

**Accounting
Building Business Skills**

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**Chapter Seven:
Internal Control, Cash and
Receivables**

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Learning Objectives

- Identify the principles of internal control.
- Explain the application of internal control principles to handling cash.
- Prepare a bank reconciliation.
- Discuss the basic principles of cash management.
- Identify the different types of receivables.

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Learning Objectives

- Apply methods used to account for receivables, including bad debts.
- Describe how receivables are reported in financial statements.
- Explain the principles of receivables management.
- Explain the operation of a petty cash fund.

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Internal Control ...

- all the processes & used to achieve effective & efficient operations, compliance with laws etc.
- includes policies to:
 - safeguard its assets
 - enhance accuracy and reliability of accounting of its accounting records

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Principles of internal control

- establishment of responsibility
- segregation of duties
- documentation procedures
- physical mechanical & electronic controls
- independent internal check

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Establishment of responsibility

- assignment of responsibility to specific individuals
- monitoring of compliance with procedures

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Segregation of duties

- responsibility for related activities assigned to different people
- separation of responsibility for recording and physical custody of the asset

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Documentation procedures

- all documents generated by the business to be pre-numbered
- documents to be initialled
- provides a audit trail for checking of transactions

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Physical, mechanical & electronic controls

- use of safes and safety deposit boxes
- locked cabinets and warehouses
- alarms
- monitors and sensors
- passwords to computer systems and programs
- time clocks

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Independent internal verification

- checking procedures to ensure segregation of duties
- monitoring by supervisors
- verification by internal auditor
- rotation of duties

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Internal control limitations

- Cost/Benefit – cost of establishing procedure should not exceed expected benefit
- Human element – fatigue, carelessness, indifference
- Collusion – two or more individuals who work together to get around controls
- Size of business

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Internal control over cash

Cash is the most desirable asset...

because it is readily convertible into any other asset

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Internal control over cash receipts

- Establishment of responsibility: authorised personnel handle cash receipts
- Segregation of duties: different individuals handle cash, record cash receipts and hold the cash
- Documentation procedures: remittance advices, cash register tapes, deposit slips used

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Internal control over cash receipts

- Physical, mechanical & electronic controls: cash stored securely, cash banked frequently, cash registers used/direct deposits
- Independent verification: cash receipts counted daily, comparison of receipts to bank deposits

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Internal control over cash payments

- Establishment of responsibility: authorised personnel only to sign cheques
- Segregation of duties: separate tasks of approving & making payments, signatory not to record the payment, limit knowledge of PIN, etc.
- Documentation procedures: pre-numbered cheques, approved invoices, account marked as paid

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Internal control over cash payments

- Physical mechanical & electronic controls: blank cheques stored securely, limited access
- Independent internal verification: compare cheques to invoices, reconcile bank statement monthly

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Petty Cash Fund

is a cash fund used to pay relatively small amounts

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Bank Reconciliation

Use of a Bank is good internal control:

- minimises the amount of cash that must be kept on hand
- provides a double record of all bank transactions
 - one by the business
 - one by the bank
- helps a company safeguard its cash by using a bank as a depository and clearinghouse for cheques received and written

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Reconciling the bank account

- Time lags that prevent one of the parties from recording the transaction in the same period.
 - time between when cheque is written and dated and date it is paid by the bank
 - time between when receipts are recorded and when recorded by the bank.
- Errors by either party in recording transactions

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Reconciliation procedure

- reconcile balance per books and balance per bank to their adjusted or correct balances
- the reconciliation should be prepared by an employee who has no other responsibilities pertaining to cash

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Reconciliation procedure – steps

Start with bank statement balance for reconciliation date

- a. Compare cash receipts journal to deposits on statement
- b. compare cash payments journal to withdrawals on statement
 - tick items that match
 - correct errors in cash books
 - bank statement errors added to bank reconciliation statement

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Reconciliation procedure – steps

outstanding items carried forward to next bank reconciliation

- Identify 'unticked' items on bank statement
 - adjust cashbook for dishonoured cheques and direct deposits
 - outstanding deposits and unrepresented cheques recorded in bank reconciliation statement

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Reconciliation procedure - steps

- Total cash journals and post to Cash at Bank ledger
- Complete bank reconciliation statement:
 - outstanding deposits increase the bank account
 - Unpresented cheques decrease the bank account

Adjusted bank balance should equal the balance of the Cash at Bank account

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Demonstration

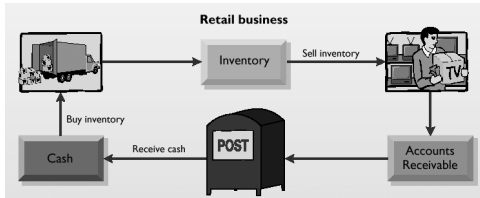
Work through the bank reconciliation illustrated for W.A. Laird Pty. Ltd.

Compare your results with the suggested solution provided

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Managing & monitoring cash

Operating cycle of a retail business



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Basic principles of cash management

- Increase the speed of collection of receivables
- Keep inventory levels low
- Don't pay earlier than necessary
- Plan timing of major expenditures
- Invest idle cash

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Assessing Cash adequacy

Ratio of cash to daily cash expenses -
Computes the number of days of cash expenses that cash on hand can cover

$$\frac{\text{Cash}}{\text{Average daily cash expenses}}$$

(\$ in thousands)	2002	2001
Cash to daily cash expenses ratio	$\frac{\$31,758}{\$382,631,365} = 30.3 \text{ days}$	$\frac{\$21,397}{\$321,223,365} = 24.3 \text{ days}$

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Receivables

Accounts Receivable: amounts owed by customers on account

Notes Receivable: claims for which formal instruments of credit are issued evidencing the debt

Other receivables: non-trade receivables e.g. Interest receivable, loans, advances, GST receivable

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Valuing Accounts Receivable

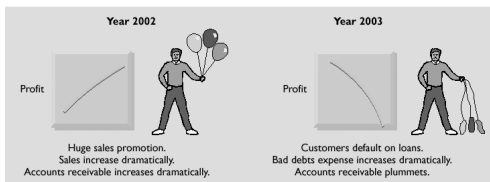
Direct write-off method for uncollectable accounts

Dec. 12	Bad Debts Expense Accounts Receivable—M.E. Doran (To record write-off of M.E. Doran account)	200	200
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Valuing Accounts Receivable

Effects of direct write-off method



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Valuing Accounts Receivable

Allowance method for uncollectable accounts

- Reports receivables at their net realisable value
- Receivables reduced by *estimated* uncollectable receivables

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Valuing Accounts Receivable

Allowance method for uncollectable accounts

Features:

- Uncollectable accounts receivable are estimates
- Recorded in Bad Debts expense and Allowance for Doubtful Debts account
- Actual uncollectables recorded in Allowance for D/Debts & Accts. Receivable

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Valuing Accounts Receivable

Recording estimated uncollectables

Dec. 31	Bad Debts Expense	12 000	
	Allowance for Doubtful Debts		12 000
	(To record estimate of uncollectable accounts)		

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Valuing Accounts Receivable

Recording estimated uncollectibles

HAMPSON FURNITURE LTD Statement of Financial Position (partial)		
Current assets		
Cash		\$ 14 800
Accounts receivable	\$ 200 000	
Less: Allowance for doubtful debts	<u>12 000</u>	188 000
Inventory		310 000
Prepaid expense		<u>25 000</u>
Total current assets		\$ 537 800

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Valuing Accounts Receivable

Recording the write-off of an uncollectable account

Journal entry

Mar. 1	Allowance for Doubtful Debts	500	
	Accounts Receivable—R.A. Ware (Write-off of R.A. Ware account)		500

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Valuing Accounts Receivable

Recording the write-off of an uncollectable account

General ledger entry

	Before write-off	After write-off
Accounts receivable	\$ 200 000	\$ 199 500
Allowance for doubtful debts	<u>12 000</u>	<u>11 500</u>
Cash realisable value	<u>\$ 188 000</u>	<u>\$ 188 000</u>

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Valuing Accounts Receivable

Recovery of an uncollectable account

(1)					
July	1	Accounts Receivable—R.A. Ware	500		
		Allowance for Doubtful Debts		500	
(To reverse write-off of R.A. Ware account)					
(2)					
July	1	Cash	500		
		Accounts Receivable—R.A. Ware			500
(To record collection from R.A. Ware)					

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Valuing Accounts Receivable

Estimating the Allowance for Bad Debts

Methods used:

- % of net sales
- Ageing of Accounts Receivable

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Valuing Accounts Receivable

Ageing of Accounts Receivable

Customer	Total	Not yet due	Number of days past due			
			1-30	31-60	61-90	Over 90
T.E. Adert	\$ 600		\$ 300		\$ 200	\$ 100
R.C. Bortz	26 300	\$26 300				
B.A. Carl	450		200	\$ 250		
O.L. Diker	700	500			200	
T.O. Ebbet	600			300		300
Riley & Sons Ltd	10 950	200	5 200	2 450	1 600	1 500
	<u>\$39 600</u>	<u>\$27 000</u>	<u>\$5 700</u>	<u>\$3 000</u>	<u>\$2 000</u>	<u>\$1 900</u>
Estimated percentage uncollectable		2%	4%	10%	20%	40%
Total estimated bad debts	\$ 2 228	\$ 540	\$ 228	\$ 300	\$ 400	\$ 760

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Notes Receivable

- A formal credit instrument
- Do not always arise from transactions with customers
- Included as an asset in Financial Statements

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Notes Receivable (cont.)

- Example:

\$1000 ← Amount in figures Brent Ltd ← Issuer Issue Date: 1 May 2003
 Due Date: 30 June 2003 ← Date of issue
 ← Date payable Brent Ltd promises to pay 2468 ← Serial no.
 to the order of Wilma Ltd ← Payee
 One Thousand Dollars Only ← Amount in words
 upon presentation and surrender of this note.
 Payable at the following offices of the Commonwealth Trading Bank
 25 Bank St Sydney ← Place of payment
 For and on behalf of Brent Ltd
Debbie Miller
 Authorised signature

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Notes Receivable

Recognising notes receivable

May	1	Notes Receivable	1 000	
		Accounts Receivable—Brent Ltd		1 000
		(To record acceptance of Brent Ltd note)		

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Notes Receivable

Disposing of notes receivable

July	1	Cash	1 000	
		Notes Receivable		1 000
(To record collection of Brent Ltd note)				

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Notes Receivable

Exchanging notes receivable

June	1	Cash	990	
		Interest Expense	10	
		Note Receivable		1 000
(To record discounting the note from Brent at 1%)				

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Managing Receivables

- Determine to whom to extend credit
- Establish a payment period
- Monitor collections
- Evaluate the receivables balance
- Accelerate cash receipts from receivables when necessary

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Monitoring collections

Credit risk ratio: measure of the risk that customers may not pay their accounts

Allowance for Doubtful Debts
Accounts Receivable

(\$ in millions)	2001	2000
Credit risk ratio	$\frac{\$9.2}{\$194.4} = 4.7\%$	$\frac{\$9.8}{\$194.1} = 5.1\%$

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Evaluating Receivables balance

Receivables turnover: number of times on average receivables are collected

Net Credit Sales
average Net Receivables

convert 'times' to days:

$\frac{365}{\text{Receivables turnover}}$

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Evaluating Receivables balance

Receivables turnover

Example:

Receivables turnover = $\frac{\text{Net credit sales}}{\text{Average net receivables}}$			
Average collection period = $\frac{365}{\text{Receivables turnover}}$			
(\$ in thousands)			
Austar	Receivables turnover	2000 $\frac{\$384,516}{(\$17,524 + \$11,927)/2} = 26.1 \text{ times}$	1999 $\frac{\$145,239}{(\$11,927 + \$85,401)/2} = 14.2 \text{ times}$
	Average collection period	$\frac{365}{26.1} = 14.0 \text{ days}$	$\frac{365}{14.2} = 25.7 \text{ days}$

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Accelerating cash receipts

1. Receivables may be sold due to:
- size of the debt
 - being the only reasonable source of cash
 - reduce cost of invoicing and collection

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Accelerating cash receipts

- Use of Credit card sales
- Translates to more sales without bad debts for the retailer

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Petty Cash Fund

- Establishing the Petty cash Fund

Mar.	1	Petty Cash	100	
		Cash at Bank		100
		(To establish a petty cash fund)		

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Petty Cash Fund

- Making payments from the fund
- Amount of expenditure limited
- Receipt for the expense required
- Petty cash voucher for the expense signed by authorised person

Note: sum of cash receipts and monies in fund should equal the petty cash total

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Petty Cash Fund

- Replenishing the fund

Mar. 15	Postage Expense	44	
	Supplies	38	
	Miscellaneous Expense	5	
	Cash at Bank		87
	(To replenish petty cash fund)		

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