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FRAUD: ITS CONTROL THROUGH ACCOUNTS

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BY

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TO

F. L. B.

MY PARTNER IN EVERY UNDERTAKING, THIS BOOK IS AFFECTIONATELY DEDICATED

One of the great problems confronting business throughout the world arises from the alarming prevalence of fraud. It is no new thing, but its importance increases with the growth of business and the resultant increase in opportunities for all those crimes which are classified generically as fraud.

There will always be folk who will say that conditions of any time current compare unfavorably with the antecedent times when they, the speakers, were young; but at present there is an unusually wide-spread spirit of pessimistic complaint. We are told that there is a "letting down" in all ways. Morals have gone. Honesty is rarer than ever. Business ethics are departed to the devil.

Now, there may be some truth in each of these assertions but not much in any one of them. The world as a whole is becoming better. In proportion to the opportunities there is probably less fraud than ever before. Nevertheless, there is far too much disregard of laws of right, and anything which can be done to reduce or to prevent the iniquity should be done.

Here accountants have a splendid chance to show the ability, the integrity and the stuff of which they are made. Most fraud is reflected in some way upon the books of account. Direct theft is rather uncommon. The greater numbers of fraud are perpetrated by employees who have to do with the accounts or with the handling of money which is recorded on the books. Persons who would commit or have committed fraud attempt to avoid detection by false entries of a hundred sorts, and, consequently, it is important for an accountant to be able to recognize erroneous entries and, even more vital, to be able to devise means whereby the possibilities of fraud shall be reduced to the least.

Strangely enough, there is very little in print upon the details of fraudulent practice in accounts and its prevention or detection. The subject seems to have so broad an interest that the present volume is most opportune. The author's treatment of the matter is clear and comprehensive. His attack is simple and direct. It is confidently expected that this book, *Fraud: Its Control Through Accounts*, will be helpful to the professional practitioner and instructive to the student of accountancy.

A. P. Richardson,
Editor.

September 1, 1930.

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PART I

BACKGROUND

CHAPTER I

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Accounting Errors

After a system of accounts has been designed and installed, it should operate efficiently and furnish correct information. To this end, the detailed transactions should be so treated that opportunities for withholding information concerning financial transactions; manipulating or falsifying the records; or furnishing fictitious evidence relating to accounts and records for fraudulent purposes will be practically eliminated; and inaccuracies may be prevented or discovered promptly.

From the viewpoint of administration, these matters must be given careful and serious consideration. Otherwise, confidence in account balances and in periodical reports can not be maintained.

Regardless of the source from which accounting errors may arise, usually they are traceable to some employee or officer who is ignorant, stupid, careless or dishonest. At times, also, the methods of procedure in an office tend to encourage, rather than discourage, an increase in the chances for errors — at least, they may make it easy for errors to occur.

In planning ways and means by which errors may be prevented, or at least vigorously curtailed, it seems desirable to group errors into some logical classification, even though the group adopted may overlap to some extent.

All accounting faults are either unintentional or intentional, and they arise from some mistake — innocent or deliberate — in accounting principles or technique or in clerical routine.

Unintentional errors undoubtedly arise from ignorance, stupidity or carelessness. When an employee is hired to work in an office which presumably is well organized, theoretically it is to be expected that he is capable of handling the work to which he is assigned. In practice, however, it is most difficult to find intelligent and competent help; and it is even more difficult to retain such help permanently. Certain unintentional errors occur in every office, regardless of what may be done to prevent them.

Intentional errors, generally speaking, are caused by a dishonest employee. An employee who is dishonest will make errors on the accounting records — if given the least chance to do so — for the express purpose of hiding irregularities. These errors, being made intentionally and for some dishonest purpose, largely constitute what is known generally as "fraud in accounts."

Intentional errors, however, are similar in nature to the innocent kind, at least so far as their effect upon accounting reports is concerned. The real difference lies in the fact that intentional errors, made to cover up conduct which is dishonest, may become the basis for legal proceedings of a criminal nature.

A second way to classify accounting errors might be to call them errors of omission or commission — either intentional or unintentional.

Errors of omission arise from a failure to make an entry for a transaction. Such errors usually do not affect the trial balance and hence can not be detected by merely automatic means. Often they are errors of principle, since failure to record some transaction may result in a misstatement of net profits and net worth. However, not all errors of principle are caused by omission.

Errors of omission are difficult to prevent, since the reason for failure to record a transaction — intentionally or unintentionally — may not be specific and definite. If a business concern is organized properly, there is usually some way to trace every transaction, provided the accounting system is adequate.

The detection of errors of this type should be an essential purpose of every regular audit. The audit phase of the matter can not be discussed here, however, inasmuch as this is not a text on auditing.

Errors of commission are actual mistakes in the records.

For the most part, errors of commission are encountered in the books of original entry, and they may not affect the trial balance. For example, an error in the sales register may be the result of stating quantities incorrectly, or it may be caused by extending certain items incorrectly.

Purchase and sales calculations seem best verified by the work of at least two persons at the point at which such items originate, and such verification may be assured further by a check in the offices or departments to which such items are forwarded.

Fraud

Fraud has not been defined by the courts in unequivocal language. What amounts to fraud in one case may not in another; the courts, in order to deal ably with fraud as it arises, apply no absolute test, but judge each case separately. Legal writers, those "rigidly logical authors," in accord with court decisions, recognize the variety of ways in which fraud may occur, but, for legal purposes, offer no exact definition. For example:

> "Fraud is a false representation of facts made, with a knowledge of its falsehood or recklessly without belief in its truth, with the intention that it should be acted upon by the complaining party, and actually inducing him to act upon it." (W. R. Anson, *Contracts.*)

Although the law is quite clear on the required elements of fraud, the facts which will constitute fraud depend upon the particular circumstances of each case.

With this in mind, an attempt is made to phrase an all-inclusive definition of fraud for present purposes: Any intentional misrepresentation or concealment of some past or present material fact by a party in interest, such material fact not being open equally to the observation of both parties in interest, or not to be discovered through the exercise of ordinary care, and being relied upon by one party to a transaction, to his damage. (*Mannel* v. *Shafer*, 135 Wis. 241; *Horton* v. *Lee*, 106 Wis. 439.)

Upon the basis of such a definition, in accounting fraud may be 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 owner.

The concealment of assets by a bankrupt is a fraud upon his creditors. (*Re Mullen*, 4 Am. B. R. 224; s. c. 101 Fed. 413.) Overstating the profits of a business by a vendor in a sale contract is a material misrepresentation which would constitute fraud. (*Taylor* v. *Saurman*, 110 Pa. St. 3.) The utterance of a false statement of financial condition to induce credit may be a representation held to constitute fraud. (*Cary* v. *Hotailing*, 1 Hill, 311; *Devoe* v. *Brandt*, 53 N. Y. 462; *Eaton* v. *Avery*, 83 N. Y. 31; *Shaw* v. *Gilbert*, 111 Wis. 165.)

As long as human beings exist, frauds in some form will be found in business, and, therefore, no matter what one may consider the principal purpose of an audit, detection and prevention of fraud must remain an important part of the work of the accountant and auditor.

In a business enterprise the prevention of fraud in the books and accounts is more to be desired than its detection. Although it never will be possible to eliminate fraud altogether, regardless of devices developed with that end in view, material curtailment is possible by judicious application of the principles of internal check.

Internal Check

A system of internal check may be defined as the coördination of a system of accounts and related office procedure in such a manner that the work of one employee independently performing his own prescribed duties checks continually the work of another as to certain elements involving the possibility of fraud.

Internal check is principally a method whereby an internal audit of the books and records is carried out continually by staff employees separately performing their usual duties. Briefly, the phrase is a technical one used to describe a situation where more than one employee is responsible for recording a transaction completely.

A proper articulation of operating routine with the accounting system provides a safeguard against the possibility of fraud and error. This scheme of safeguards, as a whole, comprises the system of internal check.

Briefly, auditing is:

> "An examination of the books of account, vouchers and other records of a . . . corporation, firm, or individual . . . , for the purpose of ascertaining the accuracy and integrity of the accounting and of certifying thereto upon the statements rendered." (Terminology department, *The Journal of Accountancy*.)

Auditing may be either external or internal. If conducted by an independent professional accountant, it is external; if carried out by some officer of a business concern, it is internal.

Internal auditing is accomplished by a combination of two methods, each being definitely separable from the other:

1. The deliberate audit;
2. The automatic audit.

Under the first method, some designated department of a business house reviews the transactions — it may even record them as well. The comptroller's or auditor's office may carry out the review, or the accounting department may both record and review transactions.

Under the second method, the various operating departments of a business — in a manner rather automatic — audit the transactions consummated.

The system of internal check is responsible for the automatic audit, and it is this which will largely occupy the present discussion.

The general principle of all methods of internal check is that no person in an organization shall be in complete control of any important part of operations. Thus, as far as possible, it is intended to assure:

1. Accuracy of all records and books, inclusive of those outside the double-entry records, if any;
2. Definite responsibility for each portion of the work.
3. Speedy detection of fraud, by means of systematic office procedure, scientific division of labor, and continuous supervision and inspection.

Regardless of whether errors are committed intentionally or unintentionally, a good system of internal check should reveal them.

The methods of proper internal check may be subdivided as follows:

1. Physical and mechanical checks;
2. Theoretical checks.

The first method comprises utilization of such mechanical devices as time-recording clocks, cash registers, adding machines, bookkeeping machines, etc. Mechanical devices are effective aids; the frequent objection to them — cost — may be merely a delusion, inasmuch as in reality they may be more economical than performance of the same functions by clerks.

The second method — division of work — is the one emphasized in this book.

A presentation of the subject in any other than a general way is practically impossible in limited space owing to the fact that each business is a problem unto itself. However, since the groundwork in each separate case is similar, it is possible to point out the various places in an accounting system where possibilities for fraud exist, indicate what may constitute fraud, and suggest steps which may be considered in formulating a plan to prevent or reduce fraud.

Collateral Reading

Bennett, G. E., C.P.A., *Auditing*, pages 6–8; 15–17. The Macmillan Company, New York, 1925.

Montgomery, R. H., C.P.A., *Auditing Theory and Practice*, 3d edition, vol. 1, pages 604–615. The Ronald Press, New York, 1922.

CHAPTER II

Legal Distinctions

Criminal law; crime — tort; felonies — misdemeanors; specific crimes; larceny; embezzlement; larceny versus embezzlement; comparison; misappropriation — defalcation; forgery; intent.

In relation to fraud in accounts, certain terms are in frequent use. Their popular meaning, however, is loose, careless and at times specifically inaccurate. Thus, when publicity is given the taking of money or other property by some trusted employee (usually, it is the trusted employee who is guilty of such conduct) terms are used commonly which have a technical meaning entirely at variance with that popularly imputed to them; again, they may be terms which should not at all be part of one's technical vocabulary.

Some such terms are bound to arise in the course of the conversation when one is speaking to a client or employer on some phase of internal check. It is reasonable to assume that when a person speaks of his calling as a profession some intelligence should be displayed in his choice of words. Since cases of fraud come into close contact with the law, and since the law has provided a specific vocabulary, it seems necessary and desirable to dwell rather generously upon certain definitions and upon explanations of those definitions. The point of view is that of the criminal law, under which fraud cases fall.

To emphasize further the reason for including the present chapter in a book of this character, one has only to reflect upon the attitude of many employees toward the seriousness of the criminal offense known as embezzlement, or upon the narrowness of meaning currently applied to the crime known as forgery. If a potential wrongdoer knew the penalty of error, even in general terms, frequently his dereliction would not occur, no matter how propitious the opportunity or how pressing the need for extra funds.

Many persons, if they think at all of the matter, regard the subject of criminal law in relation to office frauds, as something of minor importance at best. This is far from the case. The extreme seriousness of a criminal offense either is not known or is given only casual consideration by many employees who handle money or other property in the course of their duties. Even some accountants seem unable to understand that employers owe their employees a reasonable chance to be honest, and that the abstraction of even a few dollars from the till or the deliberate alteration of a set of books is decidedly serious.

For example, the wilful commission of a wrong act (or omission of a duty) may subject the offender to criminal punishment, even though he did not know that the act (or failure to act) was a crime. Every one is presumed to know the law and ignorance of it excuses no one. This is true even though the act be made a crime by a statute of such recent enactment as to render a general knowledge of its existence improbable.

Criminal Law

After one has defined the general term "law," a proper understanding of the subject requires that it be subdivided and each part analyzed carefully. Thus, the first subdivision may be into public and private law. In turn, public law may be subdivided into constitutional and statutory law and wrongs against the public. Continuing, criminal law and criminal procedure are found under the title "wrongs against the public."

Customs and usages long indulged in finally have the force and effect of law. When the colonists settled in America, the customs and usages brought with them — these constituting the common law of England — became the basis of the common law of this country. Thus, acts considered as offenses of a criminal nature were punishable in the colonies as in England, without the necessity of additional legislation. After the rule of England was overthrown, the recognized common law of England up to the time of settlement of Jamestown in 1607, was adopted as the common law of this country in practically all the states. The criminal law then, has its source in the common law and such legislative enactments and statutes as have been passed since 1607.

On the basis of definition and explanation in Bouvier's *Law Dictionary*, it may be said that the criminal law has to do with those wrongs which are of a character sufficiently grave that to permit the question of punishment of the wrongdoer to remain in the hands of the individual aggrieved would be to threaten the existence of organized society itself.

It seems necessary, next, to define crime and then to note what constitute the wrongful acts of larceny, embezzlement and forgery — these being the specific crimes which internal check attempts to reduce and prevent.

Crime—Tort

To be accurate, a definition of crime should show that it is not the act omitted which constitutes a crime, but the omission to act. Further, such a definition should show that an act is not necessarily a crime merely because prohibited by public law; to constitute a crime, the act must be punished to protect the public, and it must be punished by the state or other sovereign. The following definition seems to meet these requirements:

> "The commission or omission of an act which the law forbids or commands under pain of a punishment to be imposed by the state in a proceeding in its own name." (Wm. L. Clark, Jr., *Criminal Law.*)

A tort is a wrong affecting merely the rights of an individual, whereas a crime is a wrong which affects public rights, even though some particular individual alone actually suffers, and consequently is an injury to the whole community. A wrongful act may be both a tort and a crime. If the wrong committed is of a character sufficiently grave to be considered as threatening the existence of organized society, it is a crime, punishment for which will be visited upon the offender by the government; but it is nevertheless an injury to the individual who primarily suffered and who will have a right of action against the wrongdoer civilly as well.

Generally speaking, at least, two elements are necessary in every crime:

1. The intention to commit the act;
2. The act itself, which is forbidden either by statute or by common law.

Felonies—Misdemeanors

Criminal offenses may be divided into three classes. However, since treason may be considered as one class, two classes seem sufficient for present purposes — felonies and misdemeanors.

A felony, generally speaking, is any act (or omission to act) sufficiently grave to warrant punishment in the penitentiary. In American law, a clearly defined meaning seems impossible, although the offense is said to be one of considerable gravity — one of an "atrocious dye," says Blackstone. In some jurisdictions, a felony must be defined specifically, but in others it may be enacted that all offenses punishable by confinement in the penitentiary (or by death) are felonies.

As distinguished from a felony, a misdemeanor is an act which is of less grave concern and for which punishment is a fine or a number of days in jail:

> "Smaller fruits, and omissions of less consequence, are comprised under the gentler names of misdemeanors only." (4 Blackstone's *Commentaries*, 5.)

The statutes in the various states prescribe and define what punishment makes an act a felony and what a misdemeanor. However, both felonies and misdemeanors are crimes, the distinction being merely in the gravity of the offense. Thus, perchance, if the office boy steals $5, he may be guilty merely of a misdemeanor, whereas if a cashier embezzles $500, he may be guilty of an offense of a deep and atrocious dye. In the former case, a jail sentence may be all that is required, whereas in the latter instance residence at a penitentiary may be enforced.

The specific crimes which relate to the subject under consideration are larceny, embezzlement and forgery.

These crimes all fall within a group which may be designated as offenses against property — as differentiated from those which as a class may be enumerated as offenses against a person.

Larceny

Basically, larceny is the felonious and fraudulent taking and carrying away by any person of the mere personal goods of another. A more inclusive definition, often quoted, is as follows:

> "The taking and removing by trespass of personal property which the trespasser knows to belong either generally or specially to another, with a felonious intent to deprive the owner thereof." (J. P. Bishop, *Commentaries on the Criminal Law.*)

The definition by Bishop is believed to incorporate all the elements of the crime of larceny:

1. It indicates the kind of property that may be the subject of the crime;
2. It points out the ownership of the property;
3. It specifies that there must be an asportation — a taking and carrying away;
4. It states that there must be a trespass;
5. It points out that a criminal intent is necessary.

Whatever shortcomings the common law had in regard to the kind of property that may be the subject of this crime have been adjusted by statute. Thus, whereas the taking of a promissory note did not originally constitute the crime (only the taking of the paper on which it was written might do so), the taking of promissory notes, bank bills, etc., in addition to the usual goods and chattels of the common law, now, generally speaking, come within the meaning of the statutes; in fact, some statutes specify merely "anything of value."

To be the subject of larceny, this "anything of value" must have an owner in fact — even though he be unknown to the thief or to the grand jury. Two kinds of ownership are recognized by the law — general and special. A general owner possesses good title as against all the world, whereas a special owner is entitled to possession of this valuable thing and to ownership therein as against all the world except the general or real owner. Thus, a cashier may be the special owner of cash coming into his direct control, whereas the business owner is its general owner.

The asportation required does not necessarily mean actual removal to some distant place; it means only that the thief must obtain complete control of the personal property with which he attempts to make away. The property need not even be removed from the owner's premises and the control requisite need not last a particular length of time. The requirement of the definition seems satisfied once the thief gains absolute and complete control over the thing. Thus, an office boy who surreptitiously "lifts" a dollar from the cash drawer and hides it immediately under some papers on a window sill, in which place it is discovered, undoubtedly is guilty of larceny.

Trespass, the fourth element in the definition, in relation to personal property, consists of wilful interference with another's personal property without his consent. If the person who took such property had a right to do so, there is no trespass and no crime of larceny. A petty cashier who has charge of a cash fund, and is in possession of such fund, can not be found guilty of committing a trespass if he takes some money therefrom in order to attend, say, a theatrical performance. On the other hand, if some other employee comes along and takes the same amount of money from such a fund for the same purpose, a trespass has been committed, and that employee is guilty of larceny. Again, a clerk in a store may have custody of certain goods for a certain purpose, and if he takes a bundle of these articles home without special permission, a trespass is committed sufficiently to satisfy the law — he is guilty of the crime of larceny.

In larceny, as in other crimes, there must be a criminal intent present. This receives comment later in a separate section.

Embezzlement

Under the common law, a wrongful taking of personal property not accompanied by trespass was insufficient to cause the wrongdoer to be guilty of larceny. Thus, if a servant or agent were entrusted with goods and betrayed his trust, there was no way to punish him, since the requisite element of trespass was lacking. Recognition of this shortcoming was responsible for the passage of certain statutes, the object of which was to provide punishment for a situation somewhat similar to larceny yet dissimilar in that trespass was lacking.

The first statute, passed in the reign of Henry VIII, was followed by others, that of 1799 being particularly noteworthy as a basis for the various embezzlement statutes of the states in this country. The following quotation is taken from the statute passed in England in the seventh and eighth years of the reign of George IV:

"That if any clerk or servant, or any person employed for the purpose or in the capacity of a clerk or servant, shall by virtue of such employment receive or take into his possession any chattel, money or valuable security, for or in the name or on the account of his master, and shall fraudulently embezzle the same, or any part thereof, every such offender shall be deemed to have feloniously stolen the same from his master, although such chattel, money or security was not received into the possession of such master otherwise than by the actual possession of his clerk, servant, or other person so employed; and every such offender, being convicted thereof, shall be liable at the discretion of the court to any of the punishments which the court may award."

The point to remember is that the crime of embezzlement is strictly statutory. When statutes on the crime of embezzlement were passed in the various states of the United States, they were patterned after the English model. Present statutes are wider in scope than the old English one, embracing, in addition to clerks and servants, agents, corporate officers, employees, etc. Under these statutes, it is to be remembered that unless a particular perpetrator comes within the classes of persons specifically described (as set out in the statute to which he is subject) no conviction is possible in an indictment for embezzlement — criminal statutes must be construed strictly in favor of the accused.

One must examine carefully the statute of his own state to ascertain who may commit the crime of embezzlement and in what circumstances may it be committed. A knowledge of the English statutes provides the background necessary to understand the statute to which a person is subject.

In order to emphasize further that larceny and embezzlement are not one and the same crime, some distinctions in comparative form are offered.

Larceny is a common-law offense and need not be statutory, but embezzlement must be statutory. When larceny is statutory, each such statute has followed the common law, possibly adding to it and broadening its scope by defining the property which may be the subject of the offense.

Generally speaking, the distinction is between custody (larceny) and possession (embezzlement). Thus, if the property never would come into possession of the owner except through the medium of a servant, clerk, agent or other individual mentioned in the statute to which reference is made, the conversion by such person is embezzlement. If such conversion occurs after the property has come into the possession of the owner, then it is larceny.

The felonious taking of goods from the owners' shop by a clerk and packer in their employ, who had keys by means of which, at the time in question, he entered the shop after it was closed, but who was not a salesman, although the owners had occasionally allowed him to take and sell goods for them, is larceny, and not embezzlement. (*Commonwealth* v. *Davis*, 104 Mass. 548.)

If a person, as a cashier, in charge of a cash fund takes some money therefrom, and retains it for his personal use, he is undoubtedly guilty of the crime of embezzlement, since his employer has given him a relation of special trust to the property taken by him. On the other hand, if some other employee passes by the open drawer of the cashier, takes some money therefrom, and retains it for his personal use, he is guilty of the crime of larceny.

If a clerk is paid some money on account, and before he deposits it in the till he places the money in his pocket with the idea of retaining it for his personal use, the crime of embezzlement has been committed. On the other hand, if this clerk deposits this money in the cash drawer and later appropriates it to his personal use, the crime of larceny without doubt has been committed, especially if such deposit lasted more than momentarily.

Marked money was paid to a clerk, who deposited it in the till until the detective's back was turned, and then took it out again. The deposit by the clerk was momentary for his own purpose to conceal his abstraction and was not a delivery to his master; hence, a conviction on the charge of embezzlement was sustained. (*Commonwealth* v. *Ryan*, 155 Mass. 523.)

Misappropriation—Defalcation

Misappropriation and defalcation are terms much in evidence in popular conversation and writing about fraud in accounts. Even in one university (perhaps in others), a thesis for an advanced degree which in its title carried the parenthetical designation of "accounting" was written upon the subject of concealing and revealing "defalcations."

These terms have no strictly accurate technical meaning. Accountants having occasion to mention situations in which these terms popularly are used, should utilize either the term "larceny" or "embezzlement," depending upon the specific situation.

Forgery

Forgery is the fraudulent making, or material alteration, of any writing which, if genuine, might apparently import a legal obligation. Blackstone has defined forgery as:

> "The fraudulent making or alteration of a writing to the prejudice of another man's rights."

The legal definitions of forgery provide a conception of the term broader than that which is usual and popular, inasmuch as any form of instrument by means of which one person can become obligated to another — to pay money, to render service, to forego a right, to respond in damages — is a writing subject to forgery.

Any alteration in such an instrument, by which its legal effect is changed or varied, is sufficient to constitute a forgery. An alteration is false when made by a person who has no right to make it. And it is fraudulent when made with intent that the false instrument shall be used or received as valid. The forgery is complete when the instrument in question is made or altered with intent to defraud, even though it never may be used and no one actually may be defrauded.

From the various definitions of the term, it may be said that this crime is a false making or material altering (even false signing of an instrument is sufficient) of some kind of writing with intent to defraud (not some particular person, but some one).

The making or material altering of some writing is commented upon by Bishop as follows:

"The act of forgery consists of causing a writing to appear of some legal efficacy which in truth it does not possess, as by giving it the similitude of that of another person contrary to the fact, by changing the words of a genuine writing to create a false meaning different from the true one, or by fraudulently procuring a genuine signature to a writing which in fact is false."

Thus, upon the basis of this statement and the definitions it may be perceived readily that the essence of the offense consists in writing either with pen, pencil or printing a falsehood which is apparently genuine and which was written or printed to deceive some person into believing it was genuine. Forgery may be committed in the making of an instrument as a whole or by the material alteration of an existing instrument with intent to defraud and deceive:

"If a confidential clerk in a mercantile house makes in its books, even in the journal, an alteration in a figure representing the cash received less than in fact it was, that he may abstract the difference between the real and the false sum, he commits forgery."

Criminal Intent

Every crime consists of two elements — the criminal intention and the criminal act. The intent and the act are both necessary to constitute a crime, and the two must concur in point of time — the act must be the result of the intent. The act without the intent is innocent; and the intent if carried into effect without the act, is only a cheat.

The criminal intent is a condition of mind upon the part of the accused in consequence of which the criminal act was performed. This essential intent frequently has been expressed in the form of a maxim: "Actus non facit reum, nisi mens sit rea." The general idea of this maxim has been expressed most excellently by Mr. Justice Stephen in a case that came before all the judges in England for consideration.

The learned justice points out that every crime committed does not, as a consequence, contemplate the existence of a guilty mind — a "mens rea" — for the mental elements of different crimes differ widely. In the case of murder, the "mens rea" means malice aforethought; in the case of theft, an intention to steal; in some cases, it denotes mere inattention, and so on. The following principle is of interest:

"The principle involved appears to me, when fully considered, to amount to no more than this: the full definition of every crime contains expressly or by implication a proposition as to a state of mind. Therefore, if the mental element of any conduct alleged to be a crime is proved to have been absent in any given case, the crime so defined is not committed; or, again, if a crime is fully defined, nothing amounts to a crime which does not satisfy that definition." *Queen* v. *Tolson*, L. R. 23 Q. B. Div. (Eng.) 168.

It is supposed frequently that criminal intent consists of, or includes, an intent to do wrong, or an intent to violate the law. This idea is in error. A criminal intent is generally an element of crime, but every man is presumed to know the necessary and legitimate consequences of what he knowingly does.

Therefore, while criminal intent is a state of mind of the accused at the time the crime is committed and is essential to criminality in the particular case, that intent must be distinguished from the motive which induces him to do the act, or the belief in its propriety or wicked character. This intent varies so much in the different crimes that no precise and definite statement can be made as to what particular intent must exist in general.

In relation to larceny, for example, one must determine that from the circumstances surrounding the taking away, or from the defendant's own admissions, the accused actually took the goods knowing them to belong to another, with the intention of depriving the other of their ownership and using them as his own.

The existence of a criminal intent is presumed by law from the commission of the act. Thus, in a prosecution, the state need offer no evidence to prove the existence of the intent, unless the person accused attempts to show incapacity or restraint. Of the various possible conditions recognized by law for incapacity or restraint, one is of current interest — mistake. The proof of any one of these conditions successfully counteracts the presumption of criminal intent and shows that though the act was committed the person who did it has not perpetrated a crime.

Generally speaking, men are held criminally liable for their conduct according to the facts known to them at the time they did the act with which they are charged, or which by reasonable diligence they might have known. And if, without negligence on their part, they are mistaken in the facts, and do an act which would be a crime if done with knowledge of the facts, they are held only according to the facts they knew. An exception to this rule is noticed in cases of those statutory crimes in which the legislature has deemed it best to require all persons to act at their peril.

Further, in general terms, mistake or ignorance of the law is no defense to a criminal charge. This is a rule of necessity and is strictly applied. But when a crime consists of an act, an intention to do it, and a criminal purpose to be accomplished thereby — and knowledge of the law constitutes an essential part of that specific intent — ignorance is a defense. Thus, if it is alleged that the taker of property supposed it to belong to himself, the court may hold that this belief prevents the taking from being a crime.

In relation to the present topic, for example, it is necessary to distinguish carefully between a shortage uncovered in a set of books and an embezzlement. The books of account may reflect a shortage, but when payment is demanded cash may be forthcoming accompanied by a well supported claim that no intent existed to convert funds fraudulently. It would be a good defense to show that the property was converted by mistake or under a claim which seemingly is right. The accountant must be careful not to jump at conclusions too quickly.

Collateral Reading

In the statutes of your own state, look up what is said on the subjects of larceny, embezzlement and forgery; and on distinction between felony and misdemeanor.

CHAPTER III

LIMITATIONS IN THE APPLICATION OF INTERNAL-CHECK PRINCIPLES

Classes of fraud; false showing; wrongful appropriation of assets; limitations in application due to fraud classification; false showing; same: wrongful appropriation of assets; limitations in application due to collusion; limitations in application due to installation problems; limitations due to non-application of principles.

Basically speaking, the fraudulent acts with which accounting is chiefly concerned may be divided into two classes — or it may be said that two fundamental objects exist which are responsible for committing fraud:

1. To present a false showing;
2. To hide the larceny or embezzlement of cash or other assets (for example, merchandise or securities).

The first class embodies those cases of forgery in which, generally speaking, the object may be said to be the presentation or uttering of false statements. The crime of uttering a forged instrument is connected with the crime of forgery — a misdemeanor. To constitute this crime of uttering a forged instrument, it must be shown that such instrument was forged, that the person uttering it knew it to be forged, and that it was uttered with an intent to defraud.

The second class comprises those cases in which a shortage in certain assets results from wrongful appropriation by some one or more individuals. Perchance, in this instance an attempt has been made to cover up the fact that personal property has been taken wrongfully — such cases of forgery are frequent. Again, no definite attempt may have been made to cover up the fault; in one instance, this may be due to the fact that a sufficient period of time has not elapsed from the moment of the crime to permit the perpetrator to plan and carry out his campaign of concealment; in another case, a pure crime of larceny or embezzlement may have been committed with no thought of a forgery being desirable or necessary.

False Showing

Frauds in the first group — those whose object may be said to be the presentation or uttering of false statements — may be committed by:

1. One partner against another partner;
2. The management of a business against its creditors;
3. The officers of a business against the directors of such business;
4. The directors of a business against the stockholders of such business;
5. An employee whose salary or other remuneration depends upon the profitable showing of his department.

Usually, it is the officers of a company, as differentiated from other employees, who are responsible for falsifications of this sort. Naturally, officers may be guilty of embezzlement, yet cashiers and bookkeepers, for example, have practically no chance of sharing the gains that might result from issuance of false statements. For example, officers and business owners are the ones to benefit from the utterance of false statements in attempts to sell securities or the business itself.

In some way or another — directly or indirectly — the person guilty of such a fraud expects a gain. In one case, the fraud may be an attempt on the part of some chief executive to deceive the owner of the business or its creditors — perhaps by what is known generally as financial window-dressing. In another situation, it may be an attempt by the majority stockholders (when they actually manage the business) to distort financial facts in the accounts to such an extent that when these facts are set forth in statements for the perusal of the minority group of stockholders, the latter may become discouraged to the point of disposing of their holdings at less than their true value. In another instance, personal gain may be the element which predominates — an attempt to increase a bonus, a commission, dividends, etc. Again, it may have as an object a later sale of company stocks, of bonds, even of the business itself, and so on.

Favorite points of attack in attempts to carry out frauds of this type are the inventory (an inflation of some part of it); investments and properties (again for the purpose of inflation); liabilities (their suppression); reserves (their "man-handling").

The efficacy of an internal-check system in the prevention of frauds of this type is decidedly problematical (see comment on limitations, page 23).

Wrongful Appropriation of Assets

Frauds in the second group — those whose object may be said to be the larceny or embezzlement of cash or other assets, with or without the element of forgery — may be committed by cashiers, bookkeepers, storekeepers or stockkeepers, or subordinate employees. In most cases of such crimes, the wrongdoers have been living beyond their incomes; have been gambling and speculating; have insufficient salaries; have been visited by some sort of misfortune; are in need of capital with which to open a business; or are naturally dishonest.

Such a person often has something wrong with him mentally or psychologically. Persons guilty of such offenses may be classed into two groups:

1. Those who are weaklings. Whenever a fancied necessity arises, they will fall under its pressure.
2. Those who are naturally dishonest at heart. Their egotism gives them the idea that detection of their acts is impossible.

Persons of the first type usually begin their taking of assets — ordinarily cash — as an advance against salary, hoping soon to replace or repay what was taken. But failure on their part to replace or repay, plus further fancied necessities, plunges them deep into the pit. The original amount taken grows and grows by further additions until concealment is required. And once resort is made to concealment, these weaklings are down for good, with rare exception. They have not the backbone to confess, but they usually breathe a sigh of relief when detected.

Those of the second type are individuals reckless of law and of property rights of other people. Such a person worships money and craftily schemes to develop some means or "system" through which it may be taken without detection. Money is taken and the taker's tracks are supposedly obliterated. The crime is repeated and repeated, never ending until discovery occurs. This kind of criminal practically never will confess and never will cease to deny and deceive.

One guilty of fraud of this type gains directly — he has taken into his control personal property belonging to another. It may be stated, however, that except in retail stores doing a cash business the direct stealing or embezzling of cash is not for the most part as much of a danger today as it once was, because receipts in currency are now relatively meager.

It is to guard against frauds of the second group — to provide for their prevention and detection — that an internal-check system usually is planned, and for this purpose a proper system (proper in the particular circumstances of each case) should prove most efficacious.

Limitations: False Showing

Frauds of the first group, based upon misrepresentation, are best controlled through examinations by an independent professional auditor, provided he brings to his work care, thought and deductive reasoning, and supplements these with intelligent use of percentages and ratios.

Such frauds, generally speaking, are almost impossible to prevent by a system of internal check, since it is official sanction which governs the effective application of a system to a given situation. Yet proper classification of accounts and the establishment of a definite system of internal check should do much to assist the professional auditor in discovery of frauds of this type, particularly since it should relieve him of a detailed audit of transactions, thus giving him more time to concentrate upon vital issues.

Wrongful Appropriation of Assets

The successful perpetration of frauds of the second group — actual appropriation of cash or other personal property — should be rendered exceedingly difficult, if not actually impossible, by installation and operation of a good system of internal check.

The more difficult it is made for an employee to cover his tracks, the less should be the danger from offenses of this character. The certainty of a relatively quick, automatic uncovering of fraud of this type is a most valuable deterrent.

Limitations: Collusion

Although the actual functioning of a good system of internal check will do much to prevent fraud, to intimate that such a system will eliminate fraud altogether places too strong a reliance on purely mechanical safeguards. It should be remembered that no such system can be absolutely air-tight.

"It is quite impossible to devise any system which will absolutely prevent fraud. The most that can be hoped for is the inauguration of a system of internal check which will make it as difficult as possible to carry out dishonest practices." (Hunt, E. W., "Prevention and Detection of Fraud in Accounts," *Accounting and Commerce*, vol.VII, 1921.)

The possibility of collusion deserves special and careful study. To rest serene in the belief that collusion is impossible is dangerous, since every internal-check system is grounded on the theory that collusion is not likely to exist — not that it will not exist.

The task is to make collusion as difficult as possible by placing particular transactions in the hands of a number of individuals. One must realize, however, that deception may bob up in the most unexpected places and that collusion is not necessarily preceded or followed by intimacy between employees. Practice has demonstrated again and again that the only relationship existing between criminally inclined employees may be joint perpetration of larceny or embezzlement.

The ideal system of internal check would preclude any fraud whatever except through the collusion of two or more employees. On the other hand, a bad condition exists when one employee alone handles an entire business transaction. Hence, the plan should prevent wrongful taking of property without discovery by less than two persons — even better, three or more.

The more individuals in the chain which girdles each business transaction, the more secure is a business against the commission of the criminal offenses of larceny and embezzlement. As an added precaution, provision should be made, when possible, to rotate clerks engaged in detail checking work, and such rotation preferably should be between departments rather than within a department.

Limitations: Installation Problems

The scope of the internal-check system in a given case depends upon the circumstances of the situation, the controlling factors being: size of office personnel and extent of delegation of duties.

In a small concern, in which one clerk, for example, constitutes the entire office force, the system of internal check can not consist of more than methods for safeguarding cash transactions. In such a situation, also, an expensive and elaborate array of time clocks would be foolish. Again, in a small business, rotation of employees may be impossible. When accounts receivable are relatively few, for instance, the owner may be close enough to the office records to leave further check to the independent auditor upon his periodic visits.

After a business has developed to a point where many activities are entrusted to subordinate employees, however, possibilities of inefficiency and fraud assume large proportions, and a good system of internal check then becomes not only desirable but necessary.

Each case, in other words, requires special solution of its problems. The person responsible for the internal-check system must exercise keen and discriminating judgment in designing and choosing the devices by means of which the purpose may be accomplished. Accordingly, it is impossible to crystallize from this discussion a standard plan, complete in every particular, which will be applicable to all enterprises. Let it be remembered that internal check, as professional auditing, is not a matter of ironclad rules and instructions. In practice, it is rather a matter of good judgment, the procedure varying to fit each particular case.

It must also be remembered that no matter how excellent a system of internal check may be, failure to carry out its provisions completely makes the system, to that extent, as one writer has said, a "hollow warning to employees with fraudulent intentions."

Laxity in application may be either the fault of the auditor or that of the management — sometimes both are subject to criticism. When the auditor fails sufficiently to emphasize the necessity for daily, complete compliance with the requirements of the system, business men are apt to underestimate its value. The auditor should take it upon himself to remind the management continually of the importance of the system of internal check, and in terms decidedly emphatic he should comment in his report upon any laxity coming to his attention.

Thus, it is seen that in considering the subject under discussion in its entirety, it is necessary to recognize that the methods which may be utilized for securing illegitimate gains depend upon the particular conditions existing in the establishment for which the schemer works. The character of the business, the methods by which cash and other property are handled, and the accounting system: each has a distinct relation to the means of concealing irregularities. And these must all be kept in a prominent mental position if one is to develop a satisfactory plan by virtue of which such irregularities are to be reduced or discovered.

Collateral Reading

Crawford, L. U., "Defalcations," *The Journal of Accountancy*, vol. XX, No. 2, August, 1915, pages 112-121.

CHAPTER IV

Principle of Charge and Discharge

Truth in accounts; basic concept; accountability; general cash fund; imprest petty-cash fund; property other than cash; charge versus chargeable; discharge of accountability; general cash fund; imprest petty-cash fund; property other than cash; discharge versus dischargeable; expense accounts; charge and discharge in relation to internal check; personifying accounts.

The object of every business is to increase the proprietary interest, and from the viewpoint of the proprietor the most interesting feature of the business activities is their effect upon the investment therein. Hence, the most important object of books of account is to secure a truthful record, in fair detail, of the increase and decrease of capital.

Business history is reflected in accounting records. For each business these records should have as their ultimate aim the production of statements of condition and of progress which not only are accurate in form but correct in content. Inasmuch as such statements should be prepared upon the basis of booked (but audited) facts, it is essential that the record of business financial facts be truthful — not narrowly truthful merely in the sense of what is recorded, but broadly so in the sense of what should be recorded.

Experience demonstrates, however, that the truth, in this latter sense, may be grossly distorted for divers reasons. It is the purpose of this book to suggest the basic approach to eradication of some (if not all) of these distortions.

Business transactions, operations and financial changes are the only elements which a system of accounts can possibly reflect — nothing more. All is well, from the record-keeping viewpoint, if this reflection is truthful. Yet every system of accounts is subject to possible manipulation.

Actual facts may be so altered that condition and progress are represented in a distorted light by failure to record incoming or outgoing values at their true worth, or not entering truthfully the elements of gain, loss and profit.

An entry in a set of books, for example, purports to record an asset. The record keeper's view of such a charge is entirely in error if it is looked upon as something more than a book entry; it represents a debit — not necessarily what should be charged but just what actually was charged. The data supporting the entry should be in order and properly filed.

At the end of the year this entry still may be on the books without change or alteration, and the supporting data may yet be in the file in an orderly arrangement. This entry, in other words, purports to reflect the fact that some asset is on hand equal in quantity and value (depreciation at this point is not considered) to that which is called for by the entry. But what of the asset in question — does it actually still exist?

If the asset has disappeared in whole or in part — regardless of reasons — the charge as it stands now is in error. A discharge proportionate to what has disappeared must follow. In one case, such proportionate discharge may not be on the books at all; in another, the discharge as recorded may not at all reflect the truth.

This principle of charge and discharge is a basic concept in auditing, both external and internal. Hence, the principle is fundamental in establishing a satisfactory system of internal check — with this qualification: when a person carries this idea of personification too far, numerous rather awkward situations will arise.

In developing methods for prevention and curtailment of frauds through books of account, this qualified idea of charge and discharge should be uppermost in mind, and accordingly a brief commentary thereon may be desirable.

Accountability

When a debit entry is made to some account which by its title reflects property values of a particular type, the system of accounting in use is mirroring the fact that the responsibility and accountability of some individual or agency for asset value has increased to the extent of the amount shown in the debit entry.

Whoever or whatever this business agent may be, the total charges to such an account should represent total responsibility and accountability in relation to the property in question. If it is expected, for example, that some individual is to account for all values entrusted to him, the debit side of the proper account represents the amount that has been charged to him. It is the particular task of the accountant installing a system of internal check to see to it that so far as possible such charges will flow automatically into the accounts provided therefor.

General cash fund. To illustrate this point specifically, attention is directed first to the regular cash account (as distinguished from petty-cash account or any other cash account provided for some specific purpose). When a debit or charge entry is made to the cash account, the accounting system reflects the fact that some financial agent — such as cashier or treasurer — is responsible and accountable for money to the extent of the amount in that entry. The total charges to this account, therefore, should represent total responsibility and accountability of such agent.

Thus, the debits in general-ledger account with cash represent charges against some clerk or company officer — a fiscal agent. The purpose of internal check in this case is to assure as far as possible in the record proper chargeability for cash.

Imprest (petty-cash) fund. Similarly, when a petty cashier has been entrusted with an imprest fund of, say, $50, the fact must be reflected on the books by a debit or charge to a petty-cash account, showing that $50 is due from the petty cashier at some future time — that he is accountable for this amount — until he is properly released from this accountability in whole or in part.

Property other than cash. This principle of charge applies to assets other than cash — to raw materials of every kind: goods, wares, merchandise, stores and supplies, furniture, fixtures and other properties or values regardless of form, shape and condition — which should be in the hands or custody of some individual who is chargeable with them. Undoubtedly the best means for recording the necessary chargeability for these assets is the perpetual-inventory system.

The application of the idea, however, to an intangible asset, like goodwill, would be carrying the matter too far.

Discharge of Accountability

Only as the result of credits properly recorded in each account, may the agent concerned be discharged proportionately from his responsibility and accountability for values. The property custodian or agent may.

1. Return the property intact to him from whom it was received;
2. Turn the property over to some one else who assumes custodianship or trust thereof;
3. Be released proportionately from responsibility and accountability through
   a. Some legitimate and fully authorized expenditure;
   b. Some loss in value properly recognized.

General cash fund. Since it is expected that the financial agent — as cashier or treasurer — will account for all values entrusted to him, it is only by means of properly authorized and recorded credits in the cash account that such agent may be discharged from responsibility. Such a discharge may result from returning funds or expending part or all such funds in some manner both legitimate and completely authorized.

Thus, credits in the general-ledger account with cash represent a discharge of some clerk or company officer — a fiscal agent. The purpose of internal check is to assure as far as possible a proper dischargeability for cash.

Imprest (petty-cash) fund. The petty cashier may be authorized to expend part, or all, of the imprest fund for certain well-defined purposes. He must, however, account for sums disbursed by producing satisfactory evidence that expenditures have been made for authorized purposes — evidence in the form of receipts or vouchers properly approved and signed.

Internal check here, again, should insure proper approval of petty-cash vouchers, since, otherwise, a dischargeability cannot follow.

Property other than cash. Discharges of values of property other than cash will be found to vary greatly in character. If property, for example, is sold for cash, a certain property custodian is discharged proportionately, whereas the same individual, or some other, becomes chargeable for the cash.

Dischargeability of responsibility and accountability for property not cash may result from replacing one kind of asset value with some other type of asset value (where property is sold, usually, cash is substituted), or from depreciation or other loss properly recognized.

The accounting for all properties should follow the same principle as that indicated for the accounting for cash, cash is property.

Expense Accounts

To some persons it may seem rather far-fetched to suggest that the same idea has considerable merit when applied to some (if not all) expense accounts. For example, an executive's expense account may contain certain charges. The question then may arise: has this person violated the trust that has been reposed in him? If some of the charges in such an account have been made improperly — have been inflated or are completely in error — then the responsibility and chargeability of that person as reflected by the account is in error.

A system of internal check properly established and operated should provide satisfactory answers to such questions by practically insuring the accuracy of account charges.

The viewpoint of the professional auditor considers the fundamental scope of auditing as embodying two basic phases — incoming values (charges and chargeabilities), and outgoing values (discharges and dischargeabilities) — each of which must be verified.

Internal check — internal auditing — is concerned with the same things. Fraud, of course, may easily arise in relation to either, and it is a mistake to neglect either incoming charges or outgoing discharges as possible avenues of criminal activity.

If disbursements, for example, are guarded closely, without corresponding attention to incoming values, a dishonest employee will not be long in comprehending the situation and planning his fraudulent scheme accordingly. This mistake in the application of the principles of prevention and curtailment of fraud undoubtedly has been responsible for the greater concentration of fraud practices in the direction of incoming values.

If an adequate, permanent and true record is provided for incoming values, and if the necessary procedures are developed for compelling proper record of such values the chance of permanent loss is slight. Once recorded, the values may be traced through the books with relative ease and dispatch.

Theft of personal assets properly recorded in the accounts, practically without exception, may be accomplished only by actual falsification of the books. Crude theft, without alteration of the records, will result in almost certain discovery. The problem, then, is to provide the means whereby incoming values will reach the records.

Personifying Accounts

In applying the principle of charge and discharge, as has been suggested, one may discreetly utilize the long-discarded idea that accounts are with people rather than with inanimate objects. Many were the criticisms advanced against the practice of considering the cash account as Mr. Cashier. And yet, as a practical proposition, this is exactly the light in which the cash account should be viewed for purposes of internal check. It may be helpful to consider some other accounts in a like fashion.

If the amount charged to an employee or officer is not equal to that for which he is chargeable, something is amiss. And if the amount of discharges claimed exceeds the amount of discharges actually authorized in due and proper form, a clear-cut explanation should be demanded. In the establishment of a satisfactory system of internal check, provision should be made, therefore, for charging each person not only with what actually comes into his possession but with that which in usual course should come into his possession; and to discharge each person only for that which leaves his possession by due authority.

Whenever possible, in other words, accounts should be designed to reflect the fact that persons, not things, are accountable and responsible for results.

Value and result go hand in hand. When a result appears not what it should be, value accounting may be sadly in error.

CHAPTER V

Organization and Business Transactions

Organization; office departments; classes of business transactions; purchases and purchases returns; sales and sales returns; cash disbursements and cancellation of payments; cash receipts and return of receipts to senders; departmental interrelations; general division of duties; general rules; double entry as an internal-check factor; red tape in error.

No matter what may be one's business, the necessity for perfecting at the outset a thorough organization and system of procedure can not be overemphasized. In order to hold its own, the executives of a business house should give the closest attention to the profit possibilities of these features. Organization and system never should be viewed offhand as an expense both useless and foolish; although a department-store system should not be adopted by a neighborhood merchandising shop, there exist some organization and system peculiarly suited to the latter. Care should be taken to perfect the organization in harmony with existing conditions. The object of any business organization is to unite a number of individuals so that they may form one working body striving together efficiently for a common end — profit.

Departmental division is a necessity frequently not well understood, since it means much more than a mere division of authority. It is necessitated by the fact that different methods of procedure in manufacturing and marketing goods require widely varying experiences.

A close relation exists between business departments and business transactions, since all business transactions are carried out by units of an organization. Each person on the staff of a business concern has some direct relationship to the organization of the enterprise as a whole — each one is an integral part of the organization even though, at times, this part is only a small one.

A business functions through persons. Business transactions carried out by the personnel are responsible for the ultimate progress of a concern. Hence, organization bears a prominent place in the development of a system of internal check.

Office Departments

No hard and fast rules of office organization and system can be laid down, inasmuch as the nature and magnitude of each particular business governs the procedure. In a concern, for example, which disposes of its entire output to a dozen large customers, the entire work of the credit department may be conducted satisfactorily by one man, merely as something in the nature of a side issue. But, on the other hand, an establishment which sells to thousands of retailers throughout the various states will require the services of perhaps a score of people in the credit department. Regardless of the number of people required, however, the things to be done by the office and the ways of doing them are essentially the same in any business.

The functions to be performed in an average office demand its division into distinct departments, the following being a simple illustrative scheme:

1. Purchasing (inclusive of receiving and storing);
2. Selling (inclusive of advertising, credit, collections, orders, packing and shipping);
3. Collecting and disbursing money;
4. Recording and accounting.

In many cases, of course, a more detailed separation will be in order.

Classes of Business Transactions

Based upon this simple segregation of office functions, it will be found that in any business a fairly similar differentiation may be made between the financial transactions. In any business, in other words, the transactions which should find eventual expression in the accounts fall into five broad major classes and into five minor groupings.

The five major classes may be indicated as

1. Buying — purchasing;
2. Selling — sales;
3. Paying out money — cash disbursements;
4. Receiving money — cash receipts;
5. Internal transfers authorized.

Each of these major groups is closely linked to a minor group which concerns the exact opposite of that for which the major division stands:

1. Purchases returns;
2. Sales returns;
3. Cancellation of authorized cash disbursements;
4. Return of cash receipts to senders;
5. Revocation of internal transfers authorized.

The merging of each minor division with its related major group produces the following:

1. Purchases and purchases returns;
2. Sales and sales returns;
3. Cash disbursements and the cancellation of authorized payments;
4. Cash receipts and return of cash receipts to senders;
5. Internal transactions — transfers authorized and authorizations revoked.

The further discussion of the subject matter follows closely this suggested classification of activities and transactions.

Purchases and Purchases Returns

Anything bought by a business may be viewed as a "purchase." Thus, labor, services, sundry assets and expenses, etc., may be referred to properly as purchases, in addition to materials and supplies. However, the better to develop the organization plan, it is customary to separate the purchases into two or more portions so that each may represent a definite and specialized purchasing activity.

In accord with this idea, a purchasing department executes all ordinary material and supply purchases. The employment department concentrates its efforts on purchases of labor. The purchase of large items may be centered in the hands of the president or of the board of directors, while the "purchase" of the services of professional accountants may be vested in the board of directors or in the stockholders.

In relation to purchases of materials there must be the payment, receiving, storing and accounting. In turn, each one of these four functions requires some one for its execution, as the purchasing agent; receiving clerk; storekeeper and accountant.

In a small undertaking, two or more of these functions may be performed by one individual, whereas in a large concern each separate function will require one person, aided at times by one or more assistants.

Purchase returns refer not only to the actual return of goods but to such matters as allowances received and reductions in cost price because of purchases in volume.

The exact treatment of material returns, for example, will depend to a large extent upon just how far the routine booking procedures in relation to an order have gone before it is decided that a return is to be made. In one case materials may be inspected before the receiving clerk has made his report, whereas, in another, the receiving clerk may have made his report prior to inspection of the goods in question. In one case, the rejection may have occurred before the invoice was approved and entered, whereas, in another instance, the invoice may have been approved and even entered on the books before it was decided to reject the goods.

Sales and Sales Returns

Sales of every kind may be referred to as "sales," yet it is natural to assume that the sales department will not be required to assume every type of sale encountered.

The sales department markets the ordinary product. The sale of odds and ends — as excess purchases, scrap and by-products — may be promoted by the purchasing department even though, perhaps, the accounting for such items will pass through the sales department. Sales of an unusual nature may be executed by the board of directors.

When an order has been received, for example, for the regular product, basis is provided for the issuance of a shipping order. But when shipment is made, the subsequent treatment of this shipping order depends upon the system in force and perhaps upon what is called for by the order. In a factory, if the order calls for goods to be manufactured for immediate delivery, no contact of such order with the perpetual-inventory record of finished product may be necessary or desirable, whereas if the order calls for goods carried regularly in stock such contact is essential.

The opposite of a sales transaction is a sales return. If goods have been sold and are returned it is necessary to provide for their receipt and record, and a credit to the customer.

Cash Disbursements and Cancellation of Payments

It should be recognized that cash disbursements are not all of the same type; whatever may be developed for handling and booking cash disbursements must take possible variations into consideration. Cash disbursements, for example, may be made from regular bank accounts; petty cash and working funds; sinking funds; payroll funds, and so on. Provision should be made for strict separation of cash disbursements from purchases. The purchase is one act, whereas the disbursement of cash is another.

Likewise, canceled payments are of various types; for example:

1. Cheques may be canceled prior to mailing (either after or before their entry in the books of account);
2. A cheque may be sent out but returned by the payee;
3. A cheque may be issued simply as accommodation, cash of an equal amount having been received prior to issuance of the cheque.

Cash Receipts

Again, care should be observed to provide a strict separation of cash receipts from sales, inasmuch as not all cash received is the result of consummated sales transactions.

Infrequently, cash will be returned to the payor perhaps because of overpayment.

Departmental Interrelations

It will be noticed that the financial transactions of a business concern, although separable into groups, at times bear a relationship to each other. This fact is of considerable value, inasmuch as such knowledge may be utilized profitably in laying out the system of internal check. For example, the purchasing department handles no outbound cash, yet it does produce transactions which at a later time become the basis for certain disbursements. Again, before a customer is granted an allowance it is necessary to secure the O. K. of the sales department therefor. Hence, it is not the cashier alone who is concerned with granting and booking such allowance.

General Division of Duties

Internal check is the preventive expedient with which this book deals. It may be that it is one person's duty expressly to approve the work of another, or it may be that the routine is developed so that one person's function can not be performed satisfactorily if another errs in his work.

"Upon the same principle that the more planks there are in a raft the harder it is to sink it, the more persons who check a transaction the more likely it is to be handled correctly." (Greeley, H. D., in *Business Accounting*.)

In a large organization the principle may best be applied. Such a business is organized under the supervision of department heads, and the routine of approval and recording is so coördinated that it is necessary for every transaction to pass through the hands of at least two employees. Every transaction is subject to the approval, or counter-check, of at least a second person.

Such a division of duties makes it difficult and dangerous for a dishonest employee to practise fraud, and it necessitates collusion of at least two persons to conceal a shortage. For example:

1. One may record a sale, but another charges the customer therefor;
2. One may receive collections, but another records customers' credits;
3. One may handle the cash, but another keeps the ledger account with cash;
4. One accepts an order, but another ships the goods;
5. One authorizes a purchase, but another receives the goods;
6. One approves invoices for payment, but another issues the checks;
7. One delivers goods from stock, but another checks the inventory on hand;
8. One makes up the payroll, but another pays the men.

General Rules

The following rules or ideas are of general application, in accordance with the illustrations cited above:

1. The cashier should be kept exclusively busy with his cashbook;
2. Each ledger keeper should be exclusively busy with his posting labors;
3. Clerks other than the cashier and bookkeepers should be assigned the task of writing up the journals;
4. Ledger balances should be drawn off by some one other than the ledger keeper;
5. Detail work, as much as possible, should be initialed by employees responsible therefor;

6. Annual holidays should be enforced. No one should be considered so indispensable as to be given absolute and complete control over any one part of the work for more than fifty weeks each year; in fact, such control at all times should be subject to check by some other person;
7. When conditions permit, detail duties of clerks should be rearranged from time to time, to stamp out possible collusion, but without permitting the clerks to know the reason for the rearrangement;
8. Whenever possible, employees should be kept in ignorance of the checks maintained on their work;
9. Cash sales should be checked carefully each day;
10. Documents of original entry, whenever possible, should be used for posting purposes;
11. Unusual living conditions of employees should be noticed by the management;
12. Surety bonds should be secured for all employees who handle money;
13. Continual study by the management should be made of employees' peculiarities, and changes in characteristics should be studied;
14. Accounts should be audited periodically — at least annually and if possible quarterly.

Double Entry and Internal Check

Again and again one finds in accounting texts the intimation that double-entry bookkeeping reduces the possibilities of errors and fraud. The idea is put forth as one of the advantages of a double-entry system of accounts. As a matter of fact, this may be anything but true.

Double entry, at best, can not do more than provide the basis for developing a satisfactory system of internal check. Double entry in itself is no protection against the wrongful taking of funds and other assets unless its mechanics are dovetailed into the routine of handling business transactions, and the routine must provide the safeguards against errors and fraud.

Red Tape in Error

Internal check should be effected in as natural and automatic a manner as possible. Forcing methods into the routine often causes opposition, since they operate merely as so much red tape and interfere with the logical flow of transactions. It is much to be preferred to have the business routine so arranged that one employee can not function properly if another errs in his work:

"Pride in one's own work is the strongest incentive to insistence upon proper coöperation by others and partly because it obviates any irritation which might be caused by making it one's duty to correct or report another's error." (Greeley, H. D., in *Business Accounting*.)

Collateral Reading

Greeley, H. D., "Verifying and testing the accounts," *Business Accounting*, vol. IV, chapters XXIX–XXXIII, pages 379–442. Ronald Press Co., New York, 1920.

Saliers, E. A., *Accountants' Handbook*, pages 984–1006. Ronald Press Co., New York, 1924.

PART II

INTERNAL CHECK AND VARIOUS BUSINESS TRANSACTIONS

CHAPTER VI

Purchases and Purchases Returns

Classes of purchases; possibilities of fraud; delegation of purchasing authority; purchase transactions; voucher: definition and use; duties of purchasing agent; purchase-order system; purchase request; competitive bidding; purchase order; orders canceled; duties of receiving clerk; materials-received report; invoices for materials received; variation in procedure; local purchases of a sundry character; audited voucher; voucher forms; voucher system and accounts payable; substitute for voucher system; returned purchases; incoming freight; purchase of services; purchase of labor; purchase of sundry assets; conclusion.

As suggested previously (page 35) the purchase of materials and supplies, broadly speaking, does not necessarily represent the only items comprehended by the term "purchases."

A separation may be made somewhat as follows:

1. Materials and supplies — goods and commodities:
   a. Purchases from a distant vendor;
   b. Local purchases;
2. Services and labor:
   a. Services (as accountants' and attorneys' services);
   b. Labor;
3. Sundry assets (as machines, equipment, etc.).

It appears reasonable to assume — hence, the distinction is important — that exactly the same procedure (perhaps rather cumbersome) developed in relation to materials and commodities purchased at a distance should not operate without some change when a like item is purchased from a local concern situated, perhaps, in the next block. Again, when the services of accountants or attorneys are needed, as well as professional services of other kinds, it seems reasonable that the same machinery should not be put in motion to acquire such service, and to pay for it, as would be utilized to obtain a machinist or a cost clerk. Further, if a new machine appears on the market which it seems desirable to purchase, the decision to purchase and the subsequent steps entailed undoubtedly can not be similar to the procedure involved in purchasing a thousand tons of a certain raw material.

Possibilities of Fraud

Purchases provide numerous opportunities for fraud, some falling short of actual wrongful taking of assets, and others not being complete until assets actually have been diverted into improper channels. The following possibilities are illustrative, and are those particularly kept in mind as the discussion develops:

1. Those falling short of an actual wrongful taking of employer's assets:
   a. Adversely influencing the purchasing agent;
   b. Bribing employees — particularly in the purchasing department;
   c. Receiving inferior materials in lieu of those of desired quality;
2. Those requiring a diverting of employer's assets into improper channels;
   a. Diversion of assets either before or after their receipt in the storeroom;
   b. Improper payment of invoices;
   c. Manipulation of details in credits to accounts.

In actual diversion of assets, the element of forgery may enter in an attempt to conceal the deed, through overcharges, entering invoices at more than the amounts to be credited, recording fictitious sales, etc.

Delegation of Purchasing Authority

When some commodity (or even some service) is purchased, a contract relation has been entered into by vendee and vendor, which, from the viewpoint of the vendee — with whom the present discussion is concerned — involves the creation of a liability, the reduction of which demands an immediate or later expenditure of cash. But, what is more important at present, such purchase in a great majority of cases has been carried out by some persons to whom the purchasing authority has been delegated.

Because of such delegation internal check over purchases is necessary — otherwise, accuracy and control are impossible. All purchases should be made only by and through definitely delegated authority; otherwise, specific responsibility — so essential — can not exist. It is necessary next to provide a means whereby the responsibility for each transaction may be traced.

This chapter considers the means for internal check of purchases, particularly of goods and materials. The plan commences at the point where the order or request to purchase originates and ends at the point where the cash fund becomes involved.

The ordinary purchase of this type follows a path along which the outstanding landmarks are

1. Source of the purchase order;
2. Functioning of the purchasing department;
3. Receipt of goods (material control is discussed in a subsequent chapter);
4. Receipt of invoice;
5. Payment of account (actual payment is discussed in the chapter on cash disbursements).

Purchase Transactions

Each purchase includes three specific routine steps: Buying (placing the order); receiving, and passing credit (approving invoice for payment).

These three steps are intimately related, and it is due to this close relationship that internal check may be developed in a satisfactory manner. Regardless of whether a business be small or large, these three phases are encountered in every purchase.

In a small business the owner or manager may function in all three places, and in this case it is possibly unnecessary to consider internal check, although proper control over purchases even in these circumstances is encouraged by establishment of such a system.

In a large business, on the other hand, there is no question at all of the necessity of a system of internal check — the system is necessary ipso facto as soon as these three parts of the purchasing activity are attended to by employees to whom authority has been delegated.

Voucher

The invoice or bill is verified as to receipt of goods or services, the basic evidence supporting and justifying the payment of a claim from a creditor. Each invoice or bill sets forth the items for which payment is requested. Each invoice or bill, when approved by the proper individual responsible for purchases becomes a voucher — the accepted evidence showing the purpose of authorizing an expenditure.

This definition of a voucher — the accepted evidence showing the purpose of an expenditure — may be somewhat narrow when compared with other definitions of the same term, yet it is the only meaning which is practically acceptable in relation to internal check.

If a complete record of purchases is to be installed, each disbursement for purchase must be supported by a voucher which carries on its face the purchase-order number, description of purchase in question, and approval of the expenditure.

To assist in developing a satisfactory system of internal check in handling purchase invoices, there has crept into prominent use what is known generally as the "voucher system." It is shown in later comment that such a system, as generally conceived, may be seriously at fault.

Duties of Purchasing Agent

Every business which is well organized and of fair size should create the position of purchasing agent. It is the duty of this individual, or of the clerks under his supervision (in cases other than department-store buying) to obtain the best prices, with due regard for quality of goods and quickness of delivery. All purchases should be made through the purchasing department, and all purchase invoices should be approved by this department before being passed for vouchering and payment.

Purchase-Order System

As far as actual purchases are concerned, what is generally known as the "purchase-order system" seems best for controlling purposes, whereas the problem of payment beyond doubt is covered preferably by the audited-voucher scheme.

In order to effect as much centralization of purchasing responsibility and authority as possible, the purchase-order idea is of marked assistance. Regardless of whether the purchasing activity is concentrated in one department or is diffused through numerous departments, the purchase-order system provides a systematic means whereby orders may be routed, and followed up, so that the accounting department may readily trace the responsibility for each invoice presented for payment.

Purchase Request

The issuing of a memorandum form, the purchase request, usually marks the first step in making a purchase, preceding the purchase order. It may be viewed as a part of the purchase-order system or it may be considered as a sort of prologue thereto.

Every purchase request should originate outside the purchasing department proper. Such request, always in writing, informs the purchasing agent that certain purchases are desired. It is his authority to buy whatever is specified — subject to reasonable restrictions, of course.

Such orders to purchase may be prepared in duplicate on paper of different colors, consecutively numbered, the original being passed to the purchasing department, the duplicate being retained at point of issuance. Each request may be confined to one class of goods, or columns may be arranged to permit inclusion of two or more kinds of articles on one form.

In the usual situation the request should be issued by the person or department in whose custody the stores ledger is kept. If this ledger is elsewhere than in the storekeeper's custody, there undoubtedly must be collaboration between the storekeeper and that other department or person. In a factory, this outside department may be the production department (frequently the stores ledger is there) or the engineering department for instance, when a special job comes in. In such case, three copies are desirable. In any event, the request should originate outside the purchasing department.

In a small place, departmental foremen may issue requests for goods not carried in stores, and in that case, three copies are desirable rather than two: original to purchasing department, duplicate to storekeeper and receiving clerk (perhaps both duties are vested in one person), and triplicate retained by the issuing foreman. These requests are numbered consecutively, departmental symbols being used with the numbers. The foremen should keep their copies permanently.

Each establishment must develop a particular procedure suited to its needs, since uniformity among various concerns is impossible. Perhaps, generally speaking, each request honored by the purchasing department — this consisting of placing an order — is marked in some fashion, and is treated as an "order placed."

The request to the purchasing department may be retained there, or it may be returned to the place from whence it came — to storekeeper or department head. Retention in the purchasing department seems desirable in order to have in one place a complete file of authorizations to purchase. In case the request is retained in the purchasing department, a copy of the purchase order may be sent back to the point of origin of the purchase request. At any rate, each series of purchase requests ought to be retained, and be accounted for, in entirety.

Competitive Bidding

Bidding should be encouraged, although it must be recognized that frequent exceptions to the rule are necessary. The point of practical import is that, if possible, no one person should be allowed to select the vendor and place the order. Theoretically, at least, three persons should be concerned with the bids:

1. One to send out requests for bids;
2. Another to receive and tabulate the bids;
3. Another to place the order.

Whenever possible, the list of bids should accompany the voucher for account payment. It is not always necessarily the lowest bidder who receives the order; other factors — quality, transportation, etc. — may enter into the decision. The reason for selecting the vendor should be written on the bid list, and be initialed or signed by the selector.

Purchase Order

The purchase request having been received and honored, and, perhaps, bids obtained, the vendor concern is selected.

Next, the purchase order is issued, and the matter now reaches a stage of routine. The purchase-order system usually encountered consists of a set of forms prepared by some manifolding device together with the regular purchase order which is sent to the vendor — this set being carbons of the original purchase order.

The number of copies required depends upon circumstances — never less than one carbon and perhaps two, three or four, all on different colored paper. The original, for example, may be sent to the vendor concern, the duplicate (with prices and quantities preferably excluded) to the receiving clerk, and the triplicate may be retained in the purchasing department. If desired, other copies may be forwarded, one to the storekeeper and one to the accounting department.

The purchase request and the triplicate purchase order may be clipped together, and any correspondence relating to the order may be attached. To make ready reference possible, the purchase order should have marked on it the request number, and the purchase request should have the purchase-order number written on it.

The purchase order at this point, being unfilled, should be filed as an unfilled order.

Most large department stores send buyers to the big cities. The purchasing department notifies them to buy certain quantities of articles which are to retail at specified prices. Here, the buyer merely selects the vendor.

It is possible that these buyers may be influenced adversely, but they can not buy more than a certain quantity, and if the quality of the goods is poor the receiving department will reject them — an immediate reflection upon the buyer's ability.

The buyer makes out the order and sends it direct to his purchasing department for signature, after which the latter forwards it direct to the vendor.

Orders Canceled

Infrequently, the vendor for some reason may not accept the order. In this event, the copy of the purchase order sent to the receiving clerk should be recalled (this is the duplicate), the entire set of orders marked "canceled" and filed away. This treatment permits retention of each complete series of purchase-order numbers.

Duties of Receiving Clerk

Provision should be made for determining the quality of goods received, for counting the units and for certifying the quality and the accuracy of quantities reported.

There should be at least one person in the organization who knows qualities and inspects closely all incoming merchandise. In this way a check may be established against possible irregularities on the part of the purchasing department and even on the part of the receiving department. This individual may be attached to the receiving department, or he may function in a separate

It may be desirable to adopt the practice that no packages shall be accepted unless an invoice or statement therefor first be on hand; again, it may be sufficient to require that such invoice or statement shall be enclosed in shipment.

Materials-Received Report

The method for reporting materials received depends upon the system developed. Generally speaking, the report is made through the medium of the duplicate purchase order, or a receiving slip is prepared. Regardless of the method employed, each lot of goods received should be definitely identified with a specific purchase order.

When a duplicate purchase order is utilized the exact treatment varies according to whether or not quantities are shown on the duplicate. If the duplicate shows quantities one must be careful to make employees know that a mere check-off will not be sufficient. It is fundamentally necessary to make sure that incoming quantities actually will be counted. The receiving clerk's certification and signature should be required. An order partly filled, future shipments to follow, is perhaps best reported on a special duplicate purchase-order form. The duplicate purchase order or special duplicate is forwarded to the purchasing department (perhaps to the accounting department).

When a receiving report is used it is prepared in duplicate or in triplicate. The original is passed on to the purchasing department; the duplicate goes to the storekeeper with the goods (being retained by him for entry or later passed to some other department for entry if the stores ledger is elsewhere), and the triplicate, if prepared, is retained by the receiving clerk. This triplicate, with the duplicate purchase order attached, represents this clerk's record of having reported receipt of goods. In case a part shipment has been received, the purchasing department may prepare a purchase-order notification for what is to come, the duplicate going to the receiving clerk.

Carload shipments may be noted on a separate report — as on a weighmaster's report — the original of which goes to the receiving department as authority for this department's report to the purchasing department. It may accompany such report to the purchasing department. The duplicate is retained by the weighmaster. A triplicate of such report may be utilized by the traffic department, if any.

As soon as the duplicate purchase order or receiving report shows that all goods have been received as ordered, a transfer is made from the unfilled purchase-order file to the filled-order file.

Goods should be refused by the receiving department unless a copy of the purchase-order notification is on hand. This rule, however, can not be enforced in the case of returns inward. All attempts to accept unauthorized packages should be reported immediately to some officer, who should take the steps necessary to prevent recurrence of such acts.

Regardless of how receipts may be entered — on a copy of the purchase order, on a separate receiving report, or in a receiving book — the receiving department should be held accountable for everything actually received. It may be advisable, also, to provide a receipt form to be given the carrier for goods delivered by it.

The receiving department should be discharged of responsibility only for authorized deliveries made to the storekeeper or to the departments for which goods were purchased. A receipt in some form should be taken to provide the necessary discharge, as well as the charge to the storekeeper or other department. The discharge of these latter divisions is discussed at a later point.

Invoices for Materials Received

The invoice related to an inward shipment may arrive before or after the goods themselves have been received. No invoice verification should be attempted until after receipt of the goods called for has been reported. All invoices received, indicating the amount for which the company now is indebted, may go first to the purchasing department (some companies require them to be received in the accounting department).

Upon receipt, the vendor's invoice may be rubber-stamped at once with the invoice stamp, so as to make certain that approval in due form will follow.

Such a stamp should permit ready correlation of each invoice with its purchase order by number and show in detail the status of the purchase transaction. Information of a varied type may be placed upon the invoice by means of this stamp, the exact information in each case being that which is deemed desirable to secure a complete check in the circumstances. The ordinary matters which should not be overlooked — in approving all purchase invoices — comprise the following: purchase-order number; date received;

checking of terms and prices (f.o.b. requirement, etc.); date goods received; checking of goods quantities; checking of invoice extensions; approval of payment; voucher number.

In the purchasing department the duplicate copy of the purchase order or the receiving report on hand is compared with the invoice to make certain that the goods invoiced have been received; the triplicate copy of the purchase order plus correspondence thereto attached are scrutinized to determine that terms, prices, etc., are correct.

After approval — two or more employees preferably participating in the routine procedure — the invoice is sent to the accounting department. Here extensions are proved, unless this has been done in the purchasing department — it may be done in both places to assure a double check — and the invoice is prepared for entry upon the books of account, this to be followed later by payment. Perhaps the duplicate copy of the purchase order or the receiving report, routed back by the receiving clerk, is attached to the invoice to avoid a later approval of a duplicate charge for the same goods.

The procedure now may be considered as complete except for entry and payment. At this point appears the audited voucher, a desirable — even necessary — support of the cheque or voucher cheque issued to cover the invoice.

Variation in Procedure

Each particular case, as suggested previously, requires special study. If, for example, it is desired to develop a scheme somewhat more elaborate than the one which has been outlined, the following adjustments may be introduced:

1. Purchase order — one copy may be sent to the accounting department;
2. Receiving report — assuming the use of a separate receiving slip, one copy accompanied by the receiving clerk's copy of the purchase order (his notification to expect goods inward and authority to accept them) may go to the accounting department, and one copy may be routed to the purchasing department;
3. Invoice — this may be received in the accounting department to be registered and to be stamped with the invoice stamp, after which it is passed to the purchasing department.

The purchasing department satisfies itself that the delivery was in accord with the purchase-order terms, it checks the prices, the delivery point, etc., and the necessary initials are placed on the invoice, after which the latter is returned to the accounting department. The accounting department verifies the footings and extensions, and compares the results with its record of the transaction. This done, the vendor is credited with the amount involved.

Sundry Local Purchases

The regular purchase-order system which involves the purchase requisition and purchase order is generally sufficient to handle purchases made from other than local vendors and, in certain instances, the same ideas may work satisfactorily in local purchases. An attempt has been made to show that under this system purchasing authority may be specifically placed and responsibility centralized, so that a satisfactory internal check is possible.

Frequently, however, attempts to frame one standardized scheme for all purchases indiscriminately are found to be most unsatisfactory. It may be, for example, that the regular purchase-order idea does not prove particularly efficacious for small local purchases. Often, when such goods are ordered direct, a purchase order is sent out later; this, however, may not solve the situation. A special application of the purchase-order idea may be more satisfactory — one which does not conflict at all with the regular scheme.

In numerous concerns department heads must be given the privilege of purchasing locally, and in such a case variation in usual treatment may be desirable. Each department head may be authorized to issue local purchase orders, for which purpose is provided a supply of forms of a color different from the usual kind. A copy of each order should go to the purchasing department or to the accounting department to be used in checking the local vendors' monthly statements.

It must not be intimated that the actual receipt of such goods thereby is checked properly, in every instance in harmony with the principles of the usual procedure. Yet, by placing responsibility squarely upon each department head, any abuse of authority can not go long undiscovered, if only ordinary intelligence is used in checking these orders monthly.

All local dealers should be required to submit detailed statements monthly. This will permit the necessary monthly adjusting entries to be made to cover the liabilities involved.

Audited Voucher

No attempt is made here to discuss the voucher system as usually presented and understood — that is the province of the text on ordinary bookkeeping. The present discussion is on internal check, not that which advocates the elimination of the usual creditors' ledger. As a matter of fact, there is substantial ground for criticizing the usual presentation of the voucher-system idea inasmuch as the elimination of the creditors' ledger is something which rather frequently is not to be desired.

The major emphasis of the audited-voucher-system concept is on the fact that by requiring adequate vouchers for every expenditure, a control over disbursements is secured far better than by any other scheme yet developed. And this control is possible whether the creditors' ledger is discarded or retained.

Every cheque issued should be definitely related to some sort of audited voucher. This audited voucher probably will be, in most cases, a creditor's invoice definitely identified with some purchase, which has survived the ordeal of inspection, checking, etc., so that it stands clearly marked as in order and properly payable.

The use of the audited voucher plus that of the purchase-order system provides a means whereby each invoice may be traced back to the purchase requisition. Thus, the opportunity for duplicate payments based upon false invoices is reduced to minor importance. To induce such payments collusion by several persons is necessary.

Voucher Forms

Basically, the voucher and the voucher cheque are alternative forms. The first provides a completely audited record of every disbursement. The second does the same thing but in addition makes the cheque a part of the voucher. From the internal-check viewpoint, neither can be favored over the other. The point here is that every cheque issued must relate specifically to some one voucher, so that each transaction may be traced completely from the moment a liability is incurred until it is discharged.

From another point of view, the voucher cheque may be less desirable than the ordinary voucher form. If audited vouchers are not paid in the order of issuance the voucher cheque seems of less value. This frequently is the case in trading and manufacturing concerns, particularly when, although claims may have been approved for payment, the payments for reasons of finance, will, perhaps, not follow the order of payment authorizations.

Voucher System and Accounts Payable

Inasmuch as the voucher system provides that all expenditures be made on the basis of an audited invoice or bill, practically the only accounts payable encountered in a set of books will be unpaid audited vouchers.

This condition may not be particularly subject to criticism provided a purchase-order system is in operation, because in this case a complete record of all purchased goods received is maintained, which permits determination, at any date desired, of all liabilities arising from purchases.

Periodically, for statement purposes, all unaudited vouchers should be brought upon the books because of the liability involved. An adjusting entry is made for such purpose, this entry being reversed at the beginning of a new period so that the invoices, when audited, may pass through regular channels.

Substitute for Voucher System

If the voucher system, as generally understood, is not in use, it is necessary to provide for the flow of invoices to the creditors' ledger along lines fundamentally similar to those already suggested as possibilities. Thus, no goods may be accepted without an invoice or statement of contents first being on hand; and perhaps the notification copy of the purchase order should be available at the point of receipt before acceptance of a shipment.

Next, such invoices, after being carefully checked, may pass to the keeper of the creditors' ledger for posting, after which they are initialed and marked with ledger folios. From this point, they may go to the keeper of the purchase journal or recapitulation book, who enters them therein with ledger folios and also initials them. Finally, they reach the unpaid file. The work of checking footings and extensions and of correlating receipts and invoices should be executed carefully regardless of the particular scheme developed.

Returned Purchases

Basically, the accounting checks of returned purchases will be similar to those provided for sales, since many of the same elements are involved.

The usual return consists of defective material. The receiving department has received the shipment, and has made entry therefor, before the purchasing department is notified that a return is necessary. The purchasing department should take up the matter with the vendor, after which shipping instructions are issued to the receiving department whose duty then is to return the material as ordered.

The possibility of fraud usually centers in an attempt to issue a return-purchase order so as to cover up the theft of material, thus relieving the receiving department or the stores department, or both, of accountability. By dealing with the return through the purchasing department and having the latter communicate with the vendor, the vendor is put on notice that goods are being returned.

The accounting department is notified by the purchasing department that a return-purchases credit is correct for entry. But entry should be withheld until after the bill of lading covering the return shipment has been scrutinized.

Even at this point it is possible for the accounting department to be deceived through falsification of the bill of lading. However, the transaction can not be long concealed since if the vendor receives neither payment nor the returned goods he will insist upon action. Then the traffic department or some person functioning in that capacity, who has nothing to gain by covering up the matter unless collusion exists, at once will start a tracer for the shipment supposedly lost. This probably will quickly bring to light the fact that no return shipment was made, and the receiving department will be called upon to account for the missing goods.

Incoming Freight.

Incoming-freight charges should be positively identified with the actual receipt of goods. This may be accomplished by having each freight-expense bill approved by the receiving clerk, and by requiring him to place thereon the receiving-report serial number. If these freight-expense bills are filed according to serial numbers the danger of duplicate payments is obviated.

Theoretically, all incoming-freight charges increase the book value of goods, and, hence, they should be allocated to the goods in question. However, under the modern perpetual-inventory plan it may be absolutely impracticable to distribute such charges to the various lines of goods, since unwarranted expense may be entailed. Such distribution should be made if it is practicable.

It is not particularly difficult to raise amounts shown on freight-expense bills, inasmuch as the bills are usually prepared by the railway clerks in pencil, with duplicates made by carbon paper. A knowledge and careful checking of rates, as part of the office audit of freight bills, should practically eliminate this possibility of fraud.

Purchases of Services

Services of various kinds must be sought by every business, these representing items (other than labor) which can not be accounted for fully in the same manner as the purchase or goods which may pass through a storeroom. The major difficulty lies in the fact that such items can not be received and the receipt certified as correct by a receiving clerk; many can not even be traced from a purchase order — as taxes, freight, etc.

A check upon the consumption of water, gas and electricity may be maintained by installation of departmental meters. Advertising purchases may be supported by regular purchase orders, but it seems advisable to require inclusion of the page of the publication on which the advertisement appears, plus date, as part of the voucher.

Traveling expense is something which can not be checked properly in every respect. Although it is possible to obtain some sort of receipts for railroad fares and hotel accommodations, such items as tips, taxi fares, etc., can not be supported by receipts in the accepted sense. Periodic scrutiny of expense accounts by the management is perhaps the most satisfactory way of curtailing extravagance in traveling expenses.

A copy of each outgoing telegram should be retained to support the monthly vouchers authorizing payment of telegraph charges, and for every incoming telegram marked "collect" the envelope, with necessary notations thereon, should be retained (unless it is not necessary to keep the telegram itself in the files). If telephone service is purchased at a flat rate, there should be no trouble in verifying accuracy of charges; but when the service is measured a tally sheet should be kept by the switchboard operator from which the number of calls billed may be verified and the necessary distributions made.

Insurance should be purchased through the issuance of a purchase order, and the policies should be examined in vouching the bills. Local taxes may be checked against the local rates as published and state taxes against the legal rate. A copy of the income-tax return should be on file to support the payments made for income taxes. Rental payments should be supported by the leases.

Services of professional accountants may sometimes be checked against time reports submitted with bills for services. But since the professional accountant may charge on the basis of service rendered rather than on the basis of time consumed in a particular engagement, time reports may not be available. In this case the charge should be checked and approved in a manner similar to that of checking and approving attorneys' bills. Generally speaking, if such bills carry executive approval they must be accepted as correct for entry purposes.

Purchase of Labor

Theoretically, labor is purchased. Yet inasmuch as its purchase requires treatment radically at variance with that accorded goods purchased, a separate consideration must be given to the subject, which is reserved for a later chapter.

Purchase of Sundry Assets

It is evident that requests to purchase sundry assets need not originate in the same way as that suggested for purchasing goods or materials. If a machine is to be purchased, for example, the engineering department and some major executive or the board of directors, perhaps supported by resolutions spread upon the minutes, should assume responsibility.

It should be made absolutely impossible for only one person to authorize the discarding and scrapping of one machine and the purchase of a new one (unless that person is the proprietor of the business). If not more than one person is involved, it is possible that indiscriminate discards may be ordered and the equipment may be passed to a favored old-iron dealer — a confederate who will share with the employee the profit from disposal of the discarded unit. The principle of discharge and charge should be applied to sundry assets as rigorously as to the asset of cash.

General Rules

The following half-dozen rules of general application are suggested as a sort of epitome of what has been discussed in this chapter:

1. The purchase request is issued by the storekeeper only upon the authorization of some executive;
2. Exceptions to competitive bidding are to be kept at a minimum — they can not be eliminated entirely — and the employees who deal with bids should be well scattered;
3. The report of the receiving clerk, when passed to the storekeeper, should be checked carefully by the latter, and the storeroom employees should be rotated sufficiently often to prevent undesirable intimacy with the receiving clerk;
4. All material received should be inspected, preferably by someone independent of regular departments. Not only does this help to check both the purchasing and receiving departments, but it tends to forestall possible collusion between the purchasing agent and the receiving clerk;
5. The accounting department audits each invoice received, prices being checked, say, from its own copy of the purchase order, and the receipt of articles being checked, perhaps, from its own copy of the receiving department's receiving report. One clerk should check and another recheck, and the chief accountant or comptroller should scrutinize their work. Only after all this has been done should the invoice be vouchered for payment, actual payment being made by a part of the organization separate and distinct from the accounting department;
6. Ledger balances in the detail ledgers ought to be practically force proof. No accounts-payable-ledger clerk should be told just what his controlling account balance is; thus, the detail-ledger trial balances or abstracts will be submitted as the result of work independently done. In case a controlling account and its detail accounts are out of agree-

ment, the ledger clerk should be informed merely that he is out of balance. This will curtail the forcing of ledger trial balances so as to carry along the current work, as well as reduce the adjustment by arbitrary journal entry of such errors of long standing.

CHAPTER VII

SALES AND SALES RETURNS

Sales transactions; fraud in sales; cash sales; food sales; credit sales; sales orders; sales-order information; order and billing system; departments involved; credit-department control; shipping; accounting-department control; billing; accounts receivable; discounts; illustrative procedure; outgoing freight; consignments; returned sales and allowances—bad accounts; selling expenses.

In most undertakings of a commercial nature, whether mercantile or industrial, the sales transactions are numerous. Each sales transaction originates at the particular moment when an order is obtained from a customer.

Sales may be made for cash or on credit, or both; this distinction is important, inasmuch as the protective scheme evolved must vary according to such a differentiation.

A system of internal check in relation to sales, therefore, is concerned fundamentally with cash sales and with charge sales, each class being viewed as presenting a separate problem, with certain elements, perhaps, similar in both. The plan must commence at the point where the order is secured.

Preliminary expenses related to sales may be considered by some as purchasing rather than as selling. Yet in the development of a protective procedure it should be remembered that such purchasing is caused by the sales department, and that although certain goods or services may be bought through the purchasing department not all of them can thus be purchased. Hence a problem arises which requires solution as a sales matter.

When a system is installed which has given due weight to the factors suggested in this chapter, undoubtedly all operations may be treated satisfactorily, from the receipt of an order through to its billing, even including the preparation of the bill of lading, which in part at least may be written out at the first transcription.

Each particular case, at least as far as many elements are concerned, undoubtedly requires separate consideration and solution. In most instances, however, it is found that fundamental principles hold true. Accordingly, it may be advisable first to diagram the paths of the transactions, the better to visualize the critical points at which checks should be established. Here, again, also, it might be advisable to bear in mind the principle of charge and discharge — for example: a sales slip or sheet properly prepared may be authority to charge a customer and, at the same time, to discharge a certain salesman or department for the same value.

It seems desirable to reiterate that care and precision should be insisted upon at every step in the procedure developed, inasmuch as careless handling of sales orders probably causes more trouble and expense in large concerns than any other preventable error. Even though the order system has been developed to a point where it is believed by some that further improvement is impossible, errors of all degrees of seriousness are apt to occur and be passed by without discovery as soon as carelessness creeps into the work. The best order system ever devised can not and does not prevent errors due to negligence.

It is necessary, therefore, to develop a method of internal check which not only will curtail possibilities of fraud but will place responsibility for errors and negligence just where it belongs.

Fraud in Sales

The possible frauds which may be encountered in sales apparently may be classified into two basic groups: failure to enter sales and failure to enter cash collections.

The first type of fraud mentioned is thought-provoking, particularly so, perhaps, in a retail establishment. For example, a cash sale may be made without preparation of a sales slip or ticket (or whatever documentary evidence it is that should be prepared). A sales clerk may neglect to record receipts on the cash register, or the amount thus rung up may be less than that involved in the transaction. Again, collusion with a customer may exist to the detriment of the house.

Such frauds, at times, are most difficult to uncover, unless they are rather numerous. Particularly is this true in establishments having no adequate stock system by means of which it may be determined in a reasonably ready manner what goods ought to be on hand.

A perpetual-inventory system is to be advocated strongly, although frequently such a recommendation falls upon closed or deaf ears. The general belief in the impracticability of such a system has but slight support when the facts of a problem are faced in a practical manner. The perpetual-inventory theory is discussed at greater length in chapter XII.

Cash Sales

Cash sales may be relatively unimportant in one concern and of considerable volume in another — a manufacturing business as compared with a retailing establishment. Each sale should be recorded promptly, and whatever routine is established should permit this to be done. Further, the delivery or shipping phase of the sale (or the rendering of the service, where service is sold) should be checked carefully. Check of delivery, however, will be found to be dependent upon the manner in which each sales transaction is entered.

The use of sales tickets, slips, or sheets, in some form, consecutively numbered, seems highly desirable even though cash sales are relatively unimportant. Often such a ticket or slip is prepared in duplicate by some manifolding device; frequently, more than two copies are desirable to avoid excessive handling — if a stores system is in operation, the stock clerk and the shipping clerk need each a copy. It is necessary, fundamentally, to bring two persons into the routine, so that collusion is required before fraud may be perpetrated.

In general, salesmen never should receive money for sales made; if it seems impossible to adopt this idea fully, it may prove sufficient not to permit salesmen to make change. When a sales slip is prepared by hand the money may be sent to a central cashier by some type of automatic carrier. Registers may be used which will eject a slip with the amount due printed thereon, accompanied by the words "please pay cashier"; the customer may be permitted to pay the cashier, or the clerk may take the printed slip and the money and send or carry them to the cashier.

The cashier's register total at the end of each day must agree with the totals displayed by the salesmen's registers (or salesmen's summaries or both), with the cash in the drawer, and with the total taken from the sales slips.

A perpetual-inventory system at sales prices is a most satisfactory protection over merchandise subject to cash sales. This is checked periodically, as to stock issued, against sales summaries by both quantities and values.

It may be possible and profitable to require a sales clerk to deliver goods sold to a wrapper who acts as inspector. This person checks the various articles against the sales order listing them. In this case the sales clerk is not permitted to deliver any article directly over the counter until after the article has been wrapped at a station situated elsewhere and returned to the clerk for delivery only.

An automatic register may be utilized in many ways. A sale occurs and the order is prepared on this manifolding device. One or two copies are cranked out of the machine, while another copy is rolled up on a spindle inside the mechanism. The copy, or one of the two copies, turned out by the machine is sent, if need be, to some department which fills the order. When the order is filled, the order form accompanies the goods for reference in paying the bill.

The copy of the sales slip retained in the machine is used later by the person who holds the key which unlocks the register mechanism as a check in accounting for the sale.

The use of cash registers when cash sales are executed in volume and the recording of register readings in books specially devised are desirable and frequently encountered. This practice should prove satisfactory provided the registers are read and the record of the registers is prepared by someone other than the cashiers, and provided further that a tie-up with the inventory has been developed.

Consecutively numbered tickets represent the usual medium for a check on sales in a department store, in a restaurant, in a theater, etc., with or without the assistance of a cash register. Some responsible employee should be given the task of distributing these tickets and of keeping a record of those used.

Used tickets represent sales made and to be accounted for. If a ticket is not on hand it should be considered as used and someone should be charged to account therefor; hence, all unused tickets should be on hand for checking purposes.

The following suggestions are offered as means of checking:

1. From reports of agents and clerks to entry upon accounting records;
2. From commissions paid to record of sales made;
3. From meter readings to sales records;
4. From shipping record to sales record;
5. From customers' signed receipts to sales record;
6. From undelivered sales to sales orders.

Food sales. In a lunch room, for example, the customer upon entering the place may be given a sales ticket by the cashier; this ticket is handed by the patron to the sales clerk after the purchase is made; such clerk by hand, or by machine, checks off what is due; later the customer pays the cashier. It seems much better for the clerk to issue a ticket with the amount printed thereon by a special register which also automatically records the amount; the patron then pays the cashier who rings up the receipt upon a second register. Here, the two machine totals must check daily and the cash received must agree with the mechanical records.

Sales of food in hotel and club dining rooms may be controlled by having such sales recorded twice and checked. The method is illustrated as follows:

1. Each day a certain quantity of consecutively numbered sales checks is given each waiter, who signs for them;
2. As waiters pass from the kitchen to the dining room:
   a. A kitchen checker rings up the amounts on a cash register constructed for such purposes;
   b. The guest checks are printed at the same time;
3. A dining-room cashier rings up the cash received and records on charge sheets the checks which are to be charged to guests' accounts;
4. At the end of the day the hotel auditor checks the two sets of records made, one against the other. If both are found to be in agreement, the revenue from food sales is assumed as correct;
5. The night auditor checks the charges to the guests' ledger.

Credit Sales

Although it is necessary to consider the problem of credit sales separately from the problem of cash sales — when the two types are encountered in a specific case — this does not mean that the procedure developed for each kind must be different in all respects and entirely divorced from that proposed for the other. Each type of sale follows a certain prescribed and definitely determined procedural path, but, at certain points the two paths come together and for a space proceed as one.

For example, in either event an order is received; a sales ticket, slip or order is issued; an authorization must call for the release of goods; perhaps there is a shipment; a receipt of payment occurs, and a discount may be given. Thus, in certain respects, the two procedures must be coördinated. To a considerable extent, therefore, what has been said concerning cash sales may apply with equal force to credit sales. Further, in reverse order, what is said concerning credit sales may be followed at times in the solution of the cash-sales problem.

The usual landmarks along the procedural path of a credit sale may be shown as follows:

1. Receipt of order;
2. Order sheet;
3. Authorization to manufacture or release goods;
4. Shipment;
5. Sending of invoice;
6. Charging customer;
7. Statements to customer;
8. Collection of account;
9. Receipt of payment;
10. Granting of discount.

Sales orders. Sales orders may be received in one of three ways:

1. By mail, written on the vendee's order blank or letterhead;
2. From a traveling salesman, on a sales-order blank of standardized proportions furnished for that purpose by the vendor;
3. As a result of a visit by the customer to the sales office of the vendor; the form of sales-order blank used in this case is the same as that supplied to the salesmen.

All such orders should be transcribed in the office upon a regular form so that when the order starts along regular channels to be filled all forms will be uniform. The clerical work of making all required copies of the order should be reduced to one mechanical process — otherwise, differences between copies are certain to appear and cause trouble.

Sales-order information. Regardless of the number of copies of the sales order prepared in standardized form by some mechanical manifolding process, depending upon conditions, the office-record copy should contain the following information:

1. Number of order;
2. Customer's name or number;
3. Description of what is ordered;
4. How order was received;
5. Date;

6. Name and address of party to be billed;
7. Name of salesman receiving order;
8. Department;
9. Amount to be charged;
10. Terms granted to customer;
11. Manner of making delivery;
12. Date delivery made;
13. Date customer billed;
14. Name of clerk who billed customer;
15. Name of person by whom order was passed and approved;
16. Name of person who has checked amount billed;
17. Name of salesman sending in order;
18. Remarks.

All official order blanks should be numbered consecutively, and perhaps a sales-order sheet should be used as a recap for showing each day the orders received and for tracing the progress of each order up to the time shipment is billed.

Sales orders may be filed adjacent to related correspondence, in a folder separate from the correspondence folder, or each customer may be given a regular post binder in which is kept everything affecting each customer's relationship with the vendor concern. In this instance, each binder may be used as the detail account with the customer, although it seems advisable, when viewed from the auditor's viewpoint, to use such binders merely as containers of evidence supporting the regular customers' ledgers.

Order-and-billing system. Some adaptation of the order-and-billing system, an approach to which was considered in the past two sections, is necessary to smooth operation of the routine from the date an order is received to date of shipment. Such a system is intended to keep track of an order as it passes through the stages of approval, filling, shipping and billing.

The principle may be applied either by combining the order-and-billing plan or by keeping one separate from the other.

The combined plan is useful particularly in a manufacturing concern which makes a few articles of a standard type, where the price is definitely known and the work incidental to pricing and making extensions is not voluminous. However, when a manufacturing activity operates on a specific-order basis, frequently the second plan is more satisfactory. This is because a production order to fabricate a particular product must be sent through the factory, the product not being shipped until later, when the actual sales invoice is prepared.

The second plan is particularly useful, then, when the invoice as a general practice is prepared after the order has been filled and shipped — another example is a wholesale business.

Departments involved. A credit sale originates in the sales department, yet the order, credit, shipping and accounting departments are involved in each sale. These departments must be properly correlated for purposes of internal check.

Although each business is a problem unto itself, some variation of the order-and-billing system can be adopted in almost every case.

Credit-department control. The sales or shipping order requires proper approval by the person in charge of credits, inasmuch as he eventually is to be held responsible for the charge and must follow up collections. Perhaps approval of credit will be marked upon the order prior to its transmittal to the shipping department, or it may be provided for separately as a specific step in the routine; circumstances govern each case. No goods, however, must be shipped without the credit therefor having first been properly considered and indicated.

The credit division (or credit man) may scrutinize every order received, or when a new customer is secured a credit limit may be set. In the second case no further credit scrutiny is necessary until the limit is reached. When an order related to an old account arrives, approval follows as a matter of course without action by the credit department. All orders from new customers are, of course, routed through the credit department.

Shipping. In the course of executing an order it is pertinent to determine just where the process of shipping begins. Naturally this varies in accord with the character and size of a business. In a retailing establishment the first step in the shipping process is taken by the salesman himself at the moment he makes a sale.

Frequently the shipping clerk has general oversight of the stock department. Assuredly the shipping clerk will be censured if any blame comes from a customer, for it should be his business to see that the goods ordered are collected and shipped exactly according to the order and in such a manner that they will reach their destination in good condition.

The actual assembly of the stock called for by an order is a duty of the stock department. The work should be done on the day the order is received; hence, the system developed for this purpose should be conducive to speed. Otherwise, the case is hopeless, as far as efficiency is concerned.

If more than one stock room is in use — one on each of several floors, for instance — the order may be sent successively to all the floors. The big difficulty is that at certain times of the day the stock rooms are apt to have rush periods, with periods of idleness between. Hence, it seems a better plan to have each order broken up into sections corresponding with the sources of goods, in order that the work of filling orders may be distributed more evenly and systematically than otherwise may be the case.

When some items of an order are out of stock, one of two possible methods of treatment may be adopted. The order may be filled as completely as is possible, and then be held up until the missing items are received, or the goods available may be shipped, the remaining items being forwarded later. The items which are lacking become the basis for the issuance of a new order — a back order — two copies at least being prepared; one for the office and one for the shipping clerk.

Goods should be checked carefully when they are assembled, after being received in the shipping room and particularly when they are being packed. At this point a packer may call off each item as it is being packed, the order being checked by another. The name or initials of the packer may be placed on a slip which is inserted in each box so that the customer will be able to return it if he claims that something is wrong. Further, if shipments are made over many railroads, some system is necessary to prevent delivery of packages to the wrong line.

Accounting-department control. The customers' ledgers should be under the control of the accounting department, and those who are engaged in working on them should have no contact with the cashier in relation to receiving and entering up cash receipts. A distinct separation of the two classes of work is essential.

Again, a definite separation of the credit department and the bookkeeping work on customers' accounts is desirable. This, of course, is subject to qualification as noted above — some credit approval may occur in the bookkeeping department when the credit department already has established credit limits of certain accounts. Even in this case the fundamental independence of the two departments actually exists.

Debits to customers' accounts are based upon sales invoices which, in turn, are supported by approved sales orders, the latter being marked both with credit approval and shipping date. In other words, the authorization for such charges arises outside the bookkeeping division.

Credits to customers' accounts, similarly, arise outside the bookkeeping section. Payments on account come through the cashier. Returns and allowances come through some executive responsible for their authorization.

Billing. Outgoing bills must be carefully checked and rechecked to eliminate errors. Careful check of bills is more important than check of purchase invoices. The latter already have been verified in the vendor's office prior to receipt by the vendee, whereas outgoing bills are verified in the sender's office — their point of origin — for the first time.

Accounts receivable. After the billing is completed and the invoice has been sent out, the sales transaction finds entry in the books of account. At this point, again, subsidiary-ledger problems arise. Accurate trial balances of the customers' ledgers are necessary, and they provide a fair check upon the completeness of the billing.

To guard against loss of an invoice prior to its being recorded in the accounts and to uncover its possible suppression, two copies (carbons if desired) of each invoice may be used in the office. One goes to ledger clerks for entry, and one to a statistical department. The total of the distributions at this point may be checked to a similar total obtained from invoices entered upon the ledgers and those awaiting entry. A check may be made daily against the billing clerk's records, and monthly against the general-ledger control.

When a statistical department functions in some form, further check may comprehend daily check of quantities against shipping clerk's records, and monthly check of quantities against perpetual-inventory control.

Again, orders may be analyzed, to effect another check, as received, filled and unfilled. Ledger clerks never should know the amount of the respective control figures until after their own balances have been found to be in agreement with the control.

Accounts-receivable credits are considered later in relation to returns and allowances, bad debts and cash receipts.

Discounts. A standard rate of discount should be allowed to all customers. If it is found impossible to adopt a standard rate, both cashier and bookkeeper should be furnished with a record of discounts allowed. Discount deductions should be watched closely by each of these persons. Variations from practice or schedule must never be passed without proper authorization. It may be advisable to bring the billing clerk into the scheme of checking discounts.

Illustrative procedure. Although the following example is only an imaginary illustration, it contains the elements which have been emphasized. The plan is designed for a concern with sales of about $1,500,000 annually.

The general manager inspects all incoming mail in order to keep closely in touch with what is going on. If he is not in the office, the sales manager assumes this duty. If the general manager is engaged in the task and finds correspondence of interest to the sales manager, such mail is routed to the sales manager's office.

All orders are passed along by the general manager (or by the sales manager in part) to the credit manager, who after referring to his records showing purchases and ratings approves or disapproves the orders as received. His records are rather complete in that they enable him to notice errors in ordering. By knowing what a customer has been in the habit of using, the credit manager is able to display some intelligence, which will react favorably to the house, in estimating what customers ordinarily will reorder. Obvious errors may be corrected, and probable errors called to the customers' attention before goods are shipped.

After approval by the credit manager, the order passes to the billing department. Here four copies of the invoice are prepared by a manifolding process, exclusive of the shipping label which is prepared at the same time; these copies are all on different colored paper; the original goes to the customer; the duplicate to the accounting department for posting purposes; the triplicate to the shipping department; the quadruplicate to the salesman in the customer's territory. The shipping (address) label is attached to the triplicate and passed to the shipping room. Stock and shipping are handled in the same department. The original, duplicate and quadruplicate are held in the billing department until the shipping copy, properly signed, has been returned.

The shipping department is required to ship goods on the day an order is received — delays are infrequent. The shipping department checks on its copy of the order the goods to be shipped after they have been gathered for packing. Shipment weight and transportation charges (if these are to be charged to the customer) are entered on this copy.

Upon the return of the shipping-department copy to the billing department, the latter makes whatever changes are necessary on the other copies of the order in its possession, so that all copies agree. Then the original is mailed to the customer, the duplicate goes to the accounting department, the quadruplicate is passed to the salesman involved and the triplicate goes to the file, there to be retained with the customer's correspondence.

As another illustrative example, assume a company of more than fair size, with customers all over the United States and Canada, which manufactures a standard office appliance. Orders are received by mail and from agents.

When an order has been received and after it is O.K.'d, it is passed to a typist whose machine uses a special "hectograph" ribbon. This typist copies the order on a numbered "master" sheet which is ruled like an invoice, and makes one carbon which is used as a shipping order. The shipping order is perforated horizontally through the center, the upper half containing the customer's name and address, the lower half showing the articles and prices.

The master sheet is passed to a clerk who holds it until he is advised that the order is shipped. The perforated sheet is sent to the factory as a merchandise release — a factory discharge.

The packages come to the office wrapped, the address thereon being the upper half of the factory-release order pasted on the package. The mailing clerk weighs the package and affixes the necessary postage, the amount of the postage being added to the master sheet. The master sheet bears the delivery date. The lower half of the order is filed numerically for shipment information and to provide the office record of authorized factory discharges.

As soon as goods are shipped, the master sheet goes to another clerk who duplicates the information it contains on an invoice — the hectograph ribbon permits this to be done — a posting sheet, an office copy, an agent's copy and a commission sheet.

The invoice is sent at once to the customer, and the agent's notification copy is dispatched to the agent. The commission sheets form the basis of commission payments.

Posting sheets are arranged by ledger divisions, and are added by machine. These sheets then go to a bookkeeper for posting to the individual accounts affected, this posting being done on a bookkeeping machine. The total postings shown by the bookkeeping machine must agree with the adding-machine tapes. The bookkeeping machine writes up the sales journal, the statements and the customers' accounts all at one operation. The posting sheets are initialed by the bookkeeper and filed.

Office copies are filed consecutively by order numbers. The total of the posting sheets is reconciled monthly with the total of the office copies.

The master sheets play no important part in promoting internal check after they have been copied; hence, they are examined merely to see that they actually have been copied (in the process they are blurred) after which they are destroyed.

Outgoing Freight

Outgoing freight must be safeguarded in about the same general way as freight inward. However, the expense bills for outward freight must be tied up with bills of lading instead of receiving reports.

Consignments

When goods are sold on consignment for other houses, no record of a liability may be made even after such goods have been sold and the money has been received. Monthly, perhaps, the inventory of consigned goods is taken, this amount is subtracted from the inventory of the preceding month, and the difference shows the basis of accountability. Then by a debit to sales offset by a credit to cash and to commissions the consignors are satisfied. Such inventories, of course, preferably are on a sales basis in order to adopt this simple scheme. The accounting for sales, for cash receipts and for customers' charges is conducted in the usual manner.

Returned Sales and Allowances — Bad Accounts

As noted in an earlier section, credits to a customer for returns and allowances should arise outside the bookkeeping division through some important executive responsible for their authorization. All credits of this type should be supported by proper evidence — something in the way of regular vouchers, or credit memoranda acceptable as vouchers, each carrying the executive's authorization and approval.

Numerous cash peculations are covered by the issuance of false credit memoranda against accounts receivable. A cash receipt is wrongfully taken, and to divest himself of accountability the cashier may issue a credit memorandum. Fraud seems prolific in dealing with returns and allowances, particularly when the cashier and the bookkeeper are one and the same person, or when the cashier has the privilege of issuing credit memoranda.

The keeping of the customers' ledgers and the receipt of cash should be in the hands of at least two persons. Then the issuance of a credit memorandum covering a return should be traceable through the receiving department, just as in the case of vouching a creditor's invoice.

The executive approval required for each credit memorandum perhaps belongs to the sales-department executive—it seems that this is the proper place. In a small concern such approval should be voiced by the owner himself, if possible.

Each month, if possible, someone independent of regular departments should check out all closed customers' accounts to determine whether or not any have been closed improperly to sales-returns-and-allowances account.

One should arrange internal check over returns so that the returned goods will reach the perpetual-inventory records. The stock clerk may thereby be prevented from reshipping such goods without accounting for them. Further, the ultimate disposition of returned material — as in a factory — must be accounted for properly either by its sale as defective material or by its reintroduction to the factory for repair or manufacture.

Accountability must be unmistakable at every step. When goods or materials, for example, are taken into stores, the storekeeper must be made accountable, and so on. Regardless of the method of control, provision must be made against the possibility of overlooking returned materials or goods.

One should keep foremost in mind, as a useful aid, that the issuance of a credit memorandum and the issuance of a voucher demand exactly the same kind of rigid safeguards.

All bad accounts charged off should be covered by vouchers properly authorized by a responsible executive, perhaps even the owner of the business.

Selling Expenses

It seems correct to suggest that the specific costs in each account under selling expenses should be related to the units sold during a specified period, rather on sales than on delivery or on production.

Bribery, perhaps, is of small consequence in relation to advertising when well known papers and magazines are used, but in local advertising campaigns one should be careful to watch out for bribery as an influence on the placing of advertisements.

Salaries and commissions should be checked periodically against results. Expenses of the sales staff, such as expense accounts, entertainment and sundry items should not be passed for entry except with the O. K. of the sales manager.

If possible, standard sales prices should be adopted and as suggested previously standard discounts should be used. Then anyone working on forms and records is in a position to criticize such matters when they pass under scrutiny and report unauthorized variations. If job work is done, the estimates prepared in advance should be used as a check against the sales-order prices displayed.

CHAPTER VIII

Cash in General

Introduction; handling cash a separate function; basic features underlying internal check on cash; treasurer's department; accounting department.

From the viewpoint of possible loss, by means of a criminal nature or otherwise, cash has characteristics which are peculiar when compared with other property — for example, with merchandise and supplies. Cash, when taken, is difficult to trace because no conversion into the form of some other asset is required before it can be used as a medium of exchange; it does not take up much room, and it is hidden easily. Generally speaking, other stolen property must be converted into cash before becoming valuable to the thief. Assets of this type can not be as easily hidden as cash which is an asset of large value in small bulk. For these reasons cash is more likely to be wrongfully taken than other property.

The importance of internal check over cash — receipts and disbursements — frequently is not fully realized. One may go so far as to suggest, without fear of violent objection, that an employer who does not provide the safeguards necessary to make peculations of cash a reasonably difficult matter is really an accessory to the crime when cash is taken.

It is proposed first to offer some general comments upon the subject and then to follow this by a separate discussion of cash receipts and of cash disbursements. However, inasmuch as the comment on purchases preceded that on sales, it seems reasonable that the discussion of cash disbursements should precede that of cash receipts — with one prominent exception. The subject of payrolls being of sufficient importance to require a separate chapter, such a chapter follows that concerned with cash receipts.

Handling Cash a Separate Function

The establishment of a system of internal check over cash transactions of a business concern may be viewed as largely a matter of organization. From such an approach it seems that a fundamental necessity is separation of the handling of cash from the accounting records of cash.

The handling of cash usually is the responsibility of some person who may carry the title of cashier or treasurer, whose duties involve two separate and distinct acts — receiving cash and disbursing it. It is found frequently that these two separate tasks are made independent of each other. Thus, one or more cashiers may be employed on cash receipts and on nothing else. It is customary to require daily deposit in bank of all receipts intact.

Complementary to the handling of cash, is accounting for cash in the records. The accounting is commonly the responsibility of some person who may be called auditor or accounting-department chief. Since it is customary to require deposit of all receipts intact in a bank, it is usual to require that payments be made whenever possible by means of bank cheques.

It has been found that such a system, in practice, provides satisfactory internal check over cash transactions, provided the acts of depositing and disbursing are surrounded by safeguards deemed proper in the particular circumstances of each case. This does not mean that the temptation to theft on the part of employees is eliminated; the best that can be hoped for is that such procedure "tends to counteract temptation."

Basic Features of Internal Check on Cash

Although the principles of internal check on cash may be presented in more than one possible arrangement, the following general summary is illustrative:

1. General:
    a. The functions which result from cash transactions — those usually deputed to a cashier — should be so developed that they are completely divorced from the accounting;
    b. The function of receiving money should be separated as much as possible from that of paying out money — it is almost unnecessary to suggest that money may be stolen either from inflowing funds or from outgoing funds;
    c. Persons who act as cashiers should have access only to their respective original-entry records;

d. Cashbooks should be posted monthly by someone in the accounting department (as distinguished from the treasurer's department to which cashiers are attached);

e. Monthly reconciliations of the cashbook, passbook or bank statement and cheque book should be made with the cash account;

f. A satisfactory check over cash sales should be established;

g. All persons dealing with cash in any way should be under bond;

2. Receipts:

h. Persons who receive cash should be required to deposit daily all receipts intact;

i. All remittances should be received at the main office of a concern, not by its field representatives;

j. Receiving cashiers should have no access to any ledgers or statements concerning customers' accounts;

k. Receiving cashiers should not be permitted to open incoming mail;

3. Disbursements:

l. Those who act as disbursing cashiers should be required to obtain a proper voucher for each disbursement (each voucher carrying accounting-department authorization);

m. Disbursing cashiers should have nothing to do with the preparation or approval of vouchers for payment;

n. A major officer should sign vouchers for disbursements not covered by invoices;

o. All possible payments of one dollar or more should be made by cheque;

p. No cheques should be drawn payable to "bearer";

q. Cheques should carry more than one signature;

r. Disbursing cashiers should not be permitted to sign cheques;

s. All petty disbursements (those not of major consequence as suggested above) should be made from a petty-cash fund operated upon the imprest basis;

t. Replenishment of the petty-cash fund, after all past petty disbursements have been approved, should be authorized by an accounting-department voucher, entry therefor being made in the voucher record if one is used;

u. All particular funds established — petty cash and working funds (latter related to payroll, etc.) — should be checked at periodic intervals by the accounting department.

Many of these features may be applied to every business, although all of them are not practicable in every case. The person shouldering the task of developing a system of internal check must choose the ideas which will apply to the particular situation under study.

In the foregoing list the bonding of employees dealing with cash has been suggested specifically. The writer believes, however, that the bonding theory should be applied more generally to all office employees rather than to a selected few who may happen to be in the cashier's or treasurer's department.

The powers of the cashier should be limited, so that he can not exercise complete control over cash. Except where there is collusion it will seldom be possible or advantageous for any employee other than a cashier or treasurer to falsify the records, provided no cash passes through his hands.

Treasurer's Department

In a business which is large enough to have a treasurer's department as a unit separate from the accounting department, the foregoing suggestions might be applied somewhat as follows. The department, in the first place, may have employees of major importance consisting, say, of a treasurer or an assistant treasurer, a cashier, a credit man and a paymaster.

The office procedure, as far as general cash is concerned (other features receive comment later) provides that the cashier shall have charge of the cash-receipts register. Cash receipts are entered in this book in detail or in totals, and such receipts are deposited intact daily. The treasurer keeps the cheque register. Cheques are issued only when related to invoices or vouchers which have been audited, a fact which is indicated somehow in tangible form.

Accounting Department

In a business of about the same size — one large enough to separate the treasurer's department from the accounting department — the accounting department may have employees of major importance consisting, say, of an auditor or chief accountant, a head bookkeeper, one or more persons in charge of customers' ledgers, and a keeper of the creditors' ledger and/or the voucher record.

According to the office procedure concerned with general cash (other features are discussed later), upon receipt of letters or duplicate receipts which have been received at some other point accompanied by remittances and in due course have reached the accounting department, the respective customers' accounts shall be credited by the proper ledger keepers, whereas the control is adjusted by the head bookkeeper. Audited invoices approved for payment are entered in the register provided for this purpose, and if a ledger is also kept the ledger entry follows. Upon receipt of the monthly bank statement the cash account, kept by the head bookkeeper, is proved and reconciled.

CHAPTER IX

Cash Disbursements and Cancellation of Payments

Petty-cash disbursements; possibilities for fraud; imprest basis for petty cash; working-fund disbursements; cheque disbursements; kiting; forcing footings; raising canceled cheque returned by bank; forging cheques; cheque signatures; false vouchers; vouchers covering fixed payments; presenting vouchers twice; notes and drafts payable; reconciliation; ratios; canceled disbursements.

A useful rule of general application — except for payments made from petty cash — all cash payments should be only by cheques supported by vouchers properly prepared and approved. In conformity with this basic differentiation, the discussion in this chapter resolves itself into two fundamental portions: petty-cash disbursements and cheque disbursements. So-called working funds may be classed with either division, depending upon whether they are disbursed by cheque or otherwise.

The current chapter, like the previous one, contains no discussion of payrolls, which are so important as to warrant a separate chapter.

Petty-Cash Disbursements

Payments from petty cash are less easily safeguarded than cheque disbursements. The amounts involved are small, and in the belief that their protection does not justify much expenditure of effort or money, it is difficult at times to convince the owner or officers of a business of their importance.

Again, it is difficult, frequently impossible, to obtain satisfactory vouchers from those to whom petty payments are made. This makes it possible for the petty cashier to forge vouchers calling for disbursement of money, to place them in the petty-cash box or drawer, and to abstract the money for his own use.

Possibilities for fraud. The usual means by which a petty cashier may attempt to cover a wrongful shortage in his petty-cash fund may be enumerated as follows:

1. False vouchers;

2. False totals of vouchers;
3. Entering items twice — one entry on the petty-cash record and one entry on the regular cash record.

Dates on petty-cash vouchers may be changed so that after doing duty for one payment they may be made to support another. Again, the amounts called for by such vouchers may be increased with dishonest intent. The petty cashier may secure stationery of outside firms from which no purchases have been made and prepare petty bills thereon to support illegitimate appropriations of funds.

It was mentioned in the preceding section that the inability to secure vouchers from numerous persons to whom petty payments are made opens opportunities for a dishonest petty cashier to take small amounts of money to which he is not entitled, with a fair chance of avoiding discovery. To this may be added the frequent difficulty of identifying those to whom such payments are made. The formalities of purchase request, purchase order, etc., are practically impossible in relation to petty-cash disbursements.

These factors are responsible for the treatment accorded petty cash — treatment which may be viewed as fairly well standardized.

Imprest Basis for Petty Cash

Disbursements in actual cash, rather than from a bank account, are handled preferably by establishing the petty-cash system on an imprest basis. It is to be remembered, however, that this supplement to internal check is not sufficient for automatic protection.

The imprest cash system places in the hands of a petty cashier — someone other than the regular cashier — a specific sum of money which remains fixed and does not fluctuate from day to day. This sum should not be any larger than is reasonably necessary, with consideration for desired fund-replenishment dates and for the volume of petty expenditures between such dates. The greater the volume of expenditures day by day, the shorter should be the periods between replenishment of the fund. It is suggested that the period never should be longer than one month, and that when shorter periods are desired they should be of such length that replenishment must occur at the close of each month, in order to facilitate preparation of the usual monthly statements.

When the fund requires replenishment, the vouchers covering disbursements should be summarized and presented, say, to the auditor so that the petty cashier may obtain, through him, the necessary reimbursement for the money expended.

At any particular moment of time, the petty-cash fund may consist entirely of cash, or of cash plus vouchers covering disbursements, or of vouchers entirely.

Inasmuch as the imprest system does not of itself provide an automatic check against wrongful withdrawals from a petty-cash fund, a few miscellaneous suggestions are offered so that a satisfactory check may be developed:

1. Whoever has the duty of auditing the petty cashier's records should have an intimate knowledge of the business;
2. Paid and filed vouchers should be safeguarded so that the petty cashier has no access to them;
3. When examined, each voucher should be initialed or signed and stamped, to prevent its use again;
4. The one whose duty it is to examine and O. K. petty-cash vouchers should always be alert to detect false vouchers, and he should attempt as much of a deliberate check as is possible; a deliberate check is particularly valuable in detecting false voucher totals;
5. Unless it is the internal auditor who checks the petty cashier, the one to whom this duty falls should be replaced in this work rather frequently, with due regard, however, to selection of persons having an intimate knowledge of the business.

Working-Fund Disbursements

A working fund, strictly speaking, differs in certain particulars from a petty-cash fund. A working fund is established for the purpose of advancing cash to some employee or to a branch office or factory at a distance from the main office so that certain disbursements may be made for current expenses.

A petty-cash fund, when depleted or nearly so, or periodically, is reimbursed for the amount of the depletion after proper audit of vouchers supporting the disbursements. On the other hand, a working fund is not necessarily restored to its original amount by a reimbursement. A sum of money is advanced to the working fund, and when payments therefrom are made and properly reported and audited the fund account is credited. The fund may be increased over its initial amount by receipts of cash from various sources. When the fund is low, more cash is advanced as required. The fund usually is large in comparison with a petty-cash fund, so large at times that payments therefrom are made entirely by cheque.

The recommendations in this discussion for internal check over petty-cash disbursements, cheque disbursements and cash receipts (next chapter), are sufficient for development of a protective plan for working funds.

Cheque Disbursements

Payments by cheque are safeguarded more easily than are petty-cash disbursements. The amounts involved, also, justify expenditure of considerable effort and money for protection.

Most cheque disbursements are recorded through the medium of an accounts-payable account or vouchers-payable account. If a cheque is drawn to the order of the payee named in the voucher calling for expenditure, and if the voucher is prepared and then approved by some vigilant person in authority, it will be exceedingly difficult for a clerk in the treasurer's department to secure the cash for himself.

Possibilities for fraud. There are numerous chances for fraud in dealing with cheques, in disbursements, and some in both disbursements and receipts. The following are illustrative, others being mentioned in later chapters:

1. Kiting;
2. Forcing footings to make cash balance;
3. Raising canceled cheques returned by the bank so that they may be made to agree with erroneous cashbook entries;
4. Forging cheques, and destroying them when returned by bank;
5. Preparation of false vouchers;
6. Presenting vouchers twice for payment after changing dates;
7. Understating cash discounts, not stating discounts at all or underfooting them;
8. Showing fictitious purchases, or expenses, or interest payments or personal account charges; overfooting payments and charging expense;
9. Cashing cheques which represent unclaimed dividends;
10. Failing to show purchase returns and allowances.

Kiting. Kiting may be intended either to show a false cash balance for statement purposes or to cover up an abstraction of cash. The careful operation of a satisfactory internal-check system is particularly useful in relation to the latter possibility — more so than in the former.

On the one hand, kiting occurs when a cheque is drawn on one bank near the end of an accounting period and is deposited in another bank without crediting the first bank until some time in the subsequent period. Only the debit is recorded and, accordingly, there exists a book increase in the cash balance which is not justified by the actual facts. On the other hand, the cheque may be entered on the books without a corresponding take-up as an increase in the "in transit" items. Such a cheque may be doing duty (and probably is) for a similar amount of cash which should be on hand but has been abstracted.

The treasurer should be careful when he is signing cheques near the end of an accounting period to make certain that everything is in order before his signature is written. All transfers of bank funds should be duly authorized by a major officer, and at every audit all such transfers should be traced completely. The cashier should not be permitted to prepare vouchers.

Forcing footings. Although periodical audits should uncover forced footings, it is not with the detection of fraud so much as its prevention that this book is particularly concerned. Conditions permitting, some one other than the disbursing cashier (or cashier) should be assigned the task of footing the cheque register (or cashbook). The keeper of the general journal, or some responsible officer, or his confidential clerk, may be given this duty.

After the record is footed (which is perhaps monthly), a voucher is prepared for the ledger postings and forwarded to the general-ledger keeper who enters up the items and amounts shown and inserts the requisite ledger folios. Subsequently the voucher is routed back to the cashier to permit him to insert ledger folios in his record.

The theory underlying this method of posting to ledgers frequently may be used advantageously in posting the other records of original entry.

Raising canceled cheques returned by bank. The cashier should be denied access to cheques returned by the bank. Some other clerk should receive canceled cheques, the cashier not being permitted even to see or touch them. They are arranged in numerical order, and a record is made of the lowest and highest cheque numbers and the numbers of all missing checks. The cashier may see a copy of this record. Then the canceled cheques are filed, still inaccessible to the cashier, to be used by the auditor. Frequently this procedure may be found impossible. In that event the problem becomes more one of fraud detection than of fraud prevention: the problem of detection rests in the hands of the auditor.

Cheque raising may be rendered quite difficult by the perforations in the cheques made by the bank. Frequently, the paper is so punched as to make alteration practically impossible. The use of a mechanical cheque writer makes this fraud difficult, provided a machine is used which, among other safety factors, shreds the paper after the amount is filled in. It is to be noticed that cheque-protector machines do not furnish absolute protection because there are persons expert enough to defeat any protective machine so far developed.

The treasurer should make certain that all cheques submitted to him have been filled in fully before he signs them.

Forging cheques. Forgery, like the fraud just mentioned, may be rather difficult to execute and also may prove somewhat difficult to prevent.

All cheques drawn payable to bearer should be viewed with grave suspicion. Perhaps the best preventive of forgery is the development of a careful system of authorization and approval of payments along the lines suggested in this chapter. It seems a wise policy to require two signatures on each cheque issued.

Cheque signatures. Each cheque should carry the signatures of two officers or employees, preferably the former. Such a scheme may prove most helpful in developing an efficacious internal-check system. Yet, in certain circumstances, even this precaution may not eliminate danger.

Frequently, those whose duty it is to sign cheques believe themselves too busy to give any particular thought to the task — to inquire into the nature of the disbursements. They sign almost automatically. Such an attitude is to be deplored. Anyone who signs a cheque should realize the importance of the matter. He should satisfy himself, at least, in a broad way, that each disbursement is a matter of usual routine, or, if an unusual transaction, he should familiarize himself with its nature before signing.

False vouchers. Nothing but vouchers properly authorized and approved should be acceptable in support of payments of any kind, and as many persons as possible should be brought into the scheme. This matter has already received comment.

Vouchers covering fixed payments. The officers whose duty it is to sign cheques should be supplied with the necessary fixed-charge schedules — as to interest, insurance, salaries, etc. Each schedule should be prepared on paper so ruled that it is possible to check off items periodically as paid.

All vouchers related to cheques for such charges should refer to the proper schedules. Changes made on any schedule should be signed or initialed by some principal or chief departmental officer.

Presenting vouchers twice. While signing cheques, the treasurer, for example, should so deface or mark vouchers and accompanying proofs that no doubt exists that payments have been made and that the same documents can not be used without detection to support a second payment. Perhaps a rubber stamp marked "paid" and showing date and cheque number may prove satisfactory.

Some concerns follow the practice of pasting a tab on the voucher, with the voucher number printed on it. These tabs are in numerical order and when pasted on the vouchers indicate that payment has been made.

After vouchers have been paid they may be filed away numerically, and should be inaccessible to the cashier.

Notes and drafts payable. Notes and drafts present a rather serious problem — serious, perhaps, as much in their possible effect on the concern's business standing as in danger of loss. Failure to pay a note after it falls due, for example, is viewed by a lender (prospective or otherwise) as more reprehensible than an overdue account payable. Again, the issuance of a firm or company note may develop a serious fraud, since if such a note falls into innocent hands collection may be possible if the concern is solvent.

Cheque disbursements covering notes and drafts may prove a fertile field for a dishonest clerk, especially if he handles the notes payable register, draws the cheques, or handles the transactions with the bank.

If only one clerk is in charge of these duties, a common method of a fraud is to secure the money from a bank which is not related to the business of the enterprise. A false note is issued to an accomplice who presents it to this bank for payment. A cheque is drawn payable to "bank," presumably to cover some other note issued in the usual regular manner. The cheque is presented to the bank, the note is redeemed, and the proceeds are remitted by the bank to the accomplice.

No one clerk or person should be permitted to handle the duties related to notes payable. To develop an automatic check which has possibilities of success:

1. One clerk should handle the notes-payable register — perhaps some accounts-payable clerk;
2. Another should draw the cheques — each upon specific official authorization;
3. Another should handle the payment of the notes — perhaps the treasurer.

Specific authorization has been mentioned previously. In other words, all disbursements not covered by vouchers in regular course should require specific authorization evidenced by the proper signature of some major officer. This authorization may be called a "cheque requisition." Such a requisition may, and really should, form part of every voucher.

The possibility of defect in the internal check makes it desirable to check, balance and draw off a list from the notes-payable register and drafts-payable register at regular intervals. This should be done by some responsible person, such as the auditor. A careful check of all transactions is desirable, comprising the canceled notes and drafts.

Reconciliation

When a satisfactory system of internal check is in force it is fairly certain that the usual disbursements will be checked automatically each time the bank account is reconciled, provided the vouchers are audited and details of the liabilities are balanced against the control.

In the reconciling procedure it is usual to examine the cheques for proper signatures and endorsements. It is suggested that this is more satisfactory as a part of internal check than it is when done by a professional accountant as part of his periodic audit. The internal auditor by constant repetition of his work becomes acquainted with innumerable signatures and all usual indorsements, and such knowledge may prove exceedingly valuable. The outside auditor who comes to the place only infrequently, generally speaking, has not the opportunity to memorize signatures and indorsements on cheques encountered in the offices of many clients, each, perhaps, in a distinct line of business.

Ratios

Even though the use of ratios and percentages may be viewed more as a part of detection rather than prevention of fraud, a word or two on the matter seems desirable. Frequent computations of percentages of expenses and profits often will bring to light the fact that something is amiss and result perhaps in a later unearthing of fraud. Comparison of expense ratios, for instance, with those of the past should permit detection of fraud before peculations reach ruinous proportions.

Canceled Disbursements

If the control of cash receipts is developed separately from the control of cash disbursements no serious difficulty should arise in relation to these items. Under these conditions, no error should remain undetected beyond the date of each bank reconcilement.

However, carelessness in entering canceled disbursements is something which should be emphatically discouraged. Such carelessness frequently leads to understatement of the cash balance, and may indicate that laxity prevails in watching for duplicate payments.

CHAPTER X

Cash Receipts and Return of Cash Receipts to Senders

Sources of cash receipts; cash sales; receipts; possibilities for fraud; when not particularly important; when most important; receipts from customers on account; possibilities of fraud; general precaution: separation of duties of cashier and ledger clerk; auditing accounts receivable; taking charge of incoming mail-deposits; taking funds without manipulating the records; falsifying totals; holding out receipts without entry; lapping; overstating discounts; crediting wrong accounts; traveling representatives; sundry receipts; returned-cash receipts; miscellaneous methods.

When disbursements are made by cheque, payments may be audited much more readily than receipts. Without a system of internal check it is exceedingly difficult, if not exactly impossible — unless as a result of a detailed audit — to determine just what should have been received. Of course, the cashbook may be consulted, but that may not show the true receipts — the difference between what is shown and what should be shown may have been pocketed by the cashier.

The handling of cash receipts undoubtedly offers fertile opportunity for a dishonest employee to make away with cash that belongs to his employer, unless methods are developed which in the regular course of events will point unerringly to the guilty party. In one case clerks or cashiers may take small amounts daily from the day's receipts, whereas, in another, some trusted executive may embezzle large sums subject to his complete control.

Disappearances of cash are apt to occur before any record of receipts has been made, rather than after written evidence of their arrival has been prepared. This means that there is no evidence of just what cash has been received, which, in turn, means that no trace of missing amounts may be visible. One should, therefore, do his utmost in establishing an internal-check system to provide some method whereby it is absolutely necessary to record promptly all money and cheques received. Once cash is entered as part of the business receipts, any wrongful taking thereof — except perhaps temporarily — must be hidden by adjusting the records in some manner. Once the records are tampered with, given a fairly satisfactory automatic accounting procedure, detection is facilitated, and fraud prevention is immediately effective to a material extent.

Sources of Cash Receipts

Sources of cash receipts are varied, but in the ordinary course of events they come principally from sales. In developing automatic checks over the receipt of money, therefore, sales may advantageously be divided into two classes:

1. Cash sales — each sale presumably followed by immediate receipt of cash;
2. Charge sales — each sale presumably followed by an immediate charge to some customer, which subsequently requires that cash be received on account. The receipt of cash is delayed, not immediate.

A sharp line of cleavage can not be drawn in all cases in accord with this classification. In a small enterprise the distinction may be quite unimportant, but in a large business it may be vital.

Cash Sales — Receipts

In developing a satisfactory internal check over receipts resulting from cash sales it seems necessary to distinguish, in a general way, between a business in which cash sales are not the most important item of revenue and an enterprise in which cash sales represent the most important element of revenue. Such a distinction may have a fundamental bearing upon what should be developed as a protective scheme.

One should not completely divorce his approach to a safeguard over cash, from that maintained over the sales factor. A sale is made and a receipt occurs; hence, what is involved in the receipt is only a continuation of what is involved in the sale.

Possibilities for fraud do not seem to be particularly numerous. Some of them may apply with equal force to the receipt of cash from charge customers. The following possibilities are illustrative:

1. Pocketing cash from unreported sales;
2. Pocketing cash in excess of reported sales;
3. Overstating cash discounts on sales (this is more apt to occur however, in relation to customers' accounts);

4. Entering unauthorized improper allowances (also more common in relation to customers' accounts);
5. Underfooting cash-sales column.

Relatively unimportant loopholes. Of the various devices used to assist in checking the completeness of receipts from cash sales, perhaps the most favored is the counterfoil or duplicate receipt. This is provided, perhaps, in a form which comes from a cash register or one which is written, as a duplicate of the sales slip, and is serially numbered, in order that some one (such as the auditor) may insist upon a complete accounting for all numbers.

For example, each duplicate receipt or bill may be prepared by the clerk making the sale, he being held accountable for using a certain particular set of receipt forms. Then

1. The original is given the customer — it may even be wrapped up in his package;
2. The duplicate is
   a. Given to the customer with instructions to pay the cashier; or
   b. Sent direct to the cashier, with the money, by the clerk himself;
3. The triplicate copy is retained by the clerk in his book. When his book of forms is used up, it is sent to some office (perhaps that of the auditor) for audit and check against the cashier's records.

Care should be observed to safeguard blank books not in current use.

The same idea has been advanced previously in commenting upon the use of a machine which emits original and duplicate forms and winds up the triplicate upon a spindle inside the mechanism, the key to which is in the possession of the auditor.

Important devices. Extended use of the cash register may prove to be highly satisfactory. However, even that may be subject to abuse, and at times it may be expected that no positively accurate check can obtain — for instance, in a restaurant where an overage or shortage in receipts of a cashier is a daily occurrence.

In some types of business, especially those which are subject to rush periods, (the restaurant is an example) short change and long change in accepting customers' payments frequently present a difficult problem. Some one other than the salesmen, or in the case of restaurants the waiters, should take in the money.

If the cashier is honest, one day's shortage will ordinarily be balanced by another day's overage, at least in the long run. A perfect balance of cash every day is almost a sure earmark of dishonesty when a business is subject to rush periods. If a cashier is dishonest, he is almost sure to have a correct cash balance. He may be gambling with the business, keeping all overages and making good all shortages.

Such juggling can be prevented fairly well by having some person in authority — not the cashier — keep the register key and take the readings. If the cashier is unable to see the total as shown by the cash register, he will be unable to make the cash agree with it unless his work has been accurately done. Ordinarily, two checks exist against the amount of cash in the drawer: the cash-register reading and the total of the sales slips. All three totals should be entered upon a form daily and should be compared.

Of course, if the difference is small in relation to sales volume, it perhaps should be ignored. The accuracy of cashiers may be improved by offering a bonus or a premium.

Frequently, a check is attempted by means of an average price per meal. However, this is worthwhile only when a classification is made by different cashiers in a chain system. In such circumstances the reports of the entire group may show which cashier needs attention.

Local conditions, of course, govern the procedure, and each case must be considered a separate problem.

Receipts from Customers on Account

A number of methods exist by which a cashier may attempt to take cash receipts for his personal use. It is exceedingly difficult to discuss these in a general way inasmuch as local conditions and bookkeeping procedures in force in a particular establishment are important factors. The following, however, are believed to be illustrative:

1. Ordinary theft of funds without regard to what the records may or may not show;
2. Falsifying totals;
3. Holding out receipts without entry;
4. Lapping;
5. Overstating discounts;
6. Crediting wrong accounts — for example: fictitious sales or freight allowances, and sales returns;

7. Undercharging customers, and pocketing the difference.

Bank statements and pass books may be altered to assist in concealing fraud. In a small business, fraud ordinarily consists of theft of cash. It is probably not inaccurate to suggest that more cash is taken through manipulation of accounts receivable than through any one of the other accounts.

General Precautions

Separation of duties of cashier and ledger clerk. Cash received from charge customers should be in custody of a cashier who never is allowed to handle the customers' ledgers and statements and has nothing to do with making sales. This separation of duties will do much to make theft of money received from debtors exceedingly difficult — practically impossible unless there is collusion.

When the functions of the cashier and ledger clerk are divorced, the ledger clerk should learn of charges against customers from, say, the accounting department, which may serve as a source at which the debit side of the ledger may be checked. The ledger clerk credits the accounts only upon notification from the cashier, from some responsible employee whose duty it is to open the mail and prepare what may be viewed as a cash blotter, and from a major sales-department officer of a major capacity or other important officer who has the power to grant allowances and return privileges.

The credits to the control may come from the cashier in whole or in part, but whatever may be the source the clerk keeping the customers' ledger should never see the amounts involved. Thus, if control totals entered in the general ledger do not agree with details sent to the ledger clerk, the customers' ledger can not balance with its control.

If the cashier pads his receipts the bank account should be in excess of the actual balance. This safeguard, however, depends on control of bank balances in some separate department, such as the auditor's and on periodic verification and reconciliation. A dishonest cashier is likely to enter a credit to accounts receivable which belongs properly to some other account.

Auditing accounts receivable. Perhaps it is best to communicate direct with each customer, stating the amount of his balance as shown by the books and requesting that he notify a specific executive (perhaps the auditor) if the amount seems to be incorrect.

Such a check may be accomplished in either of two ways:

1. Some official representative takes possession of the monthly statements before they are mailed to customers; he checks them with the accounts or with a trial balance which he has prepared and checked with the ledgers; he stamps each statement with a request that the customer confirm the amount at once; a self-addressed envelope is enclosed; perhaps he arranges with the post office to have incoming mail placed in a separate bag (furnished by the company), locked at the post office and delivered direct to himself, who has the key. This is a wise protective measure.
2. Regular monthly statements of account are sent out as usual. Then a special form is mailed independently with a request for confirmation, using the principles already outlined.

Taking charge of incoming mail — deposits. It is desirable that incoming mail be carefully supervised as a matter of daily routine, rather than only at the first of each month in circularizing the customers. Some responsible person other than cashier or bookkeeper should have this duty. The cashier never should be permitted to open incoming mail. The person who has this task perhaps will be some confidential clerk attached to the office of an officer — frequently he is secretary to the treasurer. It seems advisable to have some one perform this duty who knows little about bookkeeping, the less the better.

This clerk lists all remittances, preparing two or three copies. Both this clerk and his superior (the treasurer or other executive) initial each list. One copy may go with the cheques to the cashier; perhaps the cashier does not even see the cheques but only the list. Each cheque should be indorsed by the cashier (or by some executive if the cashier does not see the actual cheques) "for deposit only" or to the order of the bank.

The cheques, with or without the list of incoming remittances, preferably, it is believed, should go to the cashier so that he can make the necessary cashbook entries after remittance letters have been checked by the accounts-receivable bookkeeper, notations made on the remittance letters as to the dates of the accounts paid, and the cash discount allowed. These remittance letters would then come back to the cashier and provide the proper basis for his entries.

At this point, the question must be decided whether freight deductions should be credited through the cashbook. Whether they are entered through the cashbook or through other credit books, there still remains the important question of approval of allowances for freight deductions.

With respect to "allowances claimed," it seems that allowances should be made by credit memorandum.

A different clerk — not the cashier, however — should take the deposits to the bank. This clerk should have nothing to do with counting or recording cash. Deposit slips should be prepared in duplicate, the duplicate being stamped by the bank teller and returned, say, to the office of the treasurer in which, after being compared with cashbook totals and with the daily list of remittances made at the time the incoming mail was opened, it is filed. Further, to prevent the forging of the bank teller's approval on the duplicate deposit slip, the totals of the incoming remittances for each day, as shown in the original list, should be compared with the deposits entered on the bank statement received at the close of each month.

The following plan has been used satisfactorily in preparing these lists in certain concerns which receive a rather large number of cheques daily.

Instead of using a form of blotter with one column, or one with columns for customer's name, amount, discount, freight deducted, allowances claimed, etc., the remittances are listed on a deposit slip marked "duplicate," with names of payors inserted. The cheques then go to the cashier who signs for them, either on this slip or on a separate one. The duplicate deposit slip then is handed to the keeper of the customers' ledger, who posts the items to the individual accounts affected, inserting the ledger folios on the slip. He signs the slip and turns it over to the cashier. The cashier enters the ledger folios in the L. F. column of his cashbook.

However, when the question of cash discount arises, especially when it seems desirable that the cash-receipts record should show, in addition to the discount, the actual invoices paid, the percentage of discount allowed and on which amount discount is allowed, this method is not apt to work most effectively.

When a cash register is used, the officer who has possession of the key takes the daily reading. He watches the cashier count the cash or does it himself. Cash then is entered on both deposit slips.

If it is believed impracticable to list remittances on a duplicate deposit slip, the blotter may be used to advantage for posting to the individual accounts.

Taking Funds without Manipulating the Records

Theft of money without manipulation of records is crude and unfinished, and invites discovery at the end of any month when the bank statement is received and reconciled with the books. A person who uses this method probably plans to drop out of sight as soon as the job is done. No collusion may be necessary to temporary success.

Falsifying Totals

All items in the cashbook may be stated correctly yet the totals may be reduced for purposes of posting to the general ledger. Collusion with the ledger clerk is necessary so that the trial balance or abstract of the ledger may agree with the control.

Verification of the cashbook footings should detect this attempt to cover theft of cash receipts. Care should be observed in tracing footings from the bottom of one page to the top of the next one (those carried forward) so that premeditated transpositions may not be passed by unnoticed.

Holding out Receipts without Entry

Temporarily, an employee may be successful without collusion in holding cash receipts without entry in the records, but unless the cashier is able to suppress or alter the monthly statements sent to customers their complaints should lead to detection. A periodic direct communication with customers should disclose fraud of this type.

Lapping

Lapping consists of delaying the entry of cash receipts — a borrowing from the future. This method of fraud may be worked easily by a clerk who handles cash receipts unless some internal-check plan is in effect. As long as the books are not quite up to date, a cashier with a free hand in recording and depositing daily receipts has access to money which has not yet been recorded.

Suppose a business is of such size that fairly large remittances are received each day. The cashier previously has been guilty of holding out cash. On receiving a fairly heavy payment, he fails to enter it on the books for, say, twenty-four hours, but deposits the cheques to make up the balance he should have on hand. The next day, he enters up the old cheques and deposits the new ones received on that day, but does not enter the new cheques until the following day, and so on.

The following tabulation of cash collected over a period of four days illustrates the idea of lapping more clearly. No safeguard is in evidence to force the cashier to account daily for all cash received.

Customers' collections				Collections entered and deposited			Collections held back (lapping)		
Day of	Receipts		Total	Total	Customers credited		Increases	Decreases	Total
Month	Checks	Currency	Receipts	Deposits	Name	Amount	Daily	Daily	Held Back
19– Nov. 26	1550	300	1850	1750	Sundry Cus.	1750	100		100
" 28	2210	440	2650	2500	Jones	100	150		250
					Sundry Cus.	2400			
" 29	1875	525	2400	2450	Brown	250		50	200
					Sundry Cus.	2200			
" 30	2360	640	3000	2850	White	200	150		350
					Sundry Cus.	2650			
Totals	7995	1905	9900	9550	√	9550	400	50	350

The cashier uses a certain number of customers' accounts in his lapping scheme. If only a few accounts are used detection is apt not to be as easy as when many accounts are manipulated. In the illustration, the accounts of Jones, Brown and White are the ones involved in the scheme.

As this practice continues on the part of the cashier the amount involved has a tendency to grow in size so that other steps must be taken in the attempt to hide the fraud. Eventually he may resort to forgery to cash business cheques or to make accounts balance.

Lapping is simple in practice and hence it is a most common method of fraud. It requires no collusion and may be exceedingly difficult to discover unless the accounting system provides some systematic safeguards, for example:

1. Deposit intact of all cash receipts daily by some one other than the cashier;
2. Preparation of daily deposit slips in duplicate:
   a. Both copies to go to bank to be stamped there by receiving teller;
   b. Duplicate, signed by receiving teller, to be returned direct to some one other than the cashier — perhaps the auditor;
3. Daily comparison of duplicate by this person against detailed cash-receipt entries.

Overstating Discounts

The cashier may overstate discounts in his cashbook and pocket the difference between the actual discount and the reported discount. The entry may increase the discount actually deducted or deduct a discount when none was claimed.

This must be done with currency receipts only; otherwise, lapping occurs, which is subject to discovery by the lapping tests. Also there must be collusion with the keeper of the customers' ledger if the ledger is kept separately; otherwise, the latter's knowledge of discounts — particularly the rates — will lead to discovery.

The amount of money involved will never be great. A constant comparison of duplicate deposit slips with the cashbook, and an occasional check of discounts reported on currency receipts should provide a sufficient safeguard.

Crediting Wrong Accounts

An attempt to cover theft of funds by crediting wrong accounts requires collusion between cashier and the keeper of the customers' ledger, and even then without executive carelessness the attempt will not be successful.

The development of good accounting and its appreciation by executives have reduced the popularity of this method.

If Jones, a delinquent customer, pays up his bill no record of the money taken may be entered in the cashbook. Then a journal entry may be made charging off Jones' balance, say, as a bad debt.

It seems advisable to adopt the rule that all journal entries — entries in the general journal — should be approved by one or more specified executives prior to inscription. This will decrease the possibility of this method of fraud.

Traveling Representatives

If possible, traveling representatives never should be permitted to collect money from customers. Payment should be made direct to the company's office.

In cases where it is believed impracticable to adopt this rule, each agent may be given two receipt books of the carbon counterfoil type with a triplicate on transparent paper. At the end of each week, each agent should forward one book to the office, having sent in remittances daily as received. The remittances may be checked weekly, and each agent always has on hand a receipt book for use.

Under favorable conditions a practical plan may be utilized to control collections by delivery-system men. The traveler takes with him receipts completely filled in by the office for all accounts which he is to collect. A record of receipts issued to him is kept at the office. In other words this record charges him with the receipts he takes. Daily the traveler sends in all collections, and as he finishes with one town he forwards all receipts for money which he has been unable to collect, with explanations for his failure. Remittances plus returned receipts should equal receipts issued, so that upon the office record he may receive total credit eventually equal to the total charges.

In no circumstances should such representatives be allowed to use collections for the payment of expenses. Expenses should be paid under some plan which utilizes the imprest or working-fund principle suggested previously in relation to petty-cash disbursements.

Sundry Receipts

Sundry receipts require careful attention. Each kind should be given separate consideration as far as possible, rather than dealing with them as one group.

Freight claims may be protected by treatment similar to that accorded accounts receivable, even as far as carrying them in the customers' ledger. Sales of scrap or waste should be closely related to material control, and a perpetual-inventory plan should be developed to account for scrap material. Sales of stock shares and of bonds should be accounted for separately through the use of subscription blanks, books, calls, share accounts and numerous clerks. Unclaimed pay should be protected as part of the payroll system (see next chapter). Telephone calls and telegrams chargeable to employees may be treated somewhat similarly to sundry accounts receivable, even as far as entering them in the ledger holding miscellaneous accounts.

If any property is rented to others by the concern, some one — such as a rental agent — should be charged with the property under his control and then discharged on the basis of cash received and satisfactory explanation of discrepancies between cash received and predetermined estimates.

Refunds for freight overcharges, damages, insurance cancellations, etc., may prove difficult to check and to verify. For example, an insurance policy may be canceled before expiration date, and the refund cheque may be cashed by the cashier and the proceeds pocketed. All policy modifications, adjustments and cancellations perhaps are best investigated by the professional auditor on his periodic visits. He is probably best equipped to look closely into the whole matter of refunds.

Returned Cash Receipts

The accounting procedure involved in returned cash receipts depends upon whether the receipt is to be returned in part or in whole.

In the first instance, the original cash receipt should be deposited in due course, then a regular voucher should be prepared and a refunding cheque issued. The procedure, in other words, should provide for complete record of the disbursement in the usual way, leaving no wider opening for fraud than that which occurs in regular disbursements.

On the other hand, a return in whole, as when there has been an underpayment and a voucher cheque has been received calling for a receipt in full, requires the return of the received paper intact to the customer. If the accounts-receivable ledger is not under the control of the cashier, the possibility of fraud is slight.

Miscellaneous Methods

The following methods of stealing cash receipts, in addition to those which have been considered in some detail, are suggested as possibilities:

1. Overfooting the sales-discount column;
2. Charging some expense account to affect a credit made to a customer;
3. Selling articles such as containers without entry therefor;
4. Holding out interest received on notes and accounts;
5. Charging accounts which are inactive or which represent persons who are parties to a conspiracy to defraud;
6. Withholding payments received on accounts charged off;
7. Borrowing from month to month;
8. Switching bank balances;
9. Raising cheques after they have been returned from bank;
10. Utilizing false sheets where records are loose-leaf, these to be inserted for purposes of examination (even complete records may be prepared, one for use and one for examination).

CHAPTER XI

Payrolls

Payment by cheque and in currency; conditions favorable to fraud; possibilities of fraud; basic objects of internal-check system; padding the payroll; earnings falsified; overpayments refunded; underpayments; withholding unclaimed pay; application of internal-check principles; steps in payroll routine.

The subject of payrolls was omitted purposely from the discussion of purchases and cash disbursements, because of its importance and the complexity of the details encountered. In many business concerns, particularly manufacturing companies, expenditures for wages may assume proportions of vast importance. A large amount of detail may be necessary in the routine of determining just what amount of money is due each employee.

Payrolls provide a most fruitful field for the practice of criminal schemes unless particular pains are taken to preclude every opportunity for misdeed. Thus, payroll transactions must be considered most carefully in adopting a satisfactory internal-check plan. Every known device for testing the accuracy and proper handling of payrolls should be studied. Even then, regardless of what may be developed to protect the payrolls of a particular concern, it is not going too far to suggest that the deliberate audit may be looked upon as an additional necessity.

Payment by Cheque and in Currency.

Employees may be paid either by means of cheques or actual currency. Only to a slight degree are payments ever made in goods or materials — as by advances from stores — and even when such advances occur they satisfy only part of what may be due the employee, not all.

The factors which may be responsible for deciding in favor of one method of payment rather than another are numerous. The common methods reflect the desires of the particular concern and the requirements of local statutes. Payment in currency may be a disadvantage as well as an advantage; the same may be said about cheque payments. When payment is made in currency, for example, a longer time is consumed in preparations for payment than when payment is made by cheque. Cash payment is subject to errors such as putting wrong amounts in the envelopes, but undoubtedly it is more popular with the men, as it saves them the inconvenience of cashing their cheques; and it is required by the law in certain places. Internal check may not be advanced materially by choosing the cheque method in preference to the currency method, or vice versa, depending on conditions.

If a business man adopts the cheque method, he should not rest secure in the belief that he is necessarily safeguarded better than when currency is used; it may be true, and, again, it may not. Under the cheque method of payment, unless scrupulous care is observed, little difficulty may be experienced by an employee who decides to line his pockets with some of the payroll funds. Opinions to the contrary notwithstanding, cheque indorsements may not mean much, if anything; many employees in some businesses can not sign their own names.

It will be noticed later that regardless of the method adopted the elements of a considerable portion of the protective scheme may be identical.

Conditions Favorable to Fraud

The person who attempts to pocket payroll money illegally must have certain conditions in his favor to engineer his scheme with a fair chance of success. Basically, these are two in number:

1. He must be in such a position that he controls the money which is withdrawn from the bank for payroll purposes;
2. He must control, in some manner, what the employees are to receive, on and after pay day.

Possibilities for Fraud

Payroll frauds may be accomplished in various ways. The following schemes are fairly representative:

1. The amount called for by the payroll may be in excess of what is actually needed, the excess being retained by the criminal;
2. Padding the payroll — placing names on the payroll which do not represent individuals actually employed. The names may be entirely fictitious or may be those of past employees or of new employees whose length of service is less than that indicated on the record;

3. Failure to omit from the payroll time during which employees may have been absent and for which they are not entitled to full pay;
4. Falsifying the earnings of employees by showing excessive working time or by using an excessive rate may be used in computation;
5. Falsifying payroll footings;
6. Holding out amounts which have been refunded for overpayment;
7. Falsifying amounts paid out for underpayment;
8. Withholding unclaimed pay;
9. Recording separate payment in cashbook for fictitious special work.

In a large concern the opportunities for one with fraudulent intentions may be innumerable. New schemes for defrauding through the payroll are created constantly.

Basic Objects of Internal-Check System

Before proceeding to consideration in detail of some of the fraud possibilities mentioned, it may be well to suggest some points of general application in development of the internal-check procedure:

1. Means subject to check and control should be adopted, to determine the correct amount due each employee on pay day;
2. It is necessary to make certain that each such amount is paid to the proper person;
3. One should guard against payments to fictitious persons;
4. Care should be taken that no portion of a payment be for time not actually consumed in the work of the concern;
5. It is highly desirable that labor cost be distributed accurately to the units of the business which actually have utilized each employee's time;
6. As many persons should be brought into the scheme developed for protection as is possible in the circumstances.

Padding the Payroll

The fraudulent scheme of padding the payroll is not now so prevalent as it once was, since the use of mechanical recording devices and cost studies have done much to reduce its danger. Timekeepers may pad the payroll and have dummies present themselves to the paymaster for pay collection, after which the two split the proceeds. Since such timekeepers expose themselves to blackmail by these dummies, protracted operation of the scheme is improbable. Yet one should not rely fully for protection upon this factor since the losses may be heavy before the quarrel between the two reaches a breaking point and a "squeal" uncovers the misdeed.

Time clocks may assist materially in establishing a satisfactory check against padding. However, there is a possibility of one man punching two or three cards on entering and leaving the plant. It is advisable to provide for check of time-clock cards against individual labor slips or reports prepared in the various departments, all being gathered at one place, say, to determine costs. If no time slips are found for a certain clock card, an investigation is in order; and if there is variance between the time on the labor report of a workman, as certified by his foreman, and the time displayed for the same man that day on the clock card, an explanation should be sought. Further, the labor reports should be stamped by automatic clocks to assist in preventing the use of false reports to match with false clock cards.

If the misdeed is promoted by deliberate failure to drop an employee from the rolls, the same precautions may prove satisfactory. It is difficult to steal money by this means when the duties of timekeeping and paying are segregated carefully. The same safeguards should be effective when names are placed upon the rolls prior to employment.

Padding can not be eliminated completely, perhaps, by any one scheme, but must be further discouraged by deliberate audits, with particular reference to:

1. Checking labor reports and clock cards with the payroll, particularly to uncover names of fictitious employees on the payroll.
2. Checking the employment-department records in relation to hiring dates and dates of withdrawal of employees, to disclose failures to drop employees and enrolment of employees prior to date of actual employment.

Earnings Falsified

The time or rate of labor may be falsified only by collusion between the timekeeper and the employee or when the timekeeping and the paying are both duties of one employee.

Falsification may be uncovered by deliberate audit of the clock cards, the labor reports, employment records, etc., as has been suggested.

Payroll Footings Falsified

Payroll footings may be falsified by any clerk handling both payroll and money. The paymaster may be guilty of the act also if payrolls are entrusted to his care prior to advising the treasurer of the amount for which the cheque authorization should be drawn.

Each payroll may be prepared in a payroll department; then it may be presented to the accounting department for audit, and next the treasurer may be advised of the amount of the cheque to be drawn. Subsequently the payroll may be forwarded to the paymaster. Occasionally the auditor may be present at the time of payment, and take over from the cashier or paymaster the unclaimed pay.

Overpayments Refunded

When an employee returns an overpayment, the return usually is made to the paymaster. One should check the accuracy of accountability in this relation by means of a deliberate audit after payment is completed. Checking the payroll may uncover an overpayment. A demand for refund then may be made of the employee concerned, or a corresponding deduction may be made from a later payroll.

If an employee protests, one should look further and more closely into the matter. In an isolated instance there may arise a dispute between an employee and the paymaster requiring conciliation. But if the same thing occurs with other employees, it is advisable to watch the paymaster closely.

Underpayments

Disbursements to supplement underpayments may be checked by requiring an authorization for each one from the auditor, and by permitting such payments to be made only by the cashier upon such authorization. Each case deserves attention before approval is given.

Withholding Unclaimed Pay

Unclaimed pay may be important in some concerns and not particularly important in others. When the labor turnover is small and attendance is steady, unclaimed pay requires scant attention. But when employees frequently leave without claiming the total pay due to them, and later return or write in for the amount due, the situation may entail serious consequences.

If unclaimed pay is left in the paymaster's hands, it may be possible for him to falsify receipts and thus cover a shortage temporarily, preparing later receipts to insert in their places if he is called upon to make payments claimed later. If unclaimed pay is returned to the cashier, however, to be replaced in general cash — perhaps with receipts for pay already disbursed — and if the receipt blanks, usually serially numbered, are held in the paymaster's office, no further check may be necessary.

Unclaimed pay in the cashier's hands should be audited deliberately at definite times, and a watch should be kept for lapping. When an auditor's department exists it may be well to have the payroll receipts, as soon as they are signed, turned over to that department, and receive demands for pay at other than regular payment dates at that place only. This department may authorize disbursement by the cashier to disburse and the authorization then may be matched with the receipt. The auditor must demand that each employee asking for separate payment be identified satisfactorily.

The auditor's authorization for disbursement should be prepared in duplicate and the carbon retained for follow-up purposes. The receipt taken by the cashier should be sent to the auditor so that proper clearance may be made from the liability account of unclaimed wages. Such a receipt attached to the carbon copy of the authorization may be used as authority for the journal entry recording such clearance.

Application of Internal-Check Principles

The internal-check theory is applied to the payroll by specific separation of duties — as in the case of the cash item. The employment manager, the timekeeper, the foreman, the payroll clerk (if not timekeeper) and the paymaster may be brought into the scheme advantageously.

The work of the paymaster, or whoever it is who acts as payroll cashier, should be separated carefully from that of the payroll clerk at least. The latter is perhaps a clerk in the accounting section who in carrying out his duties continuously audits the work of the paymaster. Such a clerk should never have anything to do with making up the payroll or with paying the workmen. The control of the payroll should be out of the paymaster's hands entirely except perhaps for the short time during which the men are being paid.

Then again, no cheque for a round sum should ever be drawn for payroll purposes. Each payroll cheque should be exactly equal in amount to the gross amount of the payroll (especially when a payroll fund is in operation). Some adaptation of the imprest scheme is advisable, so that whoever is in charge of the payroll may be accountable for the money at all times. The gross amount of the payroll less advances to employees is the amount to be paid. Then if a payroll fund is operated, the fund may be replenished to its original amount as a result of cash advances included in the payroll cheque but not paid out to the men. From time to time the fund may show an excess over its original amount, after a payment is completed, because of advances of goods or materials to workmen. Such excess, to be returned to general cash, should equal in amount the total of the advances of goods or materials. When payment is made by cheque, the cheques should be of a color different from those used for regular disbursements, should be numbered separately and should be recorded upon a separate cheque register — this register may be the payroll in extended form.

The payroll sheets, as suggested, should be passed through as many hands as possible. If the cashier has to be involved in the payroll procedure in the absence of a separate paymaster he should have nothing to do with the rolls other than the actual distribution of the pay envelopes.

It is generally advisable to install some system of time clocks. The exact system to be adopted depends upon local conditions. As the men "punch in" and "punch out" they should be watched by someone, such as their foreman. After a man is "in," it should be made certain that he stays in on the job.

Questionnaires should be filled out by each applicant for employment, calling for whatever information may be considered necessary. These questionnaires should be filed and should be transferred to a "dead" file when a man is discharged or leaves the employ of the company. Payroll rates should be a matter of record. Some major officer, preferably, should supervise payment of the men.

Steps in Payroll Routine

By noticing the various distinct steps in the payroll routine one may comprehend definitely how an internal-check system may be made effective in controlling employees' wages. These steps are as follows:

1. Employment — authorization to hire an employee at a specified wage rate;
2. Timekeeping — time clock or time book (when possible, preference should be given to the time clock);
3. Supervision — approval necessary for time taken off, and other matters;
4. Labor time records — records made during each day by means of which that day's time is accounted for in relation to work done;
5. Time and labor checking — daily check-up of time records and labor reports;
6. Labor diffusion — labor distribution and costing;
7. Payroll record — calculation of each employee's pay;
8. Payment—paying employees and obtaining necessary receipts.

The various agencies concerned in these steps have a certain relationship to each other. It is through this relationship that a satisfactory internal check is developed without overlapping of detail.

In carrying out any plan concerned with the routine for making up, checking and payment of a payroll, a great amount of detail is encountered. This makes it necessary to observe certain rules for efficient operation of the plan. Although some of these have been mentioned previously, a recapitulation may be in order:

1. When possible an automatic time-recording device should be used. If such a device seems undesirable, a time report should be prepared by someone as timekeeper. This report should carry the approval of each department head;
2. Preferably labor time should be reported separately and be approved separately;
3. No names should be added to the payroll except by formal written authorization by one who is responsible for employment;
4. All rate changes should have the approval of the head of the department concerned, and perhaps that of a superior officer;

5. Each payroll should be calculated twice; for example
   a. By payroll department;
   b. By accounting department;
6. When paying in cash some form of pay receipt should be provided. After an employee signs one of these he turns it in and receives his money. When payment is made by cheque, it should not be cashed by the paymaster.

Pay receipts presumably prevent distribution of envelopes to persons other than the right ones and furnish vouchers for auditing the payrolls and for quieting a dispute when an employee insists he has not been properly paid. Receipts should be signed only on the morning of each pay day, so that if one is lost the finder can not get it cashed.

When an employee comes for his pay he should be identified by his foreman. The signature on each receipt turned in should be verified by reference to the signature on the previous receipt.

CHAPTER XII

INTERNAL TRANSACTIONS

Definition; expenses; reserves; endorsements or guaranties; inventory transactions; control through perpetual inventory; limitations on control; storekeeper; chargeability; dischargeability; stores ledger; manufacturing processes; scrap and spoilage; supplies and repair parts; returns inward; methods of fraud summarized.

An internal transaction is one which takes place wholly within the confines of a business establishment. Such transactions concern the handling, exchanging and distribution of many items, such as the following:

1. The transfer of physical commodities from one department to another concerning such items as
   a. Perpetual inventory;
   b. Stores;
   c. Supplies and repair parts;
   d. Scrap and spoilage;
2. Transactions not concerned with inventory, in the general acceptance of the term, viz.
   a. Repairs;
   b. Power production;
   c. Depreciation;
   d. Patent amortization;
   e. Reserves;
   f. Expense and expense pools;
   g. Departmental burden;
   h. Closing entries.

The allocation of results of operations between departments depends completely upon the correctness of the record of the internal transactions. The correctness of the record fundamentally depends upon the extent to which the rule or principle of charge and discharge is followed by the system constructor — the person whose task it is to plan a system of internal check for such transactions. The practice of signing or initialing work will help largely in identifying transactions for this purpose.

Inasmuch as inventory transactions comprise the most important division of the subject of internal transactions, the greater part of this chapter must be devoted to inventory. Other matters, therefore, will be outlined briefly.

Expenses

In a manufacturing concern the manufacturing processes, properly speaking, should be considered as assets and be accorded treatment which recognizes that fact — they are revenue expenditures which create assets, inventory assets. However, it should be remembered that so far as the books of account are concerned these expenses are of an intangible nature until they have been absorbed by a product, such absorption resulting from proper operation of a cost system.

Expense distribution, in general, is a matter of cost-accounting accuracy. The cost plan must be basically correct. There is little of interest to the auditor in the distribution of expense, unless for some reason it seems desirable to establish a bonus plan whereby a department head is given an incentive, beyond his regular salary, to do his work in the most efficient manner.

If a bonus plan is in effect, an incentive appears which may cause a department head to attempt to manipulate the mechanism of apportionment of expense to his department. However, it seems unnecessary to do more than to mention this possibility, because, ordinarily such a person can not succeed in accomplishing his ends without wide collusion.

Reserves

Certain reserves may be used to advantage by those in control of a company to deceive minority stockholders — as by reserving excessive amounts. Again, excessive reserves may be built up in an attempt to avoid taxation on earnings or on assets.

Inasmuch as the parties in interest — from the company viewpoint — are those in official control, internal check is of little value, if any, in having reserves set up in accord with the best accounting practice. About the only thing that can be done to protect the stockholders from such abuses is to have a periodic audit conducted by a competent public accountant — one who is not susceptible to influence and pressure but will do his work and report his findings in harmony with the best professional technique and ethics.

Endorsements or Guaranties

For the most part, there is no unanimous agreement among accountants — except perhaps in relation to discounted notes — as to the best way in which indorsements and guaranties should be treated. In some fashion, as by notation, card files or actual entry, an up-to-date record should be available and its preparation should be made a matter of regular routine.

It seems basically immaterial whether such items are shown in a balance-sheet as actual liabilities or are entered either in short or in footnotes, so long as they are set forth clearly. Failure to set them forth in a clear manner may be considered as a wilful attempt at deceit. Credit statements, for example, apparently are often barren of information on matters of this kind.

Inventory Transactions

It is not uncommon to encounter a business establishment with practically no internal check whatsoever over its materials, merchandise and supplies on hand. A physical inventory — a listing of all materials, merchandise and supplies on hand as of a given date — is accepted generally as a true and satisfactory basis for the determination of the profits of a given period.

Thus, during each period between physical inventories abundant opportunity is afforded to one so inclined who deals with goods and merchandise to make way with varying quantities of such assets without much fear of discovery. The larger the house, the more apt is merchandise to disappear during the daily confusion entailed in carrying out internal transactions related thereto.

When one considers further that the taking of each physical inventory is looked upon too often as a necessary evil — an attitude breeding carelessness and irresponsibility — the need for establishing some scheme which will enforce complete and accurate accounting is emphasized.

There should be provided means whereby receipts are given by all those who receive merchandise, regardless of its kind, to those from whom such articles are obtained. Such a series of internal transactions, for example, forms a link between goods received on orders and goods sent out on orders, distributed on requisition to production, maintenance and betterment departments, or to departments for sale.

Control through Perpetual Inventory

Control of inventory transactions is imposed best by some adaptation of the perpetual-inventory principle. In the cogitations of some writers on accounting, it is intimated that in certain establishments a perpetual-inventory plan is never possible of adoption. It is believed that such an attitude is completely in error. Some plan always is possible, the only restriction being that of cost, a restriction which, however, may be encountered in any attempt to develop other methods of control. If benefits are weighed against cost and cost outweighs the benefits, it is natural that some benefits will go by the board.

The methods of maintaining a perpetual inventory are fundamentally valuable as a check upon the accountability for values entrusted to the storekeeper and his department and to numerous other departments in a business of fair size. The records may be used as a check against the physical-inventory count when this is taken, and as a safeguard against losses resulting from the wrongful taking of goods and from inefficiency.

As suggested earlier, goods are not so likely to be converted to an employee's wrongful use as is cash, since a person who dishonestly appropriates merchandise to his own use usually must convert it into cash before he can benefit. However, the many losses from waste and inefficiency, growing out of an uncontrolled inventory, may also be curtailed by internal check, and so from either point of view some such system is merited.

The real purpose of inventory control is to determine the quantity and value of goods on hand, so that a physical inventory becomes a matter of checking against the balance. Overage or shortage in the balance requires an attempt to find the error.

The value of the system under consideration — it may involve a cost basis, an average-cost basis or a sales-price basis — is dependent fundamentally upon the establishment of a definite relationship between the physical control and the accounting control of all stores.

Limitations on Control

The same degree of accuracy can not be obtained in accounting for most goods as is obtainable in accounting for cash, since a certain amount of waste is bound to occur. However, true waste may be estimated by past experience in most instances, and a proper allowance may be made therefor in the inventory account as a known cost factor. The extent of the waste must be determined on the basis of actual experience, considering in each case the nature of the commodity to be controlled.

When these special allowances are taken into consideration, little excuse exists for a large discrepancy between the inventory count and the inventory balance carried on the books of account.

Storekeeper

The physical protection of goods and their arrangement are primarily matters of operation, whereas the manner in which materials, supplies and merchandise are to be handled should depend entirely upon the business in hand. In a trading establishment, goods usually are under the supervision of the sales departments. In a manufacturing business, however, materials and stores of finished product may be placed, except for special items perhaps, entirely in the hands of the storekeeper. In any event, a definite imposition of responsibility for physical goods, is essential before the accounting department can properly carry out its internal-check plan developed for the inventory.

Some person should be given entire control over stores; he must account for all goods received. This should be the invariable rule, whenever possible. Such a storekeeper, for example, has control over all merchandise or materials not purchased for specific orders or for immediate departmental use. The storekeeper's department should be located centrally so as to facilitate receipts from the receiving department and distribution for various purposes. The storeroom should be so situated that all goods coming in and passing out come under the eye of the storekeeper.

The storekeeper should sign for all goods received by him. This may be done on a special form of receipt, on a triplicate purchase-order form retained by the receiving department, or in a special column on the pages of the receiving book. Under the purchase-order system, for example, the storekeeper reports all goods received, and when a stores ledger is operated, he makes entries of quantities in the received section of the ledger on the basis of his receiving report, whereas the values entered are based upon information on invoices routed through to him.

The operating routine requires that transactions concerned with receiving goods shall come through to the accounting department for notation in the general records. Such transactions are entered as debits in an account which is treated as a control over the detailed stores. Accounts are kept in some systems for each class of goods in the storeroom. Controlling-account charges are made only upon the basis of audited vouchers, each of which carries the storekeeper's check-mark indicating somehow that he has reported acceptance of the goods. Thus, for example, accountability on the debit side of the control is determined directly or indirectly from the voucher register or the purchase journal, and the requisite check is exercised between the storeroom and the stores controlling account.

The storekeeper who is held responsible for the disposition of goods must have in hand some evidence of the delivery of goods from the storeroom. The cost department, also, must be given some evidence of the products or departments benefiting from the use of goods delivered. Some method must be employed, therefore, whereby dischargeability on the credit side of the inventory-control account may be established and under which the cost of materials consumed or of goods sold may be obtained. This is done by means of material requisitions or requisitions in the form of shipping tickets properly authorized. Daily, weekly or monthly summaries are prepared therefrom. In each case, such a requisition, properly authorized, is a valid order on the storekeeper to deliver materials or merchandise.

The material requisition is made out and authorized in the department requiring the material, and is signed also by the party to whom delivery is made. The shipping ticket usually is a duplicate copy of the sales order — it may consist of a copy of the sales ticket, as in a retail store — on which all goods sold are shown.

After these vouchers have been duly entered by the storekeeper upon his records (provided any are kept), entry also is made upon the summary which is periodically transmitted to the accounting department, where the requisite steps are taken to adjust the controlling stores account to the facts displayed in the summary. The control receives a credit representing the total cost of goods consumed or delivered. Frequently, the accounting department prepares this summary.

It will be noticed that all goods received or issued by the storekeeper finally become a debit or a credit to the inventory controlling account, which represents his net accountability for goods.

The accuracy of the book-inventory balance depends entirely upon the care which is given to the system. An honest attempt at system operation, holding the storekeeper responsible for large discrepancies shown when a physical inventory is taken, should make the plan generally satisfactory.

To recapitulate, the storekeeper's accountability increases for each debit made to the inventory-control account, as based upon the voucher register or purchase-and-expense journal. Dischargeability is found on the credit side of such account, and is established by his honoring requisitions properly authorized. If materials are issued to a producing department they later return to the storekeeper as finished product. The discharge of the producing department for materials is equal to the charge to such department; and the chargeability to stores for finished product is equal to dischargeability of the production department. The storekeeper is also discharged by authorized sales transactions.

The perpetual-inventory principle, properly operated, is an adequate check, reducing the problem of material accounting to an almost automatic routine.

If the number of transactions and other conditions do not permit profitable use of a storekeeper, distribution may be made direct from the receiving department. The receipt which the latter obtains acts as a discharge of this department and as a charge against the receiver.

Stores Ledger

The perpetual-inventory procedure, by means of which a book-inventory balance is established in the general ledger, does not of itself complete the internal check required to control inventories. A stores ledger should be introduced to obtain the best results — with one exception noted later.

Although the stores ledger has a most important function outside of internal check on inventory, the latter is the only matter of present interest. As part of the internal-check system, the stores ledger furnishes the means for making a check on certain items during the accounting period and thus provides a basis for proving the physical count.

An inventory ledger, where possible, should be actually subsidiary to some controlling account in the general ledger, in order that a direct tie-up between the two ledgers may be secured. It is then possible at any time to obtain a complete proof of the inventory of goods on hand. Such treatment of the stores ledger requires considerable detail posting, yet it provides the only absolute check over transactions of goods and supplies.

The general-ledger account titled "stores" or "general stores" becomes a real controlling account, the summary postings to which in total represent the detailed postings of amounts to the several inventory accounts in the subsidiary inventory ledger.

The postings to the inventory ledger for goods received should be shown on receiving slips and invoices which, in turn, support the charges to the controlling account. Postings for goods delivered come from material requisitions or shipping tickets, which are summarized to obtain the controlling-account credit.

Identification of all postings made to a subsidiary ledger with vouchers supporting control-account entries is necessary if the inventory ledger is to be controlled completely by the general ledger.

The exception which has been mentioned concerns materials not under the supervision of the storekeeper. These are perhaps controlled better through separate accounts outside general-stores account. For example, quantities and value of coal and basic materials may be carried in separate general-ledger accounts.

Manufacturing Processes

When material leaves a producing department in practically the same form in which it entered, such material may be traced readily. But when the form and/or composition has been changed materially, it may be exceedingly difficult to verify completely the accountability for material down to the finished product.

In this case, if the storekeeper should forge a requisition indicating that he has issued a certain amount of a certain material, it may be easy for him to charge a producing department; but it is not going to be as easy for him to discharge that department unless he is in a position to watch and compare departmental results. Rising costs may occur in producing one unit. Hence, if an analysis is made to determine whether the rise is due to the quantity of material used or to the price one is in a position to question the transaction intelligently. If a rise in cost is found to be caused by an increase in quantity of material used, not by price, then an investigation is in order.

Scrap and Spoilage

Proper records should be established and be maintained to account for scrap and spoilage, so that inefficiency in handling materials in the producing departments will come to light quickly. An inspection department performs a most useful and satisfactory audit function in checking accountability by reporting all defective finished products.

Supplies and Repair Parts

An opportunity for theft of supplies and repair parts may present itself in a way similar to the situation in the case of goods held for sale. A perpetual-inventory scheme should be utilized to assist in controlling these items, and, if the business is large enough, a storekeeper or some department should be held responsible for such assets. In other words, supplies and repair parts may be handled through a storeroom in approximately the same manner as materials are treated.

The use of supplies may be checked in a general way by watching and comparing the departmental expenses and the departmental use of such items period by period. Yet this will not be apt to check and uncover minor thefts. Perhaps a fair check may be maintained by requiring authorization by the superintendent or others in authority of repairs and supplies needed therefor.

Returns

The details of returns should be noted carefully at the point of receipt so that when necessary a duplicate of the note may be passed to the manager or to some other officer for authorization of the credit involved.

If possible, returns for which some customer is to receive credit should be taken care of by credit notes signed by some officer after investigation of the reasons for the return. An actual refund of cash is not advisable as a general practice, although it should be noted that after a return has been accepted the customer may rightly demand the cash refund. Such a credit note may be prepared in duplicate, the original to go to the customer and the duplicate to the keeper of the customers' ledger. The latter posts it, inserts the ledger folios, initials it and passes it along to the keeper of the sales returns journal.

Methods of Fraud Summarized

In relation to merchandise and materials possibilities of fraud are not numerous; in fact, they have been suggested broadly in the discussions offered in this chapter and in the former one concerned with purchases. The following are enumerated in summary:

1. Appropriation by unauthorized requisitions;
2. Appropriation of goods finished or those in process of manufacture;
3. Appropriation of supplies;
4. Unauthorized shipments — either more than called for by an order or to confederates. These frauds may be encountered at the stock or store room and beyond. It is to be remembered that diversion of goods and materials may happen before such items reach either the stock or storeroom.

PART III

APPENDICES

APPENDIX A

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APPENDIX C

REVIEW QUESTIONS AND PROBLEMS

Introduction

1. Define "internal check."
2. How is the position of a professional auditor affected if the system of a concern under audit is defective as to internal check?
3. State two ways in which the principle of internal check may be used to guard against fraud and error.
4. Name ten matters of special importance to be considered in devising any system of internal check in handling office records.
5. In what respect and for what purpose may comparative statistics or percentages be used to advantage in the detection of fraud?

Legal Distinctions

6. What is the difference, in your opinion, between fraud and misrepresentation?
7. What facts must be proved in order to convict a person of embezzlement under the laws of your state?
8. During your examination of the accounts of a certain cashier, you find a duplicate payment has been made by cheque. This cheque was paid and cleared by the bank but was not received by the creditor. The cheque is missing. In your opinion, under the laws of your state are you justified in charging the cashier with a crime?

Organization

9. What condition of office organization, above all others, leads to the commission of fraud and larceny and embezzlement by bookkeepers and cashiers?
10. What are the main objects to be sought in arranging the distribution of the work of the treasury and accounting departments of a business? Along what general lines would you distribute the work in order to attain these objects?
11. The accounting department of a wholesale house which is composed of five men keeps the books, does the billing, makes city collections, handles the general and petty cash and pays the company invoices Along what general lines would you distribute the work of the department in order to effect the best possible internal check in the circumstances?

Purchases

12. Suggest a workable plan by means of which the risk of fraud in relation to purchases invoices may be minimized.
13. Enumerate the factors which in your opinion would influence you to select one of the following methods for recording invoices payable:
    a. Blank book containing money columns in which invoices are pasted;
    b. Usual form of columnar purchase journal;
    c. Voucher register;
    d. Invoices are not recorded. They are filed by creditors' names, no subsidiary ledger being used, such filing being only after goods are received and invoices audited. Periodically, the invoices are

grouped by creditors, cheques are drawn for the net amount due each one, and an entry is made in the cashbook for each such creditor — one entry per creditor.

14. Trace the various operations in a well-regulated wholesale mercantile office from the time an order is given for the purchase of material until such material is paid for, so that the company may be protected from any possible loss in the transaction.
15. What would you desire to find by way of system in an average business establishment which will simplify your task of having the outstanding liabilities relative to trade accounts payable properly taken up in the balance-sheet?

Sales

16. How would you prevent the stealing of merchandise by collusion between a shipping clerk and a driver whose task it is to deliver to customers?
17. How would you prevent the wrongful taking of cash by collusion between manager and cashier of a manufacturing concern in which original orders are destroyed, bills against customers fail to reach the regular books, and returns are kept?
18. The auditor of a certain company has established the practice of sending out monthly verification statements or letters to its customers to determine the condition of their accounts. The verification requests have printed on them a request to O. K., or indicate error, and return immediately. Many customers fail to answer these formal inquiries. What presumption of law can you assume in regard to the accounts receivable concerned?
19. Where would irregularities be most likely to be discovered in a men's furnishing store which employs ten salesmen? Assume that a good accounting system is in use, but that one bookkeeper has complete charge of the office with only the occasional supervision of the owner.

Cash

20. Indicate two possible general methods which may be employed by a criminally minded cashier in order to make away with cash.
21. Enumerate four different methods by which a bookkeeper can abstract cash, which ordinarily would not be detected.
22. Enumerate six different methods by which a bookkeeper can abstract cash, which ordinarily may be easily detected.
23. The general ledger of a certain mercantile company contains personal accounts with its officers. To these accounts salaries are credited and drawings charged. The officers, also, are all privileged to pay private bills with company cheques and to purchase company merchandise for personal use. This general ledger and the general journal are in charge of and are kept by one of the officers, but this officer handles no company funds. State three ways by which this officer, without collusion, may defraud the company.
24. When embezzlement of cash by the usual means is impossible, how can fraud be perpetrated by manipulating the accounts and records so that ultimately a large loss will result?
25. Suggest a plan by means of which the risk of fraud in accounting for cash receipts may be minimized.
26. In case it is suspected that cash has wrongfully disappeared, to what test may the bookkeeping records be subjected in an attempt to determine whether there had been any "lap-overs" in the cash entries?
27. Enumerate the reasons you would advance for having a manufacturing company discontinue paying petty expenditures direct from cash receipts.
28. A certain manufacturing company has numerous plants at various points throughout the country. Prepare a set of instructions by means of which the head office may control adequately expenditures for plant additions

and replacement repairs at these numerous plants, keeping in mind that the treatment must be uniform and correct as to principles of accounting.

29. A large jobbing concern has several thousand customers. Outline briefly your recommendations whereby its cash receipts and disbursements may be handled properly and adequately.

Payrolls

30. Suggest a plan by means of which the risk of fraud in payrolls may be minimized. Go into considerable detail.
31. A manufacturing concern employs 3,000 men, some on a day-rate basis and some on a piece-work basis. Enumerate the factors which you consider of importance in verifying thoroughly the payroll transactions.

Inventory

32. Enumerate the advantages, if any, of keeping a book-inventory record. Point out how the disadvantages outweigh the advantages, or vice versa.
33. In a certain manufacturing business, it is desired to guard the accuracy of the book inventory. What steps would you take to effect the required result?
34. A company which manufactures musical instruments has its main office and factory in Syracuse, one branch for sales purposes in New York, another branch in Chicago, and a third in Atlanta. Enumerate the principles which would guide you in determining the adequacy of the control over stock on hand at the home plant and at each of the branch stores.
35. A company manufactures machinery, but purchases its castings from others. In your task of devising and installing a system of cost accounts in this company, outline your idea of the requirements for securing an adequate control of material and finished product.
36. Outline how you would guard against the dishonesty of employees in a large jewelry store who have access to valuable jewels and plate.

General

37. A certain manufacturer has numerous retail establishments in nearby cities which sell his goods exclusively. The manufacturer has placed the entire clerical work and the cash transactions in the hands of one clerk in each such store. Suggest a method of account keeping which, in a practical manner, will produce a satisfactory check.
38. Outline the best system of internal check for a wholesale grocery concern which does a yearly business in excess of $3,000,000. This concern has 5,000 customers. An annual audit is made by professional accountants.
39. The office organization chart of a retail business activity shows the following divisions of work coming under the charge of the office manager:

Sales
  Clerks...... } { Cash
  Departments } { Charge } Customers' accounts { Regular accounts / Will calls / C.O.D. / Approval

Cash
  Received
    Customers.
    Cash sales
      Cashiers
    Miscellaneous
  Petty cash
    Balancing
    Disbursements
  Banks
    Balancing
    Deposits

Drawing cheques

Paying bills..........
File paid bills......

Purchases
Accounts payable
File unpaid bills
Merchandise.....Expense
Departments.....Enter bills
Enter bills.......Audit bills
Audit bills.......Check bills
Check by buyers File incoming bills
File incoming bills
as unchecked...File confirmation
File confirmation Issue confirmation
Issue confirmation
Perpetual stock records
Departments
Purchases
Sales
Mark-downs
Office
Store
Balances
General records
Weekly
Merchandise
Payroll
Monthly
Balance-sheet
Profit-and-loss statement
Departmental statements
Clerks' records

1. Upon the basis of the five major divisions and the various detail divisions prepare organization chart (using rectangles and colors for distinctions) for each of the following:
   a. When the manager and one other employee constitute the entire office force;
   b. When the manager and two other employees constitute the entire office force;
   c. When the manager and three other employees constitute the entire office force.
2. Assuming such a growth of this business that it becomes necessary to add more persons to the force, suggest the principles that should be followed in the assignment of duties.

NOTE: These questions and problems by no means exhaust the possibilities. The list is a selected one, representing what a person should be able to do as a minimum in order to pass this phase of the subject in professional examinations, and in order to have a solid foundation for professional accounting practice.

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