

**\*Internal control:** process for assuring achievement of an organization's objectives in operational effectiveness and efficiency, reliable financial reporting, and compliance with laws, regulations and policies. (protection and control risk)

+ Designed to provide reasonable assurance regarding the achievement of objectives relating to operations

+ **Five components:**

- ✓ **Control environment:** The set of standards, processes, and structures that provide the basis for carrying out internal control across the organisation (integrity and ethical values & governance oversight responsibilities)
- ✓ **Risk assessment:** form a basis to manage risk (also consider external environment)
- ✓ **Information and communication:** enable carry out responsibilities /authorised system/ensure adequate approvals for recording (**internal communication:** control responsibilities & **external communication:** in response to expectations/requirements)
- ✓ **Control activities:** policies and procedures to mitigate risk – segregation of duties is built (**Preventive controls:** policies and procedures designed to prevent errors, inaccuracy or fraud before occurs & **Detective controls:** designed to identify problems already exist) & **General control:** accounting control which ensure accuracy of financial records
- ✓ **Monitoring** (ongoing or separation evaluation - assess quality, performance): **Internal auditors** ensure following company policies and operation efficiency (evaluate on continual basis) & **External auditors** ensure financial statements are presented fairly with standards

+ **Areas relevant:**

- **Segregation of duties:** specific responsibility -> reduce risks of mistakes, illegal act and promote accuracy (splitting responsibility for bookkeeping, deposits, reporting and auditing) -> monitor compliance with procedures (Eg. Different individuals receive cash, record cash receipts)  
+ No overlapping or undefined areas (responsibility commensurate with ability and authority)
- **Good record maintenance:** maintain documentation to substantial transactions (require storing, safeguarding) – avoid misappropriation or misuse of assets
- **Safeguards:** prevent loss of valuable business assets (can be physical items)
- **Approval authorities:** require manager to authorise certain transactions

+ **Specifically relate:**

- **Physical audits:** hand-counting/physical asset tracked (reveal discrepancies in account balances) – safeguard -> e-commerce requires a higher level of sophistication in data security (Eg. Store cash in safes, limit access to storage access)
- **Standardised documents:** range of documents such as invoices, receipts that help to maintain consistency in record keeping over time. (easy to view past records, lack of standardisation would lead to overlook or misinterpret) – provide evidence
- **Trial balance:** use of double-entry system to identify errors
- **Reconciliations:** necessary to compare figures from the accounts with figures for the same category.

+ **Main aim**

Setting objectives, budgets, plans and other expectations establish criteria for control

**Objective to accomplish:**

- ⇒ Safeguard assets
- ⇒ Follow organisational policy (proper authorisation)
- ⇒ Promote operational efficiency (no waste resources)
- ⇒ Ensure reliable, accurate and ethical accounting records
- ⇒ General controls (employees) and Accounting controls (ledger, journal...)- document records
- ⇒ Corporate governance operates
- ⇒ Electronic control and computer devices

+ **key elements (standard level):**

Honest reliable staff & clear system of responsibility, authority, separation duties & proper procedures (transactions processed) & suitable documents and records & appropriate control over asset & independent verification of performance & process to check system and security

+ **Implementing internal control:**

Organisation chart, description & manual procedure & authorisation process & budget & comparative FS & relevant reconciliations & Train staff (staff feedback) & responsibility for compliance .....

+ **Special consideration:**

Proper knowledge and skills & fraud prevention tools & PCI standards & ensure accessibility to records for audit & overall strategy in high activity & outsourcing activities (risk with provider) & adjust existing policies to related control & legal and regulatory issues & **firewalls** (limit access to local network to keep out intruders) and virus protection & **encryption** (coding of message make unintelligible to users not authorised, may consider cybersecurity – achieve confidentiality) of protection

+ **Limitations:**

- ✓ Human element
  - Collusion (beat internal control): illegal undermine system
  - Unexpected transactions: transactions not covered by procedure manual
  - Dishonesty and judgement errors
  - Management override: authority could override any aspect of a control system for his advantage
- ✓ Weak internal control: incorrect information and decision, inefficient system
- ✓ Size of business
- ✓ Cost versus benefit: cost of procedure should exceed benefit

**Issues with e-commerce**

- + Electronic (not paper trail) – easy to stole & Need to expand internal control system (inter-organised system) & new element of risk & public network & lack of technical expertise & legal/technical issues
- + Special consideration: knowledge and skills of staff & fraud pretention & Payment Card Standards & record for audit
- + Encryption: coding of a message to make unintelligible to any user not authorised to read messages (software built and change information to ensure safety or protect against theft)
- + Firewalls: the limit access to local network to keep out intruders

**Computerised Accounting**

- + **Advantages:** reduction in processing costs & speed of processing & error reduction & automatic posting & automatic production
- + **Disadvantages:** failed systems & power failure & fraud

**\*Internal control over cash**

[Internal control over cash receipts: Responsibility and segregation of duties -> Documentation procedures -> Physical and electronic controls -> independent internal verification]

Electronic funds transfer (EFT): transfer funds among parties without use of cheques

Petty cash: cash fund used to pay relatively small amounts

**\*Bank Reconciliation:** provide a double record of all bank transactions & helping a company safeguard its cash by using a bank as a depository and clearinghouse for cheques received and written. Reconcile the difference between the business record and the bank record on a specific date (record service charges, checks, receipts, deposits...)

+ **Difference** caused by: Time lag (timing difference) & Contain items not recorded at bank (outstanding cheques, deposits in transit) & Bank/book errors & contains items not recorded in company (service charge, bank collections, dishonoured cheques, interest earned)

+ **Bank reconciliation Process:** Check the correctness -> Adjusting the balance per bank (correct balance) -> Adjusting balance per book -> Comparing adjusting balances -> Preparing journal entries (no errors were made)

+ Bank side reconciliation: Outstanding Deposits in transit – petty cash/cheques to your entity (+) & Outstanding cheques (-) & Bank errors

+ Book side reconciliation: Bank collections (+) & EFT collections (+) & Interest revenue (+) & EFT cash payment (-) & Service charge (-) & Cost of printing (-) & Other bank charges (-) & Dishonored cheques (-)

**STATEMENT OF CASH FLOWS**

**Statement of cash flow:** shows the entity's cash flows movement (inflows, outflows and net cash flows) for the reporting period

- + Investors: more reliable of earning quality, minimal agency
- + Lenders: sufficient \$ to pay loan & interest

The statement of cash flows concerned with when receipts and payments are made (not revenue/expense recognition)

+ Measures the entity's ability to generate cash flows & meet financial commitments (principal, interests, dividends) & fund changes in scope & obtain external finance & ascertain cash generation from cycle and identify changes in balance sheet

+ provide information on the success or shortcomings (reconcile between profit and net cash provided by Operating activities)

+ concerned with cash equivalents (not timing of underlying transactions) – highly liquid assets are subjective to an insignificant risk of change in value

**Operating activities:** principal revenue-producing activities (provision of goods/services) -> determine profit/loss.

-> ability to repay loan, maintain operating capability, pay dividends, invest without relying on external finance -sustain

-> Current assets / revenue/ expense

-> Positive net CF

-> Measure to gauge the entity's ability to generate cash, to meet its obligations, to continue as going concern and to expand

+ **Cash inflows:** cash sales, accounts receivable, sales in advance, commissions

+ **Cash outflows:** payments of inventories, prepayments, accounts payable, accrued expenses, wages, entitlements, income tax payments...

**Investing activities:** acquisition/ disposal of long-term assets & investments

-> resources generate future income & cash flow

-> Negative net CF (expenditures to generate future cash flows – increase capital)

+ **Cash outflows:** Acquiring PPE, intangibles, deposits (long-term interests), shares, securities

+ **Cash inflows:** Proceeds from disposing non-current assets, receive principal

**Financing activities:** cash flow results in change in size and composition of contributed equity & borrowings.

-> claims on future cash flows by providers of capital

-> Negative OR + = - Investing

+ **Cash outflows:** repayments of principals, buy-backs,

+ **Cash inflows:** borrowing or issue debts, issue shares, issue of notes payable

**Choices for interest & dividends**

**Interest/ dividends received** – Operating or investing (returns on investments)

**Interest/ dividends paid** – operating or financing (change equity)

	Healthy	Decline	Despair	Death
Operating	+ ve	- ve	- ve	- ve
Investing	- ve	0	+ ve (sell non-current assets i.e. PPE)	0
Financing	+/- ve	+ ve (Borrow to finance day to day problems)	0 (no more borrowings/ investments)	0

**Cash flow positive signs**

+ Adequate levels of cash and cash equivalents (last figure in statement of cash flow), but not excessive levels (may want to make investments or buy back shares if too much cash)

+ (+ ve) Operating CF

+ Receipts from customers > Payments to suppliers (cash generated from operations line item)

+ NOCF  $\approx$  Profit (indication of earnings quality)

+ (- ve) Investing CF (indication of growth)

+ (- ve) Financing CF or + ve Financing CF  $\approx$  -ve Investing CF

**Cash flow warning signs**

+ Cash received less than cash paid

+ operating 'outflow'

+ cash receipts from customers being less than cash payments to suppliers and employees

+ cash from operating activities being lower then operating profit after tax

+ proceeds of share capital being used to finance operating activities

+ consistent inflows from investing activities

+ proceeds from borrowings continually much greater than the repayment of borrowings.

**Reconciling cash and cash equivalents**

+ Disclose the components of cash and cash equivalents and present a reconciliation (cash flows <-> financial position)

**Non-cash transaction** – investing and financing transactions not require use of cash – disclosed in Notes e.g. acquire a business through share issue/ acquire PPE through loan/convert debt (convertible notes) to equity/land appreciation

**Reconciliation b/w net operating CF and profit/loss** => Profit includes non-cash expense => often < CF

Profit +/- Depreciation/Amortisation/net accruals = Net operating cash flows

+ greater the disparity between EBIT and Net CF, greater indication of earnings management

**Reconciliation b/w net operating CF and cash and cash equivalent BS** => Often equal. If not, due to overdrafts.

**Direct method:** presents cash payments as deductions from cash receipts to determine “net cash presented by operating activities” (shows **operating receipts and payments**)

**Indirect method:** starts with **profit and reconcile(adjust)** for timing differences, non-cash items, financing/investing to determine “net cash presented by operating activities”

+ Adjustments to convert profit to net cash: Add depreciation expense, amortisation expense, unrealised loss & Deduct: unrealised gain (**disclose in notes**)

+ **Reconciles from profit:** EBIT + depreciation – dividends received – gain on sale + loss + (increase in liability – increase in AR + increase in bad debts + decrease in inventories + increase of payables) = cash generated – interests/tax payments = net cash from operating activities

~ Cash receipts: Beginning AR + Sales revenue – Ending AR – discount allowed – bad debts

~ Dividends: Opening retained earnings + Net profit – Closing retained earnings (if no reserves)

~ payments for purchases: (Cost of sales – beginning inventory + ending inventory) + beginning AP – ending AP – discount received

**Free cash flows:** cash available for expansion or the payment of dividends (**discretionary cash flow** and maintain dividends at minimum levels)

#### **Limitations of statement of cash flows**

- Past cash flows reported: heavy reliance on past cash flows
- Non-cash transactions and events: do not represent the whole significant interests of business (debt to equity)
- Liquidity/solvency: sufficient to meet obligations are not provided