Learning Objectives

1. Define internal control
2. Describe good internal control procedures
3. Prepare a bank reconciliation and the related journal entries
4. Apply internal control to cash receipts
5. Apply internal control to cash payments
6. Make ethical business judgements

Objective 1

Define internal control.
Internal Control

- What is internal control?
- It is the organisational plan and all the related measures that an entity adopts to...
  - safeguard assets,
  - ensure accurate and reliable accounting records
  - encourage adherence of personal to company policies,
  - promote operational efficiency.

Objective 2

Describe good internal control procedures
Establishing an Effective System of Internal Control

- Characteristics of an effective internal control system include:
  1. Competent, reliable, and ethical personnel
  2. Assignment of responsibilities
  3. Proper authorisation
  4. Separation of duties

Separation of Duties

- Separation of operations from accounting
- Separation of the custody of assets from accounting
- Separation of the authorisation of transactions from the custody of related assets
- Separation of duties within the accounting function

Logical security: Fraud and Information Systems Security

- Security should be assigned to data based on the value of the data and confidentiality requirements.
- Access should be restricted to an exception basis.
- There should be a formal authorisation process for new users.
- Passwords should be changed at first login and then at regular intervals, should be at least six characters and shouldn’t be written down.
Logical security: Fraud and Information System Security

- Reviews of access rights should be undertaken on a risk-determined basis.
- Logs of access rights should be reviewed for suspicious activity.
- Personnel who move throughout the organisation should have their access reviewed to reduce the risk of 'access creep'.
- Personnel who leave the organisation should have their access revoked.
- Access controls should reinforce the segregation of duties.

Internal Controls for e-Commerce

- Stolen credit-card numbers
- Computer viruses and Trojan horses
- Impersonation of companies

Internal Controls for e-Commerce

- What is encryption?
- It is the primary method of achieving confidentiality in e-commerce.
- Plain-text messages are rearranged by some mathematical process.
- The encrypted message cannot be read by anyone who does not know the process.
Internal Controls for e-Commerce

- What are firewalls?
- They limit access to a local network to keep out intruders
- They enable members of the local network to access the Internet while keeping non-members out of the network
- There are usually several firewalls built into a local network

The Limitations of Internal Control

- Most internal control measures can be circumvented or overcome.
- Collusion is when two or more employees work as a team with the purpose to defraud the firm.

The Bank Account as a Control Device

- Documents used to control a bank account include:
  - signature card
  - deposit slip
  - cheque
  - bank statement
  - bank reconciliation
The Bank Reconciliation

- What are the two records of a business’ cash?
  1. **Cash account** in the business’s own general ledger.
  2. **The bank statement** which tells the actual amount of cash the business has in the bank.

The Bank Reconciliation

- Items recorded by a company not on the bank statement:
  - deposits in transit
  - outstanding cheques

The Bank Reconciliation

- Items on a bank statement and not recorded by the business:
  - bank collections
  - electronic funds transfers
  - service charges
  - interest earned or paid on account
  - NSF cheques (bounced cheques)
Objective 3

Prepare a bank reconciliation and the related journal entries.

Steps

1. Start with two figures, the balance shown on the bank statement (balance per bank) and the balance in the firm’s Cash at Bank account (balance per books).
2. Add to, or subtract from, the bank balance those items that appear on the books but not on the bank statement (the bank side of the reconciliation):
   a) Add deposits in transit to the bank balance.
   b) Subtract outstanding cheques from the bank balance.
   c) Calculate the adjusted bank balance.

Steps

3. After checking their correctness, journalise those items that appear on the bank statement but not on the firm’s books
   a) Debit to Cash at Bank (1) bank collections, (2) EFT cash receipts, and (3) interest revenue earned on money in the bank.
   b) Credit to Cash at Bank (1) EFT cash payments, (2) service charges, (3) cost of printed cheques, and (4) other bank charges (for example, charges for dishonoured cheques or stale-date cheques).
Steps

4. Compare the *adjusted bank balance* and the *adjusted book balance*. The two adjusted balances should be equal.

5. Notify the bank of any errors it has made.

The Bank Reconciliation Example

- At the beginning of July, Tran Limited received June’s bank statement.
- It indicated the following:
  - The bank balance was $63,275.
  - The bank had collected a note receivable from one of Tran’s customers for the amount of $1,325.
  - The bank paid the electric bill of $1,500.
  - There was a $200 cheque returned for NSF.
  - Interest earned on the account was $265.
  - Bank service charges were $12.
The Bank Reconciliation Example

- Tran’s books indicate a cash balance of $66,647.
- A deposit of $11,250 was mailed to the bank on June 30.
- Cheques issued in June for $8,000 have not yet been paid by the bank.

Balance per bank, June 30 $63,275
Add deposit in transit 11,250
$74,525
Less outstanding cheque 8,000
Adjusted bank balance $66,525

Balance per books, June 30 $66,647
Add: Note receivable collected by the bank 1,325
Interest revenue 265
$68,237
Less: Payment of electric bill 1,500
NSF cheque 200
Service charge 12
Adjusted book balance $66,525
The Bank Reconciliation Example

Balance per books $66,525
Balance per bank $66,525

Equal amounts

Record Reconciling Items

June 30, 20X0
Cash 1,325
Bills Receivable 1,325
Bill collected by the bank

June 30, 20X0
Cash 265
Interest Revenue 265
Interest earned on bank balance

Record Reconciling Items

June 30, 20X0
Electricity Expense 1,500
Cash 1,500
Monthly electricity expense

June 30, 20X0
Accounts Receivable – NSF 200
Cash 200
NSF cheque returned by bank
Record Reconciling Items

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 30, 20X0</td>
<td>Bank Service Fees</td>
<td>12</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td>12</td>
</tr>
</tbody>
</table>

Objective 4

Apply internal controls to cash receipts.

Cash Receipts Over the Counter

- The terminal should be positioned so that customers can see the amount the cashier enters into the cash register.
- The cash drawer should open only when the sales clerk enters an amount on the keypad.
- The roll of tape locked inside the machine records each sale and cash transaction.
Cash Receipts Over the Counter

- Pricing merchandise at “uneven” amounts means that the sales assistant has to open the cash drawer.
- This requires entering the amount of the sale on the keypad and so onto the register.

Cash Receipts Over the Counter

- At the end of the day, the cashier deposits the cash in the bank.
- The register record goes to accounting.

Cash Receipts by Mail

- All incoming mail should be opened by a mailroom employee.
- This person should compare the cheques received with the remittance advice.
- Cash receipts should be given to the cashier.
- The mailroom employee forwards the remittance advice to accounting.
Cash Receipts by Mail

- Many companies use a *bank direct deposit system*.
- Customers send their cheques directly to an address that is a bank account. Or use electronic funds transfer (or net banking).
- Company personnel do not handle the cash.

Cash Short and Over

- Assume that the cash register tapes indicate sales revenue of $25,000.
- However, the cash received was $24,980.
- What entry would record the day’s sales?

<table>
<thead>
<tr>
<th>Cash</th>
<th>24,980</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Short and Over</td>
<td>20</td>
</tr>
<tr>
<td>Sales Revenue</td>
<td>25,000</td>
</tr>
</tbody>
</table>

Daily cash sales

Objective 5

**Apply internal controls to cash payments.**
Control Over Approval of Payments

- The accounting department...
  - combines all of these documents,
  - checks them for accuracy, and...
  - forwards this document set to
designated officers for approval and
payment.

Controlling Petty Cash Payments

- On June 15, Tran Pty Ltd decided to
  establish a $250 petty cash fund.
- What is the entry?

  June 15, 20X0
  Petty Cash        250
  Cash in Bank      250
  To open the petty cash fund
Controlling Petty Cash Payments

- Ly is the petty cash custodian responsible for the fund.
- On June 20, she purchased supplies in the amount of $70.
- For each disbursement, she prepares a petty cash slip.
- At all times the amount of cash in the petty cash fund plus the petty cash slip must (should) equal $250.

- Ly also spent $20 for delivery charges and $60 for coffee and other miscellaneous expenses.
- What is the journal entry to record the replenishment of the fund?

**Journal Entry**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Supplies 70</td>
<td>Delivery Expense 20</td>
</tr>
<tr>
<td>Miscellaneous Expense 60</td>
<td>Cash in Bank 150</td>
</tr>
<tr>
<td><strong>To replenish the petty cash fund</strong></td>
<td><strong>To replenish the petty cash fund</strong></td>
</tr>
</tbody>
</table>
Reporting Cash on the balance sheet

- Cash is the first current asset listed on the balance sheet of most businesses.
- Most businesses have several bank accounts and one or more petty cash funds.
- Will normally combine all under a single "Cash" or similar account.
- Will also include liquid assets such as term deposits.

Objective 6

Make ethical business judgements.

Ethics and Accounting

- Most businesses have a code of ethics.
- CPAA, ICAA and CIMA were discussed in Chapter 1 have a joint code of conduct.
- Decision guidelines: (page 382-3 text)
  - What are the facts?
  - Identify the ethical issue
  - What are the options?
  - What are the possible consequences?
  - What shall I do?