Chapter 7

Internal control, cash and receivables

PowerPoint presentation by Anne Abraham
University of Wollongong
©2009 John Wiley & Sons Australia, Ltd

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
Principles of internal control continued

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

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

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
Reconciling the bank account

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

- 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

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
Bank reconciliation continued

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
Assessing Cash Adequacy

Ratio of cash to daily cash expenses

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

\[
\text{Cash} \quad \text{Average daily cash expenses} \\
\text{($ in thousands) } \quad \text{2006} \quad \text{2005} \\
\text{Cash to daily cash expenses ratio} \quad \$19,322 \quad \$17,779/365 = 41.1 \text{ days} \\
\text{ } \quad \$27,37 \quad \$13,821/365 = 7.2 \text{ days} \\
\]

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

Accounting for receivables continued

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)

Accounting for receivables continued

Effects of direct write-off method

<table>
<thead>
<tr>
<th>YEAR 2009</th>
<th>YEAR 2010</th>
</tr>
</thead>
</table>
| Profit soars
  - Huge sales promotion
  - Sales increase dramatically
  - Accounts receivable increases dramatically |
| Profit plummets
  - Customers default on loans
  - Bad debts expense increases dramatically
  - Accounts receivable plummets |
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

   • 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)

   • Recording estimated uncollectables by allowance method — Balance Sheet

     HAMPSON FURNITURE LTD
     Balance Sheet (partial)

     Current Assets
     Cash $ 14 800
     Accounts receivable $200 000
     Less: Allowance for doubtful debts  12 000 188 000
     Inventory 310 000
     Prepaid expenses 25 000
     Total current assets $537 800
Accounting for receivables continued

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

  Mar 1
  Allowance for Doubtful Debts 500
  Accounts Receivable – R.A. Ware 500
  (To record write-off of R.A. Ware account)

  - Balance Sheet

  Before write-off          | After write-off
  Accounts receivable      | $200 000    | $199 500
  Allowance for doubtful debts | 12 000      | 11 500
  Cash realisable value    | $188 000    | $188 000

Accounting for receivables continued

- Recovery of an uncollectable account
  - 2 journal entries:

  Jul 1
  Accounts Receivable – R.A. Ware 500
  Allowance for Doubtful Debts 500
  (To reverse write-off of R.A. Ware account)

  Jul 1
  Cash 500
  Accounts Receivable – R.A. Ware 500
  (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.E. Adert</td>
<td>$600</td>
<td>$300</td>
<td></td>
<td></td>
<td>$200</td>
<td>$100</td>
</tr>
<tr>
<td>R.C. Bortz</td>
<td>26,300</td>
<td>$20,300</td>
<td></td>
<td></td>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td>B.A. Carl</td>
<td>50</td>
<td>500</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>O.J. Diller</td>
<td>700</td>
<td>500</td>
<td></td>
<td></td>
<td>200</td>
<td></td>
</tr>
<tr>
<td>T.O. Elbet</td>
<td>600</td>
<td>300</td>
<td></td>
<td></td>
<td></td>
<td>300</td>
</tr>
<tr>
<td>Riley &amp; Sons Ltd</td>
<td>10,950</td>
<td>200</td>
<td>2,400</td>
<td>1,600</td>
<td>1,500</td>
<td></td>
</tr>
<tr>
<td>Estimated percentage uncollectable</td>
<td>2%</td>
<td>4%</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>$540</td>
<td>$228</td>
<td>$300</td>
<td>$400</td>
<td>$700</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>Method Used</th>
<th>Rate</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Jan. 2018</td>
<td>Opening balance</td>
<td>2%</td>
<td>$1,200</td>
</tr>
<tr>
<td>1 Mar.</td>
<td>Write-off of A.M. Weeks account</td>
<td>50%</td>
<td>$600</td>
</tr>
<tr>
<td>1 Apr.</td>
<td>Release instead of A.M. Weeks account</td>
<td>50%</td>
<td>$600</td>
</tr>
<tr>
<td>1 May</td>
<td>Bad debt reserve</td>
<td>30%</td>
<td>$1,800</td>
</tr>
<tr>
<td>1 Jun.</td>
<td>Bad debt reserve</td>
<td>30%</td>
<td>$1,800</td>
</tr>
<tr>
<td>1 Jul.</td>
<td>Bad debt reserve</td>
<td>30%</td>
<td>$1,800</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%)
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

3. Monitoring collections
   • Credit risk ratio
     – measure of the risk that customers may not pay their accounts
     Allowance for Doubtful Debts
     Accounts Receivable

<table>
<thead>
<tr>
<th>($ in thousands)</th>
<th>2006</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit risk ratio</td>
<td>$133  = 2.45%</td>
<td>$104  = 2.06%</td>
</tr>
<tr>
<td>($425)</td>
<td>($5053)</td>
<td></td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>($ thousands)</th>
<th>2006</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Qantas</td>
<td>$13,355.40  = 11.3 times</td>
<td>$12,467.20  = 7.7 times</td>
</tr>
<tr>
<td>($12,288.7 + $11,303.3)/2</td>
<td>($11,303.3 + $21,163.3)/2</td>
<td></td>
</tr>
</tbody>
</table>
Managing receivables continued

b. Average collection period
   - convert ‘times’ to days:
   
   \[
   \frac{365}{\text{Receivables Turnover}}
   \]

<table>
<thead>
<tr>
<th>($) thousands</th>
<th>2006</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Qantas</td>
<td>11.3</td>
<td>7.7</td>
</tr>
</tbody>
</table>

Receivables Turnover

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

   Mar 1  Petty Cash  100
   \hspace{1cm} Cash at Bank  100
   \hspace{1cm} (To establish a petty cash fund)
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

3. Replenishing the 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