INTERNAL CONTROL

- **Internal control** consists of all the processes used by management to achieve effective and efficient operations, compliance with laws, etc.
- It includes policies to:
  - safeguard assets
  - enhance accuracy and reliability of accounting records
- It is an essential part of risk management

Principles of internal control

1. **Establishment of responsibility**
   - Assignment of responsibility to specific individuals
   - Monitoring of compliance with procedures
2. **Segregation of duties**
   - Responsibility for related activities assigned to different people
   - Separation of responsibility for recording and physical custody of the asset
3. Documentation procedures
- All documents generated by the business to be pre-numbered
- Documents to be initialled
- Provides an audit trail for checking of transactions

4. Physical, mechanical and 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

5. Independent internal verification
- Checking procedures to ensure segregation of duties
- Monitoring by supervisors
- Verification by internal auditor
- Rotation of duties
Limitations of internal control

- **Cost vs. 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**

CASH

- **Cash** is the most desirable asset because it is readily convertible into any other asset
- **Cash consists of**
  - Cash on hand (notes and coins)
  - Cash at bank
  - Cheque accounts
  - Cash equivalents (bank overdrafts, deposits on money market, 90-day bank acceptance bills)

Internal control of cash

1. **Internal control over cash receipts**
   a. Establishment of responsibility
      • authorised personnel handle cash receipts
   b. Segregation of duties
      • different individuals handle cash, record cash receipts and hold the cash
   c. Documentation procedures
      • remittance advices, cash register tapes, deposit slips used
Internal control of cash continued

d. Physical, mechanical and electronic controls
   • cash stored securely, cash banked frequently, cash registers used/direct deposits

e. Independent verification
   • cash receipts counted daily, comparison of receipts to bank deposits

Internal control of cash continued

2. Internal control over cash payments
   a. Establishment of responsibility
      • authorised personnel only to sign cheques
   b. Segregation of duties
      • separate tasks of approving and making payments, signatory not to record the payment, limit knowledge of PIN, etc.
   c. Documentation procedures
      • pre-numbered cheques, approved invoices, account marked as paid

Internal control of cash continued

d. Physical, mechanical and electronic controls
   • blank cheques stored securely, limited access

e. Independent internal verification
   • compare cheques to invoices, reconcile bank statement monthly
Internal control of cash continued

• Petty cash fund
  – A petty cash fund is a cash fund used to pay relatively small amounts
  – Operation of a petty cash fund is covered in the Appendix

Bank reconciliation

• The use of a bank contributes significantly to good internal control over cash by:
  – Minimising the amount of cash that must be kept on hand
  – Providing a double record of all bank transactions
    • one by the business
    • one by the bank

Bank reconciliation continued

– Helping a company safeguard its cash by using a bank as a depository and clearinghouse for cheques received and written
Bank reconciliation continued

Reconciling the bank account

• Lack of agreement between firm’s books and bank statement can result for two main reasons:
  – Time lags
  – Errors

Bank reconciliation continued

• Time lags prevent the parties recording transactions 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

Bank reconciliation continued

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
Steps in the reconciliation procedure
1. 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

2. Identify ‘unticked’ items on bank statement
   - Adjust cashbook for dishonoured cheques and direct deposits
   - Outstanding deposits and unpresented cheques recorded in bank reconciliation statement
   - Outstanding items carried forward to next bank reconciliation

3. Total cash journals and post to Cash at Bank ledger
4. 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
Bank reconciliation continued

- Illustrated example
  - Work through the bank reconciliation illustrated for W.A. Laird Pty Ltd
  - Compare your results with the suggested solution provided

Managing and monitoring cash

Operating cycle of a retail business

Managing and monitoring cash continued

Basic principles of cash management
1. Increase the speed of collection of receivables
2. Keep inventory levels low
3. Don’t pay earlier than necessary
4. Plan timing of major expenditures
5. Invest idle cash
ASSESSING CASH ADEQUACY

Ratio of cash to daily cash expenses

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

\[
\text{Cash} \div \text{Average daily cash expenses}
\]

<table>
<thead>
<tr>
<th>($ in thousands)</th>
<th>2008</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fantastic Holdings</td>
<td>$8,072</td>
<td>$5,988</td>
</tr>
<tr>
<td>$322,929 / 365</td>
<td>$288,512 / 365</td>
<td></td>
</tr>
<tr>
<td>= 9.1 days</td>
<td>= 7.6 days</td>
<td></td>
</tr>
</tbody>
</table>

RECEIVABLES

- Accounts receivable are amounts owed by customers on account
- Notes receivable are claims for which formal instruments of credit are issued evidencing the debt
- Other receivables include non-trade receivables such as interest receivable, loans, advances and GST receivable

If a client sought your advice on how best to manage receivables, what would you suggest?
Accounting for receivables

- Accounts receivable are the most significant receivables for most firms
- 3 accounting problems associated with accounts receivable are:
  - Recognising accounts receivable
  - Valuing accounts receivable
  - Accelerating cash receipts from receivables

Valuing accounts receivable

1. Direct write-off method

- Bad debts expense is recognised when the uncollectable account is specifically identified and written off
- Receivables are reported at gross amount

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

Effects of direct write-off method

YEAR 2009
- Profit soars
  - Huge sales promotion
  - Sales increase dramatically
  - Accounts receivable increases dramatically

YEAR 2010
- Profit plummets
  - Customers default on loans
  - Bad debts expense increases dramatically
  - Accounts receivable plummets
Accounting for receivables continued

2. Allowance method for uncollectible accounts
   - Receivables reported at their NRV
   - Receivables reduced by *estimated* uncollectable receivables
   - Journal entries
     a. *Estimated* uncollectables recorded in Bad Debts Expense (Dr) and Allowance for Doubtful Debts (Cr) accounts
     b. *Actual* uncollectables recorded in Allowance for Doubtful Debts (Dr) and Accounts Receivable (Cr) accounts

Accounting for receivables continued

• Recording estimated uncollectables by allowance method — journal entry

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

Accounting for receivables continued

• Recording estimated uncollectables by allowance method — Statement of Financial Position

<table>
<thead>
<tr>
<th>HAMPSON FURNITURE LTD Statement of Financial Position (partial)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Assets</td>
</tr>
<tr>
<td>Cash</td>
</tr>
<tr>
<td>Accounts receivable</td>
</tr>
<tr>
<td>Less: Allowance for doubtful debts</td>
</tr>
<tr>
<td>Inventory</td>
</tr>
<tr>
<td>Prepaid expenses</td>
</tr>
<tr>
<td>Total current assets</td>
</tr>
</tbody>
</table>
Accounting for receivables continued

- Recording the write-off of an uncollectable account by the allowance method:
  - Journal entry

<table>
<thead>
<tr>
<th>Date</th>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mar 1</td>
<td>Allowance for Doubtful Debts</td>
<td>500</td>
</tr>
<tr>
<td></td>
<td>Accounts Receivable – R.A. Ware</td>
<td>500</td>
</tr>
</tbody>
</table>

(To record write-off of R.A. Ware account)

- Statement of Financial Position

<table>
<thead>
<tr>
<th>Before write-off</th>
<th>After write-off</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
<td>$200,000</td>
</tr>
<tr>
<td>Allowance for doubtful debts</td>
<td>12,000</td>
</tr>
<tr>
<td>Cash realisable value</td>
<td>$188,000</td>
</tr>
</tbody>
</table>

Accounting for receivables continued

- Recovery of an uncollectable account
  - 2 journal entries:

<table>
<thead>
<tr>
<th>Date</th>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jul 1</td>
<td>Accounts Receivable – R.A. Ware</td>
<td>500</td>
</tr>
<tr>
<td></td>
<td>Allowance for Doubtful Debts</td>
<td>500</td>
</tr>
</tbody>
</table>

(To reverse write-off of R.A. Ware account)

<table>
<thead>
<tr>
<th>Jul 1</th>
<th>Cash</th>
<th>500</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Accounts Receivable – R.A. Ware</td>
<td>500</td>
</tr>
</tbody>
</table>

(To record collection from R.A. Ware)

Accounting for receivables continued

- Estimating the allowance for bad debts
  - Methods used:
    - The percentage of net sales
    - Ageing of accounts receivable
## Accounting for receivables continued

### Ageing of Accounts Receivable

<table>
<thead>
<tr>
<th>Customer</th>
<th>Total</th>
<th>Not yet due</th>
<th>1–30</th>
<th>31–60</th>
<th>61–90</th>
<th>Over 90</th>
</tr>
</thead>
<tbody>
<tr>
<td>T.F. Adert</td>
<td>$ 600</td>
<td>$ 300</td>
<td>$ 200</td>
<td>$ 200</td>
<td>$ 100</td>
<td></td>
</tr>
<tr>
<td>R.C. B Hall</td>
<td>20,500</td>
<td>20,200</td>
<td>300</td>
<td>200</td>
<td>500</td>
<td></td>
</tr>
<tr>
<td>B.A. Carl</td>
<td>450</td>
<td>200</td>
<td>300</td>
<td>250</td>
<td>800</td>
<td></td>
</tr>
<tr>
<td>O.W. Diller</td>
<td>700</td>
<td>500</td>
<td>300</td>
<td>250</td>
<td>700</td>
<td></td>
</tr>
<tr>
<td>T.O. Elbet</td>
<td>600</td>
<td>200</td>
<td>300</td>
<td>800</td>
<td>500</td>
<td></td>
</tr>
<tr>
<td>Riley &amp; Sons Ltd</td>
<td>10,950</td>
<td>200</td>
<td>500</td>
<td>300</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>Estimated percentage uncollectable</td>
<td>2%</td>
<td>6%</td>
<td>10%</td>
<td>20%</td>
<td>40%</td>
<td></td>
</tr>
<tr>
<td>Total estimated bad debts</td>
<td>$ 2,228</td>
<td>$ 500</td>
<td>$ 228</td>
<td>$ 300</td>
<td>$ 700</td>
<td></td>
</tr>
</tbody>
</table>

---

### Notes receivable

- A note receivable is a formal credit instrument.
- It does not always arise from transactions with customers.
- It is included as an asset in the financial statements.

---

### Allowance for Doubtful Debts

<table>
<thead>
<tr>
<th>Date</th>
<th>Particulars</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Jan. 2009</td>
<td>Opening balance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 Jul.</td>
<td>Wages of A's wife account</td>
<td>500</td>
<td></td>
</tr>
<tr>
<td>31 Dec.</td>
<td>Bad debt expense</td>
<td></td>
<td>500</td>
</tr>
</tbody>
</table>

---
Accounting for receivables continued

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

- Disposing of notes receivable
  Jul 1
  Cash 1 000
  Notes Receivable 1 000
  (To record collection of Brent Ltd note)

Accounting for receivables continued

- Exchanging notes receivable
  Jun 1
  Cash 990
  Interest Expense 10
  Notes Receivable 1 000
  (To record discounting the note from Brent Ltd at 1%)

Managing receivables

1. Determine to whom to extend credit
2. Establish a payment period
3. Monitor collections
4. Evaluate the receivables balance
5. Accelerate cash receipts from receivables when necessary
Managing receivables continued

1. Extending credit  
   - A firm needs to be careful that it does not end up with risky customers as a result of extending its credit policy

2. Establishing a payment period  
   - The payment period should be consistent with that of the firm’s competitors

Managing receivables continued

3. Monitoring collections  
   - Credit risk ratio  
     - measure of the risk that customers may not pay their accounts
     
     | Allowance for Doubtful Debts | Accounts Receivable |
     | ($ in thousands) | 2008 | 2007 |
     | Fantastic Holdings | $30  | $30  |
     | $1,852  | = 1.62% | = 0.98% |
     | $3,073  | |

Managing receivables continued

4. Evaluating the receivables balance  
   a. Receivables turnover  
     - number of times on average receivables are collected

     | Net Credit Sales | Average Net Receivables |  |
     | ($ thousands) | 2008 | 2007 |
     | Qantas | $15,748.80 * 11.2 | $14,828.20 * 11.4 |
     | ($1434.9 + $1376.8)/2 times | ($1376.8 + $1228.7)/2 times |
Managing receivables continued

b. Average collection period
   – convert ‘times’ to days:

   \[
   \text{Average Collection Period} = \frac{365}{\text{Receivables Turnover}}
   \]

<table>
<thead>
<tr>
<th>($) thousands</th>
<th>2008</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Qantas</td>
<td>365</td>
<td>365</td>
</tr>
<tr>
<td></td>
<td>(=) 32.6 days</td>
<td>(=) 32.0 days</td>
</tr>
</tbody>
</table>

5. Accelerating cash receipts
   a. Sale of receivables
      – Reasons for sale:
        • Size of the debt
        • Being the only reasonable source of cash
        • To reduce cost of invoicing and collection
   b. Use of credit card sales
      – Translates to more sales without bad debts for the retailer

APPENDIX
Operation of the petty cash fund

1. Establishing the petty cash fund
   – Journal entry

\[
\begin{align*}
\text{Mar 1} & \quad \text{Petty Cash} & 100 \\
& \quad \text{Cash at Bank} & 100 \\
& \quad \text{(To establish a petty cash fund)} & \\
\end{align*}
\]
APPENDIX continued

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

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

APPENDIX continued

3. Replenishing the fund

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mar 15</td>
<td>Postage Expense</td>
<td>44</td>
</tr>
<tr>
<td></td>
<td>Supplies</td>
<td>38</td>
</tr>
<tr>
<td></td>
<td>Miscellaneous Expense</td>
<td>5</td>
</tr>
<tr>
<td></td>
<td>Cash at Bank</td>
<td>87</td>
</tr>
</tbody>
</table>

   (To replenish petty cash fund)

   – At times the petty cash receipts may not match the cash
   – A cash shortage (or surplus) is debited (or credited) to the *Over and Short Account* (an expense account)

Demonstration problem

- Dylan Ltd
- Work through on your own and check your results with the suggested solution provided