

CHAPTER 9: INTERNAL CONTROL

Review Questions 9.1

1. *What is a bad debt?*

A debt which the business does not expect to be repaid. The business owner writes it off, knowing that the debt is unlikely to be paid by the customer.

2. *List two advantages of internal control.*

For example:

- Lessen accidental errors
- Keep accurate records
- Ensure transactions are properly authorised
- Minimise wastage
- Safeguard assets against theft and fraud

3. *Define internal control.*

The overall methods and procedures which a business adopts in order to ensure that assets are safeguarded, correct procedures, policies, regulations and laws are adhered to, financial information is valid and that the effectiveness and efficiency of the business is improved.

4. *What is the difference between administrative controls and accounting controls?*

Administrative controls are designed to promote overall operational efficiency, effectiveness, and adherence to the policies and procedures that management have put into place for the business. Accounting controls are designed to safeguard business assets and ensure the accuracy of financial records. An accounting control is anything (methods or procedures) that aims to limit the possibility of a transaction being manipulated.

5. *Suggest inventory control methods that a bookshop retailer could implement.*

For example:

- Protect from weather by not displaying outside the shop or in sunlight
- Use sticker tags to prevent theft
- Seal expensive books and have one only as a display item so that books are not damaged by customers looking through them
- Lock display cabinets

6. *List two internal control measures over non-current assets.*

For example:

- Use of an Asset Register
- Having a formal approval process for the purchase of new assets
- Locking assets away securely
- Determining correct depreciation methods and scrap values
- Insuring all assets adequately
- Distributing responsibilities for maintenance, storage and recording
- Tagging and numbering all assets
- Regular security checks.

7. *Write an internal control policy over accounts receivable for a dentist.*

The management of accounts receivable for a dentist may include some of the following:

- Invoices should be issued on a timely basis - as the customer is finishing each appointment.
- Invoices should be issued in numerical sequence, and large bills broken down into manageable amounts.
- Different people should be responsible for billing and maintaining accounts receivable records, receiving or handling incoming payments and reconciling receivable records to the general ledger.
- Late accounts should be followed up regularly to facilitate payment.

Review Questions 9.2

1. *What should a business owner do if they are having trouble paying their accounts payable?*

The business owner should get in touch with the creditor as soon as it becomes apparent that there might be difficulty in meeting a payment deadline. They must keep a positive relationship with creditors and open communication lines, this should enable them to negotiate a new payment schedule.

2. *What are two things a business needs to consider before extending credit to a customer?*

For example:

- Credit history
- Employment history
- Security
- Bad debts

3. *List and explain three limitations of internal control.*

For example:

- If the business does not have many staff the owner may not be able to segregate duties properly
- Human error
- Employee conspiracy
- May not pick up unusual, out of the ordinary transactions
- Controls can be overridden
- Needs constant review

4. *Summarise the steps a small business owner should follow when deciding whether to extend credit to a customer.*

Develop a credit policy that examines potential debtors credit history, ability to pay and any security they might offer for a large debt.

Chapter 9 Activities

1. INTERNAL CONTROL OVER CASH

- A. Yes Sally must adopt internal control measures over cash. Cash is vital to her small business so it must be protected.
- B. Sally could adopt the following controls over cash:
- Different employees should be responsible for receiving and recording cash collections, balancing daily cash receipts to related cash recordings and verifying that the deposit amounts reflected in the general ledger match the departmental records. As the business only has two employees these duties will be split between Sally and the receptionist. As the business is too small to allow for proper role segregation, Sally must be aware of this shortcoming and periodically do additional checks to ensure that the cash funds are being adequately protected.
 - Separate, lockable containers should be available for Sally and the receptionist. The money should be locked and keys to the cash box be available only to them. The work experience student should not have access to this. The cash should be locked in a drawer or safe overnight.
 - If cash is kept in a safe, the safe combination should be changed regularly.
 - Cash should be counted in a secure area where the person is free from interruptions.
 - Cash should be banked either at the end of each day or weekly depending on how large the amounts are.
 - All cash receipts should be recorded on a cash receipt form, cash register or a properly controlled computer database at the time of receipt.
 - If the work experience student does the banking, Sally must fill in the amount and check when the student arrives back at the office that it was all banked.
- C. The advantages of using internal control for Sally's business include:
- Lessening accidental errors
 - Keeping accurate records
 - Ensuring transactions are properly authorised
 - Minimising wastage
 - Safeguarding assets against theft and fraud

2. INTERNAL CONTROL OVER INVENTORY

- A. Jeremy may have some of the surfboards which are outside the shop stolen as they are not always being watched. Also, some of the surfboards outside may fade due to the exposure to the outside elements of wind, rain and sun. Because Jeremy gets different friends to deliver the surfboards to the shop, some of the boards may be damaged as not all the cars will be suitable for transporting surfboards.
- B. Possible inventory control methods for Jeremy's surfboard inventory:
- protect surfboards from sun damage by not displaying them outside the shop
 - use protective bags to transport surfboards
 - use a reputable transport company for delivering the surfboards
 - secure stock that is displayed outside
 - install security cameras to prevent theft by customers.

3. DEFINITIONS

- A. Internal control refers to the overall methods and procedures that a business adopts in order to ensure that:
- assets are safeguarded
 - correct procedures, policies, regulations and laws are followed by employees
 - financial reports and records are valid
 - the effectiveness and efficiency of business operations are improved.
- B. Administrative controls refer to any method or procedure that has been implemented to promote the overall operational efficiency, effectiveness, and adherence to the policies and procedures that management have put into place for the business.
- C. An accounting control is any methods or procedures that aim to limit the possibility of a transaction being manipulated. They exist to make sure that:
- errors do not accidentally occur
 - errors do not deliberately occur through manipulation
 - records are kept accurately
 - transactions are authorised correctly
- D.
- **Cash** = money that is legal tender such as coins and notes.
 - **Inventory** = the stock or goods that a trading or retail business has for sale.
 - **Accounts receivable** = individuals and businesses that owe the business entity money
 - **Accounts payable** = individuals and businesses that the business entity owes money.
 - **Non-current assets** = items of value to the business that will be kept in the business, being used to earn income, for a period of time usually longer than 5 years.

4. INTERNAL CONTROL OVER NON-CURRENT ASSETS

- A. Darwin has no safety guidelines and operating instructions to ensure machinery is operated efficiently. He has no locks on his garage, or fence and locked gate, to prevent vandalism or theft. He provides no training in the correct use of carpentry equipment for his friends.
- B. Darwin could introduce the following controls over non-current assets:
- safety guidelines and operating instructions to ensure machinery is operated efficiently
 - locks on garage to prevent theft or vandalism
 - installation of a fence and locked gate to prevent theft or vandalism
 - staff training in the correct use of carpentry equipment
 - the observance of legal noise level requirements when loud manufacturing equipment is being used - find this out from the local council
 - the recording all relevant details of each non-current asset in an Asset Register
 - keeping the Asset Register up to date to ensure all assets are accounted for, maintained when required, and disposed of when they are no longer of use.

5. INTERNAL CONTROL OVER ACCOUNTS PAYABLE

Tilly can manage her accounts payable by, for example:

- contacting creditors as soon as it becomes apparent that there might be difficulty in meeting a payment deadline, especially in the last week of every month, to organise new payment plans
- banking all cheques daily so that cashflow does not dry up
- keeping a positive relationship with creditors and open communication lines so they know what is happening. Most businesses prefer a late payment to no payment
- forecasting potential cash flow problems and comparing them with payment deadlines
- taking advantage of discounts for early payment
- using a computerised accounting system to keep track of deadlines.

6. ACCOUNTS RECEIVABLE AND SUPPLYING CREDIT

A. To manage accounts receivable Bobbi can, for example:

- keep contact details of customers so they can be contacted if they have forgotten to pick up their dry cleaning
- follow up late accounts regularly to facilitate payment – an SMS reminder could be used
- set up a specific set of procedures for determining bad debts and collection actions
- make customers pay for their dry cleaning when they bring it in rather than when they pick it up.

B. Winfred

- i. Extending credit facilities to customers can increase business, as some people want to take advantage of buying a luxury car but are unable to pay up front. However, the downside of extending credit is that Winfred then has to make sure all his customers pay. There is a risk that some customers will not pay and will end up being a bad debt. Winfred should therefore not extend credit to all customers, but rather only to those who have a good credit history and the regular income that will allow them to meet their repayments.
- ii. As part of internal control systems over accounts receivable, Winfred will have to create a policy for supplying credit to customers. Some of the areas he must consider are:
 - **Credit history:** this is a record of the prospective customers past borrowing and repaying history. It will list all personal and business information, credit lines currently being utilised and the two biggest risk factors – whether the prospective customer makes late payments or has had a bankruptcy in the last 7 years. It is relatively simple to obtain a credit history in Australia.
 - **Employment history:** if credit is to be extended to someone, it helps to know whether that person is employed and how long they have been employed. A person with a good employment history is less likely to default on paying their bill.
 - **Security:** this is what a business promises if it is unable to pay its bill. The business should very rarely lend money without this. If a customer does not have enough of his or her own assets to offer as collateral/security, then the business may accept someone acting as a guarantor for the extended line of credit. This means that if the customer cannot pay, the person who has acted as the guarantor will have to make the payments.
 - **Bad debts:** the business needs to consider the likelihood that the customer could become a bad debt and if so, to what extent this would affect the business.

7. LIMITATIONS OF INTERNAL CONTROL

A. Monty

- i. No internal control system is perfect – some of the reasons why are:
- Staff size – if the business does not have enough staff, these limitations may prevent the owner from implementing a system of segregating duties properly.
 - Humans can and do make errors – this inaccuracy may lead to a seemingly perfect internal control system being not as effective as it was designed to be.
 - If two or more people conspire together to falsely report an activity to protect themselves, then the internal control system will probably not pick up on this.
 - Most internal control systems are designed to monitor the usual everyday transactions of the business and will not pick up on the unusual, out of the ordinary transactions.
 - People in management can override a control making the overall system vulnerable.
 - The controls may need to be reviewed and changed if the business grows or changes the way it currently operates. Without such changes, the existing system could be ineffective and irrelevant. This is a limitation if the owner does not constantly review the system.
 - Businesses design internal control systems to be cost effective – this objective means that some errors may never be detected.
- ii. As cheques are pre-numbered each one should be recorded against the account payable immediately when it is issued. Another employee can double check that the correct procedure has been followed, such as the owner when they sign the cheques. The processed invoice and bills should be filed correctly both in physical copy (which could be scanned) and in the accounting records on the computer. Reconciliations should be regularly carried out.

B. Ingrid needs:

- The stock to have security, such as tags and a beeper to detect customers going out of the shop, a video surveillance camera or a security guard
- Stock in the back office to be secure and locked
- A lockable display cabinet in the main shop for the small items of equipment
- Stock to be protected from the elements, so the window needs to be fixed straight away. The broken window is ruining stock and could potentially help a burglar get into and out of the storage area
- The rotation of duties among the three staff with regard to checking the daily takings and
- banking them. Having the same administration person completing all these is poor internal control.

8. INVENTORY CONTROL

- **Accidents:** health and safety guidelines, staff training
- **Employee error:** segregation of duties so that there is a double check being done of inventory movement, check daily totals
- **Customer theft:** Security cameras, tags, staff training in monitoring of customers, lockable cabinets for small expensive items
- **Employee theft:** Security cameras, different employees responsible for different areas of inventory management, secure storage areas, physical security and surveillance of cash register area (also for employee safety), authorisation of voided or cancelled sales transactions by a different staff member
- **Spoilage:** Rotate raw materials, so that “use by” dates do not expire, secure and sturdy shelving and refrigeration to ensure stock does not spoil, correct training for staff in storage requirements for fresh goods (fruit and vegetables), refrigerated and frozen goods (meat, milk products).