

# **Internal Control and Cash**

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## **OPENING COMMENTS**

In recent years, events have occurred that have resulted in increased emphasis on proper financial reporting and on ensuring that controls are in place to accomplish this. Chapter 8 introduces background on the Sarbanes-Oxley Act of 2002, which has significantly increased the outside demand for assuring proper financial reporting. The chapter also addresses the development of internal control frameworks for a business and the financial accounting practices relating to recording cash transactions. Cash is highlighted in this chapter because it is the asset most vulnerable to manipulation. The chapter ends with an explanation of the ratio of cash to monthly cash expenses.

After studying the chapter, your students should be able to:

1. Describe the Sarbanes-Oxley Act and its impact on internal controls and financial reporting.
2. Describe and illustrate the objectives and elements of internal control.
3. Describe and illustrate the application of internal controls to cash.
4. Describe the nature of a bank account and its use in controlling cash.
5. Describe and illustrate the use of a bank reconciliation in controlling cash.
6. Describe the accounting for special-purpose cash funds.
7. Describe and illustrate the reporting of cash and cash equivalents in the financial statements.
8. Describe and illustrate the use of the ratio of cash to monthly cash expenses to assess the ability of a company to continue in business.

## KEY TERMS

bank reconciliation  
bank statement  
cash  
cash equivalents  
cash short and over account  
compensating balance  
control environment  
electronic funds transfer (EFT)  
elements of internal control  
employee fraud  
internal control  
petty cash fund  
ratio of cash to monthly cash expenses  
Sarbanes-Oxley Act  
special-purpose funds  
voucher  
voucher system

## STUDENT FAQs

- Where do I go to get more information about working with Sarbanes-Oxley when I graduate? I also need to make sure I take the correct courses in college.
- When a person doesn't work all the hours they are supposed to during the day, are they defrauding the company?
- Why must I learn to balance the cash account when I put the money in the bank to protect it?
- Do I have a legal obligation to give cash back to someone when I have no idea who that person is?
- Why do we spend so much time on internal control for cash receipts and disbursements? Shouldn't we be just as concerned over other assets? Expenses? Revenue? Liabilities?
- Why don't we make journal entries for bank errors?
- Why do we worry about deposits in transit and outstanding checks? Won't they "work themselves out" the following month?
- Why do we need a new asset account called Petty Cash? Can't we use the cash account?
- If we use the account Petty Cash when we establish a petty cash fund, why don't we use Petty Cash when we replenish the fund?
- What is the normal balance of the "cash short and over" account? Why is this account treated as an expense or revenue account on the income statement rather than an asset account on the balance sheet? After all, isn't it a cash account?

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## OBJECTIVE 1

**Describe the Sarbanes-Oxley Act and its impact on internal controls and financial reporting.**

### SYNOPSIS

This chapter begins with the effects of the Sarbanes-Oxley Act. This act, passed by Congress, was to strengthen the internal controls of publicly held companies. Internal control defines the processes meant to safeguard assets, process information accurately, and ensure compliance with laws and regulations.

### *Key Terms and Definitions*

- **Internal Control** - The policies and procedures used to safeguard assets, ensure accurate business information, and ensure compliance with laws and regulations.
- **Sarbanes-Oxley Act** – An act passed by Congress to restore public confidence and trust in the financial statements of companies.

### *Relevant Exhibits*

- Exhibit 1 – Effect of Sarbanes-Oxley
- Exhibit 2 – eBay’s Report of Compliance with Sarbanes-Oxley

### SUGGESTED APPROACH

Chapter 8 discusses the Sarbanes-Oxley Act of 2002 (the most important law affecting publicly held companies in recent history). Although the law applies only to publicly traded companies, it really has become the standard for assessing the financial controls and reporting of all companies. In essence, it emphasizes the importance of effective internal control. Internal control procedures and processes have been greatly emphasized and increased under Section 404 requirements. The Committee of Sponsoring Organizations (COSO) is the widely accepted standard by which companies design, analyze, and evaluate internal controls.

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## OBJECTIVE 2

**Describe and illustrate the objectives and elements of internal control.**

### SYNOPSIS

The objectives of internal control are described in this section. Internal control has three objectives: making sure those assets are safeguarded and used for business purposes, ensuring that all accounting and business information is accurate, and making sure that employees and managers comply with laws and regulations. The objectives can be achieved by using the five elements of internal control. The control environment is the overall attitude of the company, including management, personnel policies, and organizational structure. Exhibit 5 shows how these interact to complete the control environment. Risk is

the second element: all risks should be identified, analyzed, and assessed and actions taken to minimize their occurrence. Control procedures provide assurance that goals will be met and include the prevention of fraud. Exhibit 6 shows how procedures protect the business. Monitoring is the fourth element and is used to assess weaknesses and improve controls. Exhibit 7 explains some of the warning signs of internal control problems. Information and communications is the fifth and final element of internal control. It is the link that allows all the other elements to work together. Internal control is not a guarantee that assets are safeguarded, all information is accurate, and no laws are broken. Internal controls are only as good as the human element that provides them, and they are limited by cost-benefit considerations.

### ***Key Terms and Definitions***

- **Control Environment** - The overall attitude of management and employees about the importance of controls.
- **Elements of Internal Control** - The control environment, risk assessment, control activities, information and communication, and monitoring.
- **Employee Fraud** - The intentional act of deceiving an employer for personal gain.

### ***Relevant Example Exercise and Exhibits***

- Exhibit 3 – Objectives of Internal Control
- Exhibit 4 – Elements of Internal Control
- Exhibit 5 – Control Environment
- Exhibit 6 – Internal Control Procedures
- Exhibit 7 – Warning Signs of Internal Control Problems
- Example Exercise 8-1 – Internal Control Elements

## **SUGGESTED APPROACH**

The text lists the three objectives of internal control as reasonable assurance that (1) assets are safeguarded and used for business purposes, (2) business information is accurate, and (3) employees and managers comply with laws and regulations. The five elements of internal control are (1) control environment, (2) risk assessment, (3) control procedures, (4) monitoring, and (5) information and communication. To stimulate interest in these topics, use the following Lecture Aid.

## **LECTURE AID—Internal Control**

Ask the following questions (also shown on Handout 8-1):

If you owned a business, would you expect your employees ...:

1. To work to achieve the business goals and objectives you establish?
2. To use business assets (such as machinery or automobiles) only for legitimate business purposes and avoid wasting business resources?

3. To record accurate data regarding business transactions so you could accurately judge how well your business is doing?
4. To refrain from stealing your cash, supplies, inventory, or property, plant, and equipment?

In theory, you should be able to expect these things. In practice, however, you must establish an internal control framework to make sure your business objectives are achieved, assets are protected from theft and misuse, and financial data are recorded accurately.

Handouts 8-2 through 8-4 include information to use in reviewing the elements of internal control.

Possible response to Handout 8-3: (1) Salespersons on commission also approved to grant credit represent a conflict of interest. Denial of credit to a potential sale would take money out of the pocket of the salesperson, creating an opportunity to grant credit to customers not worthy of credit in order to make a sale. Separation of duties to have a non-commissioned individual to approve credit would be the preferred method. (2) Having a single individual responsible for all of these duties creates an opportunity to easily order goods, check them in, approve payment, and allow that individual to carry the inventory away. Again, separation of duties will not eliminate this possibility of theft; however, it will make the process more difficult to perform. (3) Although the size of the possible theft is greatly diminished in this scenario and many donut shops would follow this model, a better model would be to separate the responsibilities here, having one employee take the order, a second fill the order, and a third accept the payment. In all three instances, separation of duties is the ultimate model whenever possible.

Possible response to Handout 8-4: (1) Allowing the clerk to accept cash and update customer account records gives a single individual an opportunity to accept the cash, pocket it, and provide the customer record with the credit. Requiring a second individual to balance the bank deposit against the customer account credits could make this model workable, but separation of duties would be a preferred model. (2) Allowing a single individual to approve invoices, prepare checks, mail them, and update hospital records provides an opportunity to create fictitious vendors and to prepare checks to these fictitious vendors that can then be cashed by the employee for personal use. In both scenarios, separation of duties would have made the potential fraud more difficult to execute.

When reviewing the control environment, give an illustration of a poor control environment and a good control environment. For example, in a poor control environment, you have a dominating management staff that pressures employees to meet budgets and projections at all costs, regardless of circumstances. A good control environment is established by a management that encourages employees to adhere to control policies and procedures and an employee code of conduct.

Under proof and security measures, you may want to emphasize that businesses should protect their accounting records by using off-site backup computer files and fireproof file cabinets. Companies have gone out of business because fire or theft destroyed their accounting records. For example, the destruction of accounts receivable files could result in significant losses to a business.

Exhibit 7 in the text presents a good list of the “red flags” that may indicate employee fraud or embezzlement. Refer your students to this list for helpful tips in monitoring internal controls.

## GROUP LEARNING ACTIVITY—Internal Control Structure

Ask your students to assume that they have decided to open a bookstore that sells textbooks and competes with the campus bookstore (Handout 8-5). With students in small groups, instruct them to list the internal control procedures they would implement in their store. After giving the groups a few minutes to work, ask each group to share a couple of their ideas.

Potential response to Handout 8-5: Students might focus on the physical layout of the store. The doors should be protected with scanning devices that detect removal of inventory that has not been security deactivated. Security cameras, one-way mirrors, and limited access are also good ideas. Restricting students from bringing backpacks into the store is also a good security measure. Students should also address the employee's duties. They should discuss the process of cash-register safeguarding of cash using a head cashier and the validation of cash drawers and end-of-day reconciliation. See Handout 8-6 for an overview. The discussion of inventory should include ordering, receiving, and payment of invoices.

Mention should be made about the limitations of internal control and that internal control systems are not guarantees due to the human element inherent in their practices as well as consideration of the cost benefit of safeguards.

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## OBJECTIVE 3

**Describe and illustrate the application of internal controls to cash.**

### SYNOPSIS

The control of cash is important to a business because it is the asset most likely to be stolen or used improperly. To protect cash from being stolen or misused, a business must record cash from the time it is received to its deposit in a bank account. Cash received from cash sales must be safeguarded by cash register controls. There are nine steps in the cash register control, which are listed on page 404 in the text. Differences in the cash sales process are accounted for by using the cash short and over account. Cash received in the mail, usually in the form of checks or money orders, is controlled according to the steps listed on page 405 in the text. Separating the duties of the department that handles cash and the Accounting Department that records cash is a key control. Cash may also be received from customers through an electronic funds transfer. This is encouraged by most businesses because it costs less, enhances control, and reduces late payments. The payment of cash must also be controlled. The voucher system may be used for authorizing and recording cash payments. A voucher serves as proof of authorization to pay cash. When authorized, cash may be paid by check or electronic funds transfer. After payment, a voucher is filed and is proof of payment for accounts payable.

### *Key Terms and Definitions*

- **Cash** - Coins, currency (paper money), checks, money orders, and money on deposit that is available for unrestricted withdrawal from banks and other financial institutions.
- **Cash Short and Over Account** - An account which has recorded errors in cash sales or errors in making change causing the amount of actual cash on hand to differ from the beginning amount of cash plus the cash sales for the day.

- **Electronic Funds Transfer (EFT)** - A system in which computers rather than paper (money, checks, etc.) are used to effect cash transactions.
- **Voucher** - A special form for recording relevant data about a liability and the details of its payment.
- **Voucher System** - A set of procedures for authorizing and recording liabilities and cash payments.

### ***Relevant Exhibit***

- Exhibit 8 – Cash Register as a Control

## **SUGGESTED APPROACH**

Remind your students that cash includes anything a bank would accept for deposit in your account. This includes coins, currency, checks, and money orders. A good system of internal controls is necessary to protect all of these forms of cash.

The topic of internal controls can be used to stimulate a lively class discussion. Suggestions for leading that discussion follow.

The cash change fund and the cash short and over account are simple topics that can be covered appropriately in a lecture format.

## **CLASS DISCUSSION—Internal Controls**

Protecting business assets is an important concern for any manager or owner. Handout 8-6 reviews the typical controls for protecting cash received at the cash register. Review these controls with your class. Point out how the principle of separation of accounting, custody of assets, and operations is applied in this scenario.

Next, ask your class to identify the people who have the opportunity to steal cash. The candidates are the clerk and the cashier, because they are the only ones who actually handle cash. Ask your students to identify ways in which these individuals can steal cash and, more importantly, what procedures can be instituted to prevent theft by these means.

Because many of your students will have worked in businesses that use a cash register, they probably will have heard stories about employees who discovered a way to steal cash from a register. Therefore, your class discussion will probably focus on the clerk. It should point out the internal control reason for many of the policies and procedures your students have experienced in their clerk positions. To summarize the discussion, remind your students that business owners/managers must constantly be alert for ways in which employees and customers could steal cash and establish controls to prevent theft before it occurs.

The following lists some of the ways for the clerk in Handout 8-6 to steal cash and some procedures to prevent/detect this theft:

**Means to Steal Cash**

**Ways to Prevent/Detect Theft**

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| <ol style="list-style-type: none"> <li>1. Don't ring the sale on the cash register, and pocket the cash.</li> <br/> <li>2. Enter the sale on the register, then void the sale and pocket the cash.</li> <br/> <li>3. Enter a cash refund on the register and pocket the cash.</li> <br/> <li>4. If more than one clerk uses the register, simply take the cash when no one is looking and hope that someone else will be blamed.</li> </ol> | <ol style="list-style-type: none"> <li>1. Odd pricing—clerk must make change.<br/>Require receipts for refunds.<br/>Put coupons on backs of receipts so the customer will ask for a receipt.<br/>Offer customers a bonus if they are not handed a receipt (e.g., a free beverage).<br/>Have one employee ring up customer orders and another fill orders from a receipt.<br/>Proper supervision—watch for employees who do not ring up orders.</li> <br/> <li>2. Only managers can ring voids.<br/>Use cash registers that require a key to void a sale.<br/>Require all voids to be documented and authorized by a manager.</li> <br/> <li>3. Require a manager to authorize all refunds in the presence of the customer.<br/>Only managers can issue refunds.</li> <br/> <li>4. Have a separate register for each clerk.<br/>Each clerk must balance register at the end of each shift.</li> </ol> |
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Handout 8-7 presents procedures related to the receipt of cash through the mail. Use this illustration to point out how good internal controls (mainly separation of accounting, custody of assets, and operations) will reduce theft and errors. For example, pose the following questions to the class:

1. Assume that the employee who opens the mail steals a customer payment. How will this theft be detected?  
  
Possible response: The deposit amount from the cashier will not match the remittance report from the AR clerk.
  
2. Assume that the accounting clerk posts the payment to the wrong customer's account. How will this error be detected?  
  
Possible response: This error must be challenged by the customer not receiving credit for payment on account.
  
3. Assume that the accounting clerk posts a customer's payment for the wrong amount, giving the customer credit for less than he or she actually paid. How will this error be detected?  
  
Possible response: The AR report will not match the cash deposit or the payments received total.

4. Assume that an employee in the Cashier's Department loses a check. (Maybe it was placed in the customer's file rather than deposited in the bank.) How will this error be detected?

Possible response: The AR report will not match the cash deposit or the payments received total.

Handout 8-7 can also be used to explain collusion. Collusion occurs when two or more employees work together to embezzle cash or conceal errors. For example, if the accounting clerk and the employee who opens the mail decide to work together, one can steal customer payments and the other can "doctor" the accounting records. To prevent collusion, companies will institute nepotism policies, job rotation, and mandatory vacations.

Point out to students that cash may also be received by EFT. Companies encourage customers to use EFT because it is more cost efficient than processing payments received through the mail, it enhances internal controls by avoiding the human factor of cash handling, it reduces late payments, and it speeds up the processing of cash receipts.

### **LECTURE AID—Cash Change Fund and Cash Short and Over Account**

Objective 3 also presents the cash change fund and the cash short and over account. Ask students who have worked as cashiers to share what amount of cash was in their cash register at the beginning and end of the day. This represents a cash change fund.

Remind students that a cash change fund is required for any business that receives cash from its customers. Someone must be accountable for that change fund at all times. It should be locked in a company vault when not in use.

The cash short and over account is used when the cash on hand at the end of the day does not equal the amount in the beginning cash change fund plus the day's cash sales. It is used to record discrepancies due to errors in recording sales or making change. The cash short and over account is needed because employees will not be accurate 100 percent of the time.

As long as the cash short and over account shows only small discrepancies, management should not be concerned. If the account shows large discrepancies or continuous shortages, however, management should investigate these differences. Ask your students who have worked as cashiers to describe their employers' policies regarding cash overages and shortages. If a cashier consistently has large cash short and over amounts, he or she probably needs additional training.

You may want to review the journal entry illustrated on page 405 of the text with your class and remind them that a debit balance in the cash short and over account is treated as a miscellaneous administrative expense. A credit balance is included in the Other revenue section of the income statement.

## INTERNET ACTIVITY—Internal Controls over Cash

Instruct your students to search the Web using “internal controls” and “cash management” as their search criteria. At the time this manual was written, the following sites offered some interesting information:

<http://www.coso.org/IC-IntegratedFramework-summary.htm>

<http://www.securitymanagement.com/library/000304.html>

These sites discuss the importance of establishing internal controls over petty cash and many other areas.

The voucher system will require a detailed explanation in lecture format. Handout 8-8 will help you present this topic. After discussing the voucher system, use the Writing Exercise shown below to test your students’ comprehension of the system.

Objective 3 also addresses electronic funds transfers. Most students will be familiar with electronic funds transfers (EFT) through direct experience with automated teller machines (ATMs), payroll direct deposit, or point-of-sale systems. Use this opportunity to point out the control risks of EFTs and make students aware of the internal control procedures that must be implemented when EFTs are used. To achieve this goal, stimulate a Class Discussion on control issues related to point-of-sale systems. Next, assign a Group Learning Activity that requires your students to implement EFT control procedures.

## LECTURE AID—The Voucher System

Handout 8-8 is a flowchart-style illustration of the voucher system, putting the textbook description in picture format. Review this chart with your class, stressing the control aspects of the voucher system. A Writing Exercise to reinforce your coverage of this topic follows.

## WRITING EXERCISE—The Voucher System

After reviewing the voucher system, ask your class to write answers to the following questions (also listed in Handout 8-9):

1. How does the voucher system ensure that management is paying only valid obligations?  
Possible response: Comparing purchase orders, receiving reports, and invoices will provide assurance that only valid obligations are being presented for payment.
2. How does the voucher system help a company maintain a favorable credit standing by aiding management in paying all invoices on time?  
Possible response: By filing unpaid vouchers by due date, the accounts payable clerk can make sure obligations are paid on time.
3. How would a company using a voucher system investigate a supplier’s complaint that an invoice has not been paid?  
Possible response: There are two possible ways to verify payment. Cancelled checks will show payment amount, date, and invoice being paid. The paid voucher file should contain those vouchers for which checks have been issued.

## CLASS DISCUSSION—Control of Point-of-Sale Systems

The following two scenarios (Handout 8-10) relate to point-of-sale systems. In a classroom discussion, ask your students to identify the control risk associated with each system and name procedures that can be implemented to counterbalance the risk.

1. A grocery store decides to install a point-of-sale system that will allow the customer to use his or her ATM card to pay for merchandise at the checkout line. Previously, the grocery store has accepted only cash and checks as payment.

**Control Risk:** In the past, the clerks would have reconciled their cash registers by comparing the sales on the register tape to the total of the cash and checks in the register drawer. Under the new system, a clerk could steal the cash taken for a customer's order and claim that the customer paid by EFT. The clerk also could allow friends and family to leave the store without paying for their merchandise and claim they paid with an EFT. In addition, a customer might mistakenly (or intentionally) authorize the wrong payment amount when using the point-of-sale device.

**Solution:** A receipt from the point-of-sale device must be placed in the cash register drawer as evidence of the customer's payment. In reconciling the cash drawer, sales on the register tape would be verified against the total of cash, checks, and point-of-sale receipts. In addition, the point-of-sale receipts must be used to verify actual bank deposits from the EFT system.

2. A self-service gas station decides to install a point-of-sale device at the gasoline pump. This will speed the time it takes a customer to fill his or her gas tank, since payment can be made right at the pump, eliminating the time spent waiting in line for a clerk to accept payment.

**Control Risk:** Whenever a customer puts gasoline in the car and drives off, the clerk will assume that the customer paid with the point-of-sale device. In reality, the customer may not have paid at all.

**Solution:** The clerk must have a device that clearly indicates which customers have chosen to pay with the point-of-sale device. This will immediately alert the clerk to any customers who simply drive off. Installing cameras to capture the license plate number of cars with drivers who did not pay is also an important control.

## GROUP LEARNING ACTIVITY—Electronic Funds Transfers

Handout 8-11 presents information regarding a company that has decided to use EFT to pay vendor invoices. Divide the class into small groups and ask them to define procedures for paying vendor invoices via EFT. Their procedures should include any documentation, authorization, or reconciliation required and who should be made responsible for those tasks. Handout 8-12 presents a suggested solution.

## OBJECTIVE 4

Describe the nature of a bank account and its use in controlling cash.

### SYNOPSIS

Using a bank account is another way to enhance internal control. Bank accounts reduce cash on hand, provide an independent recording of cash, and can be used to electronically transfer funds. Banks maintain a record of all checking account transactions and provide a bank statement on a monthly basis. The bank shows a credit balance in the cash account because it is a liability to the bank; it is a debit for the business. A copy of the bank statement is shown in Exhibit 9. Exhibit 10 shows the debits and credits from the perspectives of both the business and the bank. Differences between the bank statement and a company's books may arise due to timing issues, errors, NSF checks, etc. Reconciling the bank statement with the business's books is an important part of cash control.

### *Key Term and Definition*

- **Bank Statement** - A summary of all transactions mailed to the depositor or made available online by the bank each month.

### *Relevant Example Exercise and Exhibits*

- Exhibit 9 – Bank Statement
- Exhibit 10 – Checking Account: Company and Bank Perspectives
- Example Exercise 8-2 – Items on Company's Bank Statement
- Exhibit 11 – Power Networking's Records and Bank Statement

### SUGGESTED APPROACH

Objective 4 explains the use of the bank account and the associated bank statement as a tool for internal control over cash. The bank statement provides an independent report of deposits and withdrawals of the company cash. This independent report provides an important tool for safeguarding cash. Debit and credit memos are explained. This provides an important foundation for Objective 5, completing the bank reconciliation. See Handout 8-13 for a summary of possible debit and credit memos in preparation of the bank reconciliation.

## OBJECTIVE 5

Describe and illustrate the use of a bank reconciliation in controlling cash.

### SYNOPSIS

Reconciling the amounts in the business's cash account with the amount in the bank account is called bank reconciliation. The bank reconciliation is divided into two parts. They are the bank section and the company section, as shown in Exhibit 12. The adjusted balances from these two sections must equal. To check this equality, nine steps are outlined in Exhibit 13. In Exhibit 14, a bank reconciliation is shown for Power Networking. Outstanding checks and deposits have to be accounted for in the bank balance. The reconciliation process then checks the balance in the company's cash account, adds any amounts that need to be added, such as interest or notes collected, and deducts NSF checks and bank services charges, and accounts for any errors. If the balances do not yet equal, the process must be repeated. Journal entries may have to be made to update the amount in the business's cash account. After the journal entries are made, the company's cash account balance should equal the bank balance for the checking account. To enhance internal control, the reconciliation should be prepared by an employee who does not handle or record any cash transactions.

### *Key Term and Definition*

- **Bank Reconciliation** - The analysis that details the items responsible for the difference between the cash balance reported in the bank statement and the balance of the cash account in the ledger.

### *Relevant Example Exercise and Exhibits*

- Exhibit 12 – Bank Reconciliation Format
- Exhibit 13 – How to Prepare a Bank Reconciliation
- Exhibit 14 – Bank Reconciliation for Power Networking
- Example Exercise 8-3 – Bank Reconciliation

### SUGGESTED APPROACH

The bank reconciliation is usually an easy task for students who have their own checking accounts. Depending on your student body, you may discover that many of your students do not have a checking account.

Begin this topic with a Class Discussion that establishes the relevance of the bank reconciliation. Next, give your students the opportunity to practice a bank reconciliation using the Group Learning Activity. Finally, demonstrate the journal entries required by a bank reconciliation.

### CLASS DISCUSSION—Establishing Relevance of the Bank Reconciliation

An interesting way to begin your coverage of the bank reconciliation is to ask your students to indicate (by a show of hands) whether they have a checking account. Next, ask if their bank has ever made an error in their checking account. You will probably find that your students will volunteer to describe the

bank's error and the wrong they suffered. After listening to these details, ask your students how they discovered the bank's error. The usual responses are either through a bank reconciliation or notification that they were bouncing checks. If the response is bouncing checks, pose this question: What if you had an extra \$1,000 (or more) in your account so that your checks would not have bounced as a result of the error? How could you have discovered the error in this case? Now the answer must be through some sort of reconciliation process.

### **BRAINSTORMING ACTIVITY—Developing the Format for a Bank Reconciliation**

After establishing the relevance of a bank reconciliation, you can discuss how one is prepared. One approach is to direct your students to the form and content of the bank reconciliation in Exhibit 14 and discuss the contents of that illustration. Another approach is to ask your class to use brainstorming to determine the items that must be included on the bank reconciliation, thereby allowing them to discover how to prepare a reconciliation. Write “Cash Balance on Bank Statement” and “Cash Balance on Depositor's Records” on opposing sides of the board. Ask your class what items can cause these two totals to disagree when the bank statement is received. As they call out reconciling items, ask whether these items are adjustments to the bank statement balance or the depositor's balance, and whether they are additions or deductions. You may need to fill in a few gaps at the end, but collectively your class should derive a format similar to the one shown in Handout 8-14.

Many students find the following hint helpful in completing a bank reconciliation successfully: If a bank reconciliation does not balance, check any bank errors and/or depositor's errors first. Students frequently add items that should be deducted, and vice versa.

It is interesting to point out that the amount of cash on deposit in a bank represents a liability to the bank. As a result, customers' accounts have credit balances. A bank credit memo is issued for items that increase a customer's balance. Debit memorandums are issued for service charges or other items that decrease the customer's account balance.

### **GROUP LEARNING ACTIVITY—Preparing a Bank Reconciliation**

Handout 8-15 presents the information for a bank reconciliation. Ask your students to work in small groups to prepare that bank reconciliation. Handout 8-16 is the solution, which you can share after the groups have finished. Emphasize that the adjusted balance on the bank reconciliation is the amount that is reported on the balance sheet.

### **DEMONSTRATION PROBLEM—Journal Entries Required by a Bank Reconciliation**

Using Handout 8-16, demonstrate the following journal entries required as a result of the bank reconciliation. Remind your students that any adjustments made to the depositor's records must be journalized.

To record the note collected by bank:

Cash.....	1,260	
Notes Receivable.....		1,200
Interest Revenue.....		60

To record the NSF check:

Accounts Receivable—J. Lane	100	
Cash.....		100

To correct the error on Check No. 548:

Utility Expense.....	27	
Cash.....		27

## OBJECTIVE 6

Describe the accounting for special-purpose cash funds.

### SYNOPSIS

Small sums of money often need to be paid out in the course of doing business. It is inconvenient to write a check for numerous small sums. Postage, minor repairs, and office supplies are some of these minor expenses. Most businesses establish a petty cash fund to account for these expenses. The fund is established by estimating the cash needed from the fund for a period of time. A check is written to the petty cash and cashed, the cash is placed in a secure location, and control of the fund is given to the petty cash custodian. The custodian is then responsible for outgoing monies from the petty cash fund and records each expense in the petty cash journal. At the end of the period, each expense is recorded and the fund replenished.

### *Key Terms and Definitions*

- **Petty Cash Fund** - A special cash fund to pay relatively small amounts.
- **Special-Purpose Funds** - Cash funds used for a special business need.

### *Relevant Example Exercise*

- Example Exercise 8-4 – Petty Cash Fund

### DEMONSTRATION PROBLEM—Petty Cash

In some cases, it is impractical to pay an expense by check, either because the expense is very small or payment is required sooner than a check can be processed. Petty cash is used to cover these types of expenses. When discussing petty cash in class, you will want to address both the journal entries and the internal controls related to the fund.

The following example can be used to illustrate the journal entries for petty cash (Handout 8-17). Emphasize that expenses paid from a petty cash fund are recorded when the fund is replenished, not when the cash is disbursed. Therefore, the petty cash fund should be replenished at the end of the accounting period to bring the accounts up to date.

Allied Plumbing Supply decides to establish a petty cash fund of \$150 on January 1. The petty cash fund will be replenished whenever the fund reaches a balance of \$20 or less. On February 10, the fund is replenished and the following receipts for items paid out of the petty cash fund are recorded: office supplies, \$34; postage, \$28; store supplies, \$12; a minor repair on office equipment, \$52; and the cost paid to FedEx to send an urgent letter, \$10.

Entry to establish the petty cash fund:

Jan. 1	Petty Cash.....	150	
	Cash.....		150

Entry to replenish the petty cash fund:

Feb. 10	Office Supplies.....	34	
	Postage Expense (\$28 + \$10)	38	
	Store Supplies .....	12	
	Repairs Expense.....	52	
	Cash.....		136

In reviewing the internal controls related to petty cash, you will want to mention the following:

1. A trusted employee must be named custodian of the petty cash fund. That employee is responsible for disbursements from the fund.
2. Guidelines should be established for the types of expenses that may be paid from petty cash. In addition, restrictions should be placed on the maximum amount that can be withdrawn from the fund in any one transaction.
3. Whenever a disbursement is made from the fund, the custodian records the details on a petty cash receipts form.
4. The fund custodian should submit receipts documenting all fund expenditures before receiving money to replenish the fund.

### **CLASS DISCUSSION—Internal Controls over Petty Cash**

Ask your students how the custodian of a petty cash fund could steal cash. (Answer: by forging a signature on a petty cash receipt)

Next, ask them how this theft could be detected. Your students' ideas may include the following: (1) a periodic audit of the petty cash fund, (2) randomly checking signatures on receipts, or (3) comparing petty cash expenditures with normal or expected amounts. Point out that the small amounts of cash in a petty cash fund normally do not justify elaborate control procedures.

## OBJECTIVE 7

Describe and illustrate the reporting of cash and cash equivalents in the financial statements.

### SYNOPSIS

On the financial statements, cash and cash equivalents are usually presented together as one amount. Cash equivalents are highly liquid investments used by companies that temporarily have extra cash to earn interest. Examples of cash equivalents are treasury bonds, notes, and money market funds. A compensating balance is the minimum balance that is required by the bank for a business.

### *Key Terms and Definitions*

- **Cash Equivalents** - Highly liquid investments that are usually reported with cash on the balance sheet.
- **Compensating Balance** - A requirement by some banks requiring depositors to maintain minimum cash balances in their bank accounts.

### SUGGESTED APPROACH

This topic can be covered quickly, but thoroughly, through a brief lecture.

### LECTURE AID—Cash on the Balance Sheet

To cover this objective, you need only remind students of the following points:

1. Cash is the first asset listed on the balance sheet because it is the most liquid.
2. Funds placed in highly liquid investments, such as Treasury bills, money market funds, and commercial paper, are called cash equivalents. Since these investments can be sold quickly and easily, funds in these investments can be accessed as easily as cash held in a bank. Therefore, they are considered “equivalent” to cash.

Readers of the financial statements normally assume that a company may use its cash at any time for any purpose. If this is not true, the amount of funds not available for withdrawal must be disclosed in the notes to the financial statements. For example, any compensating balance required by a bank as part of a loan agreement or line of credit must be disclosed.

## OBJECTIVE 8

**Describe and illustrate the use of the ratio of cash to monthly cash expenses to assess the ability of a company to continue in business.**

### SYNOPSIS

This chapter establishes how important cash and control of cash is to the successful operation of a business. The ratio of cash to monthly cash expenses is useful in assessing how long a business can pay its bills without additional financing or generating positive cash flows. It is calculated as: ratio of cash to monthly cash expense = cash as of year-end/monthly cash expenses. The cash is the total cash from the balance sheet including any cash equivalents. The monthly cash expenses are estimated from the operating expenses section of the income statement.

#### *Key Term and Definition*

- **Ratio of Cash to Monthly Cash Expenses** - Ratio that helps assess how long a company can continue to operate without additional financing or generating positive cash flows from operations.

#### *Relevant Example Exercise*

- Example Exercise 8-5 – Ratio of Cash to Monthly Cash Expenses

### SUGGESTED APPROACH

Explain to students that this computation is most critical for companies in financial distress and quite often startup companies that haven't had enough operating time to generate positive cash flows. It can be used as a measure of when a company may need additional financing.

Ask students to suggest ways for companies to raise cash (loans, owner investment, sell unnecessary assets, offer incentives to customers to make purchases).

**Handout 8-1**

**If you owned a business, would you expect your employees ....:**

1. To work to achieve the business goals and objectives you establish?
2. To use business assets (such as machinery or automobiles) only for legitimate business purposes and avoid wasting business resources?
3. To record accurate data regarding business transactions so you could accurately judge how well your business is doing?
4. To refrain from stealing your cash, supplies, inventory, or property, plant, and equipment?

## **FIVE ELEMENTS OF INTERNAL CONTROL**

### 1. Control environment:

Management attitude should be committed to ethical business practices and to following established control procedures.

### 2. Risk assessment:

Identify and minimize internal control risks.

### 3. Control procedures:

Employees should be adequately trained and supervised.

Rotate job duties or require mandatory vacations.

Clearly define job responsibilities and keep employees accountable.

Separate responsibilities for related operations.

Separate operations, custody of assets, and accounting.

Use proofs and security measures:

- Immediately deposit all cash in a bank account.
- Use cash registers to record sales.
- Have employees bonded.
- Install security cameras or hire security guards.

### 4. Monitoring:

Watch for warning signals indicating dishonesty or fraud.

### 5. Information and communication:

Gather and communicate appropriate information to assess and monitor internal controls.

## **SEPARATING DUTIES FOR RELATED OPERATIONS**

What risk do you have if the following occur?

1. Salesperson (paid on a commission basis) is responsible for granting credit.
2. Purchasing agent orders supplies, inspects supplies to verify that the correct items and quantity were received, and authorizes payment of the vendor's invoice.
3. Worker in a donut shop takes a customer's order, packs his or her donuts in a bag or box, rings the order on a cash register, and takes the customer's money.

## **SEPARATING OPERATIONS, CUSTODY OF ASSETS, AND ACCOUNTING**

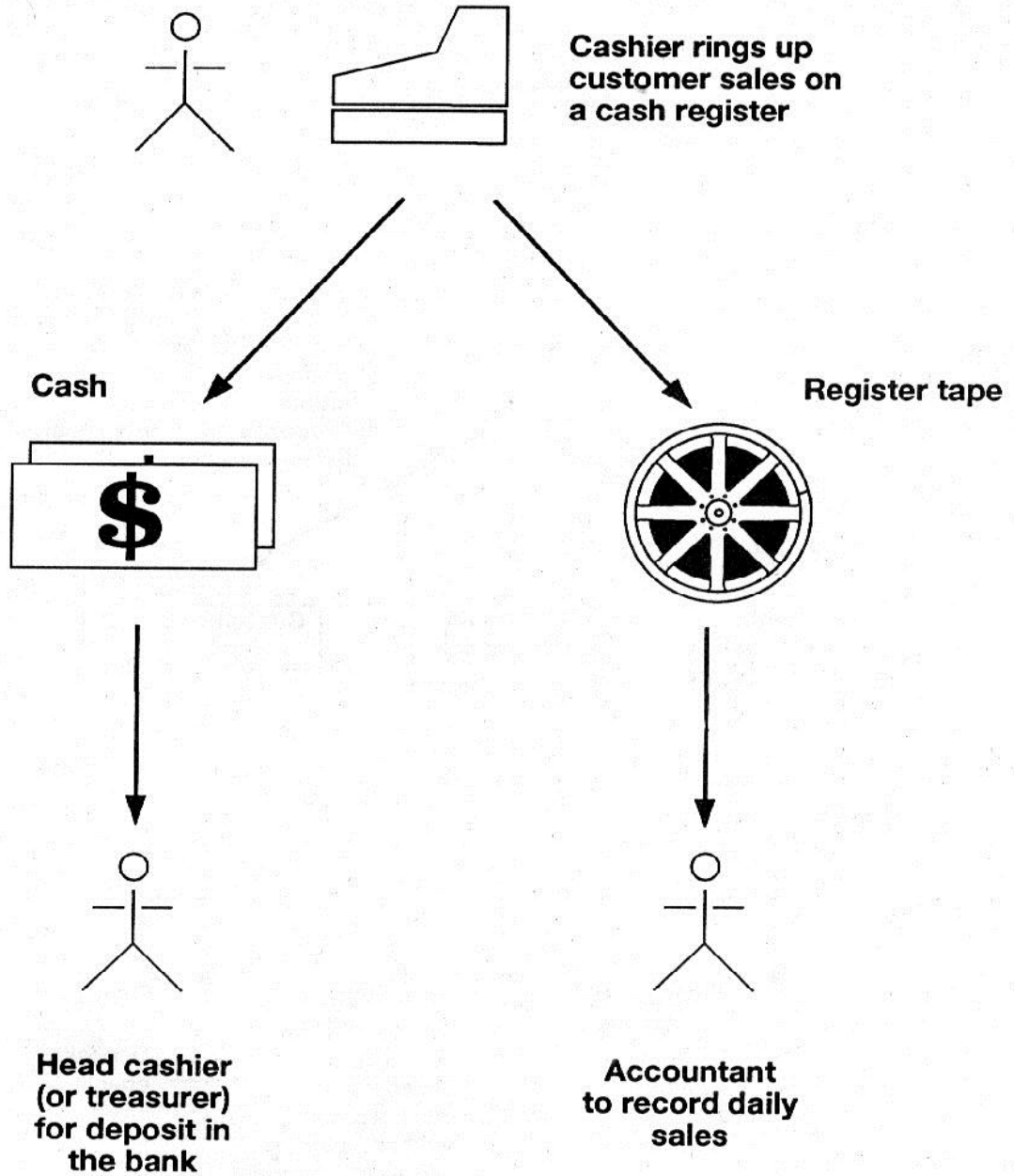
What risk do you have if the following occur?

1. A department store allows its credit customers to pay their bills in person at the store's Credit Department. Duties of the Credit Department's clerk include accepting cash payments, giving customers credit for their payments in the store's accounting records, and following up on any overdue accounts.
2. An accounts payable clerk for a hospital reviews all vendor invoices to make sure the hospital has been billed accurately, prepares checks to pay the invoices, mails the checks, and makes the entries necessary to record the payments in the hospital's accounting records.

## **INTERNAL CONTROL PROCEDURES**

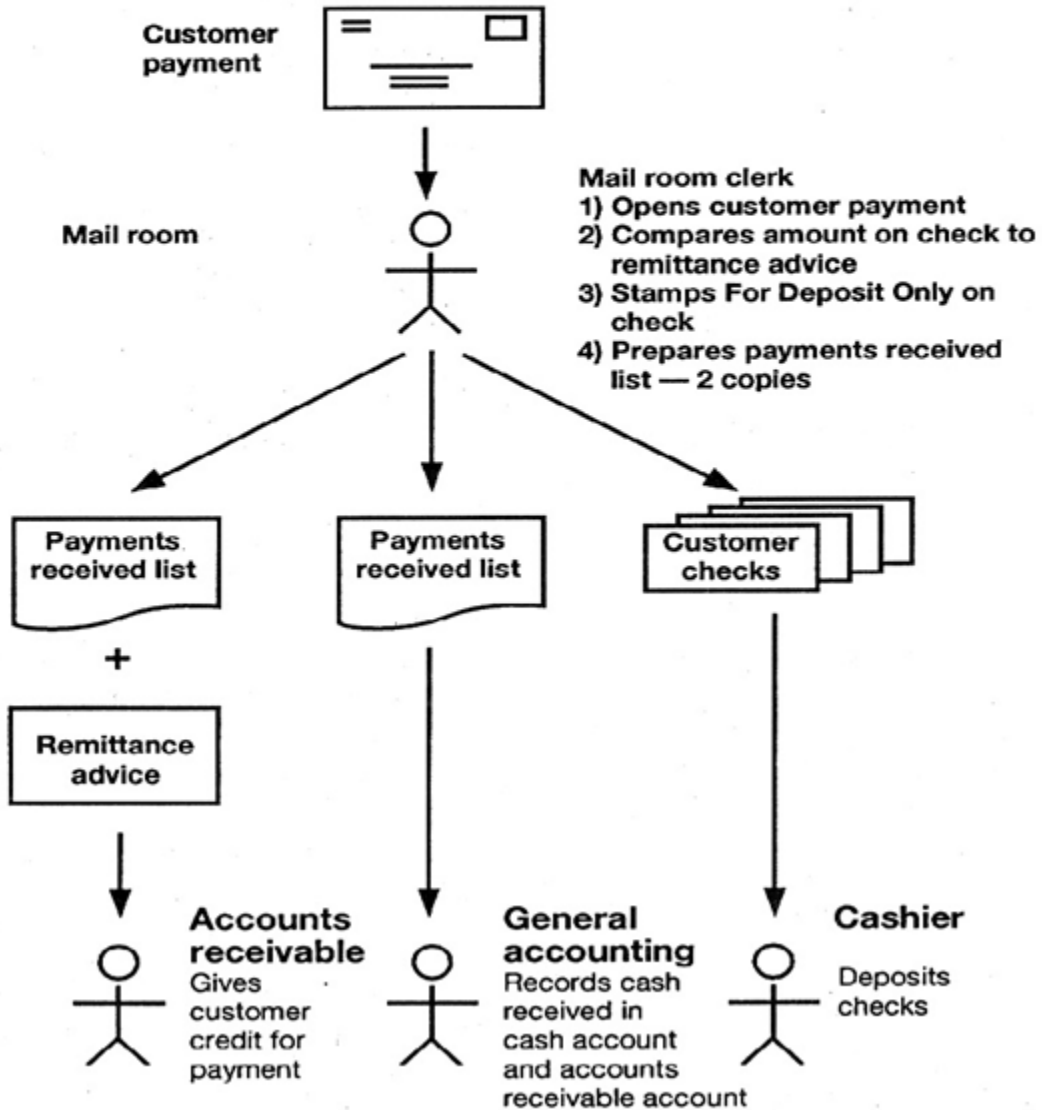
You have decided to open a bookstore that sells textbooks and competes with the campus bookstore. List the internal control procedures you would implement in running the store.

# Internal Controls—Cash Receipts Cash Register



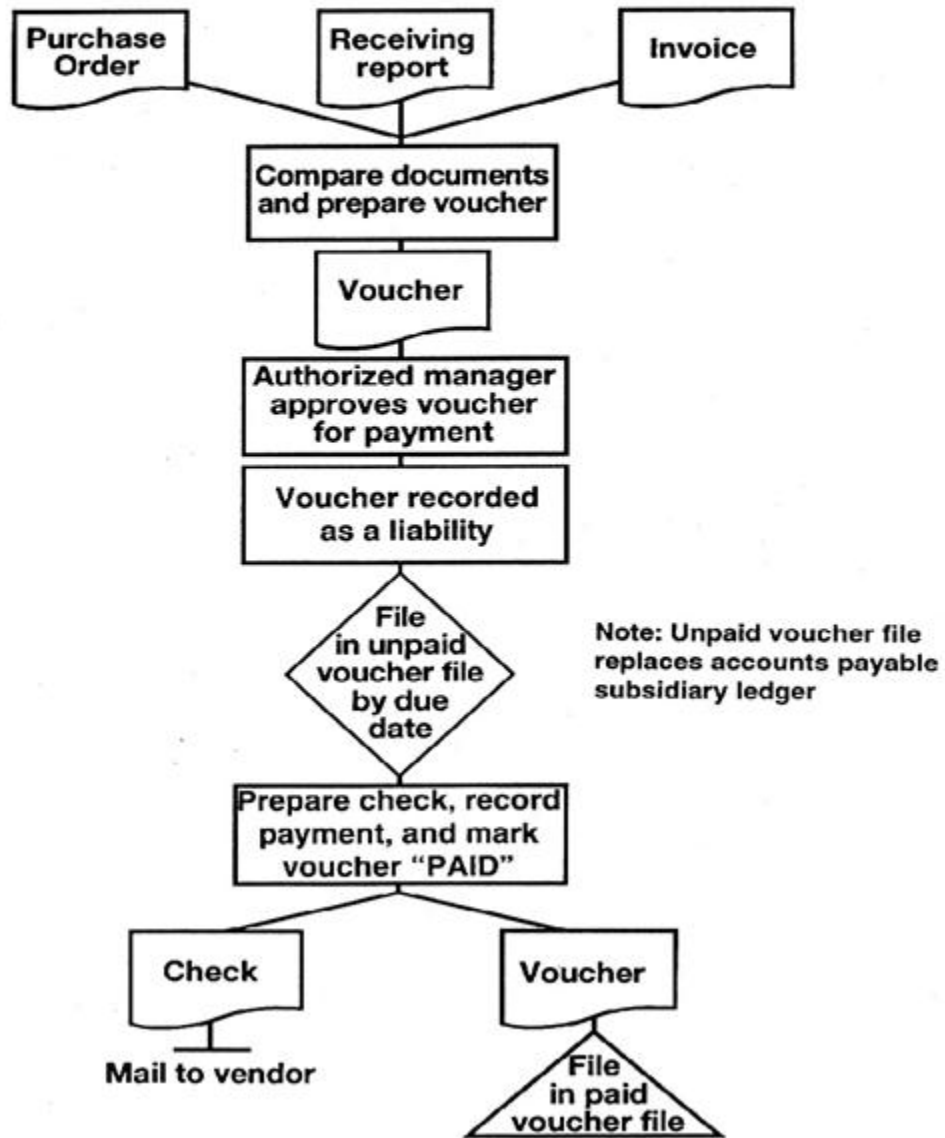
# INTERNAL CONTROLS— CASH RECEIPTS

## CUSTOMER PAYMENTS RECEIVED THROUGH MAIL



# INTERNAL CONTROLS — CASH PAYMENTS

## VOUCHER SYSTEM



## WRITING EXERCISE

1. How does the voucher system ensure that management is paying only valid obligations?
2. How does the voucher system help a company maintain a favorable credit standing by aiding management in paying all invoices on time?
3. How would a company using a voucher system investigate a supplier's complaint that an invoice has not been paid?

## **ELECTRONIC FUNDS TRANSFERS—CONTROL RISKS**

Identify the control risk in implementing each of the following EFT systems. Also identify procedures to overcome the control risk.

1. A grocery store decides to install a point-of-sale system that will allow the customer to use his or her ATM card to pay for merchandise at the checkout line. Previously, the grocery store has accepted only cash and checks as payment.
2. A self-service gas station decides to install a point-of-sale device at the gasoline pump. This will speed the time it takes a customer to fill his or her gas tank, since payment can be made right at the pump, eliminating the time spent waiting in line for a clerk to accept payment.

## **PAYMENT OF VENDOR INVOICES THROUGH ELECTRONIC FUNDS TRANSFER**

Ted's Appliance Store has decided to pay its vendors (General Electric, Maytag, Whirlpool, etc.) via electronic funds transfer.

Ted's currently uses a voucher system to pay invoices by check. Under this system, an accounts payable clerk is responsible for preparing a voucher and attaching the purchase order and receiving report documenting the order. The controller authorizes vouchers for payment. After receiving authorization, the accounts payable clerk records the vouchers.

On the date that payment is due, vouchers are sent to the cash manager, who prepares the checks. The checks are signed by the treasurer, and the vouchers and all supporting documentation are marked *paid*. The cash manager records payment of the vouchers. The voucher is returned to the Accounts Payable Department, where it is filed in the paid vouchers file by number.

## **PAYMENT OF VENDOR INVOICES THROUGH ELECTRONIC FUNDS TRANSFER**

### **(Solution)**

The accounts payable clerk should continue to prepare a voucher for each invoice and attach the purchase order and receiving report as documentation. In addition, vouchers should continue to be authorized by the controller and recorded.

On the date of payment, vouchers should be sent to the cash manager, who calls the bank and, after giving the bank an established password, authorizes an EFT to the appropriate vendor accounts. Since funds are being electronically transferred to outside accounts, the treasurer should also authorize the transactions. The voucher and all supporting documentation should be marked *paid*.

The voucher should be returned to the Accounts Payable Department, where it is held until an EFT transaction advice is received from the bank. This transaction advice should be compared to the voucher. If they agree, the voucher should be filed in the paid vouchers file by number.

## **BANK DEBIT AND CREDIT MEMOS**

A bank makes credit entries (issues credit memos) for the following:

1. Deposits made by electronic funds transfer (EFT)
2. Collections of notes receivable for a company
3. Proceeds for a loan made to a company by the bank
4. Interest earned on a company's account
5. Corrections (if any) of bank errors

A bank makes debit entries (issues debit memos) for the following:

1. Payments made by electronic funds transfer (EFT)
2. Service charges
3. Customer checks returned for not sufficient funds (NSF)
4. Corrections (if any) of bank errors

## BANK RECONCILIATION

Cash Balance on Bank Statement		Cash Balance on Depositor's Records	
+	Deposits not recorded by bank	+	Collections made recorded by bank
-	Checks that have not cleared	-	NSF checks
		-	Service charges
+/-	<u>Bank errors</u>	-/+	<u>Depositor's errors</u>
	Adjusted balance*		Adjusted balance*

\*These should agree.

## BANK RECONCILIATION

Prepare a bank reconciliation for Cartwright Company as of October 31, using the following information:

Cash balance on October 31 bank statement .....	\$10,410
Cash account balance in general ledger .....	9,890
Deposit made on October 31, not recorded on bank statement .....	1,865
Note collected by bank (\$1,200 plus \$60 in interest) .....	1,260
Outstanding checks: No. 567, \$800; No. 569, \$452 .....	1,252
Debit memorandum from bank for a NSF check written by J. Lane in payment of his account .....	100

In addition, Cartwright recorded Check No. 548 written for \$152 in payment of the October utility bill as \$125 in the cash payments journal.

## BANK RECONCILIATION

(Solution)

Cash balance on bank statement .....		\$10,410
Add October 31 deposit .....		<u>1,865</u>
		\$12,275
Deduct outstanding checks:		
No. 567 .....	\$800	
No. 569 .....	<u>452</u>	<u>1,252</u>
Adjusted balance .....		<u>\$11,023</u>
Cash balance on depositor's records.....		\$ 9,890
Add note collected by bank .....		<u>1,260</u>
		\$11,150
Deduct: NSF check.....	\$100	
Error—Check No. 548.....	<u>27</u>	<u>127</u>
Adjusted balance.....		<u>\$11,023</u>

## PETTY CASH

Allied Plumbing Supply decides to establish a petty cash fund of \$150 on January 1. The petty cash fund will be replenished whenever the fund reaches a balance of \$20 or less. On February 10, the fund is replenished and the following receipts for items paid out of the petty cash fund are recorded: office supplies, \$34; postage, \$28; store supplies, \$12; a minor repair on office equipment, \$52; and the cost to FedEx to send an urgent letter, \$10.