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Internal Control of Cash

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The definition of internal control by the Committee on Auditing Procedures of the American Institute of Certified Public Accountants is as follows: "Internal control comprises the plan of organization and all of the co-ordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies." This is a very encompassing definition, and since almost all asset, liability, revenue, and expense transactions go through the cash account, this article will be limited to the internal control of cash.

Mautz and Schlosser present seven excellent tools in the development of internal control.[1] They are as follows: organization, records, reports, review, training, physical safeguards, and clerical proof devices.

Organization is the most basic tool. If organization is not effective, other tools do not work. There should be clearly established levels and lines of authority with appropriate delegation of duties and fixed responsibilities. The important words here are authority, delegation of duties, and responsibility. There should be separation of duties between authority and performance, custodian and record keeping.

Records, of course, are the journals, ledgers, files, etc. Without these tools, no control is possible. There should be a clear flow of information from one to each of the others. They should be able to provide sufficient and reliable information on a timely basis to permit informed decisions.

Reporting may be in the form of information or responsibility reports. The latter is to report that an action has been accomplished and by whom.

Review is a necessary tool of internal control. Examples of the reviewing function are review of the custody of assets, the maintenance of records, the performance of clerical proofs, and the authority of transactions. For instance, there is review of supporting documents for cash disbursements—both for approval and check signing. Later these documents should be examined to make sure they are thoroughly cancelled. The first is pre-review and is preventative. The second is post review and uncovers unauthorized transactions. Both must be accomplished to close loopholes —pre-review is best for major transactions; post review, for minor repetitive transactions. The reviewer should know the purpose of review, should be alert, and should be free of pressures. He should be independent of control of, or retaliation from, the person reviewed, and he should be free of self-interest.

Another very important tool is training. Training is acquainting the employee with his job—his responsibilities, his duties, and how he should perform his job. It is helpful to explain the relationship of his duties to the overall firm objectives and policies. On-job and class training for improvement in the job and for advancement is advantageous to the employee and employer. Staff manuals are helpful in the above training aspects.

Examples of preventive devices, or physical safeguards, are locked cash drawers, safes, safe deposit boxes, vaults, controlled storerooms and supplies, and insurance. These help prevent loss from waste, spoilage, catastrophies, deterioration, and unauthorized transactions.

Clerical proof devices are "directed at assuring accuracy by preventing unintentional errors." Some mechanical examples of clerical proof devices are adding and calculating machines, cash registers, and bookkeeping machines, which will be discussed later. Some non-mechanical examples are double entry bookkeeping, books of original entry requiring crossfooting, write-it-once systems, and duplicate independent calculations.[2]

If used properly these seven tools will implement and provide excellent internal control.

Fraud occurs most often in cash transactions because it is a liquid medium. There is no conversion problem. Being a common medium of exchange, it is more desirable than other assets. It is easy to conceal about the person and most difficult to identify as belonging to any specific person.[3]

It has been found that 74% of the dollar amount of losses due to fraud occur through cash disbursements, 14% through cash receipts, and 12% through inventories. When it comes

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to the number of situations, 43% occur through cash disbursements, 49% through cash receipts, and only 8% through inventory fraud.[4]

The most common method of fraud in cash receipts is lapping and failure to report cash sales or miscellaneous receipts. Most receipts stolen are in currency. To cover lapping of receipts, the employee may misfoot cash columns or trial balances of the accounts receivable subsidiary, or add or remove detail ledger cards. There is also great temptation for fraud when route or delivery men make collections.[5]

Most cash disbursement frauds arise by use of fictitious documents or duplicate invoices, by not cancelling paid invoices, or by alteration of legitimate documents. There may or may not be collusion involved between employees.

There are ways to prevent these methods of fraud by better internal control over cash. Duties should be separated as much as possible. A person who collects cash from customers over the counter or by mail should not have access to the accounting records. If possible, another person should deposit the receipts. Yet another should receive the unopened bank statement and reconcile the bank account. The authorizer of cash disbursements, or the check signer, should be a different person than the one making out the checks.

An accounting office would need to be relatively large to have distinct separation of the above duties, but much can be accomplished in a small office. Employees should be required to take vacations. There should also be a rotation of duties for control and training purposes.

Cash which has been received, but not yet recorded, is the most vulnerable. A receptionist or cashier may open mail and list the receipts by amount and name. A copy of this list should go to the accounts receivable clerk for posting to the customer accounts. Another copy should be used to compare with the duplicate deposit slip. Prenumbered receipts or cash sales invoices should be given for all cash taken over the counter. All receipts should be deposited intact daily so that there is no "borrowing" from cash receipts. These internal controls will also facilitate the tracing of receipts to deposits.

A clerk, delivery boy, or even executive could make the daily deposit, thus using someone with no connection with the bookkeeping function. The cashbook entries should be compared to the deposits by someone independent of the cashier. Duplicate deposit slips should be stamped by the bank and filed.[6]

There *never* should be any payments out of cash receipts. A petty cash fund should be established for this purpose.

Billing, posting of accounts, and follow-up of delinquent accounts should be handled by someone other than the one who handles the receipts on accounts receivable. This will establish separate accountability. Failure to record a receipt will usually be followed by prompt customer response.[7] Bad debt write-offs should be authorized in writing by a proper official.

Cash disbursements should definitely be made in the form of a check rather than cash. There are many reasons for using checks. A bank will pay only on authorized signatures; checks and bank statements are written records; and the endorsement is a form of receipt. Checks should be prenumbered by a printer and all numbers accounted for. The supply of unused checks should be held in safekeeping. Voided checks should be permanently defaced and kept on file for verification.[8]

Invoices or supporting documents should be approved in writing by an authorized official, unless the only "official" will be the one who will be signing the check. He should examine the document carefully before signing the check and then initial the invoice. Two signatures are better control than one. Both signers must be fully alert and aware of a proper expenditure before signing. Any person who automatically signs a check placed before him might as well delegate the check signing to the bookkeeper, for there is no effectiveness to his control.

Once the checks are signed, they should not be returned to the preparer but should be distributed by another person. All supporting documents, invoices, statements, copies, etc. should be clearly cancelled so they cannot be presented for payment a second time.[9]

Someone in the position of authority should receive the bank statement unopened and review the cancelled checks and deposits for obvious irregularities. He or another independent person should reconcile the bank accounts.

If used properly, mechanical devices, such as bookkeeping machines, check writers, signers, etc. add more control by their own built-in controls. The bookkeeping machine has running totals and does many bookkeeping functions in one operation, so that one record cannot be easily changed. The check writers and signers should be kept locked so that only the authorized person has access to them; and, after their use, the checks cannot be changed without notice.

Petty cash funds or other imprest funds can be controlled much like cash disbursements with prenumbered vouchers, proper approval, signatures to signify receipt, cancellation, and proper reimbursement of the fund.

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not, that he has been negligent in not informing you. A positive approach would be to tell him that you were considering revising the report so that it might be more meaningful to him, and ask him for his suggestions on the revision. If it is a weekly report, ask him if a monthly report would suffice. If he gets multiple copies of the report, find out if one copy would be enough. If there is a similar report being prepared in your department for some other purpose, show him a copy of it and ask him if it is acceptable for his use. If the report is prepared just for him, be very specific in pointing this out. Whatever the results of your conversation, he will be informed that reports going to him, or prepared for him, are under review and he will probably take a second look at the material he is receiving.

One method was used by a company which, while rather extreme, produced very good results. Each internal report going out from the accounting department during a certain period of time carried a memorandum which said very briefly, "Due to a change in our accounting systems, this report will no longer be prepared." The supervisor received several calls from departments which explained their need for the information and those reports were rescheduled, but at least 50% of the reports died a quiet natural death and were prepared no more.

During the course of your review, you will begin to see your office as a systems group will see it. By discussing each operation with each employee, you may both see a better way to do the job. By reviewing all desks within a short period of time, you will probably see duplications of which you were not aware. If minor changes are involved, make them immediately. For major changes, make notes of improvements which you feel would be beneficial and pass them along to the survey team when they arrive.

By all means, eliminate the things which would prove embarrassing to you if disclosed by a systems team—and they do exist in every office! Is your accounts payable clerk filing away two copies of a paid invoice? Are your paid invoices hand-cancelled when they could be machine-perforated or stamped? Are checks held beyond the date of receipt and handled by several different employees? Is your cashier keeping a "kitty" composed of cash overages and shortages each day, rather than reporting the cash differences? Are you using forms which have been out-dated and require new headings or other time-consuming changes? Are your employees typing information on checks or invoices which could be pre-printed? Do your bookkeeping journals require the posting of information which is no longer used? Do you have pro-forma worksheets for weekly or monthly reports? Are the office duties properly assigned and scheduled? Does more than one employee know how to do each task?

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Last, but most important, is the work in your office up to date? Keep in mind that no new system could be instituted in an office which is not current. If the accounts receivable are not in balance, putting them on a machine will not balance them. As you review each desk, prepare some plan for each task that is lagging behind. If peak activity is expected on any desk within the next few weeks, such as quarterly reports on a payroll desk, plan some assistance for that desk so the clerk will have time to spend with the survey team. The team will have to talk to each employee, and a harried employee is not very helpful to a person seeking detailed information.

These are some of the things you can do before the survey team arrives. The main objective is to be able to answer questions quickly and accurately, to have as much data as possible accumulated in advance, to familiarize your employees with the purpose of the survey, and to create an atmosphere of enthusiasm in your office. The results will be more than gratifying.

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One person should have full responsibility of the fund; and reimbursement checks should be made out to the custodian of the fund.

There should be a maximum limit placed on a single petty cash disbursement, and employees should not be allowed to borrow from the fund in the form of postdated checks or I.O.U.'s. The best policy is to eliminate cashing of employee checks, either payroll or personal.

Bonding of any employee who has access to company cash is another good control, which provides many psychological advantages. An insurance company is more likely to prosecute an offender than the employer who is emotionally involved. The insurance company will usually investigate the employee before he is bonded and may decide whether this employee should be put in a position of trust according to his past record. This action should help to prevent fraud.[10]

There are many examples of specific methods used to provide internal control over cash. The weak point in a retail organization is the point of sale. Some suggested controls to prevent unrecorded cash sales in a retail organization are a central cashier, duplicate sales tickets, signs reminding customers to request cash register receipts, store detectives, and independent "spotters."[11]

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Since the gain is more than the excess depreciation, the amount recaptured or taxable as ordinary income would be—(a) 48 per cent [100 less (72-20%)] of $60,000 or $28,800 plus (b) 84 per cent [100 less (36-20%)] of $20,000 or $16,800, making a total of $45,600 taxable as ordinary income, with the balance of $54,400 taxable at capital gains rates.

The recapture formula is applied to major improvements separately, provided they are substantial and were made over a 36-month period. Improvements in any tax year that cost $2,000 or less or not more than 1 per cent of the original cost are completely disregarded. The improvements are substantial if the cost exceeds whichever is the greater of the following: (a) $5,000, (b) 25 per cent of the adjusted basis at the beginning of the 36-month period, or (c) 10 per cent of the unadjusted basis.

Now that you have read the preceding, let me enlighten you by some clear (?) and concise language (?) as used in the Code:

"EXCEPTIONS AND LIMITATIONS—

Certain Tax-free Transactions.—If the basis of property in the hands of a transferee is determined by reference to its basis in the hands of the transferor by reason of the application of Section 332, 351, 361, 371(a), 374(a), 721 or 731, then the amount of gain taken into account by the transferor under subsection (a) (1) shall not exceed the amount of gain recognized to the transferor on the transfer of such property (determined without regard to this section). This paragraph shall not apply to a disposition to an organization (other than a cooperative described in Section 521) which is exempt from the tax imposed by this chapter."

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In restaurants, prenumbered tickets written by the waitress provide control over the cashier. For more complete control, however, a third person should perform all of the three following steps:

1. Total the tickets collected by the cashier.
2. Account for all the prenumbered tickets issued since the previous day.
3. Inspect the tickets for alteration.[12]

A movie theatre can use prenumbered tickets which are accounted for. The ticket taker tears the stub in half for control. There must be collusion between the ticket taker and cashier to palm tickets and return them for resale.[13]

A common device used to control cash sales is a cash register which has locked-in totals (cannot be cleared by anyone without a key). The visible total showing at the top of the machine and the printed receipt allows the customer to help with this control. It is important to use the machine correctly by segregating duties. Not knowing how much he should have, the sales clerk counts the cash drawer at the end of the day and turns the cash and records over to the office or cashier. "Someone who has no contact with the cash 'reads' the cash register by inserting a key which is necessary to print the cumulative or daily total."[14] The machine is then cleared, the tape removed and compared to the clerk's cash record. A running record should be kept of shortages or overages to see that there is no "borrowing" of funds.[15]

When a cash register is not financially feasible, another mechanical device is a machine which holds and automatically feeds a three copy prenumbered form into an open writing space. The information, which may include the customer's signature, is completed on the form. By a turn of a crank, two copies are released—one for the clerk and one for the customer. The third copy goes into a locked compartment, opened only by key.

Internal control can exist regardless of the size of the firm. In a small office, the owner can provide internal control by using as many of the above controls as possible, through his intimate knowledge of his business, and by observation of the procedures being used. The gamut can be run to the large firm which uses an independent internal control department which reviews the actual use of the above internal control principles and also uses independent auditing procedures.

Footnotes

[1&2]R. K. Mautz and R. Schlosser, "Internal Control Techniques," *Journal of Accountancy*, October 1957, p. 45-47.

[3]W. B. Jencks, *Auditing Principles*, p. 113.

[4]C. A. Stewart, "Nature and Prevention of Fraud," *Journal of Accountancy*, February 1957, p. 42.

[5]*Ibid.*, p. 43.

[6]Cutley and Bauer, *Auditing*, p. 84.

[7]Howard F. Stettler, *Auditing Principles*, p. 192.

[8]*Ibid.*

[9]*Ibid.*

[10]Jencks, *op. cit.*, p. 118.

[11]*Ibid.*, p. 115.

[12]Stettler, *op. cit.*, p. 193-4.

[13]*Ibid.*

[14]*Ibid.*

[15]*Ibid.*, p. 192.

(See page 10 for Bibliography)

more of its support for each of three out of its last four taxable years ending prior to July 1, 1964, from such sources. Indirect contributions from the general public include contributions from other "publicly supported" organizations, such as a United Givers Fund.

The requirement that the support be received from the general public means that such support must be received from a wide segment of the public, and not solely from a few individuals or families. Therefore, contributions by any individual, trust, or corporation shall be taken into account in determining whether the ⅓ of support test is met only to the extent that such contributions do not exceed 1 per cent of the organization's total support. In applying this 1-percent limitation, all contributions made by a donor and a related person within the meaning of section 267 (b) shall be treated as made by one person. The 1-percent limitation does not apply to contributions from governmental units or from other "publicly supported" organizations."

Gain on Repossession of Real Estate

The following item written by Betty Jane Loos of the Tucson Chapter, discusses gain on repossession of real estate, the sale of which is being reported on the installment method.

"The taxable gain on repossession of real estate (for which the seller accepted indebtedness secured by the real property at the time of the sale) has been cut under a new law (P.L.88-570) applicable to taxable years beginning after September 2, 1964. Further, if you did report a gain on repossession in 1961, 1962 or 1963 (or, in unusual situations, all the way back to 1958) you may be able to get tax refunds if you elect on or before September 2, 1965, to apply the treatment provided by this law.

For example:

Sale price	$10,000.00
Down payment	800.00
Mortgage receivable	9,200.00
Cost	6,000.00

You have previously reported your gain on the sale on the installment basis, picking up $320.00 (40% of $800.00) you received as income.

This year, the buyer doesn't make his payments and you repossess. All you have to pay tax on at the time of repossession is $480.00, the difference between the $800.00 you received and the $320.00 you reported. In the past, all of the gain was to be reported ($3,680.00) for the year of repossession, raising the basis of the repossessed property.

Thus, the new law eliminates the taxing of the unrealized gain and keeps the basis of the property at a more realistic value."

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RECOGNITION BY THE ACCOUNTANTS DIGEST

The September 1964 issue of THE ACCOUNTANTS DIGEST (Volume XXX, Number 1) includes material taken from our August 1964 issue. The editor of THE ACCOUNTANTS DIGEST has selected "Gift and Estate Taxes" which was written by Esther Migdal, CPA, Chicago, Illinois. Our congratulations to Mrs. Migdal.