

# Internal Control and Cash

## THE NAVIGATOR ✓

Understand <b>Concepts for Review</b>	<input type="checkbox"/>
Read <b>Feature Story</b>	<input type="checkbox"/>
Scan <b>Study Objectives</b>	<input type="checkbox"/>
Read <b>Preview</b>	<input type="checkbox"/>
Read text and answer <b>Before You Go On</b> p. 341 <input type="checkbox"/> p. 349 <input type="checkbox"/> p. 357 <input type="checkbox"/> p. 358 <input type="checkbox"/>	
Work <b>Demonstration Problem</b>	<input type="checkbox"/>
Review <b>Summary of Study Objectives</b>	<input type="checkbox"/>
Answer <b>Self-Study Questions</b>	<input type="checkbox"/>
Complete <b>Assignments</b>	<input type="checkbox"/>

## CONCEPTS FOR REVIEW

Before studying this chapter, you should know or, if necessary, review:

- How cash transactions are recorded.  
(Ch. 2, pp. 53–66)
- How cash is classified on a balance sheet.  
(Ch. 4, pp. 158–159)
- The role ethics plays in proper financial reporting.  
(Ch. 1, p. 9)

**Minding the Money in Moose Jaw** If you're ever looking for a cappuccino in Moose Jaw, Saskatchewan, stop by **Stephanie's Gourmet Coffee and More**, located on Main Street. Staff there serve, on average, 646 cups of coffee a day—including both regular and specialty coffees—not to mention soups, Italian sandwiches, and a wide assortment of gourmet cheesecakes.

"We've got high school students who come here, and students from the community college," says owner/manager Stephanie Mintenko, who has run the place since opening it in 1995. "We have customers who are retired, and others who are working people and have only 30 minutes for lunch. We have to be pretty quick."



That means that the cashiers have to be efficient. Like most businesses where purchases are low-cost and high-volume, cash control has to be simple.

"We have an electronic cash register, but it's not the fancy new kind where you just punch in the item," explains Ms. Mintenko. "You have to punch in the prices." The machine does keep track of sales in several categories, however. Cashiers punch a button to indicate whether each item is a beverage, a meal, or a charge for the cafe's Internet connections. All transactions are recorded on an internal tape in the machine; the customer receives a receipt only upon request.

There is only one cash register. "Up to three of us might operate it on any given shift, including myself," says Ms. Mintenko.

She and her staff do two "cashouts" each day—one with the shift change at 5:00, and one when the shop closes at 10:00. The cash in the register drawer is counted. That amount, minus the cash change carried forward (the float), should match the shift total on the register tape. If there's a discrepancy, they do another count. Then, if necessary, "we go through the whole tape to find the mistake," she explains. "It usually turns out to be someone who punched in \$18 instead of \$1.80, or something like that."

Ms. Mintenko sends all the cash tapes and float totals to a bookkeeper, who double checks everything and provides regular reports. "We try to keep the accounting simple, so we can concentrate on making great coffee and food."



## STUDY OBJECTIVES

After studying this chapter, you should be able to:

1. Define internal control.
2. Identify the principles of internal control.
3. Explain the applications of internal control principles to cash receipts.
4. Explain the applications of internal control principles to cash disbursements.
5. Describe the operation of a petty cash fund.
6. Indicate the control features of a bank account.
7. Prepare a bank reconciliation.
8. Explain the reporting of cash.

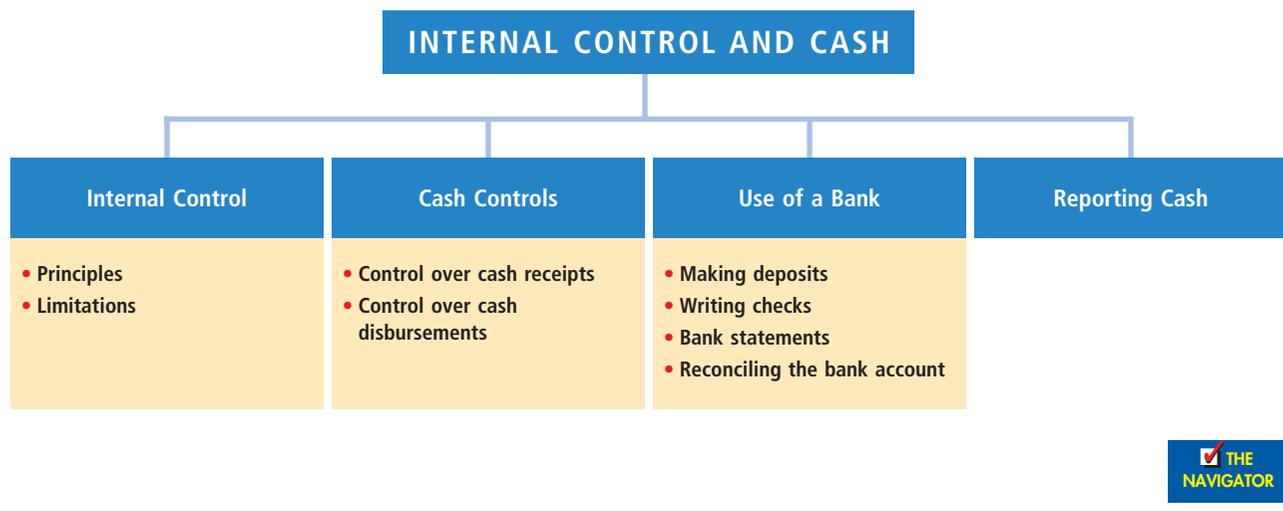


## PREVIEW OF CHAPTER 8

As the story about recording cash sales at **Stephanie's Gourmet Coffee and More** indicates, control of cash is important. Controls are also needed to safeguard other types of assets. For example, Stephanie's undoubtedly has controls to prevent the theft of food and supplies, and controls to prevent the theft of silverware and dishes from its kitchen.

In this chapter, we explain the essential features of an internal control system and then describe how those controls apply to cash. The applications include some controls with which you may be already familiar. Toward the end of the chapter, we describe the use of a bank and explain how cash is reported on the balance sheet.

The content and organization of Chapter 8 are as follows.



## Internal Control

Could there be dishonest employees where you work? Unfortunately, the answer sometimes is Yes. For example, in addition to the highly publicized frauds at **Enron**, **WorldCom**, **Tyco**, and **Global Crossing**, the financial press recently reported the following.

A bookkeeper in a small company diverted \$750,000 of bill payments to a personal bank account over a 3-year period.

A shipping clerk with 28 years of service shipped \$125,000 of merchandise to himself.

A computer operator embezzled \$21 million from **Wells Fargo Bank** over a 2-year period.

A church treasurer “borrowed” \$150,000 of church funds to finance a friend’s business dealings.

These situations emphasize the need for a good system of internal control.

**Internal control** consists of the plan of organization and all the related methods and measures adopted within a business to:

- Safeguard its assets** from employee theft, robbery, and unauthorized use.
- Enhance the accuracy and reliability of its accounting records.** This is done by reducing the risk of **errors** (unintentional mistakes) and **irregularities** (intentional mistakes and misrepresentations) in the accounting process.

### STUDY OBJECTIVE 1

Define internal control.

### Accounting Matters!

The Foreign Corrupt Practices Act of 1977 and more recently, the Sarbanes-Oxley Act of 2002 require all major U.S. corporations to maintain an adequate system of internal control. Companies that fail to comply are subject to fines, and company officers may be imprisoned. Also, the National Commission on Fraudulent Financial Reporting concluded that all companies whose stock is publicly traded should maintain internal controls that can provide reasonable assurance that fraudulent financial reporting will be prevented or subject to early detection.

**ACCOUNTING MATTERS!**



**Ethics Insight**



Fraud takes many forms. Here are two of the dumbest: (1) In Wichita, Kansas, police arrested a 22-year-old male who tried to pass two counterfeit \$16 bills at an airport hotel. (2) And in Newport, Pennsylvania, a new-accounts bank clerk accepted for deposit a fake \$1 million bill, which was 10 times the value of the largest bill ever printed by the government (a \$100,000 bill existed for three weeks in the 1930s) and 10,000 times larger than the \$100 bill, which is the largest bill now in circulation. While the bank clerk learned a hard lesson, the fake bill passer learned about “hard time.”

**Source:** Joseph R. Wells, “The World’s Dumbest Fraudsters,” *Journal of Accountancy* (May 2003), p. 55. Copyright © 2003 from the *Journal of Accountancy* by the American Institute of Certified Public Accountants, Inc. Opinions of the authors are their own and do not necessarily reflect policies of the AICPA. Reprinted with permission.

**?** What could the Pennsylvania bank mentioned above have done to prevent such an error?

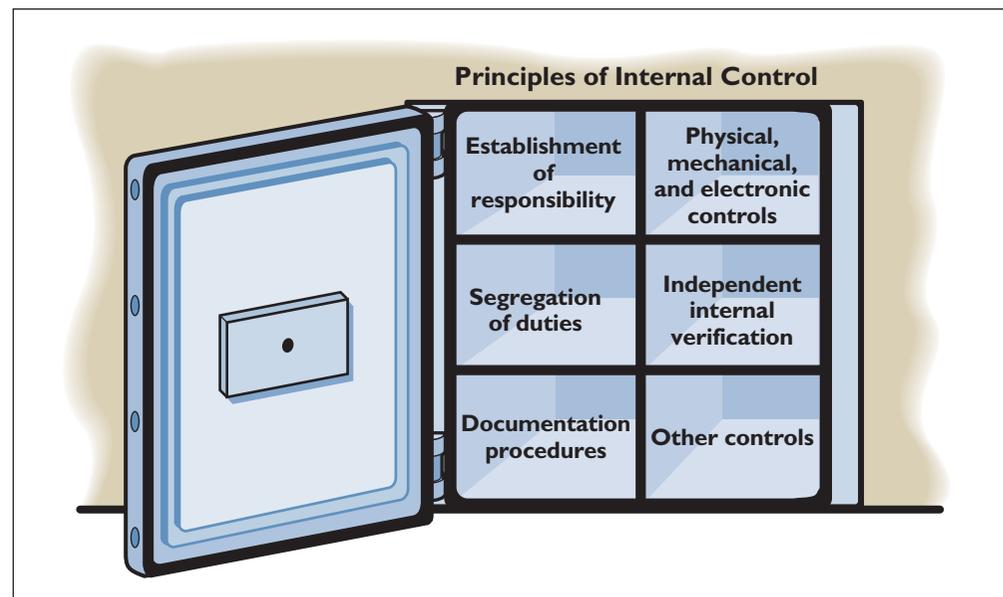
**STUDY OBJECTIVE 2**

Identify the principles of internal control.

**Principles of Internal Control**

To safeguard its assets and enhance the accuracy and reliability of its accounting records, a company follows specific control principles. Of course, internal control measures vary with the size and nature of the business and with management’s control philosophy. The six principles listed in Illustration 8-1 apply to most enterprises. Each principle is explained in the following sections.

**Illustration 8-1**  
Principles of internal control



### Establishment of Responsibility

An essential characteristic of internal control is the assignment of responsibility to specific employees. **Control is most effective when only one person is responsible for a given task.** To illustrate, assume that the cash on hand at the end of the day in a **Safeway** supermarket is \$10 short of the cash rung up on the cash register. If only one person has operated the register, responsibility for the shortage can be assessed quickly. If two or more individuals have worked the register, it may be impossible to determine who is responsible for the error unless each person is assigned a separate cash drawer and register key. The principle of establishing responsibility does not appear to be strictly applied by **Stephanie's** (in the Feature Story) since three people operate the cash register on any given shift. To identify any shortages quickly at Stephanie's, two cashouts are performed each day.

Establishing responsibility includes the authorization and approval of transactions. For example, the vice president of sales should have the authority to establish policies for making credit sales. The policies ordinarily will require written credit department approval of credit sales.



### Segregation of Duties

**Segregation of duties** (also called separation of functions or division of work) is indispensable in a system of internal control. There are two common applications of this principle:

1. Related activities should be assigned to different individuals.
2. Establishing the accountability (keeping the records) for an asset should be separate from the physical custody of that asset.

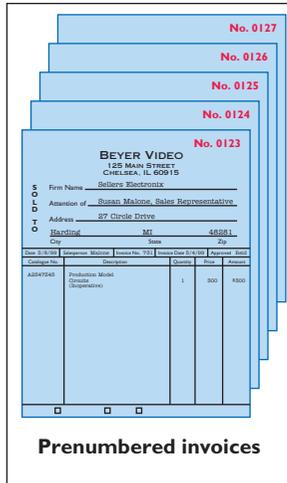
The rationale for segregation of duties is this: **The work of one employee should, without a duplication of effort, provide a reliable basis for evaluating the work of another employee.**

**RELATED ACTIVITIES.** Related activities that should be assigned to different individuals arise in both purchasing and selling. **When one individual is responsible for all of the related activities, the potential for errors and irregularities is increased.** Related purchasing activities include ordering merchandise, receiving the goods, and paying (or authorizing payment) for the merchandise. In purchasing, for example, orders could be placed with friends or with suppliers who give kickbacks. Or, only a cursory count and inspection could be made upon receiving the goods, which could lead to errors and poor-quality merchandise. Payment might be authorized without a careful review of the invoice. Even worse, fictitious invoices might be approved for payment. When the ordering, receiving, and paying are assigned to different individuals, the risk of such abuses is minimized.

Similarly, related sales activities should be assigned to different individuals. Related selling activities include making a sale, shipping (or delivering) the goods to the customer, billing the customer, and receiving payment. When one person handles related sales transactions, a salesperson could make sales at unauthorized prices to increase sales commissions; a shipping clerk could ship goods to himself; a billing clerk could understate the amount billed for sales made to friends and relatives. These abuses are reduced by dividing the sales tasks: the salespersons make the sale; the shipping department ships the goods on the basis of the sales order; and the billing department prepares the sales invoice after comparing the sales order with the report of goods shipped.



**ACCOUNTABILITY FOR ASSETS.** To provide a valid basis of accountability for an asset, the accountant should have neither physical custody of the asset nor access to it. Likewise, the custodian of the asset should not maintain or have access to the accounting records. **When one employee maintains the record of the asset that should be on hand, and a different employee has physical custody of the asset, the custodian of the asset is not likely to convert the asset to personal use.** The separation of accounting responsibility from the custody of assets is especially important for cash and inventories because these assets are very vulnerable to unauthorized use or misappropriation.



**Documentation Procedures**

Documents provide evidence that transactions and events have occurred. At **Stephanie’s Gourmet Coffee and More**, the cash register tape was the restaurant’s documentation for the sale and the amount of cash received. Similarly, the shipping document indicates that the goods have been shipped, and the sales invoice indicates that the customer has been billed for the goods. By adding signatures (or initials) to the documents, the individual(s) responsible for the transaction or event can be identified. Documentation of transactions should be made when the transaction occurs. Documentation of events, such as those leading to adjusting entries, is generally developed when the adjustments are made.

Several procedures should be established for documents. First, whenever possible, **documents should be prenumbered, and all documents should be accounted for.** Prenumbering helps to prevent a transaction from being recorded more than once. It also helps to prevent the transactions from not being recorded. Second, documents that are **source documents for accounting entries should be promptly forwarded to the accounting department. This control measure helps to ensure timely recording of the transaction** and contributes directly to the accuracy and reliability of the accounting records.

**Physical, Mechanical, and Electronic Controls**

Use of physical, mechanical, and electronic controls is essential. Physical controls relate primarily to the safeguarding of assets. Mechanical and electronic controls also safeguard assets; some enhance the accuracy and reliability of the accounting records. Examples of these controls are shown in Illustration 8-2 on page 339.

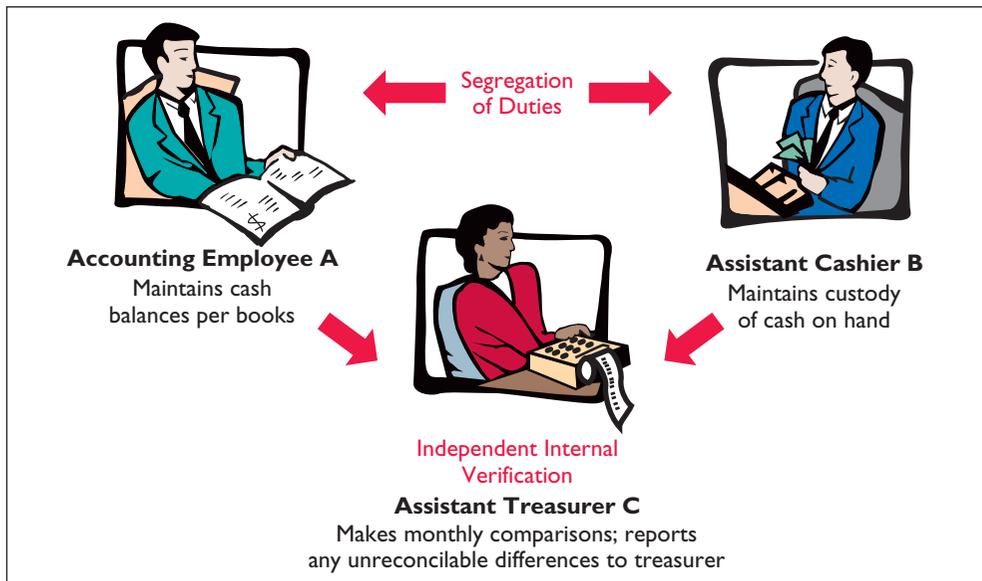
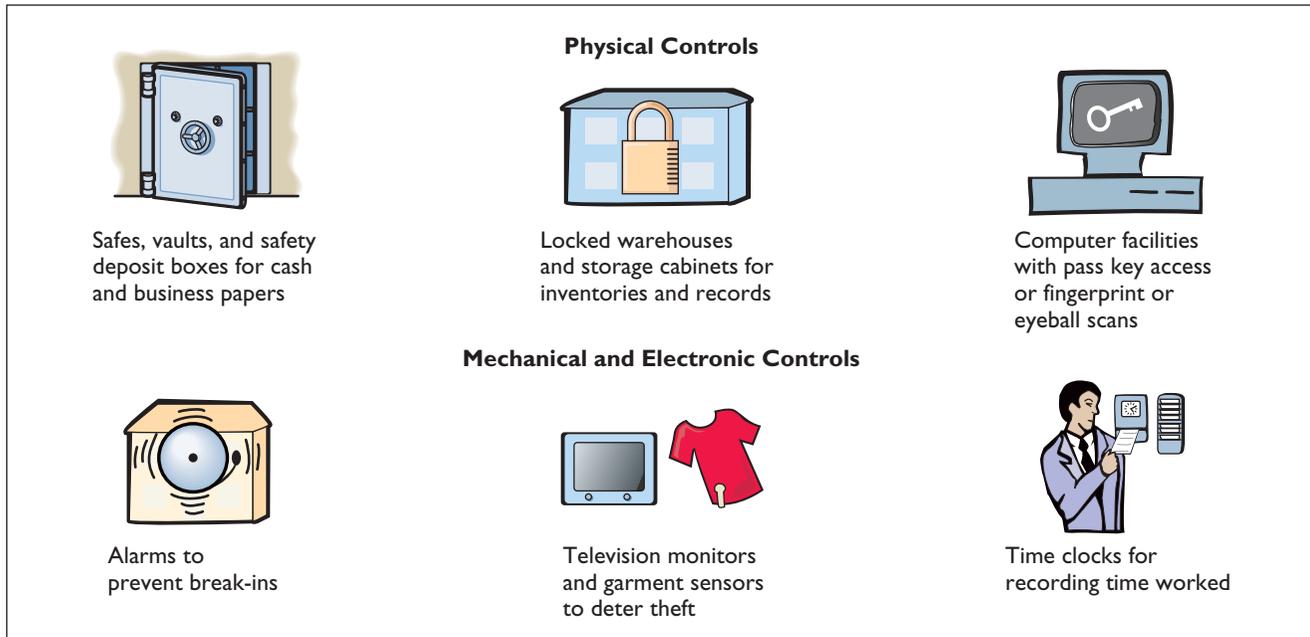
**Independent Internal Verification**

Most internal control systems provide for **independent internal verification.** This principle involves the review, comparison, and reconciliation of data prepared by other employees. To obtain maximum benefit from independent internal verification:

1. The verification should be made periodically or on a surprise basis.
2. The verification should be done by someone who is independent of the employee responsible for the information.
3. Discrepancies and exceptions should be reported to a management level that can take appropriate corrective action.

Independent internal verification is especially useful in comparing recorded accountability with existing assets. The reconciliation of the cash register tape with the cash in the register at **Stephanie’s Gourmet Coffee and More** is an example of this internal control principle. Another common example is the reconciliation by an independent person of the cash balance per books with the cash balance per bank. The relationship between this principle and the segregation of duties principle is shown graphically in Illustration 8-3 on page 339.

**Illustration 8-2**  
Physical, mechanical, and electronic controls



**Illustration 8-3**  
Comparison of segregation of duties principle with independent internal verification principle

In large companies, independent internal verification is often assigned to internal auditors. **Internal auditors** are company employees who evaluate on a continuous basis the effectiveness of the company's system of internal control. They periodically review the activities of departments and individuals to determine whether prescribed internal controls are being followed. They also recommend improvements when needed. The importance of this function is illustrated by the fact that most fraud is discovered by the company through internal mechanisms, such as existing internal controls and internal audits. The recent alleged fraud at **WorldCom** involving billions of dollars, for example, was uncovered by an internal auditor.

**Accounting Matters!**



### Other Controls

Other control measures include the following.

1. **Bonding of employees who handle cash.** Bonding involves obtaining insurance protection against misappropriation of assets by dishonest employees. This measure contributes to the safeguarding of cash in two ways: First, the insurance company carefully screens all individuals before adding them to the policy and may reject risky applicants. Second, bonded employees know that the insurance company will vigorously prosecute all offenders.
2. **Rotating employees' duties and requiring employees to take vacations.** These measures are designed to deter employees from attempting any thefts since they will not be able to permanently conceal their improper actions. Many bank embezzlements, for example, have been discovered when the perpetrator was on vacation or assigned to a new position.

## ACCOUNTING MATTERS!



## International Insight



It's said that accountants' predecessors were the scribes of ancient Egypt, who kept the pharaohs' books. They inventoried grain, gold, and other assets. Unfortunately, some fell victim to temptation and stole from their leader, as did other employees of the king. The solution was to have two scribes independently record each transaction (the first internal control). As long as the scribes' totals agreed exactly, there was no problem. But if the totals were materially different, both scribes would be put to death. That proved to be a great incentive for them to carefully check all the numbers and make sure the help wasn't stealing. In fact, fraud prevention and detection became the royal accountants' main duty.

**Source:** Joseph T. Wells, "So That's Why It's Called a Pyramid Scheme," *Journal of Accountancy* (October 2000), p. 91. Copyright © 2000 from the *Journal of Accountancy* by the American Institute of Certified Public Accountants, Inc. Opinions of the authors are their own and do not necessarily reflect policies of the AICPA. Reprinted with permission.



Which principle of internal control was implemented in ancient Egypt? Who do you think investors today expect to detect and prevent fraud?

### HELPFUL HINT

Controls may vary with the risk level of the activity. For example, management may consider cash to be high risk and maintaining inventories in the stock room as low risk. Thus management would have stricter controls for cash.

### Limitations of Internal Control

A company's system of internal control is generally designed to provide **reasonable assurance** that assets are properly safeguarded and that the accounting records are reliable. **The concept of reasonable assurance rests on the premise that the costs of establishing control procedures should not exceed their expected benefit.** To illustrate, consider shoplifting losses in retail stores. Such losses could be eliminated by having a security guard stop and search customers as they leave the store. But, store managers have concluded that the negative effects of adopting such a procedure cannot be justified. Instead, stores have attempted to "control" shoplifting losses by less costly procedures such as: (1) posting signs saying, "We reserve the right to inspect all packages," and "All shoplifters will be prosecuted," (2) using hidden TV cameras and store detectives to monitor customer activity, and (3) using sensing equipment at exits.

The **human element** is an important factor in every system of internal control. A good system can become ineffective as a result of employee fatigue, carelessness, or indifference. For example, a receiving clerk may not bother to count goods received or may just "fudge" the counts. Occasionally, two or more individuals may work together to get around prescribed controls. Such **collusion** can significantly

impair the effectiveness of a system, eliminating the protection offered by segregation of duties. If a supervisor and a cashier collaborate to understate cash receipts, the system of internal control may be negated. No system of internal control is perfect.

The size of the business also may impose limitations on internal control. In a small company, for example, it may be difficult to segregate duties or to provide for independent internal verification.

## ACCOUNTING MATTERS!



## Business Insight

Unfortunately, computer-related frauds have become a major concern. The average computer fraud loss is \$650,000, compared with an average loss of only \$19,000 resulting from other types of white-collar crime.

Computer fraud can be perpetrated almost invisibly and done with electronic speed. Psychologically, stealing with impersonal computer tools can seem far less criminal to some people. Therefore, the moral threshold to commit computer fraud is lower than fraud involving person-to-person contact.

Preventing and detecting computer fraud represents a major challenge. One of the best ways for a company to minimize the likelihood of computer fraud is to have a good system of internal control that allows the benefits of computerization to be gained without opening the possibility for rampant fraud.



Is a computer capable of committing fraud? Discuss.

## BEFORE YOU GO ON...

### Review It

1. What are the two primary objectives of internal control?
2. Identify and describe the principles of internal control.
3. What are the limitations of internal control?

### Do It

Li Song owns a small retail store. Li wants to establish good internal control procedures but is confused about the difference between segregation of duties and independent internal verification. Explain the differences to Li.

### ACTION PLAN

- Understand and explain the differences between (1) segregation of duties and (2) independent internal verification.

**SOLUTION** Segregation of duties involves assigning responsibility so that the work of one employee evaluates the work of another employee. Segregation of duties occurs daily in executing and recording transactions. In contrast, independent internal verification involves reviewing, comparing, and reconciling data prepared by one or several employees. Independent internal verification occurs after the fact, as in the case of reconciling cash register totals at the end of the day with cash on hand.

Related exercise material: *BE8-1, BE8-2, and E8-1.*



## Cash Controls

Just as cash is the beginning of a company's operating cycle, it is also usually the starting point for a company's system of internal control. Cash is the one asset that is readily convertible into any other type of asset. It is easily concealed and transported, and it is highly desired. Because of these characteristics, **cash is the asset most susceptible to improper diversion and use**. Moreover, because of the large volume of cash transactions, numerous errors may occur in executing and recording them. To safeguard cash and to ensure the accuracy of the accounting records for cash, effective internal control over cash is imperative.

**Cash** consists of coins, currency (paper money), checks, money orders, and money on hand or on deposit in a bank or similar depository. The general rule is that if the bank will accept it for deposit, it is cash. Items such as postage stamps and postdated checks (checks payable in the future) are not cash. Stamps are a pre-paid expense; the postdated checks are accounts receivable. In the following sections we explain the application of internal control principles to cash receipts and cash disbursements.

### Internal Control over Cash Receipts

Cash receipts come from a variety of sources: cash sales; collections on account from customers; the receipt of interest, rent, and dividends; investments by owners; bank loans; and proceeds from the sale of noncurrent assets. Illustration 8-4 (page 343) shows how the internal control principles explained earlier apply to cash receipts transactions.

As might be expected, companies vary considerably in how they apply these principles. To illustrate internal control over cash receipts, we will examine control measures for a retail store with both over-the-counter and mail receipts.

#### Over-the-Counter Receipts

Control of over-the-counter receipts in retail businesses is centered on cash registers that are visible to customers. In supermarkets and in variety stores such as **Kmart**, cash registers are placed in check-out lines near the exit. In stores such as **Sears, Roebuck & Co.** and **J. C. Penney**, each department has its own cash register. A cash sale is "rung up" on a cash register **with the amount clearly visible to the customer**. This measure prevents the cashier from ringing up a lower amount and pocketing the difference. The customer receives an itemized cash register receipt slip and is expected to count the change received. A cash register tape is locked into the register until removed by a supervisor or manager. This tape accumulates the daily transactions and totals. When the tape is removed, the supervisor compares the total with the amount of cash in the register. The tape should show all registered receipts accounted for. The supervisor's findings are reported on a cash count sheet which is signed by both the cashier and supervisor. The cash count sheet used by Alrite Food Mart is shown in Illustration 8-5 (page 343).

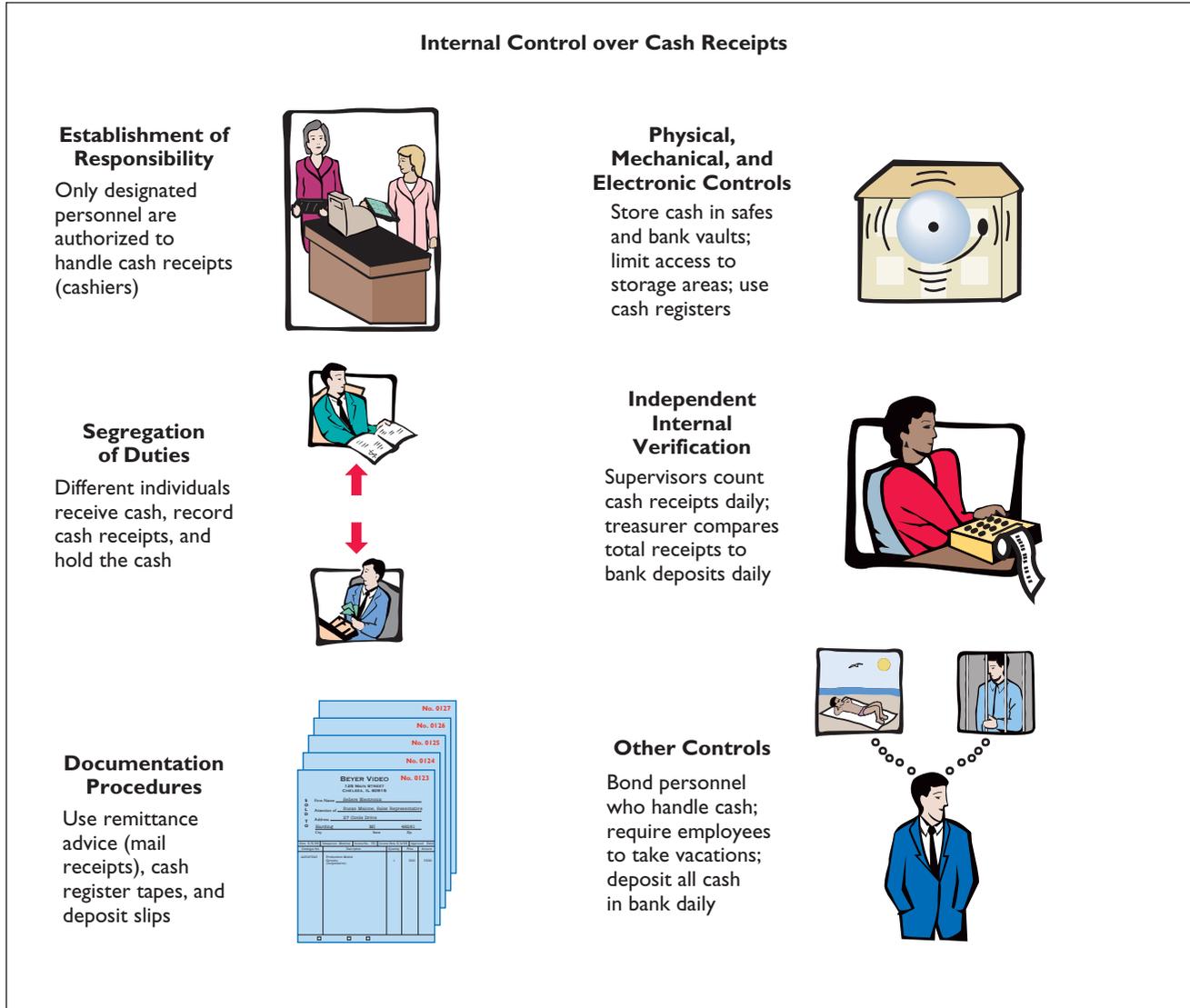
The count sheets, register tapes, and cash are then given to the head cashier. This individual prepares a daily cash summary showing the total cash received and the amount from each source, such as cash sales and collections on account. The head cashier sends one copy of the summary to the accounting department for entry into the cash receipts journal. The other copy goes to the treasurer's office for later comparison with the daily bank deposit (see daily cash summary in Illustration 8-6, page 344).

Next, the head cashier prepares a deposit slip (see Illustration 8-9 on page 350) and makes the bank deposit. The total amount deposited should be equal to the total receipts on the daily cash summary. This will ensure that all receipts have been placed in the custody of the bank. In accepting the bank deposit, the bank stamps (authenticates) the duplicate deposit slip and sends it to the company treasurer, who makes the comparison with the daily cash summary.

#### STUDY OBJECTIVE 3

Explain the applications of internal control principles to cash receipts.

**Illustration 8-4**  
Application of internal control principles to cash receipts



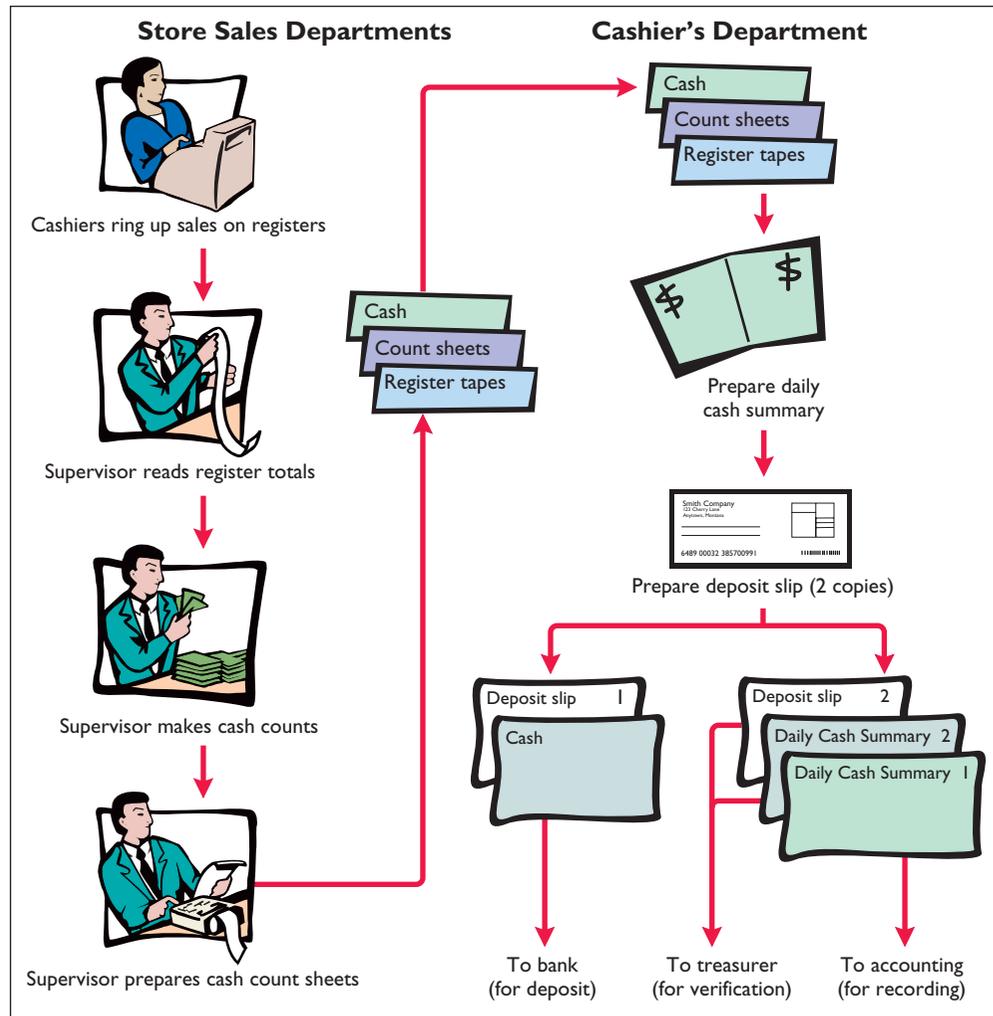
Store No. <u>8</u>	Date <u>March 8, 2006</u>
1. Opening cash balance	\$ 50.00
2. Cash sales per tape (attached)	<u>6,956.20</u>
3. Total cash to be accounted for	7,006.20
4. Less: Cash on hand (see list)	<u>6,996.10</u>
5. Cash (short) or over	\$ <u>(10.10)</u>
6. Ending cash balance	\$ <u>50.00</u>
7. Cash for deposit (Line 4 – Line 6)	<u>\$6,946.10</u>
Cashier <u>J. Cruise</u>	Supervisor <u>M. Braun</u>

**Illustration 8-5**  
Cash count sheet

These measures for cash sales are graphically presented in Illustration 8-6. The activities of the sales department are shown separately from those of the cashier's department to indicate the segregation of duties in handling cash.

**Illustration 8-6**  
Executing over-the-counter cash sales

**HELPFUL HINT**  
Flowcharts such as this one enhance the understanding of the flow of documents, the processing steps, and the internal control procedures.



### Mail Receipts

As an individual customer, you may be more familiar with over-the-counter receipts than with mail receipts. However, mail receipts resulting from billings and credit sales are by far the most common way cash is received by businesses. Think, for example, of the number of checks received through the mail daily by a national retailer such as **J. Crew** or **Abercrombie & Fitch**.

All mail receipts should be opened in the presence of two mail clerks. These receipts are generally in the form of checks or money orders. They frequently are accompanied by a remittance advice stating the purpose of the check (sometimes attached to the check, but often a part of the bill that the customer tears off and returns). Each check should be promptly endorsed "For Deposit Only" by use of a company stamp. This **restrictive endorsement** reduces the likelihood that the check will be diverted to personal use. Banks will not give an individual any cash under this type of endorsement.

A list of the checks received each day should be prepared in duplicate. This list shows the name of the issuer of the check, the purpose of the payment, and the

amount of the check. Each mail clerk should sign the list to establish responsibility for the data. The original copy of the list, along with the checks and remittance advices, are then sent to the cashier's department. There they are added to over-the-counter receipts (if any) in preparing the daily cash summary and in making the daily bank deposit. Also, a copy of the list is sent to the treasurer's office for comparison with the total mail receipts shown on the daily cash summary. This copy ensures that all mail receipts have been included.

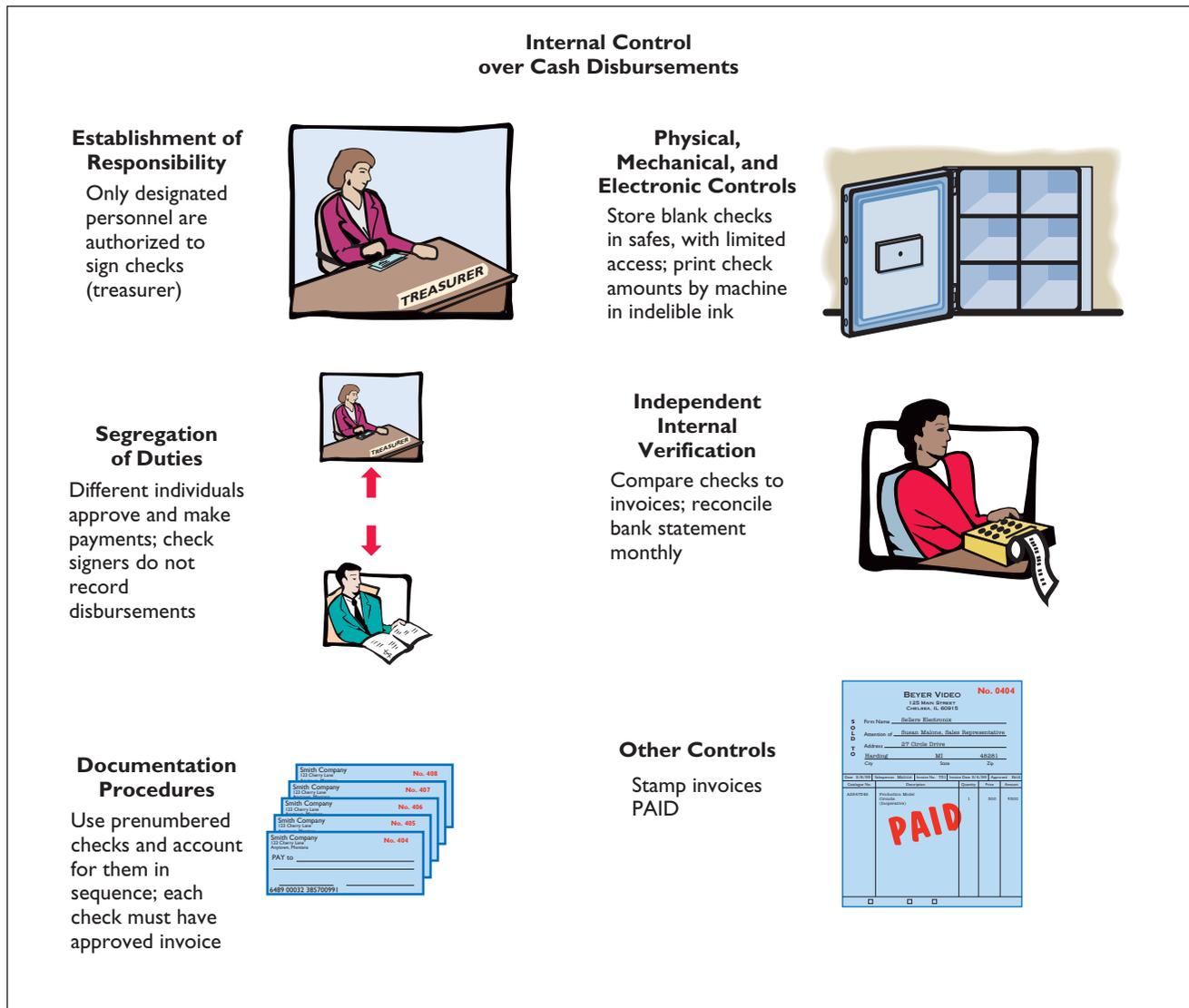
### Internal Control over Cash Disbursements

Cash may be disbursed for a variety of reasons, such as to pay expenses and liabilities, or to purchase assets. **Generally, internal control over cash disbursements is more effective when payments are made by check, rather than by cash.** One exception is for incidental amounts that are paid out of petty cash.<sup>1</sup> Payment by check generally occurs only after specified control procedures have been followed. In addition, the "paid" check provides proof of payment. Illustration 8-7 shows how principles of internal control apply to cash disbursements.

**STUDY OBJECTIVE 4**

Explain the applications of internal control principles to cash disbursements.

**Illustration 8-7**  
Application of internal control principles to cash disbursements



<sup>1</sup>The operation of a petty cash fund is explained on pages 346–349.

### ***Voucher System***

Most medium and large companies use vouchers as part of their internal control over cash disbursements. A **voucher system** is a network of approvals by authorized individuals acting independently to ensure that all disbursements by check are proper.

The system begins with the authorization to incur a cost or expense. It ends with the issuance of a check for the liability incurred. A **voucher** is an authorization form prepared for each expenditure. Vouchers are required for all types of cash disbursements except those from petty cash. The voucher generally is prepared in the accounts payable department.

The starting point in preparing a voucher is to fill in the appropriate information about the liability on the face of the voucher. The vendor's invoice provides most of the needed information. Then, the voucher must be recorded (in a journal called a **voucher register**) and filed according to the date on which it is to be paid. A check is sent on that date, the voucher is stamped "paid," and the paid voucher is sent to the accounting department for recording (in a journal called the **check register**). A voucher system involves two journal entries, one to issue the voucher and a second to pay the voucher.

### ***Electronic Funds Transfer (EFT) System***

Accounting for and controlling cash is an expensive and time-consuming process. The cost to process a check through a bank system is about \$1.00 per check and is increasing. It is not surprising, therefore, that new approaches are being developed to transfer funds among parties without the use of paper (deposit tickets, checks, etc.). Such procedures, called **electronic funds transfers (EFT)**, are disbursement systems that use wire, telephone, or computers to transfer cash from one location to another. Use of EFT is quite common. For example, many employees receive no formal payroll checks from their employers, which instead send electronic depository information to the appropriate banks. Regular payments such as those for house, car, and utilities are frequently made by EFT.

## ACCOUNTING MATTERS!



## Business Insight



A study by the Association of Certified Fraud Examiners indicates that businesses with fewer than 100 employees are most at risk for employee theft. Also, the average loss per incident for small companies—\$127,500—was actually higher than the average loss for larger companies. The high degree of trust often found in small companies makes them more vulnerable to dishonest employees. For example, in one small company the employee responsible for paying bills would intentionally ask the owner to sign checks only when the owner was extremely busy. The employee would slip in one check that was made out to himself, and the owner didn't notice because he was too busy to carefully review each check.

**Source:** Joseph T. Wells, "Occupational Fraud: The Audit as Deterrent," *Journal of Accountancy* (April 2002), pp. 24–28.



Which principles of internal control should have prevented such fraud?

### ***Petty Cash Fund***

As you learned earlier in the chapter, better internal control over cash disbursements is possible when payments are made by check. However, using checks to pay

small amounts is both impractical and a nuisance. For instance, a company would not want to write checks to pay for postage due, employee lunches, or taxi fares. A common way of handling such payments, while maintaining satisfactory control, is to use a petty cash fund. A **petty cash fund** is a cash fund used to pay relatively small amounts but still maintain satisfactory control. The operation of a petty cash fund, often called an **imprest system**, involves three steps: (1) establishing the fund, (2) making payments from the fund, and (3) replenishing the fund.<sup>2</sup>

**STUDY OBJECTIVE 5**  
Describe the operation of a petty cash fund.

**ESTABLISHING THE FUND.** Two essential steps in establishing a petty cash fund are (1) appointing a petty cash custodian who will be responsible for the fund and (2) determining the size of the fund. Ordinarily, the amount is expected to cover anticipated disbursements for a 3- to 4-week period. To establish the fund, a check payable to the petty cash custodian is issued for the stipulated amount. If the Laird Company decides to establish a \$100 fund on March 1, the entry in general journal form is:

Mar. 1	Petty Cash	100		
	Cash		100	
	(To establish a petty cash fund)			

A	=	L	+	SE
+100				
-100				

The custodian cashes the check and places the proceeds in a locked petty cash box or drawer. Most petty cash funds are established on a fixed-amount basis. No additional entries will be made to the Petty Cash account unless management changes the stipulated amount of the fund. For example, if Laird Company decides on July 1 to increase the size of the fund to \$250, it would debit Petty Cash \$150 and credit Cash \$150.

**Cash Flows**  
no effect

**MAKING PAYMENTS FROM THE FUND.** The custodian of the petty cash fund has the authority to make payments from the fund that conform to prescribed management policies. Usually, management limits the size of expenditures that may be made. Likewise, it may not permit use of the fund for certain types of transactions (such as making short-term loans to employees). Each payment from the fund must be documented on a prenumbered petty cash receipt (or petty cash voucher), as shown in Illustration 8-8. Note that the signatures of both the custodian and the person receiving payment are required on the receipt. If other supporting documents such as a freight bill or invoice are available, they should be attached to the petty cash receipt.

No. 7	W. A. LAIRD COMPANY Petty Cash Receipt	
		Date <u>3/8/06</u>
	Paid to <u>Acme Express Agency</u>	Amount <u>\$18.00</u>
	For <u>Collect Express Charges</u>	
	CHARGE TO <u>Freight-in</u>	
Approved		Received Payment
<u>L. A. Bird</u> Custodian		<u>R. E. Meins</u>

**Illustration 8-8**  
Petty cash receipt

<sup>2</sup>The term “imprest” means an advance of money for a designated purpose.

The receipts are kept in the petty cash box until the fund runs low and needs to be replenished. The sum of the petty cash receipts and money in the fund should equal the established total at all times. Surprise counts can be made at any time by an independent person, such as an internal auditor, to determine whether the fund is being maintained intact.

No accounting entry is made to record a payment at the time it is made from petty cash. It is considered unnecessary to do so. Instead, the accounting effects of each payment are recognized when the fund is replenished.

**REPLENISHING THE FUND.** When the money in the petty cash fund reaches a minimum level, the fund is replenished. The request for reimbursement is initiated by the petty cash custodian. This individual prepares a schedule (or summary) of the payments that have been made and sends the schedule, supported by petty cash receipts and other documentation, to the treasurer’s office. The receipts and supporting documents are examined in the treasurer’s office to verify that they were proper payments from the fund. The treasurer then approves the request and a check is prepared to restore the fund to its established amount. At the same time, all supporting documentation (vouchers and/or receipts) is stamped “paid” so that it cannot be submitted again for payment.

To illustrate, assume that on March 15 the petty cash custodian requests a check for \$87. The fund contains \$13 cash and petty cash receipts for postage \$44, freight-out \$38, and miscellaneous expenses \$5. The general journal entry to record the check is:

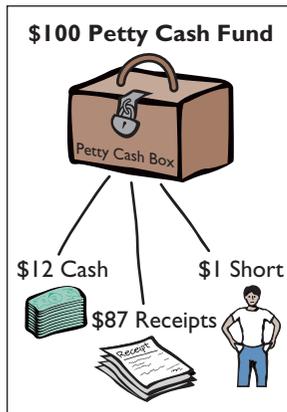
A	=	L	+	SE
-87				-44 Exp
				-38 Exp
				-5 Exp



**HELPFUL HINT**

Cash over and short situations result from mathematical errors or from failure to keep accurate records.

A	=	L	+	SE
-88				-44 Exp
				-38 Exp
				-5 Exp
				-1 Exp



Mar. 15	Postage Expense	44	
	Freight-out	38	
	Miscellaneous Expense	5	
	Cash		87
	(To replenish petty cash fund)		

Note that the Petty Cash account is not affected by the reimbursement entry. Replenishment changes the composition of the fund by replacing the petty cash receipts with cash. It does not change the balance in the fund.

It may be necessary in replenishing a petty cash fund to recognize a cash shortage or overage. This results when the cash plus receipts in the petty cash box do not equal the established amount of the petty cash fund. To illustrate, assume in the example above that the custodian had only \$12 in cash in the fund plus the receipts as listed. The request for reimbursement would, therefore, have been for \$88. The following entry would be made:

Mar. 15	Postage Expense	44	
	Freight-out	38	
	Miscellaneous Expense	5	
	Cash Over and Short	1	
	Cash		88
	(To replenish petty cash fund)		

If the custodian had \$14 in cash, the reimbursement request would have been for \$86 and Cash Over and Short would have been credited for \$1 (overage). A debit balance in Cash Over and Short is reported in the income statement as miscellaneous expense. A credit balance in the account is reported as miscellaneous revenue. Cash Over and Short is closed to Income Summary at the end of the period.

A petty cash fund should be replenished at the end of the accounting period regardless of the cash in the fund. Replenishment at this time is necessary in order to recognize the effects of the petty cash payments on the financial statements.

Internal control over a petty cash fund is strengthened by (1) having a supervisor make surprise counts of the fund to ascertain whether the paid vouchers and

fund cash equal the imprest amount and (2) canceling or mutilating the paid vouchers or receipts so they cannot be resubmitted for reimbursement.

### BEFORE YOU GO ON...

#### Review It

1. How do the principles of internal control apply to cash receipts?
2. How do the principles of internal control apply to cash disbursements?
3. When are entries required in a petty cash system?

#### Do It

L. R. Cortez is concerned about the control over cash receipts in his fast-food restaurant, Big Cheese. The restaurant has two cash registers. At no time do more than two employees take customer orders and ring up sales. Work shifts for employees range from 4 to 8 hours. Cortez asks your help in installing a good system of internal control over cash receipts.

#### ACTION PLAN

- Differentiate among the internal control principles of (1) establishing responsibility, (2) using electronic controls, and (3) independent internal verification.
- Design an effective system of internal control over cash receipts.

**SOLUTION** Cortez should assign a cash register to each employee at the start of each work shift, with register totals set at zero. Each employee should be instructed to use only the assigned register and to ring up all sales. At the end of each work shift, Cortez or a supervisor/manager should total the register and make a cash count to see whether all cash is accounted for.

Related exercise material: *BE8-3, BE8-4, BE8-5, E8-2, E8-3, E8-4, and E8-5.*



## Use of a Bank

**The use of a bank contributes significantly to good internal control over cash.** A company can safeguard its cash by using a bank as a depository and as a clearing house for checks received and checks written. Use of a bank minimizes the amount of currency that must be kept on hand. Also, the use of a bank facilitates the control of cash because it creates a double record of all bank transactions—one by the business and the other by the bank. The asset account Cash maintained by the depositor is the reciprocal of the bank's liability account for each depositor. It should be possible to **reconcile these accounts** (make them agree) at any time.

Opening a bank checking account is a relatively simple procedure. Typically, the bank makes a credit check on the new customer and the depositor is required to sign a **signature card**. The card contains the signatures of each person authorized to sign checks on the account. The signature card is used by bank employees to validate signatures on the checks.

Soon after an account is opened, the bank provides the depositor with serially numbered checks and deposit slips imprinted with the depositor's name and address. Each check and deposit slip is imprinted with both a bank and a depositor identification number. This number, printed in magnetic ink, permits computer processing of transactions.

Many companies have more than one bank account. For efficiency of operations and better control, national retailers like **Wal-Mart** and **Kmart** may have regional

### STUDY OBJECTIVE 6

Indicate the control features of a bank account.

bank accounts. A company such as **Intel** with more than 70,000 employees may have a payroll bank account, as well as one or more general bank accounts. Also, a company may maintain several bank accounts in order to have more than one source for short-term loans when needed.

### Making Bank Deposits

Bank deposits should be made by an authorized employee, such as the head cashier. Each deposit must be documented by a deposit slip (ticket), as shown in Illustration 8-9.

Illustration 8-9  
Deposit slip

**Bank code numbers** →

CHECKS	LIST SINGLY	DOLLARS	CENTS
1	74 - 331/724	175	40
2	61 - 157/220	292	60
3	19 - 401/710	337	55
4	22 - 815/666	165	72
5	15 - 360/011	145	53
6			
7			
8			
9			
10			
11			
12			
13			
14			
15			
16			
17			
18			
19			
<b>TOTAL</b>		1116	80

ENTER TOTAL ON THE FRONT OF THIS TICKET

**Front side** ↑

→ **Reverse side**

Deposit slips are prepared in duplicate (see Illustration 8-6 on page 344). The original is retained by the bank; the duplicate, machine-stamped by the bank to establish its authenticity, is retained by the depositor.

### Writing Checks

A **check** is a written order signed by the depositor directing the bank to pay a specified sum of money to a designated recipient. There are three parties to a check: (1) the **maker** (or drawer) who issues the check; (2) the **bank** (or payer) on which the check is drawn; and (3) the **payee** to whom the check is payable. A check is a **negotiable instrument** that can be transferred to another party by endorsement. Each check should be accompanied by an explanation of its purposes. In many businesses, this is done by a remittance advice attached to the check, as shown in Illustration 8-10 (page 351).

It is important to know the balance in the checking account at all times. To keep the balance current, each deposit and check should be entered on running balance memorandum forms provided by the bank or on the check stubs contained in the checkbook.

**Illustration 8-10**  
Check with remittance advice

**Check**

Maker →

Payee →

Payer →

**W.A. LAIRD COMPANY**  
77 West Central Avenue,  
Midland, Michigan 48654

No. **448**  
*April 16 2006* 74-102724

Pay to the order of Watkins Wholesale Supply \$ 1525.00  
*Fifteen hundred twenty-five and 00/100* Dollars

**NB National Bank & Trust**  
Midland, Michigan 48654

Memo W.F. Faine

⑆0124⑆0497⑆457923⑆02 448

**Remittance Advice**

Detach this portion before cashing.

Date	Description	Gross Amount	Discount	Net Amount
4-16-06	Invoice No. 27662	1525.00	---	1525.00

W. A. Laird Company, Midland, MI

ACCOUNTING MATTERS!

e Business Insight

Cash is virtually obsolete. Today, many people use debit cards and credit cards to pay for most of their purchases. But debit cards are usable only at specified locations, and credit cards are cumbersome for small transactions. They are no good for transferring cash between individuals or to small companies that do not want to pay credit card fees. Digital cash is the next online wave.

There are many digital-cash companies. One of the most flexible appears to be **PayPal** ([www.paypal.com](http://www.paypal.com)). PayPal became popular with users of the auction site **eBay**, because it allows them to transfer funds to each other as easily as sending e-mail. (PayPal is now owned by eBay, though it is operated as an independent site.)

*Source:* Mathew Ingram, "Will Digital Cash Work This Time?" *The Globe and Mail* (March 18, 2000), p. N4.

?

Will "cash" be obsolete in terms of financial statement reporting?

### Bank Statements

Each month, the depositor receives a bank statement from the bank. A **bank statement** shows the depositor's bank transactions and balances.<sup>3</sup> A typical statement is presented in Illustration 8-11 (page 352). It shows (1) checks paid and other debits that reduce the balance in the depositor's account, (2) deposits and other credits that increase the balance in the depositor's account, and (3) the account balance after each day's transactions.

<sup>3</sup>Our presentation assumes that all adjustments are made at the end of the month. In practice, a company may also make journal entries during the month as it receives information from the bank regarding its account.

HELPFUL HINT

Essentially, the bank statement is a copy of the bank's records sent to the customer for periodic review.

Illustration 8-11  
Bank statement

**HELPFUL HINT**

Every deposit received by the bank is *credited* to the customer's account. The reverse occurs when the bank "pays" a check issued by a company on its checking account balance. Payment reduces the bank's liability. Thus it is *debited* to the customer's account with the bank.



**National Bank & Trust**  
Midland, Michigan 48654 Member FDIC

**ACCOUNT STATEMENT**

LAIRD COMPANY  
77 WEST CENTRAL AVENUE  
MIDLAND, MICHIGAN 48654

Statement Date/Credit Line Closing Date

April 30, 2006

457923

ACCOUNT NUMBER

Balance Last Statement	Deposits and Credits		Checks and Debits		Balance This Statement
	No.	Total Amount	No.	Total Amount	
13,256.90	20	34,805.10	26	32,154.55	15,907.45

CHECKS AND DEBITS			DEPOSITS AND CREDITS		DAILY BALANCE	
Date	No.	Amount	Date	Amount	Date	Amount
4-2	435	644.95	4-2	4,276.85	4-2	16,888.80
4-5	436	3,260.00	4-3	2,137.50	4-3	18,249.65
4-4	437	1,185.79	4-5	1,350.47	4-4	17,063.86
4-3	438	776.65	4-7	982.46	4-5	15,154.33
4-8	439	1,781.70	4-8	1,320.28	4-7	14,648.89
4-7	440	1,487.90	4-9 CM	1,035.00	4-8	11,767.47
4-8	441	2,420.00	4-11	2,720.00	4-9	12,802.47
4-11	442	1,585.60	4-12	757.41	4-11	13,936.87
4-12	443	1,226.00	4-13	1,218.56	4-12	13,468.28
4-29	NSF	425.60	4-27	1,545.57	4-27	13,005.45
4-29	459	1,080.30	4-29	2,929.45	4-29	14,429.00
4-30	DM	30.00	4-30	2,128.60	4-30	15,907.45
4-30	461	620.15				

Symbols: **CM** Credit Memo    **EC** Error Correction    **NSF** Not Sufficient Funds    **Reconcile Your Account Promptly**  
**DM** Debit Memo    **INT** Interest Earned    **SC** Service Charge

All "paid" checks are listed in numerical sequence on the bank statement along with the date the check was paid and its amount. Upon paying a check, the bank stamps the check "paid"; a paid check is sometimes referred to as a **canceled** check. Some banks offer depositors the option of receiving "paid" checks with their bank statements. For those who decline, the bank keeps a record of each check on microfilm.

The bank also includes on the bank statement memoranda explaining other debits and credits made by the bank to the depositor's account.

**Debit Memorandum**

Banks charge a monthly fee for their services. Often the fee is charged only when the average monthly balance in a checking account falls below a specified amount. The fee, called a **bank service charge**, is identified on the bank statement by a code symbol such as SC. A debit memorandum explaining the charge is included with the bank statement and noted on the statement. Separate debit memoranda may also be issued for other bank services such as the cost of printing checks, issuing traveler's checks, and wiring funds to other locations. The symbol DM is often used for such charges.

A debit memorandum is also used by the bank when a deposited check from a customer "bounces" because of insufficient funds. In such a case, the check is marked

**NSF** (not sufficient funds) by the customer's bank and is returned to the depositor's bank. The bank then debits the depositor's account, as shown by the symbol NSF on the bank statement in Illustration 8-11 (on page 352). The bank sends the NSF check and debit memorandum to the depositor as notification of the charge. Notice of an NSF check creates an account receivable (from the bad check writer) for the depositor and reduces cash in the bank account.

### **Credit Memorandum**

A depositor may ask the bank to collect its notes receivable. In such a case, the bank will credit the depositor's account for the cash proceeds of the note. This is illustrated on the W. A. Laird Company bank statement by the symbol CM. The bank will issue a credit memorandum which is sent with the statement to explain the entry. Many banks also offer interest on checking accounts. The interest earned may be indicated on the bank statement by the symbol CM or INT.

## **Reconciling the Bank Account**

The bank and the depositor maintain independent records of the depositor's checking account. If you've never had a checking account, you might assume that the respective balances will always agree. In fact, the two balances are seldom the same at any given time. It is therefore necessary to make the balance per books agree with the balance per bank—a process called **reconciling the bank account**. The lack of agreement between the two balances is due to:

1. **Time lags** that prevent one of the parties from recording the transaction in the same period.
2. **Errors** by either party in recording transactions.

Time lags occur frequently. For example, several days may elapse between the time a check is mailed to a payee and the date the check is paid by the bank. Similarly, when the depositor uses the bank's night depository to make its deposits, there will be a difference of at least one day between the time the receipts are recorded by the depositor and the time they are recorded by the bank. A time lag also occurs whenever the bank mails a debit or credit memorandum to the depositor.

Also, errors sometimes occur. The incidence of errors depends on the effectiveness of the internal controls of the depositor and the bank. Bank errors are infrequent. However, either party could accidentally record a \$450 check as \$45 or \$540. In addition, the bank might mistakenly charge a check drawn by C. D. Berg to the account of C. D. Burg.

### **Reconciliation Procedure**

**To obtain maximum benefit from a bank reconciliation, the reconciliation should be prepared by an employee who has no other responsibilities pertaining to cash.** When the internal control principle of independent internal verification is not followed in preparing the reconciliation, cash embezzlements may go unnoticed. For example, a cashier who prepares the reconciliation can embezzle cash and conceal the embezzlement by misstating the reconciliation. Thus, the bank accounts would reconcile, and the embezzlement would not be detected.

In reconciling the bank account, it is customary to reconcile the balance per books and balance per bank to their adjusted (correct or true) cash balances. The reconciliation schedule is divided into two sections. The starting point in preparing the reconciliation is to enter the balance per bank statement and balance per books on the schedule. Adjustments are then made to each section, as shown in

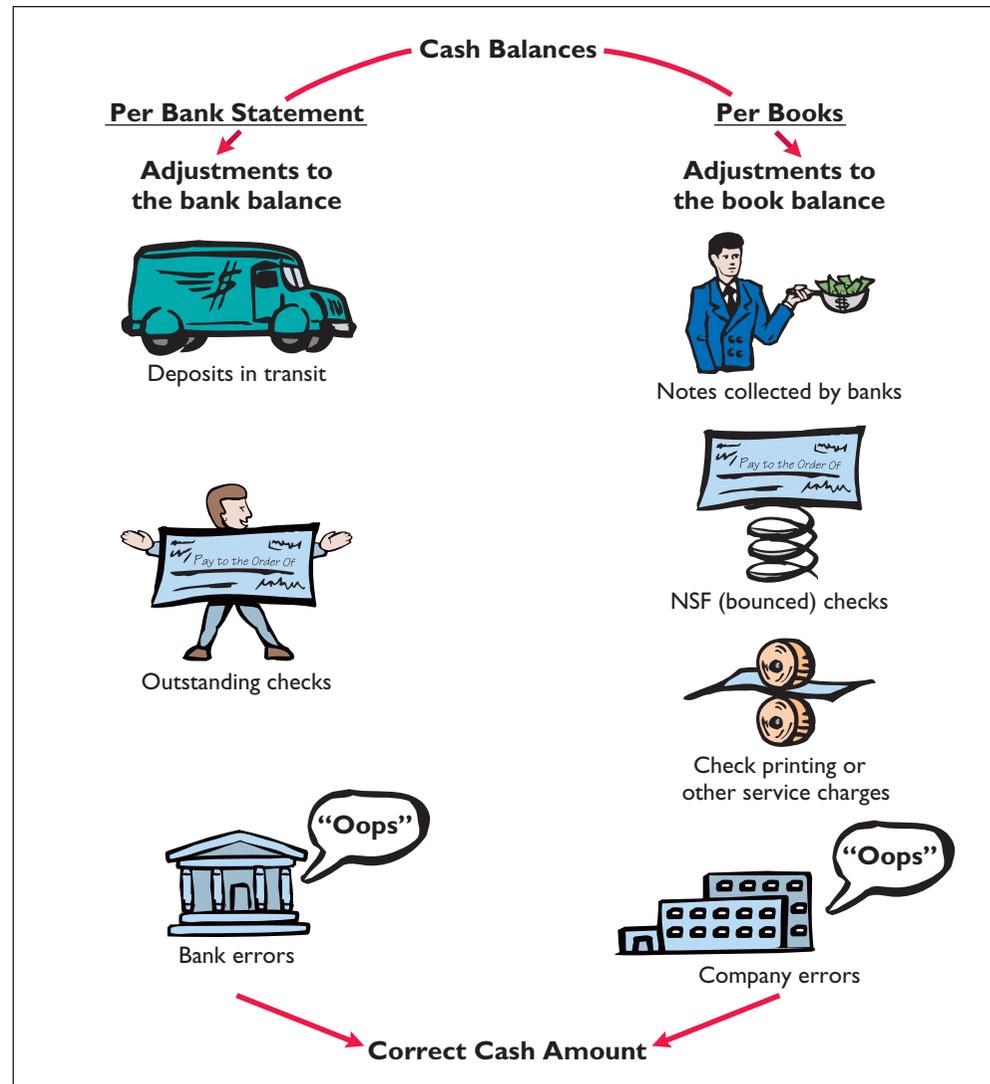
#### **STUDY OBJECTIVE 7**

Prepare a bank reconciliation.

**Accounting Matters!**

Illustration 8-12. The steps listed below and on the next page should reveal all the reconciling items that cause the difference between the two balances.

**Illustration 8-12**  
Bank reconciliation procedures



*Steps in the Reconciliation Procedure*

1. **Deposits in transit.** Compare the individual deposits on the bank statement with deposits in transit from the preceding bank reconciliation and with the deposits per company records or duplicate deposit slips. Deposits recorded by the depositor that have not been recorded by the bank represent **deposits in transit**. They are added to the balance per bank.
2. **Outstanding checks.** Compare the paid checks shown on the bank statement or the paid checks returned with the bank statement with (a) checks outstanding from the preceding bank reconciliation, and (b) checks issued by the company as recorded in a special cash payments journal. Issued checks recorded by the company that have not been paid by the bank represent **outstanding checks**. They are deducted from the balance per the bank.
3. **Errors.** Note any **errors** discovered in the foregoing steps. List them in the appropriate section of the reconciliation schedule. For example, if a paid check correctly written by the company for \$195 was mistakenly recorded by the com-

**HELPFUL HINT**

Deposits in transit and outstanding checks are reconciling items because of time lags.

pany for \$159, the error of \$36 is deducted from the balance per books. All errors made by the depositor are reconciling items in determining the adjusted cash balance per books. In contrast, all errors made by the bank are reconciling items in determining the adjusted cash balance per the bank.

4. **Bank memoranda.** Trace **bank memoranda** to the depositor's records. Any unrecorded memoranda should be listed in the appropriate section of the reconciliation schedule. For example, a \$5 debit memorandum for bank service charges is deducted from the balance per books, and \$32 of interest earned is added to the balance per books.

### Bank Reconciliation Illustrated

The bank statement for Laird Company was shown in Illustration 8-11 (page 352). It shows a balance per bank of \$15,907.45 on April 30, 2006. On this date the balance of cash per books is \$11,589.45. From the foregoing steps, the following reconciling items are determined.

<b>1. Deposits in transit:</b> April 30 deposit (received by bank on May 1).		\$2,201.40
<b>2. Outstanding checks:</b> No. 453, \$3,000.00; no. 457, \$1,401.30; no. 460, \$1,502.70.		5,904.00
<b>3. Errors:</b> Check no. 443 was correctly written by Laird for \$1,226.00 and was correctly paid by the bank. However, it was recorded for \$1,262.00 by Laird Company.		36.00
<b>4. Bank memoranda:</b>		
a. Debit—NSF check from J. R. Baron for \$425.60		425.60
b. Debit—Printing company checks charge \$30.00		30.00
c. Credit—Collection of note receivable for \$1,000 plus interest earned \$50, less bank collection fee \$15.00		1,035.00

The bank reconciliation is shown in Illustration 8-13.

#### HELPFUL HINT

Note in the bank statement that checks no. 459 and 461 have been paid but check no. 460 is not listed. Thus, this check is outstanding. If a complete bank statement were provided, checks no. 453 and 457 would also not be listed. The amounts for these three checks are obtained from the company's cash payments records.

<b>W. A. LAIRD COMPANY</b> Bank Reconciliation April 30, 2006		
Cash balance per bank statement		\$15,907.45
Add: Deposits in transit		2,201.40
		18,108.85
Less: Outstanding checks		
No. 453	\$3,000.00	
No. 457	1,401.30	
No. 460	1,502.70	
		5,904.00
<b>Adjusted cash balance per bank</b>		<b>\$12,204.85</b>
Cash balance per books		\$11,589.45
Add: Collection of note receivable \$1,000, plus interest earned \$50, less collection fee \$15	\$1,035.00	
Error in recording check no. 443	36.00	
		1,071.00
		12,660.45
Less: NSF check	425.60	
Bank service charge	30.00	
		455.60
<b>Adjusted cash balance per books</b>		<b>\$12,204.85</b>

**Illustration 8-13**  
Bank reconciliation

#### ALTERNATIVE TERMINOLOGY

The terms *adjusted balance*, *true cash balance*, and *correct cash balance* may be used interchangeably.

**HELPFUL HINT**

The entries that follow are adjusting entries. In prior chapters, Cash was an account that did not require adjustment. That was a simplifying assumption for learning purposes, because a bank reconciliation had not been explained.

A	=	L	+	SE
+1,035				-15 Exp
-1,000				+50 Rev

Cash Flows  
+1,035 

A	=	L	+	SE
+36		+36		

Cash Flows  
+36 

A	=	L	+	SE
+425.60				
-425.60				

Cash Flows  
-425.60 

A	=	L	+	SE
-30				-30 Exp

Cash Flows  
-30 

**Illustration 8-14**  
Adjusted balance in cash account

**Entries from Bank Reconciliation**

Each reconciling item in determining the **adjusted cash balance per books** should be recorded by the depositor. **If these items are not journalized and posted, the Cash account will not show the correct balance.** The entries for W. A. Laird Company on April 30 are as follows.

**COLLECTION OF NOTE RECEIVABLE.** This entry involves four accounts. Assuming that the interest of \$50 has not been accrued and the collection fee is charged to Miscellaneous Expense, the entry is:

Apr. 30	Cash	1,035.00	
	Miscellaneous Expense	15.00	
	Notes Receivable		1,000.00
	Interest Revenue		50.00
	(To record collection of note receivable by bank)		

**BOOK ERROR.** A cash disbursements journal shows that check no. 443 was a payment on account to Andrea Company, a supplier. The correcting entry is:

Apr. 30	Cash	36.00	
	Accounts Payable—Andrea Company		36.00
	(To correct error in recording check no. 443)		

**NSF CHECK.** As indicated earlier, an NSF check becomes an account receivable to the depositor. The entry is:

Apr. 30	Accounts Receivable—J. R. Baron	425.60	
	Cash		425.60
	(To record NSF check)		

**BANK SERVICE CHARGES.** Check printing charges (DM) and other bank service charges (SC) are debited to Miscellaneous Expense. They are usually nominal in amount. The entry is:

Apr. 30	Miscellaneous Expense	30.00	
	Cash		30.00
	(To record charge for printing company checks)		

The foregoing four entries could also be combined into one compound entry. After the entries are posted, the cash account will show the following.

Cash			
Apr. 30 Bal.	11,589.45	Apr. 30	425.60
30	1,035.00	30	30.00
30	36.00		
Apr. 30 Bal.	<b>12,204.85</b>		

The adjusted cash balance in the ledger should agree with the adjusted cash balance per books in the bank reconciliation in Illustration 8-13.

What entries does the bank make? If any bank errors are discovered in preparing the reconciliation, the bank should be notified. It then can make the necessary

corrections on its records. The bank does not make any entries for deposits in transit or outstanding checks. Only when these items reach the bank will the bank record these items.

### BEFORE YOU GO ON...

#### Review It

1. Why is it necessary to reconcile a bank account?
2. What steps are involved in the reconciliation procedure?
3. What information is included in a bank reconciliation?

#### Do It

Sally Kist owns Linen Kist Fabrics. Sally asks you to explain how the following reconciling items should be treated in reconciling the bank account: (1) a debit memorandum for an NSF check, (2) a credit memorandum for a note collected by the bank, (3) outstanding checks, and (4) a deposit in transit.

#### ACTION PLAN

- Understand the purpose of a bank reconciliation.
- Identify time lags and explain how they cause reconciling items.

**SOLUTION** In reconciling the bank account, the reconciling items are treated as follows.

NSF check: Deducted from balance per books.

Collection of note: Added to balance per books.

Outstanding checks: Deducted from balance per bank.

Deposit in transit: Added to balance per bank.

Related exercise material: *BE8-6, BE8-7, BE8-8, BE8-9, BE8-10, E8-6, E8-7, E8-8, E8-9, and E8-10.*



## Reporting Cash

Cash on hand, cash in banks, and petty cash are often combined and reported simply as **Cash**. Because it is the most liquid asset owned by a company, cash is listed first in the current assets section of the balance sheet. Some companies use the term “Cash and cash equivalents” in reporting cash, as illustrated by the following.

### STUDY OBJECTIVE 8

Explain the reporting of cash.



#### EASTMAN KODAK COMPANY

Balance Sheets (partial)

	<u>2003</u>	<u>2002</u>
Current assets (in millions)		
Cash and cash equivalents	\$1,250	\$569

**Illustration 8-15**  
Presentation of cash and cash equivalents

**Cash equivalents** are highly liquid investments that can be converted into a specific amount of cash. They typically have maturities of three months or less when

purchased. They include money market funds, money market savings certificates, bank certificates of deposit, and U.S. Treasury bills and notes.

A company may have cash that is restricted for a special purpose. An example is a payroll bank account for paying salaries and wages. Another would be a plant expansion cash fund for financing new construction. If the restricted cash is expected to be used **within the next year**, the amount should be reported as a current asset. When the restricted funds will not be used in that time, they should be reported as a noncurrent asset. Since a payroll bank account will be used as early as the next payday, it is reported as a current asset. In contrast, unless the new construction will begin within the next year, plant expansion fund cash is classified as a noncurrent asset (long-term investment).

In making loans to depositors, banks commonly require borrowers to maintain minimum cash balances. These minimum balances, called **compensating balances**, provide the bank with support for the loans. They are a restriction on the use of cash that may affect a company's liquidity. Thus, compensating balances should be disclosed in the financial statements.

**BEFORE YOU GO ON...**

**Review It**



1. What is generally reported as cash on a company's balance sheet?
2. What is meant by cash equivalents and compensating balances?
3. At what amount does **PepsiCo** report cash and cash equivalents in its 2003 consolidated balance sheet? The answer to this question is provided on page 378.



**DEMONSTRATION PROBLEM**

Kevin Poorten Company's bank statement for May 2006 shows the following data.

Balance 5/1	\$12,650	Balance 5/31	\$14,280
Debit memorandum:		Credit memorandum:	
NSF check	\$175	Collection of note receivable	\$505

The cash balance per books at May 31 is \$13,319. Your review of the data reveals the following.

1. The NSF check was from Brad Copple Co., a customer.
2. The note collected by the bank was a \$500, 3-month, 12% note. The bank charged a \$10 collection fee. No interest has been accrued.
3. Outstanding checks at May 31 total \$2,410.
4. Deposits in transit at May 31 total \$1,752.
5. A Kevin Poorten Company check for \$352 dated May 10 cleared the bank on May 25. This check, which was a payment on account, was journalized for \$325.

**Instructions**

- (a) Prepare a bank reconciliation at May 31.
- (b) Journalize the entries required by the reconciliation.

**SOLUTION TO DEMONSTRATION PROBLEM**

<b>(a)</b>		<b>KEVIN POORTEN COMPANY</b>	
		Bank Reconciliation	
		May 31, 2006	
Cash balance per bank statement			\$14,280
Add: Deposits in transit		1,752	
		16,032	
Less: Outstanding checks		2,410	
Adjusted cash balance per bank		<u>\$13,622</u>	
Cash balance per books			\$13,319
Add: Collection of note receivable \$500, plus \$15 interest, less collection fee \$10			505
			<u>13,824</u>
Less: NSF check	\$175		
Error in recording check	27		202
Adjusted cash balance per books			<u>\$13,622</u>

<b>(b)</b>			
May 31	Cash	505	
	Miscellaneous Expense	10	
	Notes Receivable		500
	Interest Revenue		15
	(To record collection of note by bank)		
31	Accounts Receivable—Brad Copple Co.	175	
	Cash		175
	(To record NSF check from Brad Copple Co.)		
31	Accounts Payable	27	
	Cash		27
	(To correct error in recording check)		



**ACTION PLAN**

- Follow the four steps in the reconciliation procedure. (pp. 354–355).
- Work carefully to minimize mathematical errors in the reconciliation.
- Prepare adjusting entries from reconciling items per books.
- Make sure the cash ledger balance after posting the reconciling entries agrees with the adjusted cash balance per books.

1. **Define internal control.** Internal control is the plan of organization and related methods and procedures adopted within a business to safeguard its assets and to enhance the accuracy and reliability of its accounting records.
2. **Identify the principles of internal control.** The principles of internal control are: establishment of responsibility; segregation of duties; documentation procedures; physical, mechanical, and electronic controls; independent internal verification; and other controls.
3. **Explain the applications of internal control principles to cash receipts.** Internal controls over cash receipts include: (a) designating only personnel such as cashiers to handle cash; (b) assigning the duties of receiving cash, recording cash, and custody of cash to different individuals; (c) preparing remittance advices for mail receipts, cash register tapes for over-the-counter receipts, and deposit slips for bank deposits; (d) using company safes and bank vaults to

store cash with access limited to authorized personnel, and using cash registers in executing over-the-counter receipts; (e) making independent daily counts of register receipts and daily comparisons of total receipts with total deposits; and (f) bonding personnel that handle cash and requiring them to take vacations.

4. **Explain the applications of internal control principles to cash disbursements.** Internal controls over cash disbursements include: (a) having only specified individuals such as the treasurer authorized to sign checks; (b) assigning the duties of approving items for payment, paying the items, and recording the payment to different individuals; (c) using prenumbered checks and accounting for all checks, with each check supported by an approved invoice; (d) storing blank checks in a safe or vault with access restricted to authorized personnel, and using a machine to imprint amounts on checks; (e) comparing each check with the

approved invoice before issuing the check, and making monthly reconciliations of bank and book balances; and (f) after payment, stamping each approved invoice “paid.”

5. **Describe the operation of a petty cash fund.** In operating a petty cash fund, it is necessary to establish the fund, make payments from the fund, and replenish the fund.
6. **Indicate the control features of a bank account.** A bank account contributes to good internal control by providing physical controls for the storage of cash. It minimizes the amount of currency that must be kept on hand, and it creates a double record of a depositor’s bank transactions.
7. **Prepare a bank reconciliation.** It is customary to reconcile the balance per books and balance per bank to their ad-

justed balances. The steps in determining the reconciling items are to ascertain deposits in transit, outstanding checks, errors by the depositor or the bank, and unrecorded bank memoranda.

8. **Explain the reporting of cash.** Cash is listed first in the current assets section of the balance sheet. In some cases, cash is reported together with cash equivalents. Cash restricted for a special purpose is reported separately as a current asset or as a noncurrent asset, depending on when the cash is expected to be used.



## GLOSSARY

**Bank service charge** A fee charged by a bank for the use of its services. (p. 352).

**Bank statement** A statement received monthly from the bank that shows the depositor’s bank transactions and balances. (p. 351).

**Cash** Resources that consist of coins, currency, checks, money orders, and money on hand or on deposit in a bank or similar depository. (p. 342).

**Cash equivalents** Highly liquid investments, with maturities of three months or less when purchased, that can be converted to a specific amount of cash. (p. 357).

**Check** A written order signed by the depositor directing the bank to pay a specified sum of money to a designated recipient. (p. 350).

**Compensating balances** Minimum cash balances required by a bank in support of bank loans. (p. 358).

**Deposits in transit** Deposits recorded by the depositor that have not been recorded by the bank. (p. 354).

**Electronic funds transfer (EFT)** A disbursement system that uses wire, telephone, or computers to transfer cash from one location to another. (p. 346).

**Internal auditors** Company employees who evaluate on a continuous basis the effectiveness of the company’s system of internal control. (p. 339).

**Internal control** The plan of organization and all the related methods and measures adopted within a business to safeguard its assets and enhance the accuracy and reliability of its accounting records. (p. 335).

**NSF check** A check that is not paid by a bank because of insufficient funds in a customer’s bank account. (p. 353).

**Outstanding checks** Checks issued and recorded by a company that have not been paid by the bank. (p. 354).

**Petty cash fund** A cash fund used to pay relatively small amounts. (p. 347).

**Voucher** An authorization form prepared for each payment by check in a voucher system. (p. 346).

**Voucher system** A network of approvals by authorized individuals acting independently to ensure that all disbursements by check are proper. (p. 346).

Answers are at the end of the chapter.

- (SO 1) 1. Internal control is used in a business to enhance the accuracy and reliability of its accounting records and to:
- a. safeguard its assets.
  - b. prevent fraud.
  - c. produce correct financial statements.
  - d. deter employee dishonesty.
- (SO 2) 2. The principles of internal control do **not** include:
- a. establishment of responsibility.
  - b. documentation procedures.
  - c. management responsibility.
  - d. independent internal verification.

Self-Study/Self-Test



3. Physical controls do *not* include: (SO 2)
  - a. safes and vaults to store cash.
  - b. independent bank reconciliations.
  - c. locked warehouses for inventories.
  - d. bank safety deposit boxes for important papers.
4. Which of the following items in a cash drawer at November 30 is *not* cash? (SO 3)
  - a. Money orders.
  - b. Coins and currency.
  - c. A customer check dated December 1.
  - d. A customer check dated November 28.

- (SO 3) 5. Permitting only designated personnel to handle cash receipts is an application of the principle of:
  - a. segregation of duties.
  - b. establishment of responsibility.
  - c. independent check.
  - d. other controls.
- (SO 4) 6. The use of prenumbered checks in disbursing cash is an application of the principle of:
  - a. establishment of responsibility.
  - b. segregation of duties.
  - c. physical, mechanical, and electronic controls.
  - d. documentation procedures.
- (SO 5) 7. A check is written to replenish a \$100 petty cash fund when the fund contains receipts of \$94 and \$3 in cash. In recording the check,
  - a. Cash Over and Short should be debited for \$3.
  - b. Petty Cash should be debited for \$94.
  - c. Cash should be credited for \$94.
  - d. Petty Cash should be credited for \$3.
- (SO 6) 8. The control features of a bank account do *not* include:
  - a. having bank auditors verify the correctness of the bank balance per books.
  - b. minimizing the amount of cash that must be kept on hand.
  - c. providing a double record of all bank transactions.
  - d. safeguarding cash by using a bank as a depository.
- 9. In a bank reconciliation, deposits in transit are: (SO 7)
  - a. deducted from the book balance.
  - b. added to the book balance.
  - c. added to the bank balance.
  - d. deducted from the bank balance.
- 10. The reconciling item in a bank reconciliation that will result in an adjusting entry by the depositor is: (SO 7)
  - a. outstanding checks.
  - b. deposit in transit.
  - c. a bank error.
  - d. bank service charges.
- 11. The statement that correctly describes the reporting of cash is: (SO 8)
  - a. Cash cannot be combined with cash equivalents.
  - b. Restricted cash funds may be combined with Cash.
  - c. Cash is listed first in the current assets section.
  - d. Restricted cash funds cannot be reported as a current asset.



**QUESTIONS**

1. "Internal control is concerned only with enhancing the accuracy of the accounting records." Do you agree? Explain.
2. What principles of internal control apply to most business enterprises?
3. At the corner grocery store, all sales clerks make change out of one cash register drawer. Is this a violation of internal control? Why?
4. Pam Duffy is reviewing the principle of segregation of duties. What are the two common applications of this principle?
5. How do documentation procedures contribute to good internal control?
6. What internal control objectives are met by physical, mechanical, and electronic controls?
7. (a) Explain the control principle of independent internal verification. (b) What practices are important in applying this principle?
8. The management of Yaeger Company asks you, as the company accountant, to explain (a) the concept of reasonable assurance in internal control and (b) the importance of the human factor in internal control.
9. Yorkville Fertilizer Co. owns the following assets at the balance sheet date.
 

Cash in bank savings account	\$ 6,000
Cash on hand	850
Cash refund due from the IRS	1,000
Checking account balance	12,000
Postdated checks	500
10. What amount should be reported as cash in the balance sheet?
10. What principle(s) of internal control is (are) involved in making daily cash counts of over-the-counter receipts?
11. Aurora Department Stores has just installed new electronic cash registers in its stores. How do cash registers improve internal control over cash receipts?
12. At Oswego Wholesale Company, two mail clerks open all mail receipts. How does this strengthen internal control?
13. "To have maximum effective internal control over cash disbursements, all payments should be made by check." Is this true? Explain.
14. Ted Rampolla Company's internal controls over cash disbursements provide for the treasurer to sign checks imprinted by a checkwriter after comparing the check with the approved invoice. Identify the internal control principles that are present in these controls.
15. How do the principles of (a) physical, mechanical, and electronic controls and (b) other controls apply to cash disbursements?
16. (a) What is a voucher system? (b) What principles of internal control apply to a voucher system?
17. What is the essential feature of an electronic funds transfer (EFT) procedure?
18. (a) Identify the three activities that pertain to a petty cash fund, and indicate an internal control principle that is applicable to each activity. (b) When are journal entries required in the operation of a petty cash fund?

19. “The use of a bank contributes significantly to good internal control over cash.” Is this true? Why or why not?
20. Faye Uhlik is confused about the lack of agreement between the cash balance per books and the balance per the bank. Explain the causes for the lack of agreement to Faye, and give an example of each cause.
21. What are the four steps involved in finding differences between the balance per books and balance per bank?
22. Pauline Duch asks your help concerning an NSF check. Explain to Pauline (a) what an NSF check is, (b) how it is treated in a bank reconciliation, and (c) whether it will require an adjusting entry.
23. (a) “Cash equivalents are the same as cash.” Do you agree? Explain. (b) How should restricted cash funds be reported on the balance sheet?

### BRIEF EXERCISES

*Explain the importance of internal control.*

(SO 1)

*Identify internal control principles.*

(SO 2)

*Identify the internal control principles applicable to cash receipts.*

(SO 3)

*Identify the internal control principles applicable to cash disbursements.*

(SO 4)

*Prepare entry to replenish a petty cash fund.*

(SO 5)

*Identify the control features of a bank account.*

(SO 6)

*Indicate location of reconciling items in a bank reconciliation.*

(SO 7)

*Identify reconciling items that require adjusting entries.*

(SO 7)

*Prepare partial bank reconciliation.*

(SO 7)

**BE8-1** Pam Duffy is the new owner of Duffy Parking. She has heard about internal control but is not clear about its importance for her business. Explain to Pam the two purposes of internal control and give her one application of each purpose for Duffy Parking.

**BE8-2** The internal control procedures in Naperville Company provide that:

- (a) Employees who have physical custody of assets do not have access to the accounting records.
  - (b) Each month the assets on hand are compared to the accounting records by an internal auditor.
  - (c) A prenumbered shipping document is prepared for each shipment of goods to customers.
- Identify the principles of internal control that are being followed.

**BE8-3** Sycamore Company has the following internal control procedures over cash receipts. Identify the internal control principle that is applicable to each procedure.

1. All over-the-counter receipts are registered on cash registers.
2. All cashiers are bonded.
3. Daily cash counts are made by cashier department supervisors.
4. The duties of receiving cash, recording cash, and custody of cash are assigned to different individuals.
5. Only cashiers may operate cash registers.

**BE8-4** Helen Hunt Company has the following internal control procedures over cash disbursements. Identify the internal control principle that is applicable to each procedure.

1. Company checks are prenumbered.
2. The bank statement is reconciled monthly by an internal auditor.
3. Blank checks are stored in a safe in the treasurer’s office.
4. Only the treasurer or assistant treasurer may sign checks.
5. Check signers are not allowed to record cash disbursement transactions.

**BE8-5** On March 20, Batavia’s petty cash fund of \$100 is replenished when the fund contains \$9 in cash and receipts for postage \$52, freight-out \$26, and travel expense \$10. Prepare the journal entry to record the replenishment of the petty cash fund.

**BE8-6** Louis St. Pierre is uncertain about the control features of a bank account. Explain the control benefits of (a) a signature card, (b) a check, and (c) a bank statement.

**BE8-7** The following reconciling items are applicable to the bank reconciliation for Hinckley Company: (1) outstanding checks, (2) bank debit memorandum for service charge, (3) bank credit memorandum for collecting a note for the depositor, (4) deposits in transit. Indicate how each item should be shown on a bank reconciliation.

**BE8-8** Using the data in BE8-7, indicate (a) the items that will result in an adjustment to the depositor’s records and (b) why the other items do not require adjustment.

**BE8-9** At July 31, Shabbona Company has the following bank information: cash balance per bank \$7,420, outstanding checks \$762, deposits in transit \$1,620, and a bank service charge \$20. Determine the adjusted cash balance per bank at July 31.

**BE8-10** At August 31, DeKalb Company has a cash balance per books of \$8,900 and the following additional data from the bank statement: charge for printing DeKalb Company checks \$35, interest earned on checking account balance \$40, and outstanding checks \$800. Determine the adjusted cash balance per books at August 31.

*Prepare partial bank reconciliation.*

(SO 7)

**BE8-11** Plano Company has the following cash balances: Cash in Bank \$15,742, Payroll Bank Account \$6,000, and Plant Expansion Fund Cash \$25,000. Explain how each balance should be reported on the balance sheet.

*Explain the statement presentation of cash balances.*

(SO 8)

## EXERCISES

**E8-1** Sue Ernesto is the owner of Ernesto's Pizza. Ernesto's is operated strictly on a carryout basis. Customers pick up their orders at a counter where a clerk exchanges the pizza for cash. While at the counter, the customer can see other employees making the pizzas and the large ovens in which the pizzas are baked.

*Identify the principles of internal control.*

(SO 2)

### Instructions

Identify the six principles of internal control and give an example of each principle that you might observe when picking up your pizza. (*Note:* It may not be possible to observe all the principles.)

**E8-2** The following control procedures are used at Sandwich Company for over-the-counter cash receipts.

*Identify internal control weaknesses over cash receipts and suggest improvements.*

(SO 2, 3)

1. To minimize the risk of robbery, cash in excess of \$100 is stored in an unlocked attaché case in the stock room until it is deposited in the bank.
2. All over-the-counter receipts are registered by three clerks who use a cash register with a single cash drawer.
3. The company accountant makes the bank deposit and then records the day's receipts.
4. At the end of each day, the total receipts are counted by the cashier on duty and reconciled to the cash register total.
5. Cashiers are experienced; they are not bonded.

### Instructions

(a) For each procedure, explain the weakness in internal control, and identify the control principle that is violated.

(b) For each weakness, suggest a change in procedure that will result in good internal control.

**E8-3** The following control procedures are used in Morgan's Boutique Shoppe for cash disbursements.

*Identify internal control weaknesses over cash disbursements and suggest improvements.*

(SO 2, 4)

1. The company accountant prepares the bank reconciliation and reports any discrepancies to the owner.
2. The store manager personally approves all payments before signing and issuing checks.
3. Each week, Morgan leaves 100 company checks in an unmarked envelope on a shelf behind the cash register.
4. After payment, bills are filed in a paid invoice folder.
5. The company checks are unnumbered.

### Instructions

(a) For each procedure, explain the weakness in internal control, and identify the internal control principle that is violated.

(b) For each weakness, suggest a change in the procedure that will result in good internal control.

**E8-4** At Teresa Speck Company, checks are not prenumbered because both the purchasing agent and the treasurer are authorized to issue checks. Each signer has access to unissued checks kept in an unlocked file cabinet. The purchasing agent pays all bills pertaining to goods purchased for resale. Prior to payment, the purchasing agent determines that the goods have been received and verifies the mathematical accuracy of the vendor's invoice. After payment, the invoice is filed by vendor, and the purchasing agent records the payment in the cash disbursements journal. The treasurer pays all other bills following approval by authorized employees. After payment, the treasurer stamps all bills PAID, files them by payment date, and

*Identify internal control weaknesses for cash disbursements and suggest improvements.*

(SO 4)

records the checks in the cash disbursements journal. Teresa Speck Company maintains one checking account that is reconciled by the treasurer.

**Instructions**

- (a) List the weaknesses in internal control over cash disbursements.
- (b)  Write a memo to the company treasurer indicating your recommendations for improvement.

Prepare journal entries for a petty cash fund.

(SO 5)



**E8-5** LaSalle-Peru Company uses an imprest petty cash system. The fund was established on March 1 with a balance of \$100. During March the following petty cash receipts were found in the petty cash box.

Date	Receipt No.	For	Amount
3/5	1	Stamp Inventory	\$39
7	2	Freight-out	19
9	3	Miscellaneous Expense	6
11	4	Travel Expense	24
14	5	Miscellaneous Expense	5

The fund was replenished on March 15 when the fund contained \$4 in cash. On March 20, the amount in the fund was increased to \$150.

**Instructions**

Journalize the entries in March that pertain to the operation of the petty cash fund.

Prepare bank reconciliation and adjusting entries.

(SO 7)



**E8-6** Lisa Ceja is unable to reconcile the bank balance at January 31. Lisa's reconciliation is as follows.

Cash balance per bank	\$3,660.20
Add: NSF check	590.00
Less: Bank service charge	25.00
Adjusted balance per bank	<u>\$4,225.20</u>
Cash balance per books	\$3,875.20
Less: Deposits in transit	530.00
Add: Outstanding checks	930.00
Adjusted balance per books	<u>\$4,275.20</u>

**Instructions**

- (a) Prepare a correct bank reconciliation.
- (b) Journalize the entries required by the reconciliation.

Determine outstanding checks.

(SO 7)

**E8-7** On April 30, the bank reconciliation of Ottawa Company shows three outstanding checks: no. 254, \$650, no. 255, \$720, and no. 257, \$410. The May bank statement and the May cash payments journal show the following.

Bank Statement			Cash Payments Journal		
Checks Paid			Checks Issued		
Date	Check No.	Amount	Date	Check No.	Amount
5/4	254	650	5/2	258	159
5/2	257	410	5/5	259	275
5/17	258	159	5/10	260	790
5/12	259	275	5/15	261	500
5/20	261	500	5/22	262	750
5/29	263	480	5/24	263	480
5/30	262	750	5/29	264	560

**Instructions**

Using step 2 in the reconciliation procedure, list the outstanding checks at May 31.

**E8-8** The following information pertains to Worthy Video Company.

1. Cash balance per bank, July 31, \$7,263.
2. July bank service charge not recorded by the depositor \$28.
3. Cash balance per books, July 31, \$7,284.
4. Deposits in transit, July 31, \$1,500.
5. Bank collected \$800 note for Worthy in July, plus interest \$36, less collection fee \$20. The collection has not been recorded by Worthy, and no interest has been accrued.
6. Outstanding checks, July 31, \$691.

**Instructions**

- (a) Prepare a bank reconciliation at July 31.
- (b) Journalize the adjusting entries at July 31 on the books of Worthy Video Company.

**E8-9** The information below relates to the Cash account in the ledger of Dick Wasson Company.

Balance September 1—\$17,150; Cash deposited—\$64,000.

Balance September 30—\$17,404; Checks written—\$63,746.

The September bank statement shows a balance of \$16,422 on September 30 and the following memoranda.

Credits		Debits	
Collection of \$1,500 note plus interest \$30	\$1,530	NSF check: J. E. Hoover	\$725
Interest earned on checking account	\$45	Safety deposit box rent	\$65

At September 30, deposits in transit were \$4,150, and outstanding checks totaled \$2,383.

**Instructions**

- (a) Prepare the bank reconciliation at September 30.
- (b) Prepare the adjusting entries at September 30, assuming (1) the NSF check was from a customer on account, and (2) no interest had been accrued on the note.

**E8-10** The cash records of Satter Company show the following four situations.

1. The June 30 bank reconciliation indicated that deposits in transit total \$920. During July the general ledger account Cash shows deposits of \$15,750, but the bank statement indicates that only \$15,600 in deposits were received during the month.
2. The June 30 bank reconciliation also reported outstanding checks of \$880. During the month of July, Satter Company books show that \$17,200 of checks were issued. The bank statement showed that \$16,400 of checks cleared the bank in July.
3. In September, deposits per the bank statement totaled \$26,700, deposits per books were \$25,400, and deposits in transit at September 30 were \$2,600.
4. In September, cash disbursements per books were \$23,700, checks clearing the bank were \$24,000, and outstanding checks at September 30 were \$2,100.

There were no bank debit or credit memoranda. No errors were made by either the bank or Satter Company.

**Instructions**

Answer the following questions.

- (a) In situation (1), what were the deposits in transit at July 31?
- (b) In situation (2), what were the outstanding checks at July 31?
- (c) In situation (3), what were the deposits in transit at August 31?
- (d) In situation (4), what were the outstanding checks at August 31?

**P8-1A** Anita Theater is located in the Zurbrugg Mall. A cashier's booth is located near the entrance to the theater. Two cashiers are employed. One works from 1–5 P.M., the other from 5–9 P.M. Each cashier is bonded. The cashiers receive cash from customers and operate a machine that ejects serially numbered tickets. The rolls of tickets are inserted and locked into the machine by the theater manager at the beginning of each cashier's shift.

*Prepare bank reconciliation and adjusting entries.*

(SO 7)



*Prepare bank reconciliation and adjusting entries.*

(SO 7)



*Compute deposits in transit and outstanding checks for two bank reconciliations.*

(SO 7)

*Identify internal control weaknesses over cash receipts.*

(SO 2, 3)

After purchasing a ticket, the customer takes the ticket to an usher stationed at the entrance of the theater lobby some 60 feet from the cashier's booth. The usher tears the ticket in half, admits the customer, and returns the ticket stub to the customer. The other half of the ticket is dropped into a locked box by the usher.

At the end of each cashier's shift, the theater manager removes the ticket rolls from the machine and makes a cash count. The cash count sheet is initialed by the cashier. At the end of the day, the manager deposits the receipts in total in a bank night deposit vault located in the mall. The manager also sends copies of the deposit slip and the initialed cash count sheets to the theater company treasurer for verification and to the company's accounting department. Receipts from the first shift are stored in a safe located in the manager's office.

**Instructions**

- (a) Identify the internal control principles and their application to the cash receipts transactions of the Anita Theater.
- (b) If the usher and cashier decide to collaborate to misappropriate cash, what actions might they take?

Journalize and post petty cash fund transactions.

(SO 5)



**P8-2A** M.L. McArtor Company maintains a petty cash fund for small expenditures. The following transactions occurred over a 2-month period.

- July 1 Established petty cash fund by writing a check on Landmark Bank for \$200.
- 15 Replenished the petty cash fund by writing a check for \$196.30. On this date the fund consisted of \$3.70 in cash and the following petty cash receipts: freight-out \$94.00, postage expense \$42.40, entertainment expense \$45.90, and miscellaneous expense \$10.70.
- 31 Replenished the petty cash fund by writing a check for \$192.00. At this date, the fund consisted of \$8.00 in cash and the following petty cash receipts: freight-out \$82.10, charitable contributions expense \$30.00, postage expense \$47.80, and miscellaneous expense \$32.10.
- Aug. 15 Replenished the petty cash fund by writing a check for \$188.00. On this date, the fund consisted of \$12.00 in cash and the following petty cash receipts: freight-out \$74.40, entertainment expense \$41.50, postage expense \$33.00, and miscellaneous expense \$38.00.
- 16 Increased the amount of the petty cash fund to \$300 by writing a check for \$100.
- 31 Replenished petty cash fund by writing a check for \$283.00. On this date, the fund consisted of \$17 in cash and the following petty cash receipts: postage expense \$145.00, entertainment expense \$90.60, and freight-out \$46.00.

**Instructions**

- (a) July 15 Cash short \$3.30
- (b) Aug. 31 balance \$300

- (a) Journalize the petty cash transactions.
- (b) Post to the Petty Cash account.
- (c) What internal control features exist in a petty cash fund?

Prepare a bank reconciliation and adjusting entries.

(SO 7)



**P8-3A** Agricultural Genetics Company of Lawrence, Kansas, spreads herbicides and applies liquid fertilizer for local farmers. On May 31, 2006, the company's cash account per its general ledger showed the following balance.

CASH					No. 101
Date	Explanation	Ref.	Debit	Credit	Balance
May 31	Balance				6,781.50

The bank statement from Lawrence State Bank on that date showed the following balance.

LAWRENCE STATE BANK		
<u>Checks and Debits</u>	<u>Deposits and Credits</u>	<u>Daily Balance</u>
XXX	XXX	5/31 6,804.60

A comparison of the details on the bank statement with the details in the cash account revealed the following facts.

1. The statement included a debit memo of \$40 for the printing of additional company checks.
2. Cash sales of \$836.15 on May 12 were deposited in the bank. The cash receipts journal entry and the deposit slip were incorrectly made for \$846.15. The bank credited Agricultural Genetics Company for the correct amount.

3. Outstanding checks at May 31 totaled \$315.25, and deposits in transit were \$936.15.
4. On May 18, the company issued check no. 1181 for \$685 to M. Datz, on account. The check, which cleared the bank in May, was incorrectly journalized and posted by Agricultural Genetics Company for \$658.
5. A \$2,000 note receivable was collected by the bank for Agricultural Genetics Company on May 31 plus \$80 interest. The bank charged a collection fee of \$25. No interest has been accrued on the note.
6. Included with the cancelled checks was a check issued by Bohr Company to Fred Mertz for \$600 that was incorrectly charged to Agricultural Genetics Company by the bank.
7. On May 31, the bank statement showed an NSF charge of \$734 for a check issued by Tyler Gricius, a customer, to Agricultural Genetics Company on account.

**Instructions**

- (a) Prepare the bank reconciliation at May 31, 2006.
- (b) Prepare the necessary adjusting entries for Agricultural Genetics Company at May 31, 2006.

(a) Adj. cash bal. \$8,025.50

**P8-4A** The bank portion of the bank reconciliation for Michael Mooney Company at October 31, 2006 was as follows.

Prepare a bank reconciliation and adjusting entries from detailed data.

(SO 7)



**MICHAEL MOONEY COMPANY**

Bank Reconciliation  
October 31, 2006

Cash balance per bank		\$12,444.70
Add: Deposits in transit		<u>1,530.20</u>
		13,974.90
Less: Outstanding checks		
<u>Check Number</u>	<u>Check Amount</u>	
2451	\$1,260.40	
2470	720.10	
2471	844.50	
2472	503.60	
2474	<u>1,050.00</u>	<u>4,378.60</u>
Adjusted cash balance per bank		<u>\$ 9,596.30</u>

The adjusted cash balance per bank agreed with the cash balance per books at October 31.  
The November bank statement showed the following checks and deposits:

<b>Bank Statement</b>				
<b>Checks</b>			<b>Deposits</b>	
<b>Date</b>	<b>Number</b>	<b>Amount</b>	<b>Date</b>	<b>Amount</b>
11-1	2470	\$ 720.10	11-1	\$ 1,530.20
11-2	2471	844.50	11-4	1,211.60
11-5	2474	1,050.00	11-8	990.10
11-4	2475	1,640.70	11-13	2,575.00
11-8	2476	2,830.00	11-18	1,472.70
11-10	2477	600.00	11-21	2,945.00
11-15	2479	1,750.00	11-25	2,567.30
11-18	2480	1,330.00	11-28	1,650.00
11-27	2481	695.40	11-30	<u>1,186.00</u>
11-30	2483	575.50	Total	<u>\$16,127.90</u>
11-29	2486	900.00		
	Total	<u>\$12,936.20</u>		

The cash records per books for November showed the following.

Cash Payments Journal						Cash Receipts Journal	
Date	Number	Amount	Date	Number	Amount	Date	Amount
11-1	2475	\$1,640.70	11-20	2483	\$ 575.50	11-3	\$ 1,211.60
11-2	2476	2,830.00	11-22	2484	829.50	11-7	990.10
11-2	2477	600.00	11-23	2485	974.80	11-12	2,575.00
11-4	2478	538.20	11-24	2486	900.00	11-17	1,472.70
11-8	2479	1,570.00	11-29	2487	398.00	11-20	2,954.00
11-10	2480	1,330.00	11-30	2488	1,200.00	11-24	2,567.30
11-15	2481	695.40	Total		\$14,694.10	11-27	1,650.00
11-18	2482	612.00				11-29	1,186.00
						11-30	1,338.00
						Total	\$15,944.70

The bank statement contained two bank memoranda:

1. A credit of \$1,505 for the collection of a \$1,400 note for Mooney Company plus interest of \$120 and less a collection fee of \$15. Mooney Company has not accrued any interest on the note.
2. A debit for the printing of additional company checks \$72.

At November 30, the cash balance per books was \$10,846.90, and the cash balance per the bank statement was \$17,069.40. The bank did not make any errors, but two errors were made by Mooney Company.

**Instructions**

(a) Adjusted cash balance per bank \$12,090.90

- (a) Using the four steps in the reconciliation procedure described on pages 354–355, prepare a bank reconciliation at November 30.
- (b) Prepare the adjusting entries based on the reconciliation. (*Hint:* The correction of any errors pertaining to recording checks should be made to Accounts Payable. The correction of any errors relating to recording cash receipts should be made to Accounts Receivable).

Prepare a bank reconciliation and adjusting entries.

(SO 7)



**P8-5A** Mario Tizani Company’s bank statement from Last National Bank at August 31, 2006, shows the following information.

Balance, August 1	\$17,400	Bank credit memoranda:	
August deposits	73,110	Collection of note	
Checks cleared in August	69,660	receivable plus \$90	
Balance, August 31	25,932	interest	\$5,090
		Interest earned	32
		Bank debit memorandum:	
		Safety deposit box rent	40

A summary of the Cash account in the ledger for August shows: Balance, August 1, \$16,900; receipts \$77,000; disbursements \$73,570; and balance, August 31, \$20,330. Analysis reveals that the only reconciling items on the July 31 bank reconciliation were a deposit in transit for \$4,000 and outstanding checks of \$4,500. The deposit in transit was the first deposit recorded by the bank in August. In addition, you determine that there were two errors involving company checks drawn in August: (1) A check for \$400 to a creditor on account that cleared the bank in August was journalized and posted for \$420. (2) A salary check to an employee for \$275 was recorded by the bank for \$278.

**Instructions**

(a) Adjusted balance per books \$25,432

- (a) Prepare a bank reconciliation at August 31.
- (b) Journalize the adjusting entries to be made by Mario Tizani Company at August 31. Assume the interest on the note has been accrued by the company.

Prepare comprehensive bank reconciliation with theft and internal control deficiencies.

(SO 2, 3, 4, 7)

**P8-6A** Stupendous Company is a very profitable small business. It has not, however, given much consideration to internal control. For example, in an attempt to keep clerical and office expenses to a minimum, the company has combined the jobs of cashier and bookkeeper. As a

result, Jake Stickyfingers handles all cash receipts, keeps the accounting records, and prepares the monthly bank reconciliations.

The balance per the bank statement on October 31, 2006, was \$18,280. Outstanding checks were: no. 62 for \$326.75, no. 183 for \$150, no. 284 for \$253.25, no. 862 for \$190.71, no. 863 for \$226.80, and no. 864 for \$165.28. Included with the statement was a credit memorandum of \$300 indicating the collection of a note receivable for Stupendous Company by the bank on October 25. This memorandum has not been recorded by Stupendous Company.

The company's ledger showed one cash account with a balance of \$21,892.72. The balance included undeposited cash on hand. Because of the lack of internal controls, Stickyfingers took for personal use all of the undeposited receipts in excess of \$3,795.51. He then prepared the following bank reconciliation in an effort to conceal his theft of cash.

### BANK RECONCILIATION

Cash balance per books, October 31		\$21,892.72
Add: Outstanding checks		
No. 862	\$190.71	
No. 863	226.80	
No. 864	<u>165.28</u>	<u>482.79</u>
		22,375.51
Less: Undeposited receipts		<u>3,795.51</u>
Unadjusted balance per bank, October 31		18,580.00
Less: Bank credit memorandum		<u>300.00</u>
Cash balance per bank statement, October 31		<u>\$18,280.00</u>

#### Instructions

- Prepare a correct bank reconciliation. (*Hint:* Deduct the amount of the theft from the adjusted balance per books.)
- Indicate the three ways that Stickyfingers attempted to conceal the theft and the dollar amount pertaining to each method.
- What principles of internal control were violated in this case?

(a) Adjusted balance per books \$20,762.72

## PROBLEMS: SET B

**P8-1B** Gore Office Supply Company recently changed its system of internal control over cash disbursements. The system includes the following features.

Instead of being unnumbered and manually prepared, all checks must now be prenumbered and written by using the new checkwriter purchased by the company. Before a check can be issued, each invoice must have the approval of Sally Morgan, the purchasing agent, and John Countryman, the receiving department supervisor. Checks must be signed by either Ann Lynn, the treasurer, or Bob Skabo, the assistant treasurer. Before signing a check, the signer is expected to compare the amount of the check with the amount on the invoice.

After signing a check, the signer stamps the invoice PAID and inserts within the stamp, the date, check number, and amount of the check. The "paid" invoice is then sent to the accounting department for recording.

Blank checks are stored in a safe in the treasurer's office. The combination to the safe is known only by the treasurer and assistant treasurer. Each month, the bank statement is reconciled with the bank balance per books by the assistant chief accountant.

#### Instructions

Identify the internal control principles and their application to cash disbursements of Gore Office Supply Company.

**P8-2B** Sammy Sosa Company maintains a petty cash fund for small expenditures. The following transactions occurred over a 2-month period.

- July 1 Established petty cash fund by writing a check on Cubs Bank for \$200.
- 15 Replenished the petty cash fund by writing a check for \$198.00. On this date the fund consisted of \$2.00 in cash and the following petty cash receipts: freight-out \$94.00, postage expense \$42.40, entertainment expense \$46.60, and miscellaneous expense \$11.20.

Identify internal control principles over cash disbursements.

(SO 2, 4)



Journalize and post petty cash fund transactions.

(SO 5)

- 31 Replenished the petty cash fund by writing a check for \$192.00. At this date, the fund consisted of \$8.00 in cash and the following petty cash receipts: freight-out \$82.10, charitable contributions expense \$45.00, postage expense \$25.50, and miscellaneous expense \$39.40.
- Aug. 15 Replenished the petty cash fund by writing a check for \$187.00. On this date, the fund consisted of \$13.00 in cash and the following petty cash receipts: freight-out \$74.60, entertainment expense \$43.00, postage expense \$33.00, and miscellaneous expense \$37.00.
- 16 Increased the amount of the petty cash fund to \$300 by writing a check for \$100.
- 31 Replenished petty cash fund by writing a check for \$284.00. On this date, the fund consisted of \$16 in cash and the following petty cash receipts: postage expense \$140.00, travel expense \$95.60, and freight-out \$47.10.

**Instructions**

- (a) July 15, Cash short \$3.80
- (b) Aug. 31 balance \$300

- (a) Journalize the petty cash transactions.
- (b) Post to the Petty Cash account.
- (c) What internal control features exist in a petty cash fund?

Prepare a bank reconciliation and adjusting entries.

(SO 7)

**P8-3B** On May 31, 2006, Terry Duffy Company had a cash balance per books of \$6,781.50. The bank statement from Farmers State Bank on that date showed a balance of \$6,804.60. A comparison of the statement with the cash account revealed the following facts.

1. The statement included a debit memo of \$40 for the printing of additional company checks.
2. Cash sales of \$836.15 on May 12 were deposited in the bank. The cash receipts journal entry and the deposit slip were incorrectly made for \$886.15. The bank credited Duffy Company for the correct amount.
3. Outstanding checks at May 31 totaled \$276.25. Deposits in transit were \$1,916.15.
4. On May 18, the company issued check No. 1181 for \$685 to Barry Trest, on account. The check, which cleared the bank in May, was incorrectly journalized and posted by Duffy Company for \$658.
5. A \$3,000 note receivable was collected by the bank for Duffy Company on May 31 plus \$80 interest. The bank charged a collection fee of \$20. No interest has been accrued on the note.
6. Included with the cancelled checks was a check issued by Bridgetown Company to Tom Lujak for \$600 that was incorrectly charged to Duffy Company by the bank.
7. On May 31, the bank statement showed an NSF charge of \$680 for a check issued by Sandy Grifton, a customer, to Duffy Company on account.

**Instructions**

- (a) Adjusted cash balance per bank \$9,044.50

- (a) Prepare the bank reconciliation at May 31, 2006.
- (b) Prepare the necessary adjusting entries for Duffy Company at May 31, 2006.

Prepare a bank reconciliation and adjusting entries from detailed data.

(SO 7)

**P8-4B** The bank portion of the bank reconciliation for Heinisch Company at November 30, 2006, was as follows.

**HEINISCH COMPANY**

Bank Reconciliation  
November 30, 2006

Cash balance per bank		\$14,367.90
Add: Deposits in transit		2,530.20
		16,898.10
Less: Outstanding checks		
Check Number	Check Amount	
3451	\$2,260.40	
3470	720.10	
3471	844.50	
3472	1,426.80	
3474	1,050.00	
		6,301.80
Adjusted cash balance per bank		\$10,596.30

The adjusted cash balance per bank agreed with the cash balance per books at November 30.

The December bank statement showed the following checks and deposits.

<b>Bank Statement</b>				
<b>Checks</b>			<b>Deposits</b>	
<u>Date</u>	<u>Number</u>	<u>Amount</u>	<u>Date</u>	<u>Amount</u>
12-1	3451	\$ 2,260.40	12-1	\$ 2,530.20
12-2	3471	844.50	12-4	1,211.60
12-7	3472	1,426.80	12-8	2,365.10
12-4	3475	1,640.70	12-16	2,672.70
12-8	3476	1,300.00	12-21	2,945.00
12-10	3477	2,130.00	12-26	2,567.30
12-15	3479	3,080.00	12-29	2,836.00
12-27	3480	600.00	12-30	1,025.00
12-30	3482	475.50	Total	<u>\$18,152.90</u>
12-29	3483	1,140.00		
12-31	3485	540.80		
	Total	<u>\$15,438.70</u>		

The cash records per books for December showed the following.

<b>Cash Payments Journal</b>						<b>Cash Receipts Journal</b>	
<u>Date</u>	<u>Number</u>	<u>Amount</u>	<u>Date</u>	<u>Number</u>	<u>Amount</u>	<u>Date</u>	<u>Amount</u>
12-1	3475	\$1,640.70	12-20	3482	\$ 475.50	12-3	\$ 1,211.60
12-2	3476	1,300.00	12-22	3483	1,140.00	12-7	2,365.10
12-2	3477	2,130.00	12-23	3484	798.00	12-15	2,672.70
12-4	3478	621.30	12-24	3485	450.80	12-20	2,954.00
12-8	3479	3,080.00	12-30	3486	1,889.50	12-25	2,567.30
12-10	3480	600.00	Total		<u>\$14,933.20</u>	12-28	2,836.00
12-17	3481	807.40				12-30	1,025.00
						12-31	1,190.40
						Total	<u>\$16,822.10</u>

The bank statement contained two memoranda:

1. A credit of \$3,645 for the collection of a \$3,500 note for Heinisch Company plus interest of \$160 and less a collection fee of \$15. Heinisch Company has not accrued any interest on the note.
2. A debit of \$572.80 for an NSF check written by D. Chagnon, a customer. At December 31, the check had not been redeposited in the bank.

At December 31 the cash balance per books was \$12,485.20, and the cash balance per the bank statement was \$20,154.30. The bank did not make any errors, but two errors were made by Heinisch Company.

**Instructions**

- (a) Using the four steps in the reconciliation procedure, prepare a bank reconciliation at December 31.
- (b) Prepare the adjusting entries based on the reconciliation. (*Hint:* The correction of any errors pertaining to recording checks should be made to Accounts Payable. The correction of any errors relating to recording cash receipts should be made to Accounts Receivable.)

(a) Adjusted balance per books \$15,458.40

Prepare a bank reconciliation and adjusting entries.

**P8-5B** Cell Ten Company maintains a checking account at the Commerce Bank. At July 31, selected data from the ledger balance and the bank statement are as follows.

(SO 7)

	<b>Cash in Bank</b>	
	<b>Per Books</b>	<b>Per Bank</b>
Balance, July 1	\$17,600	\$18,800
July receipts	81,400	
July credits		80,470
July disbursements	77,150	
July debits		74,756
Balance, July 31	\$21,850	\$24,514

Analysis of the bank data reveals that the credits consist of \$79,000 of July deposits and a credit memorandum of \$1,470 for the collection of a \$1,400 note plus interest revenue of \$70. The July debits per bank consist of checks cleared \$74,700 and a debit memorandum of \$56 for printing additional company checks.

You also discover the following errors involving July checks: (1) A check for \$230 to a creditor on account that cleared the bank in July was journalized and posted as \$320. (2) A salary check to an employee for \$255 was recorded by the bank for \$155.

The June 30 bank reconciliation contained only two reconciling items: deposits in transit \$5,000 and outstanding checks of \$6,200.

#### Instructions

- (a) Prepare a bank reconciliation at July 31.
- (b) Journalize the adjusting entries to be made by Cell Ten Company at July 31, 2006. Assume that the interest on the note has been accrued.

(a) Adjusted balance per books \$23,354

*Identify internal control weaknesses in cash receipts and cash disbursements.*

(SO 2, 3, 4)

**P8-6B** Anamosa Middle School wants to raise money for a new sound system for its auditorium. The primary fund-raising event is a dance at which the famous disc jockey Obnoxious Al will play classic and not-so-classic dance tunes. Rob Drexler, the music and theater instructor, has been given the responsibility for coordinating the fund-raising efforts. This is Rob's first experience with fund-raising. He decides to put the eighth-grade choir in charge of the event; he will be a relatively passive observer.

Rob had 500 unnumbered tickets printed for the dance. He left the tickets in a box on his desk and told the choir students to take as many tickets as they thought they could sell for \$5 each. In order to ensure that no extra tickets would be floating around, he told them to dispose of any unsold tickets. When the students received payment for the tickets, they were to bring the cash back to Rob, and he would put it in a locked box in his desk drawer.

Some of the students were responsible for decorating the gymnasium for the dance. Rob gave each of them a key to the money box and told them that if they took money out to purchase materials, they should put a note in the box saying how much they took and what it was used for. After 2 weeks the money box appeared to be getting full, so Rob asked Erik Radley to count the money, prepare a deposit slip, and deposit the money in a bank account Rob had opened.

The day of the dance, Rob wrote a check from the account to pay the DJ. Obnoxious Al, however, said that he accepted only cash and did not give receipts. So Rob took \$200 out of the cash box and gave it to Al. At the dance Rob had Mel Harris working at the entrance to the gymnasium, collecting tickets from students and selling tickets to those who had not pre-purchased them. Rob estimated that 400 students attended the dance.

The following day Rob closed out the bank account, which had \$250 in it, and gave that amount plus the \$180 in the cash box to Principal Foran. Principal Foran seemed surprised that, after generating roughly \$2,000 in sales, the dance netted only \$430 in cash. Rob did not know how to respond.

#### Instructions

Identify as many internal control weaknesses as you can in this scenario, and suggest how each could be addressed.

## BROADENING YOUR PERSPECTIVE

### Financial Reporting and Analysis

#### ■ FINANCIAL REPORTING PROBLEM: PepsiCo

**BYP8-1** The financial statements of **PepsiCo, Inc.** are presented in Appendix A at the end of this textbook.



##### Instructions

- (a) What comments, if any, are made about cash in the report of the independent auditors?
- (b) What data about cash and cash equivalents are shown in the consolidated balance sheet?
- (c) In its notes to Consolidated Financial Statements, how does PepsiCo, Inc. define cash equivalents?
- (d) In management's letter that assumes "Responsibility for Financial Statements," what does PepsiCo's management say about internal control? (See page 78 of its 2003 Annual Report or page A7 of Appendix A in this book.)

#### ■ COMPARATIVE ANALYSIS PROBLEM: PepsiCo vs. Coca-Cola

**BYP8-2** **PepsiCo's** financial statements are presented in Appendix A. **Coca-Cola Company's** financial statements are presented in Appendix B.



##### Instructions

- (a) Based on the information contained in these financial statements, determine each of the following for each company:
  - (1) Cash and cash equivalents balance at December 27, 2003, for PepsiCo and at December 31, 2003, for Coca-Cola.
  - (2) Increase (decrease) in cash and cash equivalents from 2002 to 2003.
  - (3) Cash provided by operating activities during the year ended December 2003 (from Statement of Cash Flows).
- (b) What conclusions concerning the management of cash can be drawn from these data?

#### ■ RESEARCH CASE

**BYP8-3** The September 6, 2001, issue of the *Wall Street Journal* includes an article by Shirley Leung titled "Checks, Balances Were Needed to Avert Alleged Game Scam by Simon Worldwide."

##### Instructions

Read the article and answer the following questions.

- (a) Describe the nature of the theft that is described in the article.
- (b) What were the internal control weaknesses that allowed this theft to occur?
- (c) What methods do other companies in this industry use to avoid a similar type of theft?
- (d) What was one "clue" that the company managers overlooked that should have alerted them that there was a problem?

#### ■ INTERPRETING FINANCIAL STATEMENTS

**BYP8-4** **Microsoft** is the leading developer of software in the world. To continue to be successful Microsoft must generate new products, and generating new products requires significant amounts of cash. Shown on page 374 is the current assets and current liabilities information from Microsoft's June 30, 2003, balance sheet (in millions). Following the Microsoft data is the current assets and current liabilities information for **Oracle** (in millions), another major software developer.



**MICROSOFT, INC.**  
Balance Sheets (partial)  
As of June 30  
(in millions)

	<u>2003</u>	<u>2002</u>
Current assets		
Cash and equivalents	\$ 6,438	\$ 3,016
Short-term investments	42,610	35,636
Accounts receivable	5,196	5,129
Other	4,729	4,795
Total current assets	\$58,973	\$48,576
Total current liabilities	\$13,974	\$12,744



**ORACLE**  
Balance Sheets (partial)  
As of May 31  
(in millions)

	<u>2003</u>	<u>2002</u>
Current assets		
Cash and cash equivalents	\$4,737	\$3,095
Short-term investments	1,782	2,746
Receivables	1,920	2,036
Other current assets	788	851
Total current assets	\$9,227	\$8,728
Current liabilities	\$4,158	\$3,960

**Instructions**

- What is the definition of a cash equivalent? Give some examples of cash equivalents. How do cash equivalents differ from other types of short-term investments?
- Calculate (1) the current ratio and (2) working capital for each company for 2003 and discuss your results.
- Is it possible to have too many liquid assets?

■ **A GLOBAL FOCUS**

**BYP8-5** The international accounting firm **KPMG** performed a global survey on e-fraud. Included in its virtual library, at its Web site, is a March 29, 2001, article titled “E-fraud: Is Technology Running Unchecked?” that summarizes the findings of that global survey.

**Address:** [www.kpmg.com/about/press.asp?cid=469](http://www.kpmg.com/about/press.asp?cid=469), or go to [www.wiley.com/college/weygandt](http://www.wiley.com/college/weygandt)

**Instructions**

Read the article at the Web site, and answer the following questions.

- What do most senior managers in corporations believe to be the most likely perpetrator of a breach of their network systems, and in fact, what is the actual greatest threat?
- What percentage of firms perform security audits of their e-commerce systems?
- What is the problem with fixing a security breach immediately upon learning that a breach of the system has occurred?
- What percentage of the companies had experienced a security breach in the last year? In these instances, what percentage did not take legal action against the perpetrator of the breach?
- How did the findings of the survey vary across countries and across other geographic distinctions?

### ■ EXPLORING THE WEB

**BYP8-6** All organizations should have systems of internal control. Universities are no exception. This site discusses the basics of internal control in a university setting.

**Address:** [www.bc.edu/offices/audit/controls/](http://www.bc.edu/offices/audit/controls/), or go to [www.wiley.com/college/wegandt](http://www.wiley.com/college/wegandt)

**Steps:** Go the site shown above.

#### Instructions

The front page of this site provides links to pages that answer six critical questions. Use these links to answer the following questions.

- (a) In a university setting who has responsibility for evaluating the adequacy of the system of internal control?
- (b) What do reconciliations ensure in the university setting? Who should review the reconciliation?
- (c) What are some examples of physical controls?
- (d) What are two ways to accomplish inventory counts?



## Critical Thinking

### ■ GROUP DECISION CASE

**BYP8-7** The board of trustees of a local church is concerned about the internal accounting controls for the offering collections made at weekly services. The trustees ask you to serve on a three-person audit team with the internal auditor of a local college and a CPA who has just joined the church.

At a meeting of the audit team and the board of trustees you learn the following.

1. The church's board of trustees has delegated responsibility for the financial management and audit of the financial records to the finance committee. This group prepares the annual budget and approves major disbursements. It is not involved in collections or record keeping. No audit has been made in recent years because the same trusted employee has kept church records and served as financial secretary for 15 years. The church does not carry any fidelity insurance.
2. The collection at the weekly service is taken by a team of ushers who volunteer to serve one month. The ushers take the collection plates to a basement office at the rear of the church. They hand their plates to the head usher and return to the church service. After all plates have been turned in, the head usher counts the cash received. The head usher then places the cash in the church safe along with a notation of the amount counted. The head usher volunteers to serve for 3 months.
3. The next morning the financial secretary opens the safe and recounts the collection. The secretary withholds \$150–\$200 in cash, depending on the cash expenditures expected for the week, and deposits the remainder of the collections in the bank. To facilitate the deposit, church members who contribute by check are asked to make their checks payable to "Cash."
4. Each month, the financial secretary reconciles the bank statement and submits a copy of the reconciliation to the board of trustees. The reconciliations have rarely contained any bank errors and have never shown any errors per books.

#### Instructions

With the class divided into groups, answer the following.

- (a) Indicate the weaknesses in internal accounting control over the handling of collections.
- (b) List the improvements in internal control procedures that you plan to make at the next meeting of the audit team for (1) the ushers, (2) the head usher, (3) the financial secretary, and (4) the finance committee.
- (c) What church policies should be changed to improve internal control?

### ■ COMMUNICATION ACTIVITY

**BYP8-8** As a new auditor for the CPA firm of Croix, Marais, and Kale, you have been assigned to review the internal controls over mail cash receipts of Stillwater Company. Your review reveals the following: Checks are promptly endorsed "For Deposit Only," but no list of the checks is prepared by the person opening the mail. The mail is opened either by the cashier or by the

employee who maintains the accounts receivable records. Mail receipts are deposited in the bank weekly by the cashier.

**Instructions**

Write a letter to Peter A. Bridgman, owner of the Stillwater Company, explaining the weaknesses in internal control and your recommendations for improving the system.

**Accounting Matters!**

■ **ETHICS CASES**

**BYP8-9** You are the assistant controller in charge of general ledger accounting at Springtime Bottling Company. Your company has a large loan from an insurance company. The loan agreement requires that the company's cash account balance be maintained at \$200,000 or more, as reported monthly.

At June 30 the cash balance is \$80,000, which you report to Anne Shirley, the financial vice president. Anne excitedly instructs you to keep the cash receipts book open for one additional day for purposes of the June 30 report to the insurance company. Anne says, "If we don't get that cash balance over \$200,000, we'll default on our loan agreement. They could close us down, put us all out of our jobs!" Anne continues, "I talked to Oconto Distributors (one of Springtime's largest customers) this morning. They said they sent us a check for \$150,000 yesterday. We should receive it tomorrow. If we include just that one check in our cash balance, we'll be in the clear. It's in the mail!"

**Instructions**

- (a) Who will suffer negative effects if you do not comply with Anne Shirley's instructions? Who will suffer if you do comply?
- (b) What are the ethical considerations in this case?
- (c) What alternatives do you have?



**BYP8-10 Fraud Bureau** is a free service, established to alert consumers and investors about prior complaints relating to online vendors, including sellers at online auctions, and to provide consumers, investors, and users with information and news. One of the services it provides is a collection of online educational articles related to fraud.

**Address:** [www.fraudbureau.com/articles/](http://www.fraudbureau.com/articles/), or go to [www.wiley.com/college/weygandt](http://www.wiley.com/college/weygandt)

**Instructions**

Go to this site and choose an article of interest to you. Write a short summary of your findings.

**Accounting Matters!**

■ **CONTINUING COOKIE CHRONICLE**

(Note: This is a continuation of the Cookie Chronicle from Chapters 1 through 7.)

**BYP8-11**

**Part 1** Natalie is struggling to keep up with the recording of her accounting transactions. She is spending a lot of time marketing and selling mixers and giving her cookie classes. Her friend John is an accounting student who runs his own accounting service. He has asked Natalie if she would like to have him do her accounting.

John and Natalie meet and discuss her business. John suggests that he do the following for Natalie.

1. Hold onto cash until there is enough to be deposited. (He would keep the cash locked up in his vehicle). He would also take all of the deposits to the bank at least twice a month.
2. Write and sign all of the checks.
3. Record all of the deposits in the accounting records.
4. Record all of the checks in the accounting records.
5. Prepare the monthly bank reconciliation.
6. Transfer all of Natalie's manual accounting records to his computer accounting program. John maintains all of the accounting information that he keeps for his clients on his laptop computer.
7. Prepare monthly financial statements for Natalie to review.
8. Write himself a check every month for the work he has done for Natalie.

**Instructions**

Identify the weaknesses in internal control that you see in the system that John is recommending. (Consider the principles of internal control identified in the chapter.) Can you suggest any improvements if John is hired to do Natalie's accounting?

**Part 2** Natalie decides that she cannot afford to hire John to do her accounting. One way that she can ensure that her cash account does not have any errors and is accurate and up-to-date is to prepare a bank reconciliation at the end of each month.

Natalie would like you to help her. She asks you to prepare a bank reconciliation for June 2006 using the following information.

### GENERAL LEDGER—COOKIE CREATIONS

#### Cash

Date	Explanation	Ref.	Debit	Credit	Balance
2006					
June 1	Balance				2,657
1			750		3,407
3	Check #600			625	2,782
3	Check #601			95	2,687
8	Check #602			56	2,631
9			1,050		3,681
13	Check #603			425	3,256
20			155		3,411
28	Check #604			247	3,164
28			110		3,274

### PREMIER BANK

Statement of Account—Cookie Creations  
June 30, 2006

Date	Explanation	Checks and Other Debits	Deposits	Balance
May 31	Balance			3,256
June 1	Deposit		750	4,006
6	Check #600	625		3,381
6	Check #601	95		3,286
8	Check #602	56		3,230
9	Deposit		1,050	4,280
10	NSF check	100		4,180
10	NSF-fee	35		4,145
14	Check #603	452		3,693
20	Deposit		125	3,818
23	EFT-Telus	85		3,733
28	Check #599	361		3,372
30	Bank charges	13		3,359

Additional information:

1. On May 31, there were two outstanding checks: #595 for \$238 and #599 for \$361.
2. Premier Bank made a posting error to the bank statement: check #603 was issued for \$425, not \$452.
3. The deposit made on June 20 was for \$125 that Natalie received for teaching a class. Natalie made an error in recording this transaction.
4. The electronic funds transfer (EFT) was for Natalie's cell phone use. Remember that she uses this phone only for business.
5. The NSF check was from Ron Black. Natalie received this check for teaching a class to Ron's children. Natalie contacted Ron and he assured her that she will receive a check in the mail for the outstanding amount of the invoice and the NSF bank charge.

**Instructions**

- (a) Prepare Cookie Creations' bank reconciliation for June 2006.
- (b) Prepare any necessary general journal entries.
- (c) If a balance sheet is prepared for Cookie Creations at June 30, 2006, what balance will be reported as cash in the current assets section?

**Accounting Matters!****Answers to Accounting Matters! Questions****p. 336****Q:** What could the Pennsylvania bank mentioned above have done to prevent such an error?**A:** It could have educated its tellers with regard to money currently in circulation; it could have required a supervisor to approve all transactions in excess of a predetermined limit, such as \$50,000; or it could have had mechanical controls that notified supervisors when a transaction exceeded a certain maximum amount.**p. 338****Q:** Which principle of internal control was implemented in ancient Egypt?**A:** The principle of *independent internal verification* was implemented in ancient Egypt.**Q:** Who do you think investors today expect to detect and prevent fraud?**A:** Today, investors probably expect independent auditors to detect and prevent fraud. In reality, management is assigned this important responsibility. Auditors attest to compliance with GAAP and specifically state that financial statements and the system of internal control are the responsibility of management.**p. 341****Q:** Is a computer capable of committing fraud? Discuss.**A:** People commit fraud by misdirecting or programming the computer to misstate numbers or misappropriate assets. Computers do not commit fraud—people do. (Does that make the computer an accomplice?)**p. 346****Q:** Which principles of internal control should have prevented such fraud?**A:** Three principles could have been used: (1) *segregation of duties*, with one employee requesting payment, another preparing the checks, and a third signing the checks; (2) *documentation procedures*, which require that each check have an approved, pre-numbered voucher; or (3) *independent internal verification*.**p. 351****Q:** Will "cash" be obsolete in terms of financial statement reporting?**A:** Cash, as the most liquid asset, will continue to be reported on balance sheets, and cash flows will still be reported on the statement of cash flows. Coins and currency may be less popular, but cash in the form of virtual cash (balances or deposits in accounts) will exist in a big way and will continue to appear in financial statements.**Answer to PepsiCo Review It Question 3, p. 358****PepsiCo** reports cash and cash equivalents on its balance sheet for 2003 of \$820 million.**Answers to Self-Study Questions**

1. a   2. c   3. b   4. c   5. b   6. d   7. a   8. a   9. c   10. d   11. c

**REMEMBER** to go back to the Navigator box on the chapter-opening page and check off your completed work.