Chapter 8
Internal control and cash

Learning objectives
• Define internal control
• List and describe the components of internal control and control procedures
• Describe control procedures unique to e-commerce
• Demonstrate the use of a bank account as a control device
• Prepare a bank reconciliation and the related journal entries
• Apply internal controls to cash receipts
• Apply internal controls to cash payments
• Explain and journalise petty cash transactions
• Identify ethical dilemmas in an internal control situation

Internal control
Internal control is the organisational plan and all the related measures designed to accomplish the following

1. Safeguard assets
2. Encourage employees to follow organisation policy
3. Promote operational efficiency
4. Ensure accurate, reliable accounting records
The components of internal control

A business can achieve its internal control objectives by applying five components

- Monitoring of controls
- Information system
- Control procedures
- Control environment
- Risk assessment

Companies hire auditors to monitor their controls

- Internal auditors are employees of the business who ensure that the company’s employees are following company policies and that operations are running efficiently
- External auditors are outside accountants who are completely independent of the business
- They evaluate the controls to ensure that the financial statements are presented fairly in accordance with the proper accounting principles and practices

Controls must be in place within the information system to ensure that only authorised users have access to various parts of the accounting information system

- Control procedures are designed to ensure that the business’ goals are achieved
- The control environment is the ‘tone at the top’ of the business
- As part of the internal control system, the company’s business risk, as well as risk over individual accounts, must be assessed
An effective internal control system

- Employees should be competent, reliable and ethical
- Each employee is assigned certain responsibilities. All duties should be clearly defined and assigned to individuals who bear responsibility for carrying them out
- An organisation generally has a written set of rules that outline approved procedures. Any deviation from standard policy requires proper authorisation
- Separation of duties limits the chances for fraud and promotes the accuracy of the accounting records
- An audit is an examination of the firm’s financial statements and the accounting systems, controls and records that produced them

- Business documents and records vary considerably, from source documents such as invoices and purchase orders to special journals and subsidiary ledgers. Documents should be pre-numbered
- Computers produce accurate records and enhance operational efficiency, but they don’t automatically safeguard assets or encourage employees to behave in accordance with organisational policies
- Businesses of all types keep cash and important business documents in fireproof vaults and use burglar alarms to protect buildings and other property

Internal controls for e-commerce

Risks
- Stolen credit card numbers and passwords
- Computer viruses and Trojans
- Phishing Expeditions

Security measures
- Encryption
- Firewalls
Internal controls for e-commerce

Collusion
Two or more employees work together to defraud the company

Cost
The stricter the internal control, the greater the cost

The bank account as a control device

- Cash is easy to conceal, easy to move and relatively easy to steal. As a result, most businesses use an elaborate system of internal controls to safeguard and manage their cash
- Keeping cash in a bank account is an important part of internal control
- The documents used to control a bank account include the signature card, the deposit slip, the cheque, the bank statement and the bank reconciliation

The bank reconciliation

- There are two records of a business’ cash, namely its Cash account in its own general ledger and the bank statement, which tells the actual amount of cash the business has in the bank
- The balance in the business’ Cash account rarely equals the balance shown on the bank statement at any particular date
- Differences arise because of a time lag in recording transactions
- To ensure accuracy of the financial records, the firm’s accountant must explain all differences between the firm’s own cash records and the bank statement figures on a certain date
- The result of this process is a document called the bank reconciliation
The bank reconciliation

- The bank reconciliation is an accountant’s tool separate from the journals and ledgers
- It does not account for transactions in the journal
- The bank reconciliation acts as a control device

Preparing the bank reconciliation

- Step 1: Start with two figures, the balance shown on the bank statement (balance per bank) and the balance in the firm’s Cash account (balance per books)
- Step 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)
- Step 3: After checking their correctness, journalise those items that appear on the bank statement but not on the firm’s books (the book side of the reconciliation)
- Step 4: Compare the adjusted bank balance and the adjusted book balance
- Step 5: Notify the bank of any errors it has made

Internet banking

![Exhibit 8.8 Online banking—account history (like a bank statement)](image)
Internal control over cash receipts

- Internal control over cash receipts ensures that all cash receipts are deposited in the bank quickly and that the firm’s accounting record is correct.
- The point-of-sale terminal (cash register) offers management control over the cash received in a store.
- All incoming mail should be opened by a mailroom employee. This person should compare the amount of the cheque received with the attached remittance advice.
- A difference often exists between actual cash receipts and the day’s record of cash received. Usually, the difference is small and results from honest errors.
- When the recorded cash balance exceeds cash on hand, a cash short situation exists. When actual cash exceeds the recorded cash balance, there is a cash over situation.

Internal control over cash payments

- Payment by cheque is an important control over cash payments.
- The cheque acts as a source document.
- To be valid, the cheque must be signed by an authorised official.
- Before signing the cheque, the manager should study the evidence supporting the payment.
Controls over purchase and payment

The petty cash fund

- Cash fund on site to pay for small expenditures
- Designate a custodian of petty cash fund
- Keep a specific amount of cash on hand
- All payments are supported with a petty cash slip
- Replenish the fund through normal cash payment procedures

Setting up the petty cash fund

The petty cash fund is opened when a payment is approved for a predetermined amount and a cheque for that amount is issued to Petty cash

<table>
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<th>Date</th>
<th>Account title</th>
<th>Dr</th>
<th>Cr</th>
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<tbody>
<tr>
<td>Feb 28</td>
<td>Petty cash (A+)</td>
<td>200</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash (A–)</td>
<td>200</td>
<td></td>
</tr>
</tbody>
</table>

To open the petty cash fund.
Setting up the petty cash fund

- For each petty cash payment, the custodian prepares a petty cash slip.
- The sum of the cash plus the total of the slip amounts should equal the opening balance at all times.
- Maintaining the Petty cash account at this balance, supported by the fund (cash plus slips totalling the same amount), is a characteristic of an imprest system.
- In an imprest system, the amount of cash for which the custodian is responsible is clearly identified.
- Payments reduce the amount of cash in the fund, so periodically the fund must be replenished.
- Missing petty cash funds are either debited or credited to Cash short and over.

Ethics and accounting

- Most large businesses have a code of ethics embodied in a set of principles of good corporate governance.
- As professionals, accountants are expected to maintain higher standards than society in general.
- Unacceptable actions can result in expulsion from the professional body.

Summary: Chapter 8

- Internal control is the organisational plan and all the related measures designed to safeguard assets, encourage employees to follow organisation policy, promote operational efficiency, ensure accurate, reliable accounting records.
- Cash is easy to conceal, easy to move and relatively easy to steal. As a result, most businesses use an elaborate system of internal controls to safeguard and manage their cash.
- The bank reconciliation acts as a control device.
- The petty cash fund is used to pay for small expenditures.