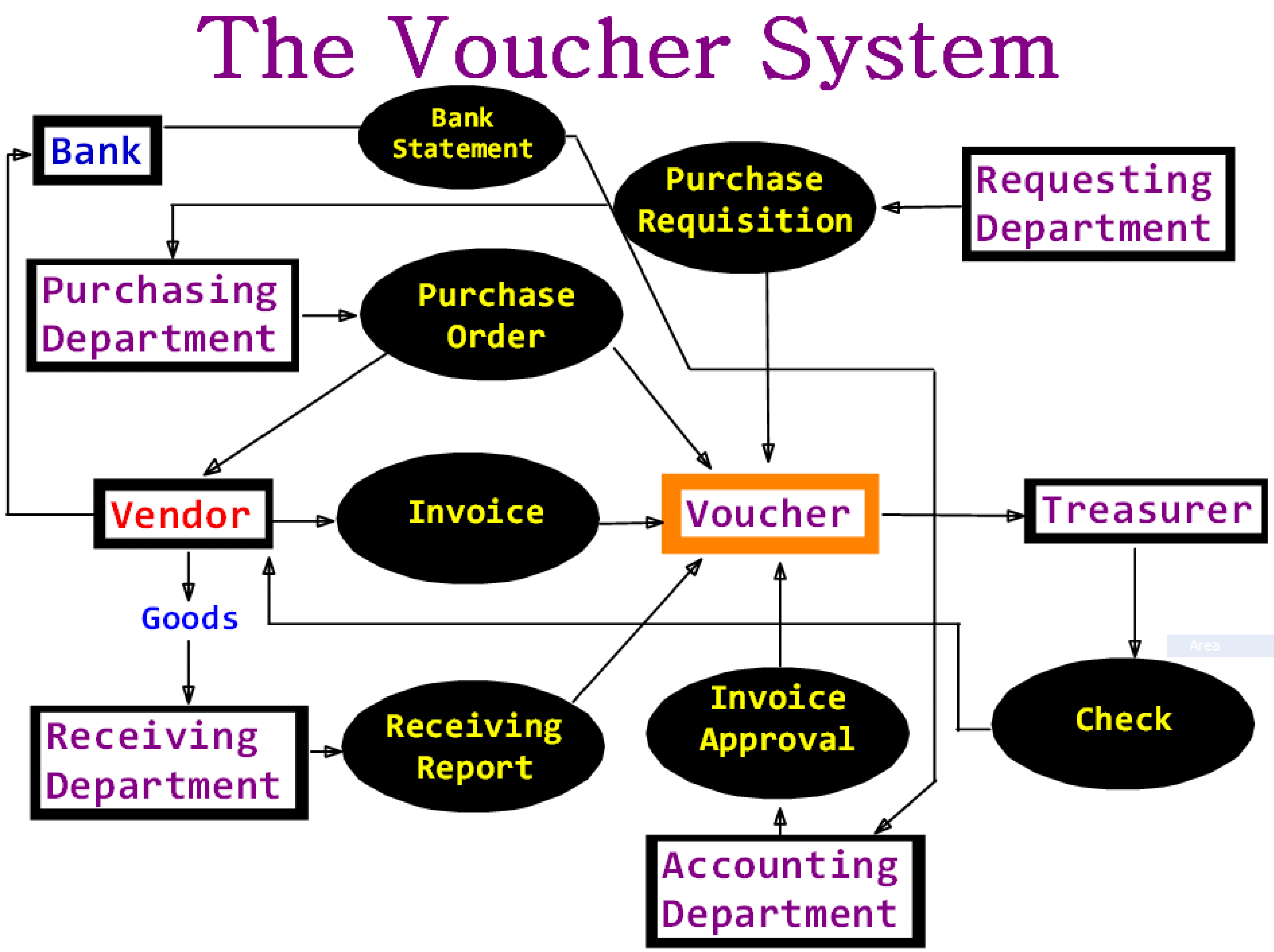
INTERNAL CONTROL

A business establishes a system of *internal control* to

1. safeguard its assets
2. check the accuracy and reliability of its accounting data
3. promote operating efficiency
4. encourage adherence to prescribed managerial policies

control procedures: ensure that assets are protected and that the accounting records are reliable. Examples include:

- requiring authorization for all transactions
- recording all transactions
- the design and use of adequate documents
- limited access to assets
- the periodic independent verification of records
- separation of duties
- sound personnel practices (bonding an employee, or insuring the employee against theft, is an example)



Limitations of Internal Control

Human error, mistakes in judgment, collusion, and changing conditions can all limit the effectiveness of a system of internal control.

Applying internal controls to common merchandising operations

Cash includes currency and coins, amounts on deposit at the bank, checking accounts, and saving accounts.

Cash Equivalents are short-term, highly liquid investment assets that are 1) close to their maturity (or due) date and 2) readily convertible to a known cash amount.

Liquidity refers to a company's ability to pay for its near term obligations. In other words, how easily can the asset(s) be converted to cash.

1. **Cash received** by mail should be handled by two or more employees. Cash received from sales over the counter should be controlled through the use of cash registers and pre-numbered sales tickets. At the end of each day, total cash receipts should be reconciled and recorded in the cash receipts journal.
2. **Cash payments** for purchases should be made by check and with authorization. Common documents include:

   a. **purchase requisition** : completed by a department requesting that the company purchase something for the department. It is sent to the purchasing department.
   b. **purchase order** : completed by the purchasing department and sent to the vendor; another copy is sent to the accounting department.
   c. **invoice** : bill sent from the vendor to the buyer's accounting department.
   d. **receiving report** : completed by the receiving department and forwarded to the accounting department; it contains information about the quantity and condition of the goods received.
   e. **check authorization** : issued by the accounting department and sent to the treasurer, it is a document showing that the purchase order, invoice, and receiving report are in agreement.
   f. **check** : issued by the treasurer and sent to the vendor.

Bank Reconciliations

The end-of-the-month balance in a bank statement rarely agrees with the balance in the company's books for that date. Thus, the accountant must prepare a bank reconciliation to account for the differences and to locate any errors made by the bank or the company. The bank reconciliation begins with the balance per books and balance per bank figures as of the bank statement date. Each figure is adjusted by additions and deductions, resulting in two adjusted cash balance figures, which must agree.
The balance per books figure is adjusted by information that the bank know on the bank statement date but the company did not. The balance per bank figure is adjusted by information that the company know on the bank statement date but the bank did not. For example:

1. outstanding checks are a deduction from the balance per bank.
2. deposits in transit are an addition to the balance per bank.
3. service charges by the bank appear on the bank statement and are a deduction from the balance per books

4. a customer's non-sufficient funds (NSF) check is deducted from the balance per books.
5. interest earned on a checking account is added to the balance per books.
6. miscellaneous charges are deducted from the balance per books. Miscellaneous credits are added to the balance per books.
7. errors must be identified and corrected.

After the bank reconciliation has been prepared, adjusting entries must be made so that the accounting records reflect the new information supplied by the bank statement. Each adjustment includes either a debit or credit to cash. Adjustments are recorded only for items that affected the balance per books.

Petty Cash Fund

Although it is good practice for a company to pay by check, it often is not practical for items of small value. For items like postage, a few inexpensive supplies, and taxi fares, many firms use a petty cash fund.
When the fund is started, Petty Cash is debited, and Cash is credited. When payment is made from the fund, the fund's custodian prepares a petty cash voucher showing the date, amount, and purpose of the expenditure. The petty cash fund is replenished periodically and at the end of the accounting period.
In each case, all the expenditures since the fund was last replenished are debited and Cash is credited. Discrepancies are recorded as Cash Short or Over.