper, the timekeeper may prepare fictitious "job" tickets forging the foreman's name and splitting the unearned wages with him. If very much of this padding should go undetected, the cost department would have to account for increased labor costs, and the fraud would thus be discovered after due examination. A quicker means of discovering it would be to send someone unannounced from the auditing department to go with the paymaster when he distributes the envelopes or checks. The auditor's assistant would note and investigate unclaimed pay envelopes. Discovery would be certain when it was found that a number of the envelopes were prepared for unauthorized employees.

After the pay roll has been approved by the pay roll auditor, it is sent to the voucher clerk for preparation of voucher check and entry in the voucher register. As soon as it has been signed by the controller, the voucher check is sent to the disbursement cashier for entry in his cash book and for numbering. After signature by the treasurer or his assistant, the check is returned to the cashier who, having been previously notified by the pay roll department as to the exact number of bills and coins required, secures them from the bank and turns this pay roll money over to the paymaster, securing from him a receipt for all cash turned over.

It is assumed, of course, that an addressograph operator has already prepared an envelope for each employee showing his name and space for the amount. As the pay roll was prepared, postings of the amounts were made to these envelopes. Either the envelopes or the pay roll proper could, therefore, serve as the basis for preparing the denomina-

TIMEKEEPING DIVISION	PAYROLL DEPARTMENT	ACCOUNTING DEPARTMENT			CASHIER	TREASURER
		COST DIVISION	AUDITING DIVISION	VOUCHER DIVISION		
<p>1. From clock cards, prepare daily report, daily proof sheet by departments and send to</p> <p>2. From daily work tickets prepare reports reconciling number of hours and amount of labor; secure foreman's OK; send to</p>	<p>For preparation of periodic payroll; make duplicate; sends original to</p>	<p>For entry on detail cost records and cost summaries</p>	<p>1) Payroll calculations and footing checked</p> <p>2) Summarize daily reports for entries to controlling account</p> <p>3) Payroll proven against timekeepers daily report sheets</p> <p>4) May test-check payroll against employment records</p> <p>5) Sent to</p>	<p>1) For preparation of voucher or voucher check</p> <p>2) Entry in Voucher Register</p> <p>3) Sent to</p>	<p>Preparation of check and entry in Cash-Book Journal, then to</p> <p>Secures money in proper denominations; money to</p>	<p>For signature</p>
	<p>1) For preparation of payroll envelopes; envelopes filled from duplicate copy of payroll</p> <p>2) Filled envelopes given to paymaster who distributes and secures receipts from workmen, receipts going to</p> <p>unclaimed wages to</p>		<p>as a check on unclaimed wages</p>			

FORM No. 7—Flow Sheet for Internal Check on Pay Roll in a Manufacturing Concern

tion sheet, such a sheet being merely an analysis by workmen of the number of bills and coins of the various denominations required to fill all envelopes.

A check on the accuracy with which the envelopes are filled is thus automatically secured, since the moneys brought from the bank should just exactly fill all the envelopes with nothing left over and with no additional money required.

Just prior to the passing out of the envelopes to employees, a clerk in the pay roll department may pass out to each workman a receipt slip which shows the amount of wages to be paid and the name and number of the employee, and provides a space for the employee to sign. The employee then passes his receipt over to the paymaster at the same moment that he is given his wage envelope. By this method no time is lost in passing out the envelopes. Illustration No. 7 shows diagrammatically the flow of work in connection with a factory pay roll.

### Unclaimed Wages

Occasionally, when the labor turnover is large, there will be cases in which pay envelopes are not called for on pay day. Under such circumstances the unclaimed envelopes should be sent to the cashier, who will hold them a week. If by that time they are still unclaimed, they should be deposited in the bank. The paymaster will accept the cashier's receipt for the envelopes and will report to the auditing or accounting department the result of his payment as follows:

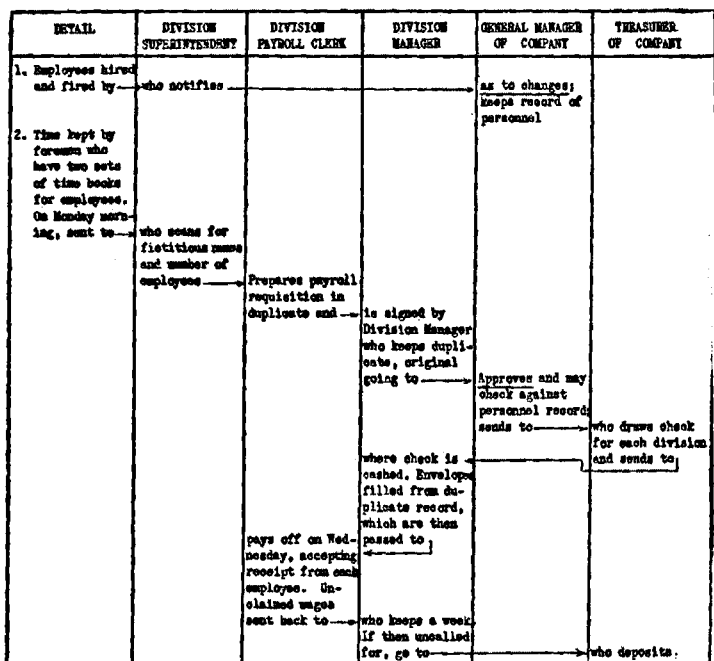
Employees' receipts.....	\$7,892.00
Cashier's receipt.....	108.00
	<hr/>
Total pay roll.....	\$8,000.00

Subsequently, workmen unable to present themselves at paying time may call for their pay envelopes. After each is properly identified, the department holding the receipts will authorize the cashier to release the envelope, the previous receipt of the cashier now being replaced by the employee's receipt. The auditor may test the unclaimed pay envelopes occasionally by actually inspecting the envelopes remaining in the cashier's office and comparing with the records of unclaimed pay kept in the account office.

### Pay Roll Procedure in an Ice Company

Not all concerns are able to work out the pay roll procedure as described above. In businesses in which the

employees are scattered over a considerable territory—such as an oil-producing company, an ice-distributing concern, a street construction company, and other such companies where the men are not checked in and out by a time clock and where the employment department cannot function as well as in the case where all the men work within the confines of one plant—it becomes necessary in order to secure an internal check over pay roll to develop methods somewhat different from those which apply to a factory or



FORM No. 8—Flow Sheet for Internal Check on Pay Roll of An Ice Company

store. As an example of the procedure which might be used, the pay roll routine in an ice company is described below.

The organization for an ice company in one of the larger cities probably includes five to ten division managers working under a general manager. Under each division manager are a division superintendent and a number of route foremen.

The pay roll procedure begins with the superintendent, who hires and fires employees in his division, sending

memoranda of such action to the general manager's office, where personnel records are kept.

Each foreman is supplied with two sets of time books for keeping driver's and helper's time. At the end of the week he turns over to the division superintendent the time books for the past week. The superintendent scans the time books for fictitious names, number of employees, and time reported for each employee, then passes the time books over to a division pay roll clerk in the division manager's office. Here a division pay roll clerk prepares in duplicate a pay roll requisition, which, after being signed by the division manager, is sent to the general manager's office. A clerk in this office checks the requisition against the personnel records, secures the signature of the manager, and sends the form to the treasurer. The check is prepared in the treasurer's office and sent to the division manager, who has it cashed at the local division bank, has the pay envelopes filled from the information appearing on the duplicate pay roll requisition, and then turns the envelopes over to the division pay roll clerk. The pay roll clerk distributes the envelopes in the presence of each route foreman accepting receipts, which are to be sent to the division manager and attached to the pay roll sheet. Unclaimed pay is sent back to the division manager's office, where it is kept a week and then, if still unclaimed, returned to the treasurer for deposit.

### **Factory Piecework and Premium Wages**

When the pay is based on actual work performed, such as units of production, and not on the time occupied, an efficient system of recording piecework is essential. When the work is given out it should be entered on the pieceworker's card. On completion, the card should be initialed by the piecework reviewer as soon as the work has been examined and checked by him. If the finished units are immediately delivered to the stock keeper, his initials will also be placed on the card. The timekeeper secures the necessary data from these individual cards or from other production records and reports daily to the pay roll division the number of good pieces finished, the number of pieces spoiled, and the piece rate.

Should the employee be allowed a bonus for attaining a certain standard or a premium on the basis of increased output, the computation of wages per individual will have to be closely checked against the rate schedule. The internal auditor's work will consist in:



1. Checking the name and number on the job ticket or summaries with the pay roll book entries.
2. Checking the extensions and entries from the job tickets to the pay roll book.
3. Establishing the piecework rates shown on the pay roll book by referring to authorized rate cards.
4. Agreeing the total pieces produced by individuals with the summarized production reports.

### **Sales and Office Salaries**

Wherever the salaries of sales persons and office workers are paid weekly, considerable detail is involved in the preparation of pay rolls. The procedure of internal control begins with the obtaining of a record of attendance time. This record may be secured by permitting each employee to keep and report his own time, or it may be secured by having each office and store employee punch the time clock. Should the former method—known as the honor system—be used, it will be necessary that each department head report to the pay roll department absences and chronic tardiness on the part of employees. The pay roll sheets are prepared from these attendance records to show the weekly rate and the amount actually earned on the basis of days worked. Extensions and footings are checked by the voucher clerk, and a pay roll voucher is prepared. The paymaster pays either by drawing checks on a pay roll bank account or in currency. If payments are made in currency, the envelopes should be filled by a machine to avoid errors in counting change.

Overtime is frequently not included in the regular pay roll, but paid separately by means of approved cash vouchers. Advance wages may be paid out of a special pay roll fund, the cash being replaced when the regular weekly pay roll is prepared.

### **Commissions**

Commissions earned by salesmen in a retail store may be controlled by requiring that someone in authority authorize the rate or rates of commission, and that another individual check the sales made by each sales clerk with sales audit division's statistics. Obviously, sales on which commissions are paid should be tied up with the total sales for the period.

Commissions paid to traveling salesmen will be controlled by the use of card records or sheets for each salesman showing shipments to customers, returns and allowances, and other pertinent information to be used as a basis for computing the commissions earned.

### Summary

Irrespective of what the internal procedure may be with regard to pay roll, the following principles should be adhered to in order to secure an internal check over the pay roll:

1. The details of keeping the time must be segregated from the disbursement of funds by the paymaster. In other words, the person preparing the roll and paying the men must not be allowed any jurisdiction over timekeeping
2. Wherever possible, mechanical timekeeping devices should be used
3. In situations in which time clocks are not adaptable, a time report, preferably daily, should be prepared and approved by the head of the division
4. Formal advices of hiring, firing, or changing employees from one department to another, and of change of wage rates should be prepared with proper authorization
5. Each pay roll should be pre-audited by the accounting department before the pay roll check is drawn
6. The paymaster, when paying cash, should invariably secure receipts for all envelopes leaving his custody.

In addition to the internal checking arrangement some provision should be made for a deliberate pay roll audit occasionally. This will take the form of a verification of the pay roll by tracing the procedure from employment to payment. It may also call for the auditor's taking over of the pay roll after it has been prepared and, with the assistance of the paymaster, distributing the envelopes or checks to the employees. In any event, the deliberate audit should discover whether the procedure as outlined by the controller is being carried out satisfactorily.

## CHAPTER IX

### INTERNAL CONTROL OVER SUNDRY ASSETS AND COMPANY TRANSFERS

#### Internal Transactions

In addition to the safeguarding of the company's transactions with outside interests against fraud and error, attention should be given to the business proper to determine whether satisfactory methods are in operation to effect a control over assets owned, transfers of assets between departments, and the allocation of expenses between divisions of the business.

Methods of determining accountability for cash have been discussed. Nothing, however, has been mentioned concerning the maintenance of a control over the physical possession of assets. Notes receivable, securities owned, inventories, tools, supplies, and even equipment may disappear unless properly controlled and periodically checked up and accounted for. An infrequent deliberate audit of plant and equipment may suffice to protect these less movable properties, but in order that accountability for security, note, and inventory values may be secured, it is most essential that frequent counts be made of these more liquid items along with the incorporation of an internal checking procedure.

The problem of securing a proper distribution of expenses between departments should be given a large amount of thought if accountability for results is to be secured.

#### Control of Notes

The principal of internal check that applies in the control of notes is that the person having charge of the notes should not be permitted to accept cash payments on them and also keep the note record.

In one of the western land and development companies, a control is secured by having the treasurer keep the notes in his possession at all times. A subsidiary ledger clerk keeps the detailed accounts, and the cashier has a card ledger file of all note accounts. When payments on notes are made, a receipt is prepared by the cashier in triplicate, the original going to the payer, one copy going to the ledger clerk, and the third copy being retained in the cashier's receipt book. This receipt book is sent to the treasurer's office daily for posting to the notes proper. When the note

is fully paid, the second copy is sent to the treasurer's office as an authorization to release the note. The treasurer stamps the copy "note released" and sends it to the accounting department for final entry. Since notice of payments due are sent out from the accounting department, there is little chance that fictitious notes will be inserted in the note portfolio or that the cashier will intercept cash received from note payments.

In many commercial and industrial banks it would be most inconvenient to separate the notes from the note teller even though such an arrangement would give a better internal check on cash received from note payments. If this separation were effected, however, the note teller would keep a card ledger on all notes due to the bank and would prepare receipts when payments were made. A copy of the receipt would be sufficient authorization for the release of the note by the note custodian who would, of course, keep a copy of the note-teller's receipt as his discharge from accountability for the note. Inasmuch as the bank's customer is not particularly interested in helping the bank secure controls over its assets, and since his time would be wasted if he were required to present himself to two separate windows to pay and secure his paid note, most banks permit the note teller to accept cash on notes and actually have custody over them. A control, however, is exercised under such circumstances by the bank auditor, who has a separate card ledger of all notes and who receives notices as to payments, renewals, and unpaid notes daily. As often as necessary the auditor will make "spot" audits on the note-teller's cage and will reconcile the actual notes seen with the general ledger control record.

### Control of Securities

A few years ago the manufacturing and mercantile concern had no problem in connection with stocks and bonds owned inasmuch as few of them owned securities other than stocks of affiliated companies. As an indication of the change which has taken place, a reading of the balance sheets of large industrial companies proves enlightening by showing that large amounts of reserve funds have been and are being placed in marketable securities. A study of the balance sheets of a few concerns as of December 31, 1930, shows government and municipal and other marketable securities held as follows:

American Radiator & Standard	
Sanitary Corporation.....	\$ 2,611,758.66
General Motors Corporation...	33,323,414.37

Standard Brands, Inc.....	10,410,713.86
Radio Corporation of America..	903,424.55
Montgomery Ward & Co.....	206,848.00

The list could be expanded over a number of pages, but it would show the same thing: namely, that not only are investment trusts, insurance companies, and banks concerned with the proper control over securities, but also that industrial concerns are coming face to face with the necessity of setting up methods of control over their investments of surplus funds.

Particular attention should be given to a control over securities held by treasurers and financial secretaries of endowed hospitals, universities, and various trust funds where a fiduciary responsibility is evident. In the absence of proper controls, the person in charge of negotiable bonds may abscond with the whole portfolio. Likewise, what is to prevent a dishonest treasurer from using company securities as collateral for his personal loans, or applying interest from such securities to his personal uses?

The following requirements and practices are suggested as means of controlling securities:

1. That all negotiable securities be kept in a lock box in a reputable bank or trust company
2. That no one individual be permitted to be in entire charge of the securities box. This requirement can be met by having two officers visit the lock box or by having previous arrangements made with the bank to permit one of its officers to be present whenever the securities box is opened. This dual control is often arranged by having two keys to the box, neither of which will alone open the box without the aid of the other
3. That all securities be registered in the name of the owner and that the names and numbers be checked periodically
4. That a separate controlling account in the general ledger be provided for each type of security held. For example, an investment house would probably have three controlling accounts, as follows:
  - a. Industrial bonds
  - b. Municipal bonds
  - c. Corporation stocks
5. That a perpetual balance of the par and cost value of securities be kept. This can be secured by having an individual account with each security handled or held. Periodical trial balances of the securities ledger should

be taken and compared with the control in the general ledger

6. That interest earned on bonds and dividends on stocks be computed independently in the accounting department and used as a predetermined figure against which to verify each income collection from securities
7. That the board of directors, an executive committee of the board of directors, or an appointed representative of the board make a physical count of the securities on hand monthly or oftener if deemed necessary. Wherever the internal organization is such as to require the internal auditor to report direct to the board of directors and not to the president of the company, the auditor may act as the directors' representative in the count of securities on hand.

### **Inventory Control**

If the large amount of fugitive literature on the subject of inventories is any indication, the public accountants of the present and the immediate past are and have been very much concerned about certifying to inventories. These accountants find the problem to be not only one of valuation of quantities on hand, but more important how they shall satisfy themselves that the goods reputed to be on hand are actually on hand. While practitioners have variant opinions as to what attitude they should take with regard to certifying inventories, they are all agreed on one point: namely, that if inventories are adequately controlled, the accountants are then in a better position to give an unqualified certificate than if no effort is being made to keep inventory records clean.

The average business concern is not operating so as to make the auditing of its respective books easy for the accountant. Inventory records are kept and inventory procedures are adopted because it is good business to do so. Without such procedures and records, responsibility for goods cannot be definitely placed on any one individual, nor can accountability be located for leakage should it be occurring. The concern that waits until the end of the year to take inventory and makes no attempt to provide any sort of internal check over inventory in between counts is leaving itself wide open for fraud on the part of its employees.

A seventy-five-room hospital which permitted any of the nurses to go into the stock room and take medicines from the shelves found after a period of two years that the medicine costs were excessive. A close investigation brought out the fact that one of the nurses was appropriating

narcotics and selling them to addicts. The placing of a storekeeper charged with the responsibility of medicines and supplies in the storeroom prevented further raids on this hospital's stores.

It is taken for granted that the manufacturer must provide means whereby receipts shall be given by those who receive materials and supplies and that requisitions shall be prepared for all such materials put into production, used for maintenance, or sold.

### **Establishment of Inventory Control**

One of the basic principles of inventory control is that detailed records shall be kept of all goods purported to be on hand, and that controlling accounts shall be set up and kept by employees not actually handling the goods. The application of this principle takes the form of a perpetual inventory system, and provides for the keeping of such inventory records as may be used to check against the inventory as secured by a physical count. The perpetual inventory records will not necessarily prevent theft of goods, but they will assist in discovering thefts should such be occurring. Detailed book inventory records will aid the management in determining when purchase commitments should be and should not be made and hence prevent wastes in buying and holding goods and materials for sale or production.

The other principle of inventory control which should go far in preventing large inventory leakages is that goods must be protected while in the hands of employees and that physical responsibility for goods must be unequivocal. Lacking this definite placing of responsibility the accounting department cannot carry on an internal check on inventory. In the trading concern, the merchandising manager or his assistant, the sales manager, is held indirectly responsible, the direct responsibility resting upon each department head of the selling division for goods in his department. Wherever goods are held for fabrication or use in the establishment such as a factory, a restaurant, a hospital, or a public utility, the responsibility for goods is centered in a storekeeper, who should be charged upon receipt of commodities and discharged when goods leave his care in due process of operation.

### **Holding the Storekeeper Accountable**

It is just as important to hold the storekeeper responsible for materials and supplies as it is to make the cashier accountable for cash. Numerous reasons too obvious to

mention prevent as absolute a control from being exercised over goods as would be maintained over cash. No system of inventory control is arithmetically perfect. It can, however, after allowing for normal waste and leakage, be developed to the extent that large variations between actual and book inventory will not obtain in the absence of fraud and inefficiency on the part of the storekeeper.

When goods are not ordered for immediate departmental use, they are normally placed in the storeroom. Upon receipt of the goods the storekeeper signs for them. This he may do on a specially printed receipt form, on a copy of the purchase order, or on the receiving clerk's receiving book. If he keeps a detailed record of his stores, he, immediately after receiving the goods, makes postings to this record. Often, he merely records the information on bin cards, the detail inventory record being kept in the accounting department.

The storekeeper is discharged from accountability for goods in the storeroom upon receipt by him of a requisition duly prepared and signed by the person actually taking possession of the goods. In addition to the copy of the requisition retained by the storekeeper as evidence that he has delivered the goods, another copy will be sent to the accounting department to relieve the inventory control account and, if it is kept in that department, the subsidiary inventory account. A copy of the sales ticket in the retail concern and the shipping ticket in the wholesale house functions in the same manner as the material requisition in the factory.

### Methods of Inventory Control

A number of different stock control systems have been devised to give information to buyers, merchandise managers, and superintendents as well as to disclose stock shortage. While it must be granted that one of the major purposes of preparing inventory records is for managerial information, this tract does not attempt to treat of these various uses of inventory control systems. The problem here is to answer the question, what type of inventory record can be most economically used to aid in placing responsibility for goods and preventing and discovering stock leakage?

Some businesses will find it entirely unprofitable to keep a real perpetual inventory, or a continuous record of each unit in stock, showing receipts and disbursements by individual items and balance on hand. Concerns handling many units of small value such as nails, small toys, cheap costume jewelry, or other staple articles of low value will find little



if any saving from the keeping of a continuous unit record of inventory. In fact, the expense of posting these items to ledger accounts would more than offset the advantage accruing from the use of a perpetual inventory record. This type of concern, however, need not, necessarily, despair of finding a method of inventory control applicable to its establishment. True, such a concern may not be able to keep daily records on numbers of units in stock, but it can determine whether the value of the inventory actually on hand is approximately the amount that should be on hand. There are two methods in use to accomplish this control, one of which goes by the name of "statistical or gross profit method of calculating inventory," and the other is the purchase-mark-up procedure usually called the "retail inventory method."

*Gross Profit Method.*—The gross profit method of calculating estimated inventory is sound, simple, and practicable in those businesses wherein the mark-up does not fluctuate materially. Its application is limited to those departments handling staple merchandise and is particularly adaptable to stores dealing in certain groceries, hardware, and books.

For illustrative purposes, let it be assumed that a check is desired on the inventory of a book store consisting of four departmental sales divisions for the month of September, 1932. The following table shows the application of this method:

	Total	Dept. 1	Dept. 2	Dept. 3	Dept. 4
A. Net Sales for Sept. . . . .	42,000	10,000	8,000	12,000	12,000
B. Estimated Gross Profit Percentage . . . . .		40%	25%	10%	15%
C. Estimated Amt. of G. P. . . . .	<u>10,200</u>	<u>4,000</u>	<u>2,000</u>	<u>1,200</u>	<u>3,000</u>
D. Cost of Sales (A-C) . . . . .	31,800	6,000	6,000	10,800	19,000
E. Inventory at 8/32 plus September purchases . . . . .	<u>120,200</u>	<u>20,000</u>	<u>27,000</u>	<u>32,200</u>	<u>41,000</u>
F. Estimated Inventory at 9/32 (E-D) . . . . .	<u><u>88,400</u></u>	<u><u>14,000</u></u>	<u><u>21,000</u></u>	<u><u>21,400</u></u>	<u><u>32,000</u></u>

In some concerns it is possible to keep a daily record of figured gross profits by departments. These gross profits when summarized for the month can be deducted (after allowing for gross profits on returned sales) from total net sales, the resulting figure being cost of sales for the

month. Subtracting cost of sales from the total of the opening inventory and net purchases will then give the latest inventory figure.

*Retail Inventory Method.*—In those wholesale concerns using this method, it goes by the name of the purchase mark-up method. Briefly, the procedure involved in the use of this method may be outlined as follows:

1. The beginning inventory and subsequent net purchases are computed at retail value
2. To this figure are added transfers from their departments at retail and additional mark-ups
3. The resulting figure gives the total retail price of goods sold or to be sold
4. Total of mark-downs and employees' discounts are added to sales during the period
5. No. 4 is deducted from No. 3, and the resulting figure is the ending inventory at sales price.

Inasmuch as the ending physical inventory is taken at sales price, any variation between the book inventory at sales price as computed above and the physical inventory at sales price will represent losses at sale price due to selling at unauthorized prices, errors in weight and measurements, undetected shortages in quantity purchased, failure to report price changes to the office, and actual losses due to theft.

This method of inventory computation permits the final inventory figure to be reduced to cost price; however, such reduction, while necessary to secure gross profits, does not particularly aid in a more effective internal check on inventory.

*Perpetual Inventory.*—Retail or wholesale concerns dealing in automotive accessories, repair and replacements parts, boots and shoes, furniture, electrical supplies, high-grade jewelry, and musical instruments will find the keeping of a perpetual inventory record relatively inexpensive in comparison with the results obtained. Manufacturing businesses operating a cost system will find such inventory system almost essential. It is through the use of a perpetual inventory record that an adequate control can be exercised over the storekeeper.

The system calls first for one or more controlling accounts, depending upon the location and number of store-rooms, to which are posted as a debit from the voucher register all goods bought for which audited vouchers were

prepared. This account is relieved by the total of requisitions issued during the period and by authorized corrections and adjustments. The second requirement is the keeping of a stores ledger as a subsidiary record to the stores control in the general ledger. This stores ledger may be in the form of a card file, loose-leaf book, or a visible record. Just what form is used is immaterial so long as a separate record is kept for each type of goods. The stores ledger is kept in the accounting department, often in the cost division of the accounting department, and secures its debits from receiving reports and its credits from requisitions, shipping tickets, or sales tickets. The stores ledger should balance at all times with the stores control account.

The use of a detailed stores record permits deliberate checks to be made of the inventory account during the period while operations are going on rather than at the end of the year. In many of the oil companies, field auditors are constantly at work counting materials in the field; such count when sent into the general office can be checked against the materials which should be in definite locations in the field. The factory auditor may find it worth while to send an assistant to the storeroom, there to count certain items each week as a check against the inventory record. If the perpetual inventory is handled in the manner described above, it will provide an absolute check over goods in stock.

### **Goods in Process of Manufacture**

After raw materials leave the storeroom, it may not be possible to trace the respective items through the manufacturing process, nor is it essential that such procedure be carried out. What is demanded is that for every credit to the storekeeper there be an offsetting charge to the production department. The securing of this charge and discharge is not difficult inasmuch as the same internal paper, the material requisition, serves both purposes.

The possibility that the stores clerk may pilfer goods and cover this fraud by forging requisitions is almost a figment of the imagination. An alert cost clerk would discover the fraud almost by the time it has been perpetrated. Particularly is this true if standard costs are used.

When the factory has completed its task with respect to the fabrication of certain units, the production report

serves to notify the accounting department as to the disposition made of goods completed. If the manufactured units are sent to a finished-goods storeroom, the stores clerk there signs for them, whereas if they are shipped immediately, the shipping clerk must be held responsible until he can produce evidence of dischargeability from a transportation company.

### Scrap

Fraud may enter through an unauthorized disposition of spoiled work in the absence of proper records and proper checks. The shop inspector's report of spoiled work can be compared monthly with the actual report of scrap returned to the storeroom or immediately sold. Usually, wherever there is a large amount of scrap or waste resulting from the manufacturing process and having a cash value, a perpetual inventory record should be kept of it in the same manner that such a record would be made of raw materials or finished goods. With such a record, if scrap sales are delivered only after regular shipping orders are prepared, as close a check will be obtained on scrap as on any other commodity in the factory.

### Loose Tools

A very considerable amount of loss may result from leaks due to theft and carelessness wherever machine and hand tools are indifferently controlled. It is generally conceded that even where tools are adequately controlled some loss will occur through misplacement and breakage. The fact, however, that an absolute control cannot be maintained should not prevent any effort whatever from being attempted. At least two methods are in use to help keep track of small tools. One of these is to operate a tool room; the other is to place responsibility on each individual worker by charging him with the required tools which he will keep locked up in his own tool crib.

When a departmental tool room is in use, each workman is supplied with several metal or other durable material "checks" bearing his number, which he presents to the tool-keeper when a tool is needed. The worker's "check" is hung on a hook near the stowage place of the tool. If the workman fails to return the tool he stands charged for it unless relieved by the foreman's report that the tool was used up in production, in which event it is charged against the product manufactured.

If individual tool cribs are in use, each factory employee

is automatically charged with the responsibility of accounting for all tools in his crib. These tool cribs should be open to inspection at all times to the foreman and to the tool inspector.

In either case, records are kept of tools in the accounting office, and periodical inventories are made of the tool room and crib so as to keep the tool account in agreement with the tools actually on hand.

### **Other Internal Company Transfers**

In addition to the problem involved in the shifting of inventories between departments of a business, there are other internal transfers which, while not so tangible as those discussed above, are just as much subject to error and hence have a place in a discussion of internal audit control. A few of the items coming under this heading are as follows:

1. Write-off of bad accounts and notes
2. Trade-in of old equipment on new
3. Transfers of equipment from one department to another, one factory to another, or from one territory to another
4. Distribution of expense between departments, and the allocation of burden
5. Amortization of patents, leaseholds, trade-marks and copyrights
6. Depreciation and depletion of property
7. Adjusting and closing entries.

At least one thing the items of this group have in common is that a journal entry must be prepared for each of them and that the basis for this entry must arise within the organization. The internal-check principle involved in each of these transfers is that entry shall not be made on the records without proper authorization, and that authorization shall not be given for the entry in the absence of documentary evidence showing the original responsibility for the transfer. The best medium for making the book record of such transfers should be the journal voucher, to be prepared after the internal papers have been approved by some one in authority. For example, it often becomes necessary in the oil-producing companies to transfer lease equipment such as rigs, tubing and casing, line pipe, etc., from one lease to another. Under such circumstances an order to make the change may be sent out from the office of the vice-president in charge of production. The order will reach the district superintendent and will be passed on to the field superintendent. The field superintendent will

see that the property is removed from his supervision and will so report. The field superintendent securing the property will also report. The superintendents' reports then constitute the basis for making the transfer entry on the books.

In order that the system may be more fully protected against errors of commission, omission, and principle, each journal voucher should, before entry, be passed to a voucher auditor who will determine whether all supporting papers due to be attached to the voucher are actually attached and whether these papers are properly authorized and initialed. He will furthermore check the voucher for arithmetical errors and determine whether the correct accounts have been debited and credited. Even then the voucher is not finally approved until after the controller or his assistant has subjected it to his personal scrutiny.

## CHAPTER X

### INTERNAL CONTROL OVER PLANT ADDITIONS AND REPAIRS

#### Importance of Fixed-Asset Property Accounting

A few years ago it was considered adequate for a manufacturing concern to charge all purchases of raw materials to an inventory account, then at the end of the fiscal period to take a physical count of goods, charging the material consumed and relieving the inventory account of the difference between the amount shown on the inventory account and the actual stock on hand. Today, such a procedure would be considered crude, ineffective for managerial purposes, and harboring potential fraud and error.

While the majority of manufacturing concerns would not countenance such inefficient inventory-control methods, many of these same companies have been blind to proper fixed-asset control devices. The fact that a large part of the capital of a manufacturing establishment is tied up in fixed property makes it most essential that adequate records be maintained in detail so that the auditor, be he internal or external, may satisfy himself that:

1. Each unit of fixed property is actually in existence
2. Installation charges have been properly capitalized
3. Transfers of assets from one department to another or from one division or subsidiary to another have been correctly booked
4. Betterments, replacements, renewals, repairs, and demolitions have been properly taken care of; and
5. Depreciation, in many cases the largest single item of operating expense, has been neither excessive nor insufficient.

Besides the opportunity for erroneous statements of operating position through failure properly to account for capital or revenue charges, as the case may be, there is also the opportunity for outright theft of small units of fixed assets when inadequate accounting records are maintained. This danger is particularly evident in those concerns—as oil-producing companies, public utilities, and construction companies—which have scattered fixed properties.

An adequate control system over fixed assets and repairs resolves itself into two parts:

1. The setting up of a routine procedure so that no equipment can be installed, removed, or scrapped without written instructions. This procedure often goes under the name of a system of authorizations. It will apply to repair and replacements above a minimum amount as well as to additions and betterments
2. The development of a fixed-asset recording system classified in such detail that units of fixed property may be located immediately.

It is the purpose of this chapter to set forth how a practical development of these two procedures may afford a control over fixed assets and repairs.

### Authorization System

Plant expenditures are best controlled when a requisition and estimate procedure, coupled with definite written instructions from proper officials, is in operation. An authorization system serves two purposes: first, it provides that no expenditures shall be made for additions, betterments, renewals, or repairs over a certain amount without the authority of those officers who are responsible for and direct the policy of the company. This authority is dual in that it grants permission to undertake a certain project at an estimated cost and also authorizes the expenditure of money to pay for the project. It also enables the accounting department to classify and record all capital expenditures so as to show exact costs for each project, thus eliminating the making of all improper charges to construction. Furthermore, it makes the deliberate auditing of plant accounts simpler, in that adequate evidence is always at hand showing the basis of distinction between revenue and capital charges, and it permits the auditor to satisfy himself that all such expenditures are regular.

In the majority of cases in which assets are to be bought or constructed, only the managing officials' signatures are required. If, however, the project is of such a nature as requires the spending of large sums, it may require the approval of the board of directors or the sanction of an executive committee of the board. When the proposed expenditure is less than \$100, there may be no need for pre-authorizations since they are frequently of an emergency nature and can be listed on a monthly request form and approved in the aggregate instead of separately.



<b>STANDARD MANUFACTURING COMPANY</b> Request and Estimate for _____ Fixed Property Expenditure						
Plant _____			Date Needed _____			
Dept. _____			Date Required _____			
Requisition # _____			Classification			
Work Order # _____			<input type="checkbox"/> Additions and Betterments <input type="checkbox"/> Repairs and Maintenance <input type="checkbox"/> Replacements and Renewals <input type="checkbox"/> Transfer <input type="checkbox"/> Retirement			
Transfer or Retirement Order # _____			Time to Complete _____			
Budget # _____			Account to be Charged _____			
Quantity	Description of Item	Reason Required	Estimated Cost			
			Material	Labor	Burden	Total
Requested by _____		Date _____	Approved by _____		Date _____	
Affirmed by _____		Date _____	Rejected by _____		Date _____	
		Supt.			Title _____	
Approved by _____		Date _____	Reasons for Rejection _____			
		Gen. Mgr.	Returned for Revision _____			
			Title _____			
			Reasons for Revision _____			

### **Preparation of Authorization Forms**

While the details of paper work in connection with authorization forms differ according to the nature of the concern, in general there are two sets of forms prepared, the first being the request for fixed-property expenditures, and the second being the actual work order or purchase order. Frequently, with the use of multiple copies, these two sets of papers may be combined into both a requisition and plant order. Plant orders may be set up in one form, or separate forms for different types of work may be used. For example, there may be separate forms for:

1. Betterment and addition job orders
2. Transfer orders
3. Dismantling, retirement, or scrap orders, and
4. Repair job orders.

It is immaterial from the standpoint of internal control whether a combination form or separate forms be used, as long as the authority for the plant or transfer order is definitely shown.

### **Authorization Procedure**

The request for expenditures may originate with a foreman, the plant superintendent, or a branch manager. The originator signs the requisition, which is prepared in triplicate or quadruplicate as needed, retaining one copy. The second copy is retained by the approving authority, the third going to the planning department or, in the absence of such a department, to the production manager. When the item is to be purchased instead of constructed by the company's own workmen, this third copy finds its way to the purchasing department. To the treasurer the fourth copy is sent, and the fifth, if one is prepared, is filed in the accounting department, where it is entered in an authorization ledger and also against the budget for the plant concerned.

Should the fixed-property item be one that must be purchased, the same procedure is followed with regard to it as obtains in the case of purchases of raw materials, as explained in Chapter VII above.

When the expenditure is to be made within the plant, a work order is prepared by the planning department or whoever performs the function of the planning department. This department sees that all detailed specifications, drawings, and essentials of construction are sup-

plied and followed. The order is prepared so that copies are supplied to:

1. The department required to do the work
2. The authority approving the request
3. The cost accounting department
4. The voucher department, and
5. The planning department (to be retained in its file).

The order proper is given over primarily to a description of the work to be performed and to attached explanatory papers. On the back of the orders are spaces for labor charges accumulated and units and amounts of material used. When the job is completed these items are totaled and placed on the front of the order, where a burden charge is computed.

After the work is completed, actual costs and actual time to finish are entered on the duplicate and sent to the comptroller's department, where actual cost is compared with estimated cost. Obviously, if the actual cost is much in excess of estimated cost, the discrepancy is brought to the attention of the general superintendent for investigation. The total cost is then cleared to the proper ledger accounts by journal voucher.

### **Transfers and Retirements**

No fixed property should be transferred, dismantled, salvaged, scrapped, or demolished except on authorization by a written "Transfer" or "Dismantling" order. Such an order may serve in the capacity of both a work order and a completion order and should show in addition to the initials of the requester, the initials of persons approving the order, a complete description of the property to be transferred, place from which and to which it is to be transferred, the original cost, the accumulated reserve for depreciation, and if the property is to be dismantled or retired, the estimated salvage value and the loss or gain through retirement.

Should there result from the demolition any usable or salable property, a "salvage material" report is prepared in duplicate. A copy of this report is sent to the storekeeper for checking-in the material salvaged, after which it is sent to the purchasing department for pricing. Thence it goes to the accounting department as a basis for adjusting the plant ledger accounts.

### Need for Fixed Property Records

A satisfactory internal checking system requires detailed and supporting fixed-property records just as surely as it has need for records of cash, receivable, investments, and inventories.

"Should the purchase of a milling machine be treated any differently from a carload of steel? In the former case the charge is made to the machinery account and as a rule goes no further, but in the case of the steel the charge is not only made to the raw material control account, but is further recorded in the stores detail records showing the quantity, kind, value of the purchase and location of the stock. With the records controlled by the raw material account in the general ledger, it is possible to make an actual count of the stock and verify the stores record which in turn supports the general ledger; . . . but why are these records maintained with the steel and not with the milling machine? Is it because a proper system of cost accounting is in operation and a control over raw material is necessary for its operation? If so, how can depreciation be properly included in the departmental costs of the component parts unless the location of the elements of fixed property are known and the depreciation on such elements applied to the product of that shop or department location?"<sup>1</sup>

In addition to making sure of the physical existence of each unit of fixed property, its location, value, and identity, fixed-property records are useful in:

1. Showing correct recording and distribution of construction charges, or in the case of purchases, the proper handling of installation charges
2. Establishing at any time the original unit costs and periodical and accrued depreciation, thus permitting the adjustment for retired or obsolete property by fact rather than by guess
3. Enabling the cost department to compute and apply depreciation to current production more satisfactorily
4. Establishing valid fire-loss claims and more intelligent property-tax renditions; and finally
5. Making available data which can be used in subjecting the plant units to selective audit checks.

### Classification of Fixed Property Accounts

The foundation of any system of accounting requires that a workable account classification be evolved. This principle

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<sup>1</sup>"Fixed Property Accounting," Anthony B. Manning, in *Administration*, December, 1921, p. 759.

holds just as true with regard to fixed as with current assets. While it is impossible to draw up a classification that can be universally applied, the following is suggestive:

<u>Kept by General Accounting</u>	<u>Kept by Property Account-</u>
<u>Department</u>	<u>ing Department</u>

*General Ledger Control*<sup>2</sup>

Plant and Machinery

*Subsidiary Ledger*  
Plant Land

Plant Land  
Tract No. 1  
Tract No. 2  
Tract No. 3

Plant Land Improvements  
Tract No. 1  
Tract No. 2  
Tract No. 3

Tract No. 1  
Grading  
Sidewalks  
Fences  
Tunnels  
Mains, etc.

Buildings

Tract No. 1  
Tract No. 2  
Tract No. 3

Tract No. 1—Building  
No. 1  
Excavation  
Foundation  
Masonry  
Steel and Iron Construc-  
tion  
Brick Construction  
Wood Construction  
Roofing  
Windows and Doors, etc.

Building Equipment

Tract No. 1  
Tract No. 2  
Tract No. 3

Tract No. 1—Building  
No. 1  
Piping  
Wiring  
Lighting Fixtures  
Lavatories  
Fire Protection and  
Sprinkler System  
Elevators  
Partitions, etc.

<sup>2</sup>Adapted from classification by Anthony B. Manning in *Administration*, December, 1921, pp. 761-3.

Fixed Factory Equipment	Tract No. 1
Tract No. 1	Furnaces
Tract No. 2	Forges
Tract No. 3	Cranes
	Hoists
	Conveyors
	Pumps
	Tanks
	Scales, etc.
Machinery	Classified according to
Tract No. 1	various types or accord-
Tract No. 2	ing to function
Tract No. 3	
Power Plant	Steam Plant (detailed)
	Electrical Plant (detailed)
	Gas Plant (detailed)
Office Equipment	Tract No. 1—Building
	No. 1
	Desks, chairs and tables
	Filing equipment
	Mechanical equipment
	Adding machines
	Typewriters, etc.
Transportation Equip- ment	Automobiles—trucks
	Automobiles — passenger cars, etc.
Miscellaneous Equipment	Laboratory equipment
	Hospital equipment, etc

The classification above is not all-inclusive nor does it show all the divisions and subdivisions into which properties may be divided. It does, however, serve as an outline to be filled in as may be desired in any specific instance. Obviously, some numbering or lettering system may be used with the above grouping.

### Property Record Cards

The property accounting division should keep detailed card records of fixed assets by types of property, function, and location. Such a card should show considerable information, namely: date acquired, cost, additions, transfers, retirements, assessed value, insurance carried, and, frequently depreciation, if separate cards are not made out for accumulating the depreciation reserve on the

asset. It should also show how the asset was acquired, the purchase requisition number if it was bought, or the work order number if it was produced by the company's own workmen.

In the case of plant land, the card should show the record of public registration, giving the date the deed was recorded and the volume, page, and line on which it is recorded. The number of the lot and block should be shown in the case of urban property, or the range, township, and section if the land is out of an incorporated city. Improvements to the land should be noted on the card, as should also the mortgage record if the property is encumbered. Finally, a chart of the locality in which the land is situated should be prepared with a sketch of the area owned shown thereon.

In the case of land improvements, a detailed description of the type of improvements made, the cost of such improvements, the voucher number setting them up, the location, and the rate of depreciation applying should be shown. If a depreciation card for the particular tract is prepared, it should have columns showing annual depreciation, previously accumulated depreciation, and depreciated value.

In addition to the usual items appearing on the building card record, one card obviously to be used for each building, there should be spaces showing the date the building was started, date completed, and date put into service, estimated life, dimensions, and disposition. Perhaps the most important information to be shown on the building card is the detailed description of items and amounts making up the total cost of the building, such as excavations, walls, roofs, and other detailed cost items concerning which information may be needed in the future when replacements and renewals may be made.

In the case of machinery it is very important that such records be prepared as will permit the easy tracing by actual count of all items of this kind. It becomes necessary, therefore, for the property accounting division to have two sets of machinery cards, one set showing each piece of machinery by location, the other showing the machinery according to class of machines. This latter grouping serves the purpose of supplying information to the management as to how many machines of certain types are owned; the former grouping permits proper charging of depreciation, and also makes some employee in the plant responsible for the care, protection, and use of such equipment. From the standpoint of audit control,

it is in this last particular—namely, that of holding someone accountable for the property—that the machine-record card serves its most useful purpose.

### **Continuous Audit of Plant Property**

As a final control over fixed property such as machinery and movable equipment, two deliberate checks must be made: first, trial balances of item cards must be checked periodically against the subsidiary ledger or group master cards and on through against the general-ledger plant-control account; and second, a physical inventory of such property must be checked against card records. This latter work may be done by the property accountant during his frequent plant inspection trips, or it may be performed by a member of the internal audit staff, or both. In either case, the various locations may be so divided up as to permit one or more departments to be inventoried each month. If this is done systematically, unreported removals or transfers will be discovered and promptly corrected on the card record.

### **Summary**

In conclusion, a satisfactory system of internal audit control over plant property requires the development of a standard procedure showing written authority for the acquisition and disposal of capital assets, the setting up of standards to serve as a basis for determining what items are revenue and what capital charges, a standard classification of fixed-property accounts, well-designed forms for keeping complete information regarding each unit of fixed property, an accounting control through general and subsidiary ledgers, and, finally, a deliberate inventory of physical units periodically or continuously.



## CHAPTER XI

### SUMMARY AND CONCLUSIONS ON PRINCIPLES OF INTERNAL CHECK

#### Purposes Served by Internal Check

In this section, attention has been directed to the automatic routine audit control which should obtain in an organization as a prevention of fraud and error. To this type of internal audit control the name *internal check* has been applied. It is worth while to note that in the application of principles of internal check there is no need for a superstructure over the organization, no special group of individuals separate and apart who carry out the work of checking against employees, neither should the orderly operation of the business transactions be slowed up because a company has a first-class system of internal check. The very nature of internal checking is that it will be merged into the business routine with the least amount of friction and duplication. It is an integral part of the orderly flow of business transactions neither hindering nor causing a speeding-up of the flow. Found in the operating as well as the administrative departments of the business, it serves as a watchdog rather than a bloodhound. Its purpose is not to discover fraud and error as much as it is to prevent them. It is important, therefore, that in planning a system of accounts, accounting records, and operating routine, attention be directed to the ways of incorporating internal checking methods in the company system. Some of the requisites which will assist in making this possible are:

1. Each employee's duties should be so well defined as to make him wholly responsible.
2. Wherever possible, an employee in the operating department should not be permitted to be in entire charge of cash or other fugitive assets and also keep the records of these assets.
3. Some form of checkable evidence should be brought into existence wherever a transaction occurs. These evidences of transactions should be numbered serially, should be used in sequence, and should be capable of being accounted for at any time.
4. On the same principle that the larger the number

- of logs attached to the raft, the less chance it has of sinking, as many individuals as is efficiently possible should have a part in the routine transaction so that if one errs another will discover the mistake.
5. It should be remembered that there can, in the nature of things, be no effective check upon misappropriation of cash, notes, tools, and merchandise unless adequate accounts are kept.
  6. Finally, there should be someone not an operative under the system who will through continual inspection and supervision of routine see that the system is being carried out as planned and that each individual is carrying out those tasks and only those tasks to which he has been assigned.

If the officers of a company are really concerned about their internal organization and operating set-up, they may test out the efficacy of their internal checking system by subjecting it to a series of questions. The answers to these questions will indicate whether the concern is adequately protected from fraud and error. Such a questionnaire is often helpful to the public accountant, as it will enlighten him as to the degree to which the organization is availing itself of self-help and to what extent and where it will be necessary to make detailed examinations and where test checks will suffice. It will, furthermore, permit the auditor immediately before undertaking the engagement to inform the client of the limitations of a balance-sheet audit should he find the internal checking system weak or improperly kept up.

The following questions are indicative of what such a questionnaire should contain:

### **Questionnaire Relating to a System of Internal Check**

#### **A. Sales**

1. Are both cash and credit sales executed by the concern?
2. Has any conscientious effort been expended to control cash sales transactions? If so, what method is in use? Are cash registers employed?
3. Are clerks allowed to pay cash refunds for purchase returns and allowances? Should an officer authorize all such refunds?
4. Is there a regular sales department? How is it organized? Is there a sales-audit department? How does it function?
5. On what authority are shipments released?

6. Is the following procedure followed with regard to sales orders:
  - a. Sales order approved by credit department
  - b. Copies of shipping order routed to stores department, shipping department, and accounting department
  - c. Billings to customers prepared in the accounting department?
7. To whom is the shipping department's copy of the shipping order sent after the shipment has been made?
8. Are branch sales reported currently to the head officer? How are branch sales controlled?
9. Are records of stray shipments maintained and followed up?
10. Is responsibility for the proper handling of sales transactions definitely placed?

**B. *Purchases and Expenses***

1. Are the several steps in the purchase routine carried out by one person or several persons?
2. Does the purchase routine include these steps:
  - a. Preparation of purchase requisitions?
  - b. Placing of purchase order?
  - c. Receipt of goods by someone other than an employee of the purchasing department?
  - d. Approval of invoices as to prices, description, etc., by the purchasing department?
  - e. Approval of invoices as to computations, extensions, and footings by the accounting department?
3. Is there a regular purchasing department? How are purchase orders placed and by whom?
4. Are purchase orders executed in writing or orally? If in writing, are copies of the orders sent to other departments concerned? If orally, are they later confirmed?
5. Are invoices as received sent direct to the receiving department as a check against goods received or are receiving tickets prepared by the receiving clerk without any knowledge of merchandise ordered? Is a complete or partial blind-check method used?
6. Are invoices subsequently matched with receiving tickets or receiving reports? What department makes the comparison? If the purchasing depart-

ment, is the work performed by an employee other than the purchasing agent?

7. Where bids are required, are all copies of bids received retained? If the lowest bid did not secure the order, are adequate reasons given for the failure?
8. Are adequate records in use for showing claims against carriers for shortages and damaged goods? Are claims against vendors for breakage and shortages carefully followed up?
9. What control is secured over local purchases?
10. Have all current expense bills the approval of the department responsible before payment?
11. If goods have been purchased for direct shipment to customers, is reference to the sales invoice charging the customer shown on the purchase invoice? Who supplies this reference?

#### *C. Pay Roll*

1. Who is responsible for hiring and firing employees?
2. Is a regular routine in effect providing for increase in the number of employees, transfers of employees, and change of employees' rate of pay? Are written advices prepared and kept on file when men are hired, fired, or transferred?
3. Is a timekeeper employed? To whom does he report?
4. Are time-recording devices used?
5. By whom and how often is the pay roll prepared? By whom is it approved?
6. Does the same person preparing the pay roll also distribute it to the employees?
7. Are employees paid in cash or by check?
8. If they are paid in cash, are receipts required?
9. If pay roll checks are issued, how often and by whom is the pay roll bank account reconciled?
10. What disposition is made of unclaimed wage?
11. Is any deliberate check made on rates being used? Is the amount of working time reconciled with clock time?

#### *D. Cash*

1. Is the department responsible for the receiving, handling, and depositing of funds entirely separated from the department keeping the accounting records?

2. Are cash receipts deposited intact daily?
3. If cash and checks are received through the mail, is an independent record of incoming remittances prepared? Is this list later compared with the cashier's receipt book and deposit ticket?
4. What duties other than handling cash are performed by the cashier?
5. If a retail store, are methods in use which will catch underreporting of cash received from sales?
6. Is the cashier allowed access to the subsidiary ledgers? Which ones?
7. What methods are employed to prevent the cashier from failing to report cash received from customers on account? Is the cashier's receipt book compared with the deposit ticket periodically? Who makes the comparison?
8. Are "spot" audits of cash on hand made? By whom and how often?
9. Is the voucher system employed? If so, are the supporting documents presented to the officer signing the check simultaneously with the check presented for signature?
10. Are checks countersigned?
11. Is it the policy of the officers signing checks to leave signed blank checks for use in an emergency during their absence?
12. Are supporting voucher documents stamped paid or otherwise marred so as to prevent their use a second time in support of cash disbursements?
13. Does the person making deposits also have access to the bank book or bank statements?
14. Who reconciles the bank statement? Does he have access to cash or prepare or approve checks?
15. Does the company cashier deposit all spoiled or voided checks, or are these checks voided without entry?
16. Are the cash records footed occasionally by some one other than the person keeping the record?
17. Is any effort being made to see that fraud in allowing unauthorized or excess customer discounts is being prevented?
18. Is an imprest system of petty cash in use?
19. Are all payments evidenced by receipts? Are these receipts so cancelled as to prevent their use a second time?

20. How often is the petty cash fund counted and by whom?

*E. Notes and Accounts Receivable*

1. Is the custody of the notes separated from the person keeping the book record of notes?
2. Is the trial balance of notes checked periodically against the control and the actual notes?
3. If there is collateral on notes, is it attached to the note or separately held?
4. Does the cashier endorse partial payments on the backs of notes, or does he simply prepare a receipt, the note custodian making the endorsement?
5. Are notices of dates due sent out by the note custodian or the note-ledger clerk? Who mails these notices?
6. Are all non-cash credits to customer accounts authorized by some one in authority? Who is responsible for granting trade discounts, allowances, and returns?
7. What control is exercised over bad accounts and notes written off?
8. Do these bad accounts and notes written off show the approval of the person authorizing their write-off?
9. Are regular statements sent to customers? Who prepares and mails these statements?
10. Who reconciles the customer's ledger with the controlling account? Are variations located or adjusted?

*F. Securities*

1. Who has authority to make purchases and sales of securities?
2. Are securities on hand under dual control, or has one officer complete custody of them?
3. Where are securities kept?
4. Are adequate records kept of securities?
5. How often and by whom are securities counted?

*G. Finished Goods, Raw Materials, and Supplies*

1. Are these goods under control of a storekeeper?
2. Do other employees have access to the storerooms?
3. Does the store clerk keep a running balance of stock on hand?

4. Is a separate inventory record kept in the accounting department? If no details are kept in the accounting department, what about controlling accounts over these items?
5. Is there or should there be a perpetual inventory record kept? If kept, does it show valuations or quantities only?
6. Are deliveries of raw materials and supplies made only on requisitions?
7. Are deliveries of finished goods to the shipping department made only on shipping orders?
8. Are physical inventories taken of all or part of the stock periodically? Who supervises the inventory taking?
9. How are discrepancies between the book inventory and the physical inventory treated?
10. Are large discrepancies followed up and reasons for their occurrence obtained?

#### *H. Notes and Accounts Payable*

1. Who has authority to sign notes payable and acceptances?
2. Is a counter-signature required?
3. Is the clerk who keeps the note-payable register and draws the notes also allowed to present the checks in payment of notes at the bank?
4. Who receives monthly statements from creditors? Are these checked against the bookkeeper's list of accounts or vouchers payable as secured from the accounts-payable record?
5. Are checks paying accounts payable and notes payable presented or mailed by a person different from the one making them out?

#### *K. General*

1. Are the employees shifted about from one task to another, one department to another, or one branch to another occasionally?
2. Are vacations required of employees occupying positions of trust?
3. Is the cashier allowed to open incoming mail?
4. Are all employees occupying positions of trust bonded?
5. Is there a personnel department whose duties include the checking up on employees' living condition?

6. What disposition is made of waste, scrap, and unused materials?
7. Are capital expenditures authorized, and, if so, are records kept of amounts expended in excess of or under authorization?
8. What control is exercised over hand and movable machine tools?
9. Is there some one person in the organization responsible for seeing that the system of internal check is being properly carried out?
10. Do you see any place in the organization where mechanical equipment would assist in securing a closer internal check on transactions without prejudicing the ordinary routine and efficiency of the concern?

### **Limitations of Internal Check**

A continuous automatic audit of current transactions and control of assets will generally succeed in protecting the interests of the company from dishonest employees, customers, and vendors. There are, however, certain definite limits beyond which even the most efficient checking system will not operate.

It cannot be expected to stop shoplifting, nor will it have any effect in preventing the issuance of fraudulent financial statements. It will not guarantee that proper accounting principles have been applied. If the management has decreed that certain revenue expenditures shall be capitalized, or *vice versa*, the internal checking system cannot be expected to right the situation.

It breaks down almost completely when there is fraudulent co-operation between employees. Internal check is deeply rooted in the idea that one man dares not perform dishonest acts for fear that the second person handling the transaction will report the dishonesty. It is also bound up with the feeling that one man may make an honest error, but a different individual a party to the transaction will not make the same error. If the second individual is sloven and indifferent in his duties, the honest error may never be found. Likewise, if two or more employees are in collusion, the fraud may be long covered up.

### **Collusion**

Collusion results when there is a secret conspiracy or connivance between two or more individuals to defraud.



It may be entirely internal or partly internal and partly external. In the latter case, a confederate is needed by the company employee to assist in disposing of company property wrongfully secured. In the former case, cash is fraudulently obtained and divided between the conspirators. Where the collusion is internal, an effort is usually made to cover up the embezzlement by falsifying the existing records or by building duplicate fictitious records.

The most usual type of collusion discovered is that between the cashier and the bookkeeper. It is a comparatively simple matter for the cashier with the bookkeeper's assistance to withhold cash received from customers, crediting their respective accounts from collections subsequently received. In a bank operated on the unit plan, the teller and individual bookkeeper may watch the action of certain depositor accounts and run forged checks through, secure the money, and cover by a continuous process of kiting. A hotel manager and office cashier have been known to defraud by collecting on checks once run through the bank and returned because of signature, endorsement, or insufficient funds and then having the accounts written off as bad debts or delinquent accounts.

These cases are only samples of the many potential collusive methods which the management must guard against. Simple cases of collusion may be guarded against by frequent rearrangement of duties. If employees, particularly those keeping original entry records, were likely to be shifted to some other duty or department at a moment's notice, the chances of improper dealing being discovered would be increased and the moral check thus exercised would be of the greatest value.

The situation, however, is different where a number of the staff employees co-operate in crime. No system of internal check can prevent wholesale collusion, as the following case admirably shows.

#### **Illustration of Wholesale Collusion**

The concern in question, an installment house accepting notes from customers, had employed reputable accountants to install an adequate accounting system with special reference to internal check through division of duties in the office. The office force consisted of the following: (1) an office manager, (2) a general ledger bookkeeper, (3) a ledger clerk, (4) a stenographer, (5) a collector, and (6) a cashier.

Unfortunately, the entire force was located in one room, and, with added familiarity, the employees began to function indiscriminately with little or no effective supervision over the various operations. The fraud began when the office manager discovered the cashier short a few hundred dollars. However, instead of reporting the discrepancy, he joined in with the cashier in furtherance of the dishonest practice. Very shortly thereafter another of the clerks discovered what was going on, but instead of reporting to the manager, he went to the office manager, who induced him to join in the "racket." The remaining clerks were then tried out to see if they would care to join, and upon their agreement there followed an orgy of embezzlement which amounted to something over \$150,000 in the course of two and one-half years. During this time the books were audited twice by outside accountants, but on neither visit was the fraud discovered. It was, however, turned up when a surprise audit was made. Their methods were as follows:

1. A duplicate set of books was kept, one set showing what should have been the case, the other showing actual conditions.
2. Cash was taken from receipt on notes, the note accounts being credited, but no entry was made on the cash book. Just before the audit was expected, fictitious cards and forged notes were placed in the file. These were given the appearance of reality by the use of names of former customers.
3. In other instances, the excess of control over details was made up in part of the use of genuine cards representing the accounts actually paid up during the last month of the year, the genuine notes, however, being retained instead of being returned to the customers. The posting of credits to these accounts was delayed until after the month's balance had been taken. The stenographer exercised care in seeing that no further notices of installments due were sent to such customers.
4. Other methods were employed such as "plugging" of adding machine tapes of lists of subsidiary ledgers so as to make them agree with the controls, by underfooting the cash receipts book; by kiting and other miscellaneous fraudulent schemes.

Of course, this wholesale fraud was eventually discovered, but it could have been prevented if there had been

one honest person in the organization. But what was really needed was some one in the organization not an operative under the system who would periodically make deliberate checks of operations and also check up on the system to see that it was being carried out as planned.

### Conclusion

The final conclusions on internal check then may be summed up as follows:

1. Some form of internal check is superior to no system whatever.
2. Internal check can be applied in the small business if the management is willing to handle some of the detail.
3. Internal checking systems are more successful when greater division of labor is possible.
4. No internal checking arrangement, however perfectly organized and arranged, will carry itself forever, but needs some person higher up to determine whether it is being effectively carried out.
5. Collusion may interfere with the system, but will seldom cause it to break down completely, except where the entire office personnel is dishonest.

The fact that internal check is not entirely fool-proof against fraud and error leads to the feeling that some other kind of check is needed. This additional check will for purposes of this discussion be called deliberate audit. Deliberate audits may be internal or external. The following section of this work is devoted to a discussion of deliberate internal audit control.

**PART III**

**DELIBERATE INTERNAL AUDIT CONTROL**

## CHAPTER III

### ORGANIZATION FOR INTERNAL AUDIT CONTROL

#### Need for Internal Auditing

In Utopia there will be no auditors; in that fanciful state where all is perfection none will be needed.

American business, however, has not yet reached that stage of development when the auditing function can be done away with. "To err is human," says the proverb, and as long as errors are committed there will be some one or ones whose duty it will be to discover and correct them. Truly enough, the auditor may become a nuisance and a bore. He does not directly assist in producing a profit for a company though he may do so indirectly. Because the auditor does not directly produce for the company, many entrepreneurs have in the past had little patience with auditing, considering it to be just so much unnecessary overhead. Others have tolerated it, considering it as a necessary evil. Today it is generally recognized that it is just as important that accounting information be verified at the source as it is that care be exercised in the tabulation of final results.

The effectiveness, the need for, and the nature of the work performed by the private auditor depend, of course, upon a number of factors. The first of these factors is perhaps the size of the company. It is axiomatic that the larger the company the greater is the necessity for having a staff of men who will function in an auditing capacity. However, even the comparatively small business will have some one in the organization either consciously or unconsciously performing an auditing function. In this small business it may be the general manager, the treasurer, the secretary, the president, the assistant cashier (in the case of a bank), a chief clerk, the office manager, or the chief accountant. The auditing work may be carefully planned in advance, or, if done by an executive officer, it may be intuitively performed from a general survey of conditions and results.

A second factor which enters in determining the need for and the type of work performed by the private auditor is the nature of the activities of the concern. A company having all of its activities centered in one place will have

less need for a large auditing staff than will the company with many subsidiaries, branches, and affiliations. The large oil company with its numerous field-producing operations and its network of retail organizations will be called upon to handle considerably more detail auditing work than will the small independently owned refinery operating within a radius of 150 miles from the plant. The large utility with its multitudinous ramifications will carry a sizable auditing staff, while the municipally-owned utility will have no need for such a staff, although even in this latter case there may be one or more individuals who answer when the name auditor is called. The railroads, the chain store organizations, the large retail and wholesale stores, not to mention the large bank, large brokerage houses, hotels, large educational institutions and municipal corporations will have need of some person or persons within the organization who will follow up the work of accounting to determine whether it has been accurately and honestly performed.

The methods of accounting followed and the extent to which the internal routine provides automatic checks on operations as they are happening will tend to increase or decrease, as the case may be, the amount of detailed auditing needed.

Finally, an internal auditor's work is limited or extended according to the internal organization of each particular concern. At this point, it might be worth while to inquire into the question, where does the auditor belong in the business organization?

### **Place of the Auditor in the Business Organization**

It might well be pointed out here that the word *auditor* does not mean the same thing to all people nor does it follow that a man who is auditor for the XY Company will perform the same duties as the auditor for the OK Corporation. There are, in fact, many cases where the person given the title of auditor does not audit at all but merely heads up an accounting department and should more appropriately be called the chief accountant. And yet this chief accountant may have under him men who spend their entire time verifying records. These men often carry such titles as traveling auditors, field auditors, warehouse auditors, voucher auditors, sales auditors, or perhaps the plain name of inspectors. In fact, an employee carrying the name of auditor may have no auditing duties whatever; he may be in charge of ac-

counting and auditing functions; he may be an employee of a department devoting his entire time to auditing one particular set of facts and figures; or he may be an entirely independent individual reporting only to the board of directors, with broad powers of auditing the work of both executives and clerks, head office and branches.

Perhaps in the majority of cases in American business houses, the auditor, if there is one, is attached to the accounting department. Since it is an auditing function to safeguard the inflow and outgo of cash, securities, merchandise, and other properties as well as to see that the records are properly kept and made use of, it is necessary that he be constantly in touch with the accounting department. There are a number of variations of this relation to the accounting department. Some of them are:

1. The auditor may be the executive head of the entire accounting department, in which case he may be reporting to the treasurer, the secretary, a vice-president, or the president.
2. The auditor may be a first assistant to the comptroller, in which case he verifies while the comptroller directs.
3. The auditor may be a free lance officer checking the work of officials as well as clerks and reporting directly to the president, the board of directors, or even the stockholders. In this position he has no supervisory powers over the accounting department but operates more as a public accountant performing a continuous audit of records and accounts.

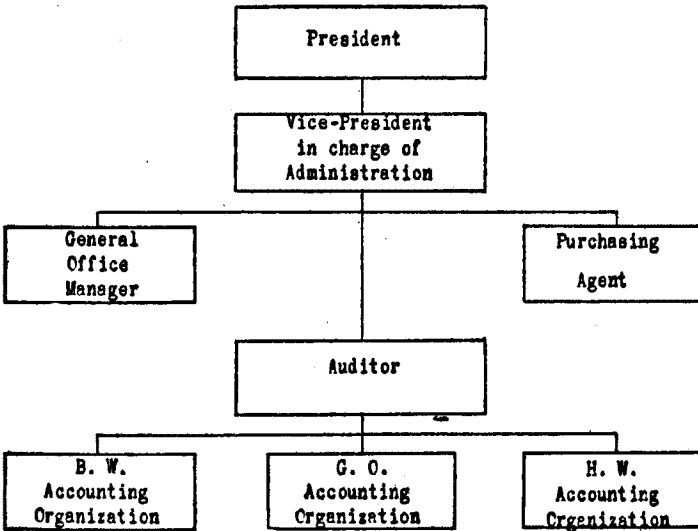
In the first case stated above the name of auditor is being used in place of chief accountant, a name which more accurately describes the position. This is due to a lack of standardization in accounting terminology which often allows a person to be called by a title that does not express accurately the real nature of the work performed. It is generally thought to be preferable that the term *auditor* or *general auditor* be reserved to describe the work of that person responsible for verifying the accuracy of records. It is manifestly absurd to expect a person to audit the work which he is doing, and hence wherever the term *auditor* is used when *chief accountant* is more accurately the title, there is neither accuracy of description nor satisfactory audit control.

On the other hand, in the organization plan of a number of large companies the supervising head of the de-

partment of records and standards, including accounting and auditing control, is called auditor but may have under him not only an assistant who is really the chief accountant but also a separate audit staff. This individual called the general auditor is in reality doing the work of the comptroller, with duties more far-reaching than those ordinarily considered to be classed as auditing functions. After all is said and done, it is immaterial what names are given to these tasks so long as effective control is secured. It is important, however, to note that the mere naming of an individual as auditor does not necessarily mean that he is an auditor nor that any of his duties will be concerned with verification work.

### The Auditor as Executive Head of the Accounting Department

As an illustration of the first case mentioned above, there is shown below that part of the organization chart of a manufacturing company relating to its accounting set-up:



In this particular case, the auditor is undoubtedly carrying out the functions of a comptroller. Responsibility for proper accounting methods and procedure is vested in him, with actual accounting performance delegated to the heads of each of these respective accounting groups.



The auditor's responsibility in this case does not end with the determination of what records and accounts are to be kept and what reports are to be prepared, but reaches into the actual work of reviewing and verifying the work as performed by the three accounting groups. This type of organization is fairly typical of a large number of American business concerns, the supervisor of the accounting organization also acting in the capacity of auditor of accounts.

The potential success of this type of organization from the point of view of internal audit control depends entirely upon the ability of the auditor. If he has the capacity for doing detailed verification and is versatile enough to adapt himself to doing both administrative and auditing tasks, and if the accounting organization is such as will permit of this dual rôle, then this type of accounting and auditing set-up will probably succeed in securing the desired control.

The outstanding weakness of such an organization from the standpoint of audit control is that the auditor is so heavily weighed down with administrative duties, with seeing that financial statements are properly and currently prepared, and with the everyday business of keeping the recording of business information up to date, that he has very little time left for a deliberate audit of company records. It is also asking altogether too much of the administrative head of the accounting department to devote his time to checking such detail as is necessary to secure an adequate deliberate internal audit. What is needed is another person, working along with but under the auditor, whose perspective is not blinded by the internal checking system and who carries with him the public accountant's philosophy of taking nothing for granted.

### **The Auditor as Assistant to the Comptroller**

The work of the comptroller and the comptroller's department has within the last ten years come in for broad discussion among accountants and specialists in business organization. That the comptroller has a very definite place and definite tasks to perform in American business is shown by a study of companies with assets of over ten million dollars made by Professor J. Hugh Jackson of Stanford University. As indicated by 132 replies to a questionnaire sent out by Professor Jackson, 75 companies had created and were retaining the position of

comptroller, and out of the remaining 57 concerns, a number of the companies were not using the title of comptroller but had officials doing the same work usually allotted to the comptroller. It, of course, is not the purpose of this tract to discuss the controller or his department further than to show the relationship of the auditor to the comptroller.

While there is no unanimity of opinion as to the exact duties of the comptroller, it is generally agreed that his functions include the following, as stated by Professor Jackson:<sup>1</sup>

A. *Accounting*

1. Administration of accounting staff
2. Devising, installing, and maintaining the system of accounts
3. Custody and control of general books and records
4. Jurisdiction over accounts-receivable and accounts-payable ledgers, cost records, expense ledgers, pay roll accounting (including timekeeping and preparation of pay rolls), material and supply ledgers, etc.
5. Preparation of invoices sent to customers
6. Taking and pricing inventories.

B. *Auditing*

1. Administration of auditing staff
2. Recording and checking purchase invoices
3. Verification of cash
4. Auditing of all books of account, expenses, and expense accounts.

C. *Reports, Statistics, and Analysis*

1. Administration of Statistical Department
2. Preparation, analysis, and interpretation of all reports and statistics compiled from accounting records
3. Advice and co-operation with all officers and department heads in all matters in which the accounts or statistics are a source of information or may be affected.

D. *Budgets*

1. Supervision of preparation of cash and earnings budgets and comparison of actual and estimated results.

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<sup>1</sup>"The Comptroller's Department," by J. Hugh Jackson, in the 1930 *Year Book of the National Association of Cost Accountants*, pp. 122-123.

E. *Standards*

1. Preparation and revision of standard manuals of accounting and auditing methods and procedure
2. Control of design, preparation, and issuance of all printed forms
3. Control of standards for office supplies, furniture, and equipment.

F. *Miscellaneous* .....

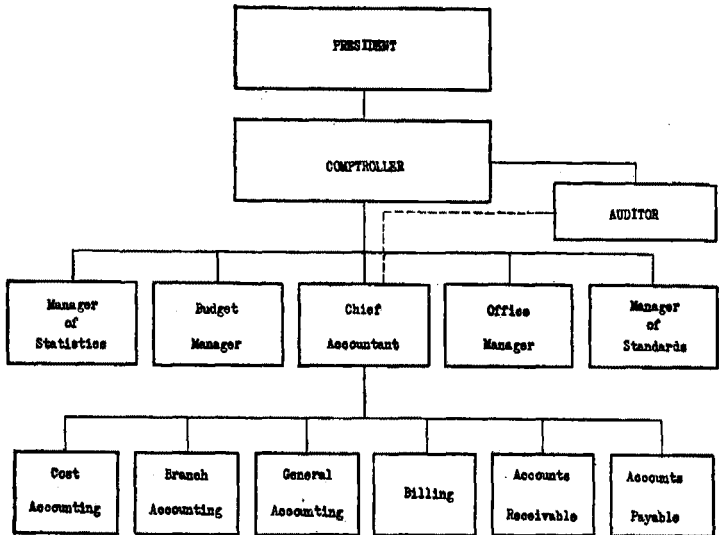
The important part of this outline of functions from the standpoint of this paper is that the auditing function is placed under the comptroller and in many cases is assigned to an assistant with the title of Auditor. Just where the auditor will be placed under the comptroller and the extent of his duties will depend in a large measure upon the organization, and the personality and ability of the man selected for the auditorship. Irrespective of the company, in the words of Chas. C. James, General Auditor of the Westinghouse Electric and Manufacturing Company,

“An executive has done only half his job when he has issued instructions to determine and govern the work of his subordinates. It is an equally important part of his duty to determine for himself that the work is carried forward in conformity to the procedure which he has outlined. Therefore, I believe that in every large organization the comptroller should have attached to his immediate office an Auditor, with the necessary number of assistants to check over all details of the work of the organization at least once each year.”<sup>2</sup>

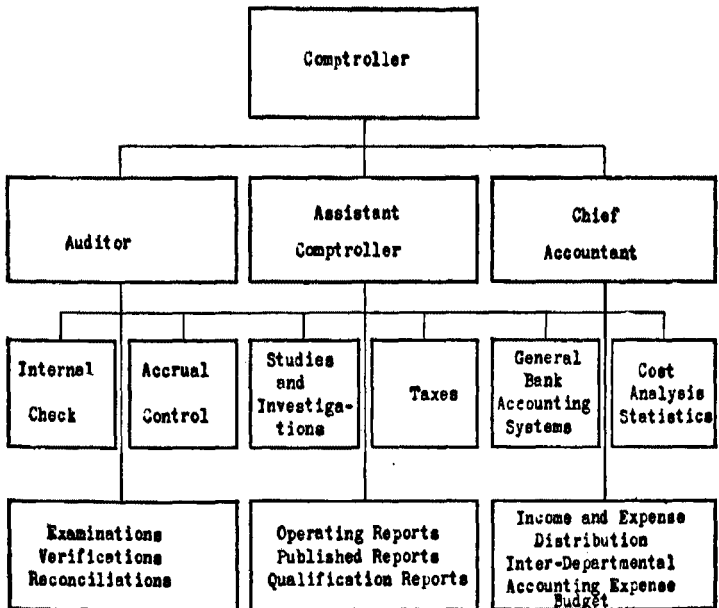
The organization chart of a large manufacturing concern in which the auditor is placed under the comptroller would look something like the following:

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<sup>2</sup>Year Book 1930—*National Association of Cost Accountants*, p. 105.

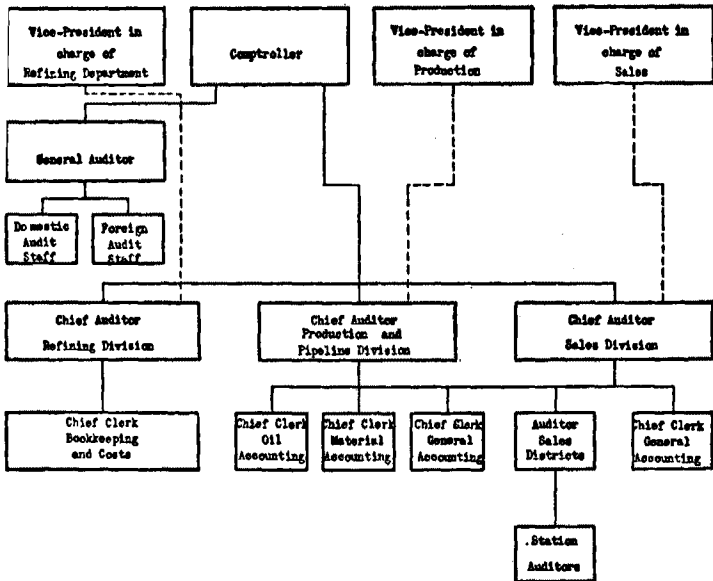


In the case of a large bank the organization chart might appear as below:



The important feature of these two set-ups from the standpoint of organization is that the work of the chief accountant is definitely separated from that of the auditor, and that the auditor working under orders from the comptroller checks the work of the chief accountant and his staff as well as the operating departments.

The organization chart below, developed for a large oil company, presents some interesting features. Here the comptroller is on a level with the operating vice-presidents in charge of accounting work performed in the



various operating divisions. For example, the chief auditor of the Producing and Pipe Line section of the business is working directly under the vice-president in charge of production and yet he takes accounting and auditing instructions from the comptroller. The auditor in this case is the supervisor of accounting for the production department or the chief accountant of that department. It is to be noted that this organization includes a general auditor on the comptroller's staff who will with his assistants verify the work of accounting for the operating departments even though each department is headed up by an auditor.

### **The Auditor as a Free Lance Officer**

The statement has often been made that the auditor should report directly to the board of directors, an executive committee of the directors, or even to the stockholders. Those who take this position have in mind the idea that an audit check on operating officials is just as important as a check on employees. Such an individual would have no executive or operating responsibility but would serve as the personal representative of the board of directors in reviewing the acts of officers and employees in order to determine whether these acts have been performed in accordance with the policy of the owners. It is manifestly impossible for the board of directors to watch constantly the assets, liabilities, income, and disbursements of the company, neither can the president devote his time to these duties. This situation would seem to demand the appointment of an auditor to perform these duties for them. From this it would appear that the auditor's place is as the representative of the board, free to criticize and free to suggest changes where necessary.

This placement of the auditor and his staff would appear to be the ideal for the board of directors and also for the auditor: for the board, because there would be always on hand an organization at its command that can be put to work gathering unbiased factual information concerning the business as well as to pass judgment on the accuracy and honesty with which the company officials and employees are conducting the business; for the auditor, because he is subject only to the will of the owners of the business through its elected directorate and is not required to report to any one official of the company. He is a man aloof, materially interested in the company but with a point of view entirely different from that of the operating heads of the business. His outlook is almost identical with that of the public accountant except that while the public accountant has the whole world for his workshop, the internal auditor devotes his entire time and attention to the one concern. There are cases, indeed, where the public accountant by virtue of his continuous audit of one concern becomes practically an internal auditor.

There are perhaps some types of business wherein this arrangement would be most satisfactory. The large banking house is an outstanding example. In state government, the state auditor and inspector of accounts

should report direct to the elected head of the state government, the governor, having auditing supervision over other state officers.

It is well to take cognizance of the fact, however, that except for a few isolated cases this type of organization often causes friction and fails to secure that necessary amount of co-ordination needed to carry the organization to a successful consummation of the tasks before it. Such a person making recommendations would find it difficult to get them into practice, inasmuch as his recommendations would have to be transmitted by the board of directors to the president and then on to the accounting head. If the matters were always of considerable importance, there would be no objection to such roundabout methods, but to burden the board of directors with the many small details sure to be handled by the auditor would be a colossal waste of its valuable time and would tend to detract its attention from the more important business of the company. If the board of directors has no faith in the ability of its president and his staff to carry on the business honestly and efficiently, then it should secure officers in whom it can place confidence. If to do so is impossible, then periodical investigations and audits by outside accountants would seem to be the next best plan.

### Conclusions

A logical weighing of the facts would seem to indicate that internal auditing is best carried on by an auditor working under the comptroller who in turn reports to the president of the company. Then if the by-laws of the company give the comptroller's department the right to safeguard the assets of the company even to the extent of determining whether the officers have lived up to, but not above, the responsibility vested in them by the board, the company has a definite statement of responsibility for audit control which will be circumvented only when the comptroller's staff is weak, inefficient, or indifferent.

## CHAPTER XIII

### THE INTERNAL AUDITOR:

#### HIS PLACE IN THE ORGANIZATION

##### Duties of the General Auditor

The internal auditing department has been likened to a patrol service in that it sets up a method whereby employees are put on notice that if errors or irregularities either in principle or practice occur they are likely to be caught to their own detriment. Perhaps there is something of this idea existent in the department. Its scope goes beyond this, however, in that the auditor is more than a policeman—he is a skilled investigator interested in improving the present procedure by eliminating and preventing waste and inefficiency in record-keeping as well as in safeguarding the properties of the concern. He must not only see that the best and most suitable methods are introduced, but he must also keep himself abreast of changing conditions of business. Processes adapted to a rapidly growing business may not be appropriate to an established and staid one. However, expansion or contraction either in the volume of trade or the area in which it is carried on may necessitate an elaboration of the accounting procedure or the modification of a system no longer necessary. While these things are principally the concern of the departmental accountant, the comptroller relies upon the auditor to keep an ever-watchful eye and to express critical opinion upon them.

These in general are the duties of the internal auditor. More specifically he is responsible for:

1. Preventing, detecting, and tracing through all manners of fraud and embezzlement in the accounts
2. Discovering and bringing to the attention of the management all inaccuracies, negligence, and discrepancies on the part of individuals in the accounting department
3. Safeguarding the properties of the concern by periodical inspections, spot audits, and examinations
4. Auditing of subsidiaries, branches, and companies in which the employment company has a working interest



5. The preparation of working papers and reports showing the result of the audit
6. Co-operating with the chief accountant and departmental accountants in getting the routine operating effectively
7. Keeping constantly on the alert to improve the accounting procedure, and the personnel of the accounting staff
8. Examining books of record and satisfying himself as to their accuracy, and
9. Making such special investigations as may be required for the general good of the company. By virtue of his special knowledge and his close contact with many divisions of the business, the auditor is likely to be called upon by the directors to collect, classify, and interpret financial facts relative to the business.

As a concrete illustration of the duties of the auditing department in charge of the General Auditor, the following is given by Mr. H. A. Halligan, Vice-President of the Western Electric Company, as his concept of the duties of such a department:

- "1. He has charge of and is responsible for the work of the Auditing Department
- "2. Subject to the approval of the comptroller, he prescribes the rules and conditions under which payments are authorized in all departments of the company
- "3. He audits the accounts of the financial officers of the company, and those of other employees who are entrusted with company funds
- "4. He is responsible for properly auditing the accounts of the treasurer of subsidiary companies
- "5. He audits the transactions in fine metals and minerals
- "6. He investigates at all locations to determine that surety bonds have been secured for employees as prescribed by the treasurer
- "7. He checks commitments and disbursements applying on specific plant appropriations granted by the board of directors and certifies to the correctness of reports covering such specific plant appropriations before they are presented to the board of directors for closing

- "8. He audits the journal entries of all departments of the company
- "9. He audits other records and accounts in all departments of the company, either completely or by test check
- "10. He consults with the European comptroller and officials of allied companies as to auditing methods and routines to be followed in the foreign associated and allied companies."<sup>1</sup>

The major part of the auditor's time or at least of that of his staff is taken up with the problem of determining whether the records and accounts have been properly maintained. While it is the duty of the comptroller to say what records and accounts shall be kept, the auditor is obliged to discover whether they are being kept and carried out as prescribed. In this endeavor the internal auditor functions in a large measure as does the public auditor. Much of the routine auditing procedure used in verification work by the public accountant is in a like manner used by the company auditing staff. Likewise, if the internal auditor is to function effectively, all the books and records of the company, including those of the treasurer as well as those of the corporate bookkeepers, should be open to the inspection of the auditor at all times.

#### **Relation of the Auditor to the Accounting Department**

The attitude taken by the general auditor to other members of the organization will in a large measure determine the effectiveness with which the auditor's work will be performed. If the attitude is one of supercilious superiority and haughty contempt, then undoubtedly the employees will do everything possible to interfere with the auditor's work. But if, on the other hand, the auditor lets it be understood that his job is not to discredit employees with the powers that be, but to assist them in more easily and efficiently carrying out their daily routine, then he is likely to secure their assistance and co-operation in his work.

The auditor must be indeed most circumspect in that organization where the position of general auditor is newly created and where there are perhaps a number of employees older in service with the company than the

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<sup>1</sup>Bulletin No. 1—*Functions of the Comptroller* (published by Metropolitan Life Insurance Co.), p. 9.

auditor himself. Should one of these older employees be the chief or departmental accountant, he is likely to resent the coming into his department of a company auditor. Under such circumstances, the chief accountant must be made to realize that no one is trying to usurp his authority or interfere in his department so long as his department is functioning according to conditions prescribed by the comptroller. It is unlikely in the majority of cases that there will be any difficulty encountered in the accounting departments, as the staff accountants usually recognize that the internal auditor may help them carry forward their own work more effectively. In the words of Mr. Charles C. James, General Auditor of the Westinghouse Electric and Manufacturing Company, "the auditor should be . . . the most welcomed person who visits the accounting office, because he and his men, and they alone, have the time and are given the opportunity to sit down with every individual and go over his work with him to determine whether or not it is well laid out, carefully planned, and co-ordinated with the work of others, and performed in the easiest and best way."<sup>2</sup>

In reporting to the comptroller the exceptions taken during the investigation of the records of the accounting department, the auditor should so choose his language as to throw the responsibility on no one individual unless a subsequent auditor develops that the one responsible for the deficiency has not taken steps to correct the fault, or unless he is recalcitrant. The report will, of course, mention that the particular condition has been discussed with those responsible for the dereliction and that proper steps have been outlined to make the situation conform to the proper practice. With this attitude on the part of the auditor, the employees of the accounting department are likely to accept the auditor as one of them rather than to consider him as their persecutor.

### **Relation of the General Auditor to the Public Accountant**

The internal auditor is in no sense in competition with the public accountant. Both, of course, are concerned with the detection and prevention of fraud and error, but one is concerned more particularly with methods and a continuous audit of routine operations, the other more particularly with results, published statements of financial position, and constructive advice.

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<sup>2</sup>*National Association of Cost Accountants Year Book, 1930, p. 105.*

In the past the public accountant devoted himself primarily to the task of detail verification. The modern public accountant may and often does spend a considerable amount of his time checking the work done. However, if there is an internal auditor in the client's organization, the public accountant may limit his verification to balance sheet accounts, leaving the current detailed checking of transactions to the company auditors. Since the public accountant is relieved of much of the detailed audit routine, he can devote his time to the more constructive services which are particularly valuable to the client because of his wealth of experience gained from contacts with many kinds of businesses. The outside accountant is needed to certify to the figures set forth on the financial statements in order to inspire confidence in the impartiality of the statements.

It must be kept in mind, however, that the internal auditor is in a position to check the records more frequently and more thoroughly than is the outside auditor. The company auditor's intimate knowledge of the particular business through all its ramifications and its minutest details places him in a favored position in the continuous audit of the records throughout the year. Whereas, the public auditor may provide a check once or twice a year on detail transactions, the internal auditor is on the job continuously, making corrections and giving advice concerning the handling of detail almost at the moment the transaction occurs. Also, the employees of the auditor's staff are more familiar with the activities of the company and do not have to be instructed each year as does the outside auditor's staff. There is then less lost time and hence less expense attached to an audit of detail by the company auditors than would be the case if the public accountant's staff made the detail verification. Whereas, the public auditor may be charging the client \$15 to \$50 a day for services of his men, the general auditor may employ men just as good and better versed in the activities of the particular concern at from \$5 to \$20 a day. This saving in audit fees permits the company to maintain a larger staff of internal auditors and consequently permits a large amount of time to be spent on detailed verification of operations.

The employees of the accounting department, it must be remembered, are employees of the company and, even though they are familiar with correct accounting and practice, may become biased to the point of view of the

management, which may or may not be orthodox accounting. The company staff auditors "may be trusted to a certain extent to protect the interests of the company from dishonest employees, customers, and vendors, but they will not have the neutral interests of the creditors and the public as well as the management."<sup>3</sup> For this reason and the others mentioned, the public accountant's annual visit is not to be taken as a reflection upon the work of the internal auditing department, but is to be considered as offering an additional service to the company.

The attitude of the general auditor to the public accountant should be one of cordial co-operation. Such will be the case if the outside accountant, having suggestions and recommendations to make, first discusses them orally with the general auditor. If such suggestions are broached in a friendly spirit and in a manner becoming a professional accountant, they will no doubt be welcomed and put into effect by the internal auditor.

### The Auditor's Calendar

The internal auditor's calendar is to the company auditor what the audit program is to the public accountant. The preparation of it will save unnecessary work and will focus attention on the work that must be done. It will permit a proper division of work among the staff auditors and will show responsibility of men assigned to the different tasks. Finally, it will aid the general auditor in reviewing the work of his staff.

A general calendar may be prepared annually in advance, or better, a calendar should be set up for each month, setting forth the features of the deliberate audit to be handled during that month, with definite assigned dates for each such feature. Of course, the dates should be varied from month to month in order that the person whose work is to be checked may not know the exact date that the audit of his work will take place. Certain features, however, such as bank reconciliations, will have the same date on the calendar from month to month. Care must be exercised to prevent the audit from becoming a routine matter. This danger can be overcome not only by changing the date of assigning work from month to month, but also by changing the staff auditors from one job to another or from one department to another.

In addition to the calendar proper, written instructions should be prepared for the use of the audit staff, outlin-

<sup>3</sup>Robt. H. Montgomery, *Auditing*, Fourth Revised Edition, p. 69.

ing their respective duties. As an example of what is actually done in this regard, the following excerpts from the instruction sheets of one of the largest oil companies operating in the United States may be taken:

### **Field Auditing**

#### *Purpose*

These instructions are issued as a guide to be followed by the Field Auditors engaged in checking records in the fields of the \_\_\_\_\_ Companies.

#### *Scope of Field Auditor's Duties*

The main reason for sending auditors from the accounting department to the field offices is to see that the many "Original Source Records" that are made up in field offices are correctly and promptly prepared.

By "Original Source Records" are meant—Authorizations, Time Sheets, Teaming Tickets, Trucking Tickets, Requisitions, Gauge Tickets, Material Transfers, and other items that originate in the field and subsequently come to the accounting department for final record.

#### *Field Offices*

##### *Time Sheets*

Time-sheet posting shall be verified with foreman's roll book.

When practicable and advisable, time sheets shall be checked with the men actually at work, in so far as this can be done.

Investigation shall be made of any men whose names appear on the rolls and who are not on duty on account of injuries, or who are absent for other reasons.

To aid in the numerical verification of men on pay rolls, periodically, pay check shall be personally delivered by the Field Auditor. The general auditor will advise when this procedure is to be followed.

##### *Team Sheets*

Team sheets shall be checked with team tickets. When practicable, teams in service shall be verified physically.

Full information as to distribution of charges shall appear on team sheets.

##### *Truck Tickets*

It shall be seen that truck tickets, covering operation of company trucks, are properly made.

### *Authorizations*

Status of authorizations shall be checked. It shall be seen that Authorization sheets are closed and completion report forwarded to the superintendent's office immediately after the completion of all authorized projects. Occasional spot checks of postings shall be made.

### *Gauge and Run Tickets*

In some of the newer districts the gauge tickets shall be spot checked. The accounting department will from time to time indicate the district in which difficulties are being encountered in this line.

### *Lease Equipment Record*

Inspection shall be made to see that this record is kept up-to-date in the field offices where it has been installed. Periodically, the equipment as shown by these cards shall be verified by a physical check on a representative lease.

### *Material Transfers*

Field auditors shall see that material transfers are written promptly after the physical movement of material.

### *Warehouses*

#### *Inventories*

Under supervision of Field Auditors, physical inventories of warehouse stock shall be made at stated intervals. The auditor will furnish the approximate date for each warehouse inventory taking.

### *Stocks*

Field auditors shall inspect stock for slow moving or obsolete items and general care and arrangement of stocks of materials and supplies. Warehousemen shall be aided in "running down" the source and condition of materials reclaimed from Plant Accounts, and crediting transfers shall be issued accordingly.

### *Joint Leases*

Upon certain occasions, investigations of some of our jointly-owned properties shall be in order. When such investigations are desired, specific instructions will be issued by the General Auditor.

### **Types of Internal Audits**

Just how much of the auditing performed in an organization is automatic and how much deliberate is often difficult to determine. An adequate system of internal

check is in itself a system of auditing. This is the case since the first principle of internal check requires that the work be so distributed among employees that the work of one employee becomes a check on the other. The way in which internal check provides a continuous audit of transactions has been discussed in Part II above.

A second type of internal audit is what is known as a deliberate audit. This type of audit is used to supplement the automatic audit at those points where an adequate internal check cannot be obtained. Deliberate audits by the internal staff may be:

1. Periodic audits, or
2. Spot audits.

The difference between these two is that the periodic audit is one which is sure to take place at regular or irregular intervals while the spot audit is irregular and touches only one man or one department, or verifies one feature of the business. As an example of the spot audit, the bank auditor may decide without a moment's notice to count the cash of teller No. 15, or the securities held by the custodian. On the other hand, in the case of a periodic audit of a local utility, the office force knows that twice during the year an auditor from the executive office will be on its premises to make certain definite verifications and test checks.

Whether the audit be periodic or spot, the same audit technique is employed by the internal auditor as is used by the public accountant. Such technical language as "footing," "scanning," "test-checking," "scrutinizing," "analyzing an account," "vouching," and "cross-footing" is used by the internal auditor as well as the professional accountant. Likewise, the internal auditor may under infrequent circumstances make a balance-sheet audit, although the major part of his time is taken up with verification rather than valuation. There is, therefore, little need in internal auditing for distinguishing between balance-sheet and detailed audits, as these are terms peculiar to public accounting.

In the next chapter, attention is given to a further elaboration of the work done by the internal auditor and his staff.



CHAPTER XIV  
THE INTERNAL AUDITOR:  
HIS PROCEDURE AND METHOD

**Internal Auditing Methods**

The committee on terminology of the American Institute of Accountants refers to an internal audit as one "made by members of the staff of the concern audited." This committee also adds that "frequently 'staff auditors,' 'traveling auditors,' or 'inspectors' are employed to make continuous or periodical audits of some or all of the transactions."<sup>1</sup>

Questions naturally arise as to methods: Just how does the general auditor function in satisfying himself as to the accuracy of these transactions? Just what methods and devices does he employ that he may go before his superiors and say, "the statements of financial conditions and operations prepared for your company are correct as to amounts, and the officers and employees of your concern are carrying out their respective duties efficiently and honestly"? At least five methods are at hand which may be summarized as follows:

1. The internal auditor may personally or through staff assistants satisfy himself that the methods of protective control established for his concern are being followed and that the automatic check is actually functioning
2. He or members of his staff may build up records and controls to be used as a check against the book records of assets, incomes, and expenses
3. He may delegate to certain members of his staff the daily duty of making positive checks of branch and departmental reports, and reconciliations of bank, branch, and intercompany accounts.
4. He may send his staff auditors to make definite investigations and periodical checks of transactions of departments, branches, and associated companies
5. He may spot leaks by making use of budgets, comparisons, standards, and ratios.

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<sup>1</sup>*Journal of Accountancy*, December, 1927, Vol. XLIV, pp. 448-452.

These various internal auditing methods are discussed in order.

### **Protective Control**

It is a truism to say that, regardless of the quality of the system installed, it will be of benefit to the concern in which established only if properly maintained. Therefore, it behooves the auditor to be constantly on his guard to see that each individual having a place in the system of internal check is doing his bit and that there is no exchanging or overlapping of tasks on the part of the employees without proper approval. If the individual ledger bookkeeper is allowed to substitute for the cashier while the latter is off duty, this information should be brought to the attention of the auditor. If the traveling collectors in a local utility office are allowed to make entries or do work on meter-record sheets or consumers' ledgers, or if the cashier is allowed to mail delinquent notices, this overlapping of functions may prevent the system from operating as was the original purpose for which it was installed.

It is obviously true that economy will result from a system of internal automatic auditing which covers daily routine operations, because it will require less of expensive deliberate checks and less interruption of the regular accounting work. But this economy will be brought about only when the auditor maintains eternal vigilance over the system to assure himself that the individuals having a part in the system are neither lax in their own duties nor overzealous in helping others.

### **Supplementary and Duplicate Records**

The use of supplementary and duplicate records as a control device operates through the accumulation of certain predetermined figures prepared currently in the auditing department from original entry records and departmental reports, or copies of such records and reports, which figures when compared with the ledger balances will prove or disprove the correctness of these balances.

A practical application of this method of audit control is found in the auditing department of many of the better-organized commercial banks wherein controls are procured on notes and discounts, investments, interest income, and certain expenses. The records for this control may be in the form of individual sheets—one sheet for each note—filed in binders or drawers, or they may

be kept in books, a line to a note. In addition to this note register, a maturity record showing by dates the maturities of all notes held by the bank, and a rate record in which is kept a record of each note according to its rate of interest or discount, are kept by the auditor. The bases for posting to these records are the duplicate or auditor's copy sheets as prepared by the loan department, the discount department, the note teller and other tellers handling loan and discount transactions. As for notes, therefore, the auditing department has a current total compiled from original source records, showing the amount which should appear in the general ledger and which should check against an actual count of notes in the note teller's cage.

With regard to income from notes and discounts, the daily or weekly accrual system permits of a positive audit control. This is secured by listing on the rate record each note bearing 4 per cent, 5 per cent, 6 per cent, etc., and totaling the amount of notes for each rate of interest. By a simple process of arithmetical computations the amount of interest earned each day is then obtained. These figures would be accumulated daily, as would also the records of receipts of cash from the note tellers. The difference between the daily accumulated accrued interest and the actual interest received should check with the interest accrued at the end of each month as shown on the note register.

This method of control applies with equal force to income from securities when the income from the different classes of securities is kept on a daily basis showing securities earnings each day. This method, when used with an interest-date tickler, indicates how much income should be earned on securities owned, and sets out clearly if there is any leakage in collections.

### **Daily Audit of Routine Transactions**

In many types of businesses the auditor and his staff may make current deliberate checks of routine transactions, thus proving the work of operating departments as it occurs and not waiting until the end of the fiscal period to make the audit. This method of procedure is particularly worth while in those businesses having a large number of transactions, such as the large retail store or the large oil company with many stations. The sales-audit division of a department store may serve as an example of this method of audit control.

Control over the sales in a large retail store begins with the issuance of consecutively numbered sales books by the auditing department. At the close of each day the sales-audit division receives all tally cards, together with envelopes containing sales clerks' stubs or duplicate sales tickets in books issued that day. The total of cash-sales tickets is secured for each cashier, and this total is checked against the amount of cash reported by the cashier or cashiers.

The charge-sales slips may have been deposited in a locked box and collected by the bookkeeping department, where a run-up of the checks is made on an adding machine. The total of these tickets is reported to the auditing department and is compared with the total secured from sales clerks' stubs or duplicate tickets. Manifestly, mathematical computations and extensions on the slips will be tested, and if inaccuracies are discovered, some member of the division will follow them up to see that they are corrected.

The sales slips are then compared with the clerks' tally cards to discover whether any tickets are missing. Should tickets be missing, this division traces the item to determine the cause. In the investigation, use will be made of cash overage reports, delivery records, and information in the credit department. Frequently, the charge-sales tickets are not missing at all, but are simply held up in the credit department awaiting proper credit information concerning the customer. C. O. D. sales will be checked for agreement with charges to the C. O. D. delivery department.

Another place where an internal auditing department may function in checking reports of operations currently is in the sales division of an oil company. In each station a daily report is prepared setting forth the amount of gasoline, oil, and greases carried over from the previous report; the amount received during the day; the sales during the day; the amount of cash received and deposited during the day; and the reading of gauges on gas and oil tanks at the end of the day. These reports when sent in to the general accounting office should be carefully checked. As an illustration of what might occur through a failure to check these reports thoroughly, the following case is submitted:

"The California division of one of the largest companies recently uncovered by accident a system of fraud extending over a considerable period of time. It appears that

one of the truck drivers lowered his report of daily receipts approximately 500 gallons each day; a colluding confederate at the general office changed the distribution stations' reports of deliveries to agree, and the two of them shared in the proceeds of the 500 gallons. The shortage losses shown by the particular station had always been high, but it had been nobody's business to perceive any significance in the fact, especially since the station handled several thousand gallons per day. Of course, the fraud would have been detected at once, *had the internal auditors compared original station reports with the copy on file in the general office.*"<sup>2</sup>

In checking such reports the following should be done:

1. All sales tickets should be checked against the report, particularly for proper signatures and correct sequence. All missing tickets should be accounted for and cash tickets should be totaled to see that the cash reported was received and deposited
2. If coupon books are issued, it should be seen that all coupons turned in agree with the report. Such coupons should be cancelled to prevent their use a second time
3. Wherever transfers of products are made between stations, these transfers should be reconciled
4. Stocks forward should be checked from the previous report
5. Shortages in excess of normal leakage should be tested and reported to the proper authority, probably the district sales manager
6. All footings on the report should be checked in detail.

This form of report and its subsequent check by an employee of the auditing department furnish an excellent safeguard against fraud; however, in order that an absolute check may be had over such stations, counts of stocks should be made periodically by a competent staff auditor.

#### **Use of Budgets, Standards, and Ratios**

The benefit to be derived from the use of budgets, standards, and ratios is, from the standpoint of internal auditing, more indirect than direct. They may be used to arouse the suspicion of the auditor as to a particular item, thus requiring that he make further investigation,

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<sup>2</sup>Moreland and McKee, *Accounting for the Petroleum Industry*, p. 239.

which in turn may lead to the detection of an error or a leak.

Budgets have long been used in governmental and municipal corporations as a protection against overspending. Here the budgeted appropriations of funds once made cannot be exceeded except through further legislative appropriations. It is the auditor's duty to see that actual expenditures do not exceed those authorized.

In commercial and industrial accounting the budget is not generally made a part of the books, nor are the estimated expenditures of such concerns so restricted as to come positively within the estimate. However, large variations of actual overestimate call for attention and justification on the part of the company auditor. Should the repair account, for example, show expenditures far in excess of the amount budgeted, it may mean that some items charged to the repair account rightfully belong to some other expense account, or it may mean that capital expenditures have been unintentionally charged to the repair account, or it may mean that replacement parts have been fraudulently taken from the stock on hand and arbitrarily charged to repairs, or again it may mean that the budget estimate was inaccurate. Whatever the cause for the discrepancy, the fact that there is a large variation should excite the auditor to action to satisfy himself as to the cause.

Similar in nature to the budget as an audit control device are standard—standards which can be used as a measure of production and accomplishment. Standards for material used in the production of finished products have been used since time immemorial in such language as "so many bushels of wheat, so much flour," and "so much cloth, so many garments." Out of the experience of each manufacturing industry there have developed certain standard costs of materials, of labor, and of factory overhead against which a comparison can be made of current production costs. Should there be material variations between the actual costs and the standard costs in a particular industry, it concerns the auditor to discover whether this variation was due to changing price levels, inefficiency among employees, erroneous cost computations, or leaks in finished goods and raw material.

Standard ratios computed for a particular business or from information secured from a number of concerns doing a certain type of business may be used in somewhat the same fashion. If the normal percentage of sales returns and allowances to net sales is approximately 3 per

cent and the current period reflects a figure of 8 per cent, then it is incumbent upon the auditor to find out whether through collusion cash has been received from customers and pocketed, with an offsetting charge to returns and allowances account, whether goods have been returned without ever having been charged to customers, or whether cash sales have not been entered. Standard cost-of-sales ratios when compared with the actual ratio may, should there be a considerable difference between the two, justify the making of a complete study of purchasing, receiving, and disbursing methods.

In the main, then, it can be said that the auditor should make use of budgets, ratios, and standards to assist him in determining whether further investigation and audit needs be made and just where detailed checks can be applied to the best advantage.

It is to be noted that in each of these methods of deliberate auditing, the work of audit and investigation is performed within the office of the auditor at the home office of the concern in question. These methods may be satisfactory and complete as far as that particular office is concerned. However, when the company operates branches and agencies, or has interest in subsidiary or related companies, to complete the deliberate audit it may be necessary to send staff auditors from the home office to make detailed checks of transactions and to pass on the valuation and count of assets and liabilities in those offices and stores. The work performed by the traveling auditor in the branch or subsidiary company office is discussed in the next chapter.

## CHAPTER XV

### THE TRAVELING AUDITOR

#### A Positive Verification

The company traveling auditor is by no means a new invention. For years he has been checking details of railroad station accounts, local express office accounts, and the accounts of other divisions and branches of the business distant from the home office.

It is to be noted, however, that it is only within the twentieth century that the impetus given to branching out through the establishing of chains of retail stores and wholesale distributing stations and through the acquiring by a holding company of numerous operating and non-operating subsidiaries, that the need has arisen for the establishing of large staffs of traveling auditors in the mercantile and industrial concerns. As a company widens its sphere of activity, thereby allowing company funds and company properties to be held and handled by employees under only partial or no close supervision, it becomes increasingly necessary that these employees be closely checked periodically in order that the officials of the concern may be assured that the work is being conducted efficiently and honestly. As far as this discussion is concerned, it may be assumed that the branches maintain adequate accounting systems which are tied-in with accounting records of the home office by means of control accounts. Under such circumstances, the primary responsibility of the auditor would be that of:

1. Reconciling the reciprocal home office and branch accounts
2. Verifying cash, accounts receivable, inventories, fixed assets, liabilities, expenses, and incomes
3. Reporting on miscellaneous matters such as methods of handling, storing and displaying stock, housekeeping conditions, and efficiency of the various employees.

Of these three duties, the largest part of the staff auditor's time is devoted to the detailed work of verifying recorded transactions and attempting to discover whether all transactions which should have been recorded have actually been booked. In order to explain more specifically



the work of the staff auditor under the circumstances mentioned above, the principal tasks of an auditor are briefly described.

### Verifying Cash on Hand

In the verification of cash on hand, wherever an imprest fund or petty cash fund is used, an actual count should be made of cash or receipts in custody of employees handling the fund. If the fund is sizable, it is a good policy to count it immediately upon arrival, assuming a surprise visit by the auditor, so as to prevent the cashier from making good any unauthorized borrowings from the fund. If the fund is small or if the cashier knows in advance the date of the auditor's visit, it is immaterial whether the cash be counted at the beginning of the audit or later.

Immediately following the count of cash, a form showing the amount of cash due to be on hand should be prepared. The following form is indicative:

Balance of Fund (per books).....	\$ 500.00
Receipts (representing receipts for the day or business day next previous):	
Total of Cash-sales tickets.....	1,250.00
Total of Collections on Account:	
Customers .....	3,500.00
Others (detailed) .....	90.00
	<hr/>
Cash to be accounted for.....	<u>\$5,340.00</u>
Accounted for as follows:	
Currency .....	\$ 650.00
Check .....	4,540.00
Receipted Petty Cash Vouchers..	150.00
	<hr/>
	<u>\$5,340.00</u>

Should there be more than one cashier, the funds in the hands of each should be counted in turn and proved with the data as to receipts and disbursements at hand. Should the size of the fund be considered as too large, the auditor should so report. He should also determine whether the various individuals handling cash are sufficiently bonded.

### Verifying Cash in Bank

The internal auditor uses the same methods employed by the public accountant in verifying cash in bank:

namely, by securing certificates from the bank in which money is deposited or by personally presenting the pass book to the bank for balancing and later calling for it. He should, of course, check off returned checks against the check register so as to substantiate checks outstanding and then reconcile the balance as shown by the pass book or bank statement with the book balance. It is a good policy for the company audit staff to have prepared forms for inserting information as to cash count and bank reconciliations for such forms will result in a considerable saving of time and a greater uniformity of audit reports of all the various branches.

Just how much detailed checking of cash is to be done depends upon the extent of the internal check in the branch or subsidiary company and the amount of detail to be checked. In any event, footings of the cash book should be made for from one to five months including the last month of the audit period.

Returned checks should be scrutinized for signature, endorsement, cancellation by the bank, and proper authorization. Bank deposit slips should be checked against the cash-receipt book figures sufficiently to satisfy the auditor that all cash received is being promptly deposited. Should the auditor have any suspicions as to the accuracy or authenticity of duplicate deposit tickets on file in the office, he may secure permission from the bank to use the bank's copy for his verification. It is also wise for the auditor to take individual items shown on deposit slips and check them back to the cash book to determine whether the currency and checks received on a particular day were the exact items received that day. This procedure will bring to light shortages covered by lapping checks and currency received from customers.

Test checks should be made of postings to the bank account or accounts, and the bank account on the general ledger should be footed. Transfer checks drawn on one bank to be deposited in another bank should be traced through to see that such transfer checks were actually deposited. Finally, the auditor should determine whether the rules of the company regarding minimum and maximum balances carried in the various branch bank accounts are being observed and also whether interest on large balances is being secured.

#### **Verification of Notes and Accounts Receivable**

Notes receivable as per books should be scheduled and an actual count made. If notes are in the hands of col-

lecting agencies, banks, or attorneys, however, they may be verified by correspondence. The internal staff auditor does not attempt to evaluate such notes although he should collect all information available concerning past-due or slow notes, reporting it to his superior, and action on such questionable assets should be taken by the chief of the auditing department in conjunction with the credit manager. The chief duty of the staff auditor in regard to notes receivable is to satisfy himself that each note is a legitimate asset, taking whatever steps may be considered necessary, even to having direct correspondence with the makers, in order to assure himself on this point.

Just how much detailed checking of accounts receivable should be done by the auditor depends among other things on the number of visits made to the branch or subsidiary annually. If several audits are made during the course of the year, the auditor should see to it that a verification is obtained of each amount during the twelve-months' period. This he can do by taking sections of the receivables for verification purposes at his various visits. If but one visit is made, he should secure a satisfactory verification by test, checking the whole receivable trial balance but giving special attention to all large accounts. This may be done in two ways:

1. By circularizing a satisfactory number of accounts, following up each account so circulated to be assured that no "dummy" accounts are included, and
2. By tracing the transactions through that gave rise to the entry on the books for a number of accounts. This procedure consists in securing all papers pertinent to the sale, such as the customer's or salesman's order, the shipping advice, the warehouseman's and shipping clerk's record, and the duplicate bill of lading or other transportation record.

In this latter verification process the auditor will be able to determine whether the procedure supposed to be operating with regard to billing and shipping procedure is being complied with.

Accounts long overdue should be investigated, and accounts supposedly good but habitually past due should be tested to determine their profitableness to the company. If a reserve for bad debts is set up on the books of the company audited, the auditor will determine whether such reserve is adequate to take care of estimated uncollectible accounts. Bad debts actually written

off should be carefully scrutinized to see that such accounts written off were properly authorized.

### Verification of Inventories

The public accountant working on an ordinary audit engagement seldom makes an actual count of stocks. The internal auditor, on the other hand, is in such a position that he may make the actual count himself, or if not able to do the whole job by himself, at least he may be on hand to supervise the actual taking. If, however, the number of branches or subsidiary operating companies is so great that a staff auditor cannot be on hand in each case at inventory time, at least the auditor can send out definite instructions as to the taking. An ideal procedure would be for the local staff members to make the count, leaving behind count cards on the various types of articles in stock. The auditor following behind may check the count, collect the cards, and note on them any errors discovered. In this way the auditor can see to it that the stock has been placed in proper shape for counting and the count check facilitated. The procedure will also give him an opportunity for passing judgment on the condition of the stock, satisfying himself that obsolete goods and shop-worn articles have been eliminated or noted for write-down and that only usable or salable goods are listed at full inventory price.

A test check is next in order to determine whether pricing and extensions of prices are correct. The auditor is to be cautioned in this test check against the misplacement of decimals by employees' computations, as errors are more likely to be made in extending a \$1,000 item as \$10,000 or *vice versa* than in most any other type of extension error. Of course, he should see that inventories are priced at both cost and replacement cost, and, in line with accepted practice, he should see to it that the lower of the two bases of value is used. Any shortages in the physical stock when compared with book inventories should be traced down. Other points in connection with inventory meriting his attention are:

1. In the case of raw material, it should be seen that the units going into future production are balanced. The investigator will find out if the company is overstocked on certain types of goods
2. He should observe whether consignment goods are included in the inventory

3. He should determine whether the stock is adequately insured
4. He should study the arrangement of stock to discover whether internal movements are efficient
5. He should determine what effort is being made to dispose of old or obsolete goods
6. He should determine whether proper records are being maintained so that complete information to those interested is available at all times.

### **Verification of Plant and Other Fixed Assets**

In cases in which an audit has been made previously by the internal auditing staff, there will be working papers showing an analysis of the plant assets as of the last audit period. Wherever this situation obtains, the current audit of fixed assets is limited to an examination of entries showing additions and deductions and an inspection of such actual additions. Manifestly, the auditor will undertake to discover whether such additions, if large, were properly authorized. He should also scrutinize additions to be assured that revenue expenditures were not included among the additions.

If plant machinery or buildings have been dismantled or sold, the auditor should give attention to entries reflecting the changes to assure himself that the plant and the corresponding depreciation reserve accounts are properly relieved. Depreciation computations should be re-computed and variations in rates as set by the comptroller noted. Before the staff auditor leaves the plant, he should make such an inspection of the properties as may be necessary to report upon their condition. He must be able to answer such questions as: Are the plant and equipment items kept in good order? Is the machinery so placed as to permit an orderly flow of production? Is there room for expansion? Is the property adequately insured?

### **Verification of Other Assets**

Should the branch or subsidiary have securities on hand, they should be counted, scheduled, and checked to the ledger for the purpose of determining that accrued interest is not included as a cost of the security. While the verification is in progress, the auditor should assure himself that all interest earned has been received, recorded and deposited.

Attention should be given to the method used for keep-

ing tab on supplies and other deferred charges. Stationery, stamps, pencils, and other printed supplies and office materials have a way of disappearing when not properly controlled.

### **Verification of Liabilities**

The internal auditor is just as anxious to ascertain that all known liabilities are on the books as is the public auditor. It is his duty to show the facts even though they may not be for publication. He should check up on notes to banks, merchandise creditors, and brokers, through the accepted audit procedure of direct correspondence. He should study the practice of the company in emitting notes and accepting drafts, and from the minutes of directors or from instructions published at the head office, discover the authority of those permitted to sign or accept such paper.

The first step in connection with verifying accounts payable is to secure a list of unpaid creditor accounts and prove against the control. These should be checked to the creditor ledger and also against the supporting data on hand. Wherever a voucher system is used, the same procedure obtains, with the added ease of matching data with the formal voucher. An inspection should be made of all invoices entered or vouchered after the closing date, to determine whether any of the items belonged in the previous period. An examination of the records of the purchasing and receiving departments should be made for a period of from ten days to two weeks prior to the closing date to discover if goods have been placed in stock but not yet taken up in the purchase records.

A detailed check of paid vouchers for a period of a month or more would be in order to prove that the company has received full value for all disbursements. This would consist in ascertaining:

1. Whether invoices are made out in the name of the concern under audit
2. That the bill has not been paid previously
3. That the bill bears evidence of the receipt of goods, assets, or services.
4. That the goods received were satisfactory and that the price and extensions have been approved
5. That the proper accounts have been charged.
6. That purchase returns and allowances have been properly handled and booked, and

7. That cash discounts have been taken wherever possible.

In addition to the voucher examination, test checks should be made of footings and cross footings on the voucher register or purchase journal. Test checks of postings to related general ledger and subsidiary ledger accounts would be in order. Non-cash debits to creditor accounts should be closely scrutinized.

Accrued expense computed by the bookkeeper should be closely observed and in some cases recomputed. The auditor may accomplish this check by setting up a column for accrued interest on notes payable on the notes-payable schedule by referring to the first pay roll in the fiscal period for accrued wages, by securing a copy of the last tax receipts for accrued property taxes, and for accrued premiums on liability insurance by securing the rates charged and applying them against the pay roll.

#### **Additional Work of the Traveling Auditor**

In addition to verifying the accounting records, the internal auditor may give attention to such of the operating activities of the concern being audited as would be of interest to the executives of the concern. The following are indicative:

1. Are high costs of goods sold due to purchase in small lots?
2. Are high costs of sales due to small stocks and hence hurry-up shipments by express, when large shipments by freight could be handled if adequate forethought were given to a study of local requirements?
3. Are purchases being made without regard for competitive bids? If competitive bidding is used, do the purchase prices reflect current market prices? If not, why?
4. Is the company property adequately covered by insurance?
5. Is the company indemnified against losses from embezzlement, public liability, and property damage?
6. Are the instructions of the comptroller concerning operating statements being carried out currently and correctly?
7. Are executives calling for too many statements, thus using up valuable time of employees? What can be done to consolidate statement requirements so as to prevent duplication of work?

8. Does the personnel of the accounting department appear to be intelligent, industrious, and co-operative?
9. What is the condition of the physical equipment? Are the housekeeping conditions satisfactory?

The answers to these questions and innumerable others which will occur to the intelligent internal auditor will materially assist the officers of the company in more clearly facing the problems of administration confronting them.

### **The Traveling Auditor of a Large Oil Company**

The traveling auditor of an oil concern usually gets his early auditing training by being assigned to the job of auditing retail stations. This work consists of

1. Counting cash at local stations,
2. Checking measurements of gasoline tanks, taking stock of oils, greases, and other merchandise kept for sale,
3. Inventorying equipment,
4. Studying housekeeping conditions,
5. Passing on the personnel,
6. Looking into reasons for accounts being delinquent, and
7. Following through any claims against surety companies occurring through employees' shortages.

The work is of a routine nature, requiring little or no especial accounting knowledge, although most oil companies hold accounting experience as a prerequisite for the position. These station auditors work under the auditor of the sale or refining division of the company.

The staff of traveling auditors proper of the company work under the supervision of the general auditor. Their work is closely akin to that of the public auditor who may be called in to audit the books. They audit subsidiary companies and companies in whose leases the employing company may have a working interest, or in whose profits it may participate through joint operation. In the two latter cases, the auditing procedure centers in the problem of reviewing the major contracts of the concern to determine whether the interest of the employing company are being protected.

It is incumbent upon the traveling auditors to familiarize themselves with the major operations of the company in order that they may interfere but slightly with the



routine of the office under audit. In general, their procedure is:

1. To verify trial balance accounts
2. To make a complete examination in connection with records covering operations
3. To study the system in use, picking out its weaknesses.

Specifically, they test-check depletion and depreciation reserves; secure bank statements and reconcile the bank accounts; voucher disbursements; list and examine notes, acceptances, securities, and receivables; inventory crude and refined products; in fact, carry through a regular audit as would be done according to accepted auditing practices. In addition, these traveling auditors may be called upon by the executives through the comptroller to make special investigations and collect specific kinds of information considered necessary and which is of such a nature as to require not only accounting and auditing training, but also a considerable amount of experience in the oil industry.

**PART IV**  
**APPENDICES**

## APPENDIX A

### HISTORY OF INTERNAL AUDITING

#### Introduction

Just when and where auditing first took root is not easy to determine, nor is it particularly significant. It is enough to know that at a very early date, in a primitive civilization, whenever one man was entrusted with the property of another, the owner of the property began searching for methods whereby a check would be placed upon the fidelity of the one trusted. Since accounting records are in themselves a means of recording and checking against the actual property received and disbursed, it follows that auditing goes back to the time when financial records of receipts and disbursements were first prepared—undoubtedly a practice as old as civilization itself.

#### Egypt

Probably the first attempt at any determined effort to set up checks and double-checks so as to safeguard property was in connection with the first regularly organized governments. Among these, the ancient Egyptians recognized the principle of double-check and arranged that receipts be recorded separately by two officials. In these very early times money was unknown and the receipts from subjects were in kind, such as oxen, corn, materials for clothing, and other products of the day. Since large quantities of these goods were paid in periodically, it was necessary that warehouses be constructed and farms operated. To carry on this type of treasury the services of porters, supervisors, and accountants—this latter group consisting of scribes—were required. Pictures in many of the old tombs give mute evidence of the existence of the scribe, who was present on all occasions writing down numbers of bushels of corn as they were measured out and numbers of cattle as they passed by. To prevent peculation on the part of the workman, the taxpayer upon delivering his product was stopped at the first entrance by a scribe who made a complete statement of the article as to quality and quantity, and then when formal delivery was made at the granary or the pasture

another scribe made a second record of the amount. These two records were independently made and had to agree. As nothing was given out of the treasury without a written order, accountability for "Pharaoh's "treasure" was definite and assured.

### Greece

The Greeks recognized the necessity of setting up means for preventing graft and theft of the state's money. The Treasurer of the Public Revenue was subject to certain legal checks and to the will of the people. The will of the people was evinced through publicity of the accounts kept by the treasurer and exhibited where the public could come and view. Publicity as a means of internal audit control dates from this period. In addition to the state treasurer there were separate treasurers of the goddess, of the tribe, the burgh and of the generals, each of whom kept records which were subject to close scrutiny at the end of their term of office. In addition to the treasurers, there were clerks who kept records of receipts and disbursements. Also, there were a head checking-clerk of disbursements and a number of subordinate checking-clerks of receipts and disbursements. It can be seen from these titles that there was a well-conceived plan for administering the finances of the state, an excellent system of checks and double-check. Unfortunately, the system seemed to fail for some reason if the statement of the historian Polybius is to be taken at face value. He said, "but if in Greece the state entrusted to anyone only a talent, and if it had ten checking-clerks and as many seals and twice as many witnesses, it could not ensure his honesty." While no doubt the spirit of administering the finances in Greece must have been bad, the failure was due to no fault of the system, but to collusion on the part of the clerks, treasurer, and checking-clerks—something which no scheme of internal check can entirely eliminate.

### Rome

Since commerce and industry in early Rome was on a small scale and then operated usually through the family, there was little need for internal checking methods. The father of the family did such bookkeeping as was needed and controlled the finances of the group.

The system developed by the state, on the other hand, was such that definite safeguards were established over

revenues. The three officials who had a part in this system were the censors, the quaestors, and the magistrates. The censors stood charged with the responsibility of taking a census of the population, which formed the basis of tax assessments, tax collections, and a check upon the treasurer. Under Augustus numerous provincial or district treasuries were operated and their records in turn were examined by the quaestors to insure that such district treasurers and governors of the provinces had made a proper accounting to the central treasury at Rome.

The Romans were concerned not only with seeing that financial officers had rendered to Caesar the things that were Caesar's but also in determining that once the funds were placed in the treasury, they should not be paid out without proper authority. A separate body was entrusted with the authority to pass on all claims against the state and to order their payment. As one writer puts it

"Disbursements from the state treasury had to be legally ordered by a magistrate. In order that funds be disbursed from the state treasury, it was incumbent upon the creditors to submit to a magistrate his account supported by proper documentary evidence as his authority for the debt and his guarantee that the work undertaken had been properly completed."<sup>1</sup>

During the later empire the routine, although it provided for complete methods of accountability from all those collecting revenues belonging to the state, must have been top-heavy and expensive, for as Kester says, "eight of the ten or twelve central offices or departments of control were devoted to accounting."<sup>2</sup>

### Following the Overthrow of Rome

After the fall of Rome as a dominant political power Charlemagne, the Emperor of the Franks, is found to have developed crude methods of accounting for his vast estate. To audit and keep the accounts of his properties, he employed men called "judices." To what extent these men really audited as opposed to simply keeping records of transactions it is difficult to say. The same may be said with regard to the revenues of the Papacy. It is said, however, that the Pope was assisted in safeguard-

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<sup>1</sup>Green, *History and Survey of Accounting*, p. 39.

<sup>2</sup>Kester, *Accounting Theory and Practice*, 1st Edition, Vol. I, p. 4.

ing these revenues by a staff of auditors, the head of whom was called a Prato Scrivarius.

### Guilds of Florence

During the twelfth and thirteenth centuries some of the Italian cities, enjoying a revival of trade and commerce as a result of their strategic position during and immediately following the Crusades, developed on economic organization far ahead of anything known in that day. The center of the Levant trade in the thirteenth century was definitely located in these cities. Florence may be taken as typical of the Italian industrial town. Here under the guild system attention was given to the need for methods of safeguarding the properties of the guild. As an illustration it may be noted that the Calimala Guild, an organization of workmen in the woolen industry which had its beginning in 1190, had fortified itself against speculation on the part of its officers. Accordingly, it was required that the treasurer of the guild upon taking office deposit as a guarantee or bond of good faith the sum of 100 lire. He was further restricted as to disbursements of the guild's funds by the approval of all four consuls, or in present-day terminology, all four directors of the guild.

The treasurer was assisted by an executive officer bearing the title of *Sindaco*, equivalent to the present-day *cashier*. His duties consisted in keeping the daily cash account at the headquarters of the guild. All payments passed through his hands, after their delegation by the treasurer, and he acknowledged receipts of all kinds. At the end of each day he submitted his report to the treasurer and transferred to him all cash on hand.

Once a year, during the month of January, a deliberate check was made by three General Inspectors, all of whom had served the offices of consul or treasurer and whose duties included among other things the checking of the acts and business transactions of the officers of the guild and the locating and exposing of irregularities if any had occurred. There were also in this organization three *Corrieri*, forerunners of our traveling auditors, two who traveled between Florence and France and one between Florence and Rome. Their duties were many, including an audit of the cash accounts of the affiliated operative companies.

A more direct example of deliberate internal auditing of this period is found in the Guild of Bankers and Money Changers. As Staley put it, "The books of all the

money-lenders were required to be open to the inspection of the agents of the Guild, who made periodical and surprise visits to every lender's table. Want of neatness in entry and illegibility were quite as severely censured as were inaccuracies and falsifications."<sup>2</sup>

### Early Double Entry

Paciolo published in 1494 his memorable book on double-entry bookkeeping, which he states was the method of bookkeeping then practiced in Italy, and other subsequent writers on the same subject, gave thus early a method of discovering the bookkeeper's mechanical errors in posting within an organization. His procedure was the same as at present, one man calling the entries out to another and both of them putting tick marks to show agreement, or as Paciolo instructed:

"First you shall get a helper as you could hardly do it alone. You give him the Journal for greater precaution and you shall keep the ledger. Then you tell him, beginning with the first entry in the Journal, to call the numbers of the pages of your Ledger where that entry has been made, first in debit and then in credit. Accordingly, in turn you shall obey him and shall always find the page in the Ledger that he calls and you shall ask him what kind of an entry it is, that is, for what and for whom, and you shall look at the pages to which he refers to see if you find that item and that account. If the amount is the same, call it out. If you find it there the same as in the journal, check it (*lanzarala*—"mark it with a lance A or V") or dot it (*pontarala*), or any proper mark over the lire mark, or in some other place, so that you can readily see it. You ask your helper to make a similar mark or check—as we are used to call it in some places—in the Journal at the same entry. Care must be taken that no entry will be dotted (*pontata*) either by you without him, or by him without you, as great mistakes might be made otherwise, for once the entry is dotted it means that it is correct. The same is done in making our statements of accounts for your debtors before you deliver them. They should have been compared with the Ledger and Journal, or with any other writing in which the entries of the transaction have been recorded.

"After you have proceeded in this way through all the accounts of the Ledger and Journal and found that the

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<sup>2</sup>Staley, *The Guilds of Florence*, p. 177.

two books correspond in debt and credit, it will mean that all the accounts are correct and the entries entered correctly. Take care that your helper shall mark each entry in the Journal with two dots or little lances; in the Ledger you mark down only one for each entry because you know that for each entry in the Journal there are two to make in the Ledger; therefore, the two dots or lances.

“After you have finished checking off the Journal, if you find in the Ledger, some account or entry which has not been checked off in debt or credit, this would indicate that there has been some mistake in the Ledger; that is, that that entry is superfluous whether in the debit or credit, and you shall correct this error by making an entry for the same amount in the opposite side—that is, if the superfluous entry was in the debit, you make an entry on the credit side, or *vice versa*. The same would be done in case your helper finds some entry which your Ledger did not show whether in the debit or credit column, which also would indicate an error in the Ledger and should be corrected in a different way. That is, you should make that entry or open that account in the debit or credit, mentioning the different dates, as the entry would be made later than it should have been. A good bookkeeper should always mention why such differences arise, so that the books are above suspicion; thus the notary public in his instruments need not mention what has been added or omitted.

“But if the said entry should have been entered on only one side, debit or credit, then it would be sufficient for you to put it where it is missing, mentioning how it happened through mistake, etc. So you will go on through all your accounts, and, if they agree, you know that your Ledger is right and well kept.”<sup>4</sup>

Paciolo has nothing to say about methods of control which might be considered as internal checking methods, probably because of the fact that he was addressing himself to the small merchant who would either keep his own books or supervise the work of the bookkeeper and cashier closely. However, a Dutch writer on double-entry in the latter part of the sixteenth century, Simon Stevin by name, did work out ingenious methods of control which today are called methods of internal check. As an example, Stevin says that in order to check the pay roll of the soldiers and other public officials, the

<sup>4</sup>Geijsbeek, *Ancient Double-Entry Bookkeeping*, pp. 69-11.



pay roll should be sent direct to the auditor, and then, he insists, the cook at the mess-house where the soldiers and officials were fed should report independently to the auditors the numbers of meals served. Another method of double-check in connection with the accounts of the government which Stevin suggested in order to stop the making of errors and the stealing of tax and rental revenues was, as reported by Geijsbeek,

“to make the subtreasurer’s report to the general treasurer each month of not only the cash receipts and disbursements, but the person remaining delinquent in their payments. After the reported delinquents remained so for three months, he suggested the sending of the sheriff by the general treasurer (not the subtreasurer) to sell the property of the delinquent taxpayers or to collect from him a bond. He explains that thus you can force the taxpayer to demand a receipt from the subtreasurer when paying and display it to the sheriff and thus get evidence against the subtreasurer of stealing.”<sup>5</sup>

Stevin was also one of the first, if not the first, to suggest the use of controlling accounts as a method of double-check against errors. He also advocated and set up a form for the keeping of a perpetual inventory on each kind of merchandise handled in order that a closer check might be had on stock leakage.

### Early English Auditing

Checking by means of separate records or duplicate records was used not only in the Italian cities where notaries often kept records for comparison against the records of the bookkeeper, but also was a favorite scheme employed in the accounting of the English Exchequer and of the Royal Wardrobe. As Brown in his *History of Auditing* says,

“At the Exchequer the Great Roll was compiled from the dictation of the Treasurer, a second roll was written out by the Chancellor’s clerk, and in the early days of the Exchequer a third roll was kept by a special representative of the king. These rolls were independently kept records which had to agree in every respect, every leaf and page of the one corresponding to the leaves and pages of the other; thus ensuring a complete check at the close of the year. The rolls are neither a copy of the other,

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<sup>5</sup>Geijsbeek, *Ancient Double-Entry Bookkeeping*, pp. 12-13.

but separately kept for the year, brought on the expiration of the year into agreement."

### **Auditing in the Household of a Tudor Nobleman**

From many of the old records and account books of the English nobility of the fourteenth, fifteenth and sixteenth centuries are found evidence that large sums of money were received from the income of the estates, many of which were vast, so that the services of experts were required to prevent theft and the withholding of funds belonging to their lords. The division of duties was such that at even this early period a most satisfactory system of internal check was in operation. Heading the list of the essential servants in the household of a nobleman, were the Steward, the Comptroller, the Surveyor, the Receiver and the Auditor. Many of the estates could not boast all of these officers, but in any case there would be found a Surveyor, a Receiver, and an Auditor so as to separate the work of accounting for funds from that of receiving and paying out the money, or, as Brathwait puts it, "the one in taking accompt, the other in receiving rents and profits."<sup>6</sup>

The duty of the surveyor, among other things, was to ferret out and set down all the amounts to be collected from rentals. A rental book was made out based on his survey, signed by himself, and a copy of it was delivered to the Receiver-General as a basis for his subsequent collections. Another copy would be sent to the various bailiffs, managing estate farms, so that at the annual audit each could be held accountable for collections.

The post of Receiver or Receiver-General was without a doubt the position of highest trust in the Lord's service. He was the treasurer and cashier of all the funds coming in from the various estates. As Jones put it, "he stood charged by the surveyor's rental book, with the rentes of all manors, lordshippes, demeanes, hamlettes, farmes, or any other commodity arising with . . . the office of survey."<sup>7</sup> As the bailiffs or others owing the lord made payments to the Receiver, he issued a signed receipt to be held by the payer until the date of audit.

When the money was disbursed by the Receiver, he was required to have a warrant for the amount from the master of the house, which could be used later as a voucher

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<sup>6</sup>Jones, *Household of a Tudor Nobleman*, p. 135.

<sup>7</sup>Jones, *Household of a Tudor Nobleman*, p. 139.

when the Receiver's accounts were audited. As an example of the form of voucher used is the following, taken from the records of the *Northumberland Household Book*, pages 132-133:

"WELBILOVYD I grete you wele and wol ande strately charge you without delay as ye intende to have me your good Lorde ande wol exchew that as may issew unto you for the contrary doying at your jeopardy Fail not to content ande pay to my welbiloved Servaunts Robart Percy Countroller of my Hous ande Gilbert Weddell Cheefe Clarke of my Kichyng standyng charged with my saide House ofr the vij and last payment of th' Assignement assigned unto theym for the kepyng of my saide Hous for this Yere begynnyng at Michaelmas in the vj Yere of the reign of our Sovereign Lorde Kyng Henry the viij and shall ende at Michaelmas next following of the Revenus of all my Landes in Northumberlande to your handes comyng dewe to my Coffers of the Whitsonday Ferm payabill at Lambmas Ye content and pay the Some of ciiijl.xiiijs.ixd. in redy

Monay over ande besids that they have xv l.vj s. charged upon theym the saide tyme as parcell of there Assignment as in the Fermes of divers Meddows ande Pastures at Lekyngfeld ande Wresill as it appereth more playnly in the Booke of Orders of my saide Hous for the making up of cxxjl. ixd. assigned unto theym in the iij quarter betwixt Midsummer and Michaelmas Wiche is in full payment of there Hole Assignment for this Hoole Yere endyng at the said Michaelmas next for to come

Geven under my Signet and Sign Manuell at my Manour of Leckyngfeld the xxj day of Novembre in the vj Yere of the reign of our Soverayn Lord Kyng Henry the viij.

To my Trusty Servaunt WILLIAM WORME Gentleman Usher of my Chambre by Coffurer ande my Recyvoure Generall of all my Lands in the North Parties for this Yere."

The Auditor's work was primarily concerned with determining whether every servant of the household had been faithful in his respective trust. The books were balanced and audited once or twice a year at the pleasure of the lord, who often insisted that once the Auditor had begun the audit, he must not see anyone of the household, "the chardge and truste being sae greate, so well betwixt partie and partie" that an unbiased audit might not be

secured otherwise. The duties of the Auditor were set forth in this language:

"The auditor beeing the laste of all offecers, is to bee judge betwixte the lorde and his accomptants, and to deale trulies for and betweene all parties, and upon the determinac'on of his audite, to presente to his lorde by book or breviatē, all his receiptes, expences, imprestes, whatsoever, with the remaines of monye, if any bee.

After the Auditor had performed his work he was required to hold the "declaration of audit." No doubt, the present-day professional auditor may trace his ancestry back to this period, inasmuch as many of the estates could not afford a full-time auditor, and hence there arose the need for a man who could serve as auditor for a number of the different lords' estates.

### Livery Companies

Many references to auditing, as early as 1564, may be discovered in the records of such crafts as the Worshipful Company of Grocers of the City of London, and Worshipful Company of Pewterers. As in the case of the Italian guilds, the books of the company were audited by a committee chosen from members of the craft. In the case of the Company of Pewterers, there is found, in their Ordinance book of the middle sixteenth century this "order for ye audytors": "Also it is agreed there shalbe foure awdytours chosen every yeare to awdit the crafte accompte and they to parvse and search it that it be perfect."

### English Government

In the eighteenth century in England there were two officers bearing the title of "Auditors of Imprest." These men, however, merely held the position, delegating to under-clerks the work of audit, which consisted of a mere ascertaining whether the accounts had been correctly added. The so-called audit was in no way a real investigation. The position "Auditors of Imprest" was abolished by Pitt and was replaced by a board of five commissioners, who were given the power to make strict audits of the accounts of each department. This committee system of auditing has its counterpart in the directors' auditing committee of our state and national banks.

<sup>1</sup>*Ibid.*

### **American Situation**

From the standpoint of private business and industry, there is little evidence that methods of internal auditing were seriously thought about in Colonial America. Such methods as were in use were brought over from England and Continental Europe. The bookkeeping texts of this period have nothing to say concerning internal checking through division of duties nor deliberate checks by either internal or external auditors. John Mair, a Scotch writer, published in 1736 *Bookkeeping Methodized*. This book was probably the most popular of all bookkeeping texts between the years 1740 to 1800, and many copies were sold in America. It is interesting to note that he limited his discussion regarding internal control to the checking of postings in almost the same manner as had Paciolo 300 years before. A study made by two graduate students of the University of Illinois of one hundred English and American text-books on bookkeeping published before 1900 brought to light only one book that even discussed the use of controlling accounts, and this book came late in the nineteenth century.

Governmental accounting, however, had reached the stage of development where internal auditing was found necessary. Practically all the state constitutions made provision for some kind of internal checking by distributing responsibility to the various departments and through the keeping of duplicate records, a system of checks and balances of one department on another. In the Federal Government definite provision was made by the act of the First Congress in 1789 for a Secretary of the Treasury, a Comptroller, an Auditor, and a Register. It was the duty of the auditor to receive all public accounts, and after examination, to certify the balances and transmit the accounts, with vouchers and certificates, to the Comptroller for his decision thereon.

### **Internal Auditing in Business a Recent Development**

As long as industry and commerce was carried on by the individual owner and through small partnerships there was little need for highly-developed methods of internal check. The personnel of any particular house was small and closely supervised by the owner. Cash and securities were generally under the control of the master, one of the partners, or a confidential clerk. Branches were few, such business as is now carried on through branches then being handled by correspondents or agents.

Under these circumstances, the chance of a clerk's covering up errors and fraud in accounts was at a minimum. Dishonesty in a trusted employe was rare and sure to be discovered. With the advent, however, of the modern corporation and large-scale business, the need for methods of determining accountability and preventing defalcations quickly came into existence. This development in the size and extent of business transactions brought with it a desire on the part of the executives to do away with the old home-spun methods of controlling cash and other assets by a close supervision on the part of the chief executive and to substitute a system whereby a division of duties among the employes and a separation of the functions of the operating departments from those of the recording or accounting departments would give the necessary internal control required over transactions. Internal check was the method chosen, with an outside auditor to come in occasionally, probably once a year, to check out thoroughly the detailed transactions.

The present tendency in the larger businesses seems to be toward a further elaboration of methods of internal check, together with the use of an internal auditing staff whose duties are concerned mostly with doing the detailed examining of transactions at the source, as they occur—the work formerly performed by the public auditor at his annual visit—and leaving thus for the outside auditor the functions of making a limited-test audit (a balance-sheet audit), or special examinations of one kind or another, and of consulting work. This tendency to meet a present-day need by extending the scope and effectiveness of internal audit control has been the basis of this dissertation.

APPENDIX B  
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## VITA

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