



Department of  
Education

# Year 11 ATAR Accounting and Finance

## Unit 1: Internal Control



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Manager Intellectual Property and Copyright  
Department of Education  
151 Royal Street  
EAST PERTH WA 6004  
Email: [copyright@education.wa.edu.au](mailto:copyright@education.wa.edu.au)

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# Year 11 ATAR Accounting and Finance

## Unit 1

### Topic: Internal Control

#### OVERVIEW

The aim of providing resources for Year 11 Accounting and Finance students is to assist students to revise and prepare for Semester 1 Examinations. Additionally, these resources are designed to supplement (not replace) your classroom teacher's programme.

The following format applies to this booklet:

#### **Section 1: Syllabus requirements**

Please familiarise yourself with the syllabus requirements for each topic. Including links to the SCSA website for important curriculum documents.

#### **Section 2: Theory Content**

Read through this section, taking notes and highlighting important concepts.

#### **Section 3: Activities**

Various questions based on the topic content. Each question is followed by the suggested solution.

## Internal Control

### Section 1: Syllabus content covered

#### Internal Control

##### Nature and importance of internal control

Students study and summarise text relating to the nature and importance of internal control. They examine the interrelationship of administrative and accounting controls.

##### Application of the principles of internal control.

Students will read, take notes and learn, using a mnemonic, the commonly accepted principles of:

- separation of duties,
- staff selection,
- responsibility,
- rotation of duties,
- document numbering,
- authorisation and
- verification.

Students will read text relating the control of Accounts Payable and the safeguarding of assets:

- cash receipts
- cash payments
- accounts receivable
- accounts payable
- inventory
- non-current assets

##### Limitations of internal control

Students read text and take notes:

- errors in judgment
- suitability of employees
- cost
- technological advances
- collusion
- over-riding rules
- weak controls.

**You can find other important Accounting and Finance Syllabus and Course Information at:**

<https://senior-secondary.scsa.wa.edu.au/syllabus-and-support-materials/humanities-and-social-sciences/accounting-and-finance>

## Internal Control

### Section 2: Reading and Note Taking Section

- *Section 2: The following pages will outline the theory components of this topic.*
- *Please take time to read through this information, taking notes and highlighting important concepts.*
- *Then move on to Section 3: Activities Section for questions and solutions.*

#### Systems of Internal Control

Would it surprise you to know that every year our courts are full of people who have been accused of tampering with financial records and stealing money, inventory or other assets from their employers?

This is an unfortunate fact. In addition, would it surprise you to know that dishonesty in business is more often than not the result of employees grasping opportunities to act in a dishonest way due to a lack of internal control?

Perhaps not so surprising is the fact that there are as many, if not more, occurrences of dishonest behaviour which go undetected as there are detected occurrences.

In addition to the internal dishonest practices, it is difficult to imagine the extent to which external dishonesty has affected small businesses.

#### What are the controls that are missing?

This topic will assist you in answering this question. You will develop knowledge of the administrative and accounting policies and procedures that businesses should implement to avoid the high cost of fraud, theft and errors.

Internal control policies and procedures which you will concentrate on include the control of:

1. cash
2. inventory
3. accounts receivable
4. accounts payable
5. non-current assets.

You will also examine the internal and external limitations which prevent businesses from being able to completely eliminate dishonest practices.

## Nature and Importance of Internal Control

Internal Control involves all of the various measures that a business undertakes in order to conduct itself in an orderly and efficient manner. Developing and implementing internal control policies and procedures:

- safeguards assets
- ensures financial data is accurate and reliable
- ensures compliance with set policies and procedures
- assists in achieving business objectives.

Internal control is achieved by:

- removing the motivation for fraud and theft
- discouraging errors and inefficiency including waste
- readily identifying mistakes.

The benefits of having internal controls in place include increased efficiency of business practice, no unexplained losses of inventory and greater security over business resources.

The small business environment and culture play an important part in the establishment of internal control. Where attitudes of sloppiness, disrespect, lavish spending and an obvious lack of audit trails exist, dishonest and inefficient behaviours often occur. The development of a code of ethics in addition to other internal control policies and procedures is a start to fostering a harmonious business environment where everyone is aware of their responsibilities and undesirable behaviours are discouraged.

It is a fact that small business owners are often preoccupied with chasing additional business, enjoying the success of their operations and too trusting to make time to develop and implement the measures which will promote a culture of loyalty, respect and acceptance of responsibility amongst their staff. Internal control policies and procedures are a means of achieving the business objectives within the desired business culture and are the responsibility of everyone in the organisation.

## Administrative and Accounting Controls

The implementation of a combination of administrative and accounting controls to discourage fraud, theft and inefficiency is essential.

For example, a business which owns a large fleet of vehicles should safeguard their assets by securely storing vehicles behind a well-lit, locked enclosure and appointing a staff member to be responsible for the vehicles (administrative control).

Business owners should also ensure asset register records relating to purchase price, maintenance expenses, licence details and insurance costs are kept for each vehicle (accounting control).

Business owners should ensure staff employed to perform bookkeeping processes are capable of doing their job and receive adequate training as required (administrative control). Checks should also be undertaken to ensure that there are not any errors in the financial recordkeeping (accounting control).

### Administrative Controls

Administrative controls deal with the implementation of written policies and procedures to maintain operating efficiency and staff adherence to the rules of the business. These policies and procedures may relate to:

- credit checks on potential credit customers
- supervision and delegation of work
- adherence to recycling practices
- adherence to health and safety policies and procedures
- staff selection, induction and training
- procedures for purchasing and selling inventory
- preparation and presentation of departmental performance reports
- product quality controls
- safe storage and the protection of assets from loss and damage.

### Accounting Controls

Accounting controls deal with maintaining the accuracy of accounting records, the protection of assets (money, inventory and other assets) and the preparation of reliable financial information.

Accounting controls should include:

- regular preparation of a trial balance to check the accuracy of the ledger
- monthly reconciliation of the bank statement and the business' bank account to account for any discrepancies
- daily banking of cash to safeguard cash receipts.

In addition, small businesses which maintain tight controls may be seen to have in place:

- a chart of accounts
- the double entry accounting system
- policies relating to responsibilities for making journal entries and approving credit applications
- a budgeting system which compares budgeted figures with actual income and expenditure
- a policy assigning responsibility for making alterations to financial records
- a policy with regard to restricted access to accounting records
- security policies to ensure assets are safeguarded.

Failure to implement policies and procedures in both administrative and accounting controls will eventuate in a negative financial result. The goals of the business will not be met, that is, the anticipated profit will be lower than expected and an unsatisfactory level of financial stability will be achieved.

## Application of the Principles of Internal Control

- **Staff Selection and Annual Leave** - The selection of reliable, qualified and competent employees is essential to developing the desired business culture and environment. The insistence of staff taking annual leave is paramount. Leave offers opportunity for others to check on the efficiency of the person on leave.
- **Separation of Duties** - Individuals should not have the opportunity to perform two consecutive tasks in the accounting process. For example, the person who records the cash received should not do the banking. The employee who has the responsibility for safeguarding assets should not be responsible for recording the accounting data in relationship to the assets. In addition, the ordering of goods should be done by one person, the goods received by another, and yet another should record the purchase in the accounting records.

This video explains the importance of separating duties

<https://www.youtube.com/watch?v=gdReLybtn3s>

- **Responsibility** - Staff should be allocated responsibility for overseeing areas which require supervision. Issuing responsibilities encourages pride in work and accountability for inefficiency and error.
- **Rotation of Duties** - To avoid collusion, staff should be multi-tasked. Rotating staff through accounting and other duties ensures the incoming operator checks the work undertaken by the previous operator and reports any discrepancies.
- **Document Numbering** - All documents should be consecutively numbered to enable the detection of missing, false or counterfeit documents.
- **Authorisation** - Only persons who are authorised to perform special duties and tasks should have access to valuable assets and financial recording processes.
- **Verification** - The accuracy of the work of individuals should be confirmed by an established checking procedure, including spot checks.

These principles are worth committing to memory. Try this strategy:

- Make a rhyme or saying out of the initial letters of the bold headings
- For example, '**SS RR DAV**' and say to yourself '**double S, double R, DAV**'.
- Say the rhyme out aloud many times, developing a rhythm as you go.
- Now write or key the letters, saying the rhyme as you go. Write it again and again whilst reciting in rhythm.
- Now match the first word in the left-hand column to the letters.
- Practice writing down the letters and matching the words to the letters several times without looking at the table.

If you follow this procedure, and practise at regular intervals over a period of time, you will commit this information to memory.

## Application of the Principles of Internal Control

### Safeguarding Cash

This area of business is a common target for employee fraud. Cash is usually visible to staff and tends to invite dishonest behaviour. Control over the handling of cash should be closely monitored. Policies and procedures for handling cash receipts should include:

#### *Separation of duties:*

- One employee should open the mail and pre-list or date stamp all money received before it is handed to the bookkeeper.
- All cheques should be stamped 'for deposit only' before being handed to the bookkeeper.
- Daily cash listings should be compared with the cash receipts journal and bank deposit slips preferably by neither the operator of the cash register nor the bookkeeper.
- The daily banking should not be done by the cashier.
- Banking the daily takings should be rotated amongst employees.
- The route taken to the bank should be changed regularly.

#### *Cash registers should be utilised with:*

- access restricted
- cash drawers assigned to individual employees
- daily cash receipts should be banked intact so that no cash is spent out of the cash register and large sums of cash are not left on the premises overnight
- pre-numbered receipts or cash register dockets should be prepared for all cash received
- cash registers should be balanced regularly by an employee who does not otherwise have access to the register
- a safe should be available for the storage of large sums collected during the day
- surveillance cameras should be considered for high risk areas
- small amounts of cash kept on the premises should be kept securely. A Petty Cash System, using vouchers and a Petty Cash Book should also be maintained.

### The Petty Cash System

Businesses will sometimes keep a small amount of cash on hand for incidental expenses such as taxi fares, flowers for staff members, parking fees etc. This is referred to as Petty Cash. It is usually kept in a locked tin in the form of small notes and change. If an employee pays for an item out of their own pocket, they may be reimbursed from petty cash. That is, if they present their receipt for the work-related item they have purchased, they can claim their money back from the business. They would be required to complete a petty cash voucher.

#### *Petty Cash Vouchers*

The petty cash control system ensures that employees present tax invoices or cash register dockets and complete vouchers before reimbursement is made by the petty cashier.

#### *Petty Cash Record Book*

The total amount spent on the vouchers and the balance in the tin must equal to the imprest amount.

## Application of the Principles of Internal Control

### Cash Payments

Easy access to cash and cheques can be an invitation for employees and others to engage in dishonest and fraudulent practice. Just as the handling of cash receipts should be monitored closely, so too should cash payments.

Policies and procedures for handling cash payments should include:

- All cash payments to be made by cheque or Electronic Funds Transfer (EFT)
- Cheques and EFT transactions to be numbered consecutively.
- Cheques to be recorded in the journal as soon as they are written.
- Cheque books to be stored securely and access restricted to authorised persons only.
- Voided cheques to be retained and destroyed by authorised persons.
- Two signatures/verifications required for each cheque or EFT if anyone other than the small business owner is required to sign/authorise.
- All cheques to be made *not negotiable* and cash cheques prohibited.
- Petty cash expenses by staff should be supported by signed vouchers and tax invoices before reimbursement.

In addition, Bank reconciliations comparing the bank statement with the business bank account and journal should be performed regularly to verify the business records. The business cheques not yet presented at the bank and deposits made by the business and not yet recorded in the bank's records are sought out and recorded on the reconciliation statement.

### Accounts Receivable

Delays in the collection of amounts owing by accounts receivable (debtors) causes cash shortages, an increase in bad debts, profit erosion and in some instances the downfall of the business.

Policies and procedures for the internal control of accounts receivable should include:

- Credit checks on prospective credit customers including their income level, trading or work history, credit history and their ability to pay in accordance with the credit policy.
- A debt collection process which includes regular billing, reminder letters and the threat of debt collection agencies.
- How accounts receivable are to be aged. Aging highlights how long Accounts Receivable have been owing and dictates how the collection policy is to be applied.
- Separation of the duties for keeping the ledger accounts for Accounts Receivable and the recording of cash receipts.
- The establishment of an Accounts Receivable Control account which summarises the individual accounts.
- Cross checking bad debts written off.
- Cross checking overdue accounts and discounts.
- Reconciliation of the trial balance and the general ledger by a person not responsible for ledger posting.

## Application of the Principles of Internal Control

### Inventory

The purchase of inventory or stock for small businesses is usually a very costly expense of their operation. It is vital that inventory is closely monitored by the business to highlight sloppy work practices and fraud.

The policies and procedures should include:

- Separation of the following duties in relation to the purchase of stock including:
  - ordering from suppliers on consecutively numbered order forms;
  - receiving of goods and matching order forms, delivery notes and suppliers' tax invoices with quantity, quality, weight, measurement and the correct goods before payment takes place;
  - dispatching the return of goods to the supplier and recording purchases in the journal.
- Separation of the following duties in relation to the sales of stock:
  - receipt of order forms from customers
  - dispatching goods to customers
  - accepting the goods returned
  - recording the sales in the journal.
- Secure storage of goods with access restricted to authorised staff.
- Safe storage away from the elements and the possible effects of fire and flood.
- An annual physical stocktake to check if what the automated records say should be on the shelf is actually on the shelf. There is no doubt there will be a discrepancy due to loss from damage or theft.
- Appropriate insurance cover against theft, loss or damage to ensure the stock lost can be replaced.

## Application of the Principles of Internal Control

### Non-Current Assets

Non-current assets are easily misused, misplaced, lost or stolen by both internal and external parties to the business and should be subject to controls as stringent as those applied to other assets.

The policies and procedures should stipulate where applicable:

- Locking away and/or securing to the desk of easily removable assets such as laptop computers
- Secure storage in locked and well-lit compounds for larger items such as vehicles and machinery.
- Security patrols and cameras.
- Preparation of an asset register for each type of asset, for example vehicles.
- Each asset register should contain full details of individual items including:
  - purchase price and date purchased
  - depreciation
  - maintenance
  - licence/registration
  - insurance
  - condition
  - storage location
  - custodianship, the allocated responsibility for high value items.
- Purchasing and selling to be undertaken only by persons with authority.

### Accounts Payable

Mistakes in the areas of purchasing and cash payments can be extremely costly. There should be simple, clearly written procedures for processing purchases and payments to which employees are encouraged to adhere.

Internal control of Accounts Payable should include:

- (i) Clear lines for timely payment of accounts to take advantage of discounts.
- (ii) Checking of creditors' monthly statements against the business records.
- (iii) Separation of ordering, journalising purchases and keeping the accounts payable ledger.
- (iv) Writing cheques or processing EFT for payment of accounts by authorised persons only, two signatures should be required in the absence of the owner.
- (v) Returns and reimbursements should be processed in a timely manner by authorised persons only.

In summary, the development and implementation of strong internal control policies and procedures by all involved in the small business:

- promotes the efficient use of resources
- protects both current and non-current assets
- assists in the development of a business culture
- encourages positive behaviour of staff.

## Limitations of Internal Control

The success of internal control in small businesses is limited to the needs, skills, abilities and attitude of the owners and their staff. The size and financial position of the business also places constraints on what is needed and what can be achieved by a small business.

### Errors in Judgement and Estimations

Errors and miscalculations made by the owner in recruiting staff; dealing with customers; checking accounts; budgeting; and analysing financial information can create situations where the opportunity for honest people to become corrupt and engage in fraudulent activities exists.

### Suitability of Employees

All businesses rely on the honesty of employees. The selection of appropriate staff is paramount. An internal control system is only as good as the loyalty, ability and attitudes of those employed in the business. Mistakes will be made and collusion to facilitate stealing and fraud will take place unless the people who are chosen fit the business culture. In addition, a lack of awareness of employees' personal situations in regard to financial stress, addictions and dissatisfaction can lull the owner into a false sense of security and open the door for employees to attempt to break the rules.

### Technological Advances

Computer fraud is prevalent and difficult to detect without an advanced computing knowledge or sophisticated and costly detection programs. This type of fraud is usually committed by individual employees who, with the allocation of passwords and other protection devices, are easily able to conceal their actions.

### Cost of Control Systems

The cost to small business of providing an absolute assurance against fraud, theft, inefficiency and misuse of assets is prohibitive and may well be detrimental to the success of the business. For example, providing the manpower to search every customer who passes through the doors of a business in order to detect stealing would be a costly exercise and perhaps a deterrent to customers. The less costly but less effective random searches, sensors at exits and warning signs of prosecution may well suit smaller operations but for some of these the cost will still be out of reach.

### Collusion

Applying the separation rule, unless combined with the rotation of duties, may lead to collusion. Fraudulent behaviour when two people are working together to commit the crime becomes hard to detect. The owner's constant or surprise presence, regular checks of the financial data and fear of being caught can be deterrents.

### Overriding the Rules

When unexpected occurrences such as bullying by others occur, employees may be pushed into exceeding their level of authority and override the controls in place. Employees often see internal controls as red tape, unnecessary and a waste of time. They sometimes disregard procedures arguing increased efficiency, but this often leads to individual employees being advantaged.

## Limitations of Internal Control

### Weak Internal Controls

Weak internal controls convey a message to outsiders that a business is an easy target for fraudsters. For example, with an outside contact an employee can have a second invoice sent to a business which has already paid an original invoice and receive a second payment. A business can be invoiced and pay for work which has never been done. Both instances could be avoided with tighter internal control.

Look back at the strategy used to commit the principles of Internal Control to memory and apply the same strategy here. Try the made-up word **JETCCOW** for committing the limitations to memory.

- J** Judgements
- E** Employees
- T** Technology
- C** Cost
- C** Collusion
- O** Over-rides
- W** Weakness

The following video helps explain the importance of identifying internal control weaknesses:  
<https://www.youtube.com/watch?v=jPAGdDQYse4>

## Internal Control

### Section 3: Activities Section

- *This section includes questions relevant to this topic.*
- *The solutions are included after each question.*
- *Attempt the question and then use the solution to assess your performance and revise.*

#### Question 1: Can you differentiate between Administrative and Accounting Controls?

(i) Assets are physically safeguarded from theft and damage

Administrative Control

Accounting Control

(ii) A different person takes the daily cash takings to the bank each week

Administrative Control

Accounting Control

(iii) Bank statements are matched with the business bank account

Administrative Control

Accounting Control

(iv) Authorisation for access to inventory is limited to two employees

Administrative Control

Accounting Control

(v) Trial Balances are regularly prepared to check the accuracy of the General Ledger

Administrative Control

Accounting Control

**Question 1 Solution**

- (i) Administrative Control
- (ii) Administrative Control
- (iii) Accounting Control
- (iv) Administrative Control
- (v) Accounting Control

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**Question 2**

a) What is internal control?

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b) Why is internal control important?

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c) What is the difference between administrative controls and accounting controls?

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d) List and explain five limitations of internal control.

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## Question 2 Solutions

### a) What is internal control?

Internal Control is when a business uses good business practices to ensure that their assets are safeguarded and that the effectiveness and efficiency of business operations are improved whenever and however they can be.

### b) Why is internal control important?

Internal Control is important because without it the business is left vulnerable to theft, fraud and ineffective operating procedures.

### c) What is the difference between administrative controls and accounting controls?

- Accounting controls are concerned with financial records (ie, ensuring accurate recording).
- Administrative controls are concerned with the organisation structure such as how the chain of command operates.

### d) List and explain five limitations of internal control.

- Two or more people may conspire together (honesty of employees can't always be counted on).
- Some internal control measures can be very costly to implement
- Some internal control measure may be too weak and easily avoided by staff and/or customers
- Errors can be easily made and overlooked (eg, checking accounts, dealing with customers)
- People in managerial positions can override the rules, making the overall system vulnerable.

**Question 3**

Susan Smith runs a small boarding school. The students in the boarding house are each given a \$100 allowance per term. There are 20 students in the boarding house. Susan is responsible for this money until the students ask for some of it to spend.

(i) What are two problems Susan may encounter?

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(ii) List and explain three control procedures Susan should adopt to ensure the safe keeping and correct recording of the cash.

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### Question 3 Solutions

**(i) What are two problems Susan may encounter?**

- Susan may find it difficult to know how much money to keep on hand each week as it is unknown as to how much cash each student may want to withdraw.
- She is in charge of running the boarding house and may not have experience in how to record and manage the money going out.

**(ii) List and explain three control procedures Susan should adopt to ensure the safe keeping and correct recording of the cash.**

- She may keep some cash on hand for students who need it immediately, she will need to ensure that this is stored in a secure place, in a locked petty cash tin or a safe.
- She needs to ensure that she is keeping an accurate record of which students have withdrawn cash, how much they have withdrawn and the remaining balance each student has.
- She could get another staff member to be with her when students are withdrawing cash to ensure the accuracy of her record keeping.



### Question 4 Solutions

(i) **List two problems Bob may encounter.**

- Inventory being left outside is exposed to the elements and may become sun damaged or ruined by rain.
- Inventory left outside could be stolen.

(ii) **List and explain two internal control procedures Bob could implement.**

- Bob needs to store the Inventory in a safe place which is locked so that it is not stolen. He also needs to ensure that Inventory is not kept outside where it can become ruined from the sun and rain.
- Bob needs to ensure his part-time workers know how to use the equipment in the correct way. He could do this by implementing an in-house training program.



## Question 5 Solutions

- Enforce safety guidelines and make sure all machines used to manufacture and package the fishing rods are operated efficiently and according to manufacturer's instructions.
- Secure locks on all factory doors to prevent theft or vandalism of either the inventory or the machinery.
- Install surveillance cameras / security systems in the factory as a deterrent for theft or vandalism.
- Make sure that his non-current assets are adequately insured.

### END OF CURRENT TOPIC

*Please access the other Resource Packages provided which cover various topics from Unit 1.*