CHAPTER

# 8

# Internal Control and Cash

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# Sarbanes-Oxley Act
(slide 1 of 2)

- The **Sarbanes-Oxley Act** (often referred to simply as Sarbanes-Oxley) applies only to companies whose stock is traded on public exchanges.
  - Its purpose is to maintain public confidence and trust in the financial reporting of companies.
  - It emphasizes the importance of effective internal control.
- **Internal control** is defined as the procedures and processes used by a company to:
  - Safeguard its assets.
  - Process information accurately.
  - Ensure compliance with laws and regulations.
- Sarbanes-Oxley requires companies to maintain effective internal controls over the recording of transactions and the preparing of financial statements.

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# Sarbanes-Oxley Act
## (slide 2 of 2)

- Sarbanes-Oxley also requires companies and their independent accountants to report on the effectiveness of the company's internal controls.
- These reports are required to be filed with company's annual 10-K report with the Securities and Exchange Commission.

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# Objectives of Internal Control

- The objectives of internal control are to provide reasonable assurance that:
  - Assets are safeguarded and used for business purposes.
  - Business information is accurate.
  - Employees and managers comply with laws and regulations.

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# Employee Fraud

- A serious concern of internal control is preventing employee fraud.
- **Employee fraud** is the intentional act of deceiving an employer for personal gain.

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# Elements of Internal Control

- The three internal control objectives can be achieved by applying the five **elements of internal control**. These elements are as follows:
  - Control environment
  - Risk assessment
  - Control procedures
  - Monitoring
  - Information and communication

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# Control Environment

- The **control environment** is the overall attitude of management and employees about the importance of controls.
- Three factors influencing a company's control environment include the following:
  - Management's philosophy and operating style
  - The company's organizational structure
  - The company's personnel policies

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# Risk Assessment

- All businesses face risks such as changes in customer requirements, competitive threats, regulatory changes, and changes in economic factors.
- Management should identify such risks, analyze their significance, assess their likelihood of occurring, and take any necessary actions to minimize them.

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# Control Procedures

- Control procedures provide reasonable assurance that business goals will be achieved, including the prevention of fraud.
- Control procedures include the following:
  - Competent personnel, rotating duties, and mandatory vacations
  - Separating responsibilities for related operations
  - Separating operations, custody of assets, and accounting
  - Proofs and security measures

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# Monitoring

- Monitoring the internal control system is used to locate weaknesses and improve controls.
- Monitoring often includes observing employee behavior and the accounting system for indicators of control problems.

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# Information and Communication

- Information about the control environment, risk assessment, control procedures, and monitoring is used by management for guiding operations and ensuring compliance with reporting, legal, and regulatory requirements.
- Management also used external information to assess events and conditions that impact decision making and external reporting.

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# Limitations of Internal Control

- Internal controls can provide only reasonable assurance for safeguarding assets, processing accurate information, and compliance with laws and regulations. This is due to the following factors:
  - The human element of controls
  - Cost-benefit considerations

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# Cash

- **Cash** includes coins, currency (paper money), checks, and money orders.
- Money on deposit with a bank or other financial institution that is available for withdrawal is also considered cash.
- Cash is the asset most likely to be stolen or used improperly in a business.

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# Control of Cash Receipts

- To protect cash from theft and misuse, a business must control cash from the time it is received until it is deposited in a bank.
- Businesses normally receive cash from two main sources:
  - Customers purchasing products or services
  - Customers making payments on account

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# Cash Received from Cash Sales
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- An important control to protect cash received in over-the-counter sales is a cash register.
- Salespersons may make errors in making change for customers or in ringing up cash sales. As a result, the amount of cash on hand may differ from the amount of cash sales. Such differences are recorded in a **cash short and over account**.

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# Cash Received from Cash Sales
(slide 2 of 2)

- If there is a cash shortage, the Cash Short and Over account is debited for the shortage.
- If there is a cash overage, the Cash Short and Over account is credited for the overage.
- At the end of the accounting period, a debit balance in Cash Short and Over is included in miscellaneous expense on the income statement.
- Alternatively, a credit balance is included in the Other Income section of the income statement.

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# Cash Received in the Mail

- Cash is received in the mail when customers pay their bills. This cash is usually in the form of checks and money orders.
- Most companies design their invoices so that customers return a portion of the invoice, called a remittance advice, with their payment. This document helps to control cash received in the mail.

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# Cash Received by EFT

- Cash may also be received from customers through **electronic funds transfers (EFT)**. For example, customers may authorize automatic electronic transfers from their checking accounts to pay monthly bills for such items as cell phone, Internet, and electric services.
- Companies encourage customers to use EFT for the following reasons:
  - EFTs cost less than receiving cash payments through the mail.
  - EFTs enhance internal controls over cash, since the cash is received directly by the bank without any employees handling cash.
  - EFTs reduce late payments from customers and speed up the processing of cash receipts.

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# Control of Cash Payments

- The control of cash payments should provide reasonable assurance that:
  - Payments are made for only authorized transactions.
  - Cash is used effectively and efficiently. For example, controls should ensure that all available purchase discounts are taken.

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# Voucher System

- A **voucher system** is a set of procedures for authorizing and recording liabilities and cash payments. It may be either manual or computerized.
- A **voucher** is any document that serves as proof of authority to pay cash or issue an electronic funds transfer.
- For the purchase of goods, a voucher is supported by the supplier's invoice, a purchase order, and a receiving report.

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# Cash Paid by EFT

- Cash can also be paid by electronic funds transfer (EFT) systems.
- Examples include the following:
  - A withdrawal of cash from a bank account using an ATM machine
  - A payment of wages or salaries (payroll check) by an employer directly to an employee’s checking account
  - A payment to a supplier or other vendor from a company

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# Bank Accounts

- A major reason that businesses use bank accounts is for internal control.
- Some of the control advantages of using bank accounts are as follows:
  - Bank accounts reduce the amount of cash on hand.
  - Bank accounts provide an independent recording of cash transactions. Reconciling the balance of the cash account in the company's records with the cash balance according to the bank is an important control.
  - Use of bank accounts facilitates the transfer of funds using EFT systems.

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# Bank Statement
(slide 1 of 4)

- Banks usually maintain a record of all checking account transactions.
- A summary of all transactions, called a **bank statement**, is mailed, usually each month, to the company (depositor) or made available online.
- A bank statement shows the beginning balance, additions, deductions, and the ending balance.

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# Bank Statement
(slide 2 of 4)

- The company's checking account balance in the bank records is a liability. Thus, in the bank's records, the company's account has a credit balance.
- Because the bank statement is prepared from the bank's point of view, a credit memo entry on the bank statement indicates an increase (a credit) to the company's account.
- Likewise, a debit memo entry on the bank statement indicates a decrease (a debit) in the company's account.

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# Bank Statement
## (slide 3 of 4)

- A bank makes credit entries (issues credit memos) for the following:
  - Deposits made by electronic funds transfer (EFT)
  - Collections of notes receivable for the company
  - Proceeds for a loan made to the company by the bank
  - Interest earned on the company’s account
  - Correction (if any) of bank errors
- A bank makes debit entries (issues debit memos) for the following:
  - Payments made by electronic funds transfer (EFT)
  - Service charges
  - Customer checks returned for not sufficient funds
  - Correction (if any) of bank errors

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# Bank Statement
## (slide 4 of 4)

- The following types of credit or debit memo entries are found on a bank statement:
  - EC: Error correction to correct bank error
  - NSF: Not sufficient funds check
  - SC: Service charge
  - ACH: Automated clearing house entry for electronic funds transfer
  - MS: Miscellaneous item such as collection of a note receivable on behalf of the company or receipt of a loan by the company from the bank

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# Using the Bank Statement as a Control over Cash

- The cash balance shown by a bank statement is usually different from the company's cash balance.
- Differences between the company and bank balance may arise because of the following:
  - A delay by either the company or bank in recording transactions
  - The bank has debited or credited the company's account for transactions that the company will not know about until the bank statement is received
  - Errors, such as an incorrect posting, made by either the company or the bank

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# Bank Reconciliation
(slide 1 of 2)

- A **bank reconciliation** is an analysis of the items and amounts that result in the cash balance reported in the bank statement to differ from the balance of the cash account in the ledger.
- The adjusted cash balance determined in the bank reconciliation is reported on the balance sheet.
- A bank reconciliation is usually divided into two sections as follows:
  - The bank section begins with the cash balance according to the bank statement and ends with the adjusted balance.
  - The company section begins with the cash balance according to the company's records and ends with the adjusted balance.
- The adjusted balance from bank and company sections must be equal.

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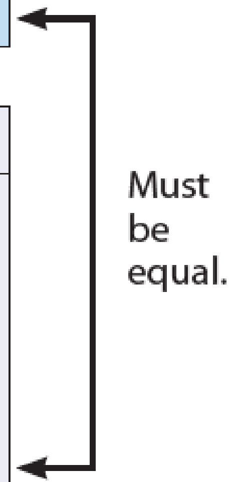
# Bank Reconciliation
## (slide 2 of 2)

| **Bank Section** | | |
|---|---|---|
| Cash balance according to bank | | $XXX |
| Add: Debits to cash not on bank statement (deposits in transit, etc.) | $XXX | |
| Deduct: Credits to cash not on bank statement (outstanding checks, etc.) | XXX | XXX |
| Adjusted balance | | $XXX |

| **Company Section** | | |
|---|---|---|
| Cash balance according to company | | $XXX |
| Add: Unrecorded bank credits (notes collected by bank) | $XXX | |
| Deduct: Unrecorded bank debits (NSF checks, service charges, etc.) | XXX | XXX |
| Adjusted balance | | $XXX |

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# Petty Cash Fund
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- It is usually not practical for a business to write checks to pay small amounts for such items as postage, office supplies, or minor repairs.
- Thus, it is desirable to control such payments by using a special cash fund, called a **petty cash fund**.
- A petty cash fund is established by estimating the amount of payments needed from the fund during a period, such as a week or a month.
- A check is then written and cashed for this amount.
- The money obtained from cashing the check is then given to an employee, called the petty cash custodian, who disburses monies from the fund as needed.

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# Petty Cash Fund
## (slide 2 of 2)

- The petty cash fund is normally replenished at periodic intervals, when it is depleted, or reaches a minimum amount.
- When a petty cash fund is replenished, the accounts debited are determining by summarizing the petty cash receipts. A check is then written for this amount, payable to Petty Cash.

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# Special-Purpose Funds

- Companies often use other cash funds for special needs, such as payroll or travel expenses. Such funds are called **special-purpose funds**.

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# Financial Statement Reporting of Cash
(slide 1 of 2)

- A company may temporarily have excess cash. This excess cash is normally invested in highly liquid investments in order to earn interest. These investments are called **cash equivalents**.
- Examples of cash equivalents include the following:
  - U.S. Treasury bills
  - Notes issued by major corporations (referred to as commercial paper)
  - Money market funds

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# Financial Statement Reporting of Cash
(slide 2 of 2)

- Banks may require depositors to maintain minimum cash balances in their bank accounts. Such a balance is called a **compensating balance** and is disclosed in notes to the financial statements.
- A compensating balance is often required by the bank as part of a loan agreement or line of credit.
  - A line of credit is a preapproved amount the bank is willing to lend to a customer upon request.

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# Financial Analysis and Interpretation: Ratio of Cash to Monthly Cash Expenses (slide 1 of 2)

- Startup companies or companies in financial distress often report losses and negative net cash flow from operations.
- The **ratio of cash to monthly cash expenses** is useful for assessing how long a company can continue to operate without additional financing or generating positive cash flows from operations.
- The ratio of cash to monthly cash expenses is computed as follows:

$$\text{Ratio of Cash to Monthly Cash Expenses} = \frac{\text{Cash as of Year-End}}{\text{Monthly Cash Expenses}}$$

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# Financial Analysis and Interpretation: Ratio of Cash to Monthly Cash Expenses (slide 2 of 2)

- The cash, including any cash equivalents, is taken from the balance sheet as of year-end. The monthly cash expenses, sometimes called cash burn, are estimated from the operating activities section of the statement of cash flows as follows:

$$\text{Monthly Cash Expenses} = \frac{\text{Negative Cash Flow from Operations}}{12}$$

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