

CHAPTER 6

ACCOUNTING FOR CASH AND INTERNAL CONTROLS

Key Terms and Concepts to Know

Purpose of Internal Controls:

- Internal controls are a system of policies and procedures used by companies to safeguard assets and ensure that transactions are recorded properly and in a timely manner.

Principles of Internal Control:

- Establish responsibilities
- Maintain adequate records
- Insure assets and key bond employees
- Separation of recordkeeping from custody of assets
- Divide responsibility for related transactions
- Apply technological controls
- Perform regular and independent reviews

Bank Reconciliation:

- Identifies and explains the differences or reconciling items between the cash balance in the depositor's general ledger and the cash balance according to the bank's records.
- Reconciling items are transactions which have been recorded by either the depositor or the bank, but not both, AND transactions which were not properly recorded by the depositor and/or the bank.
- Adjusting entries are recorded by the depositor for all reconciling items on the depositor's side of the bank reconciliation. If the adjusting entries are not recorded, these items will continue to appear on the reconciliation if subsequent months until the adjusting entries have been made.

Petty Cash Account:

- Imprest account (balance does not fluctuate as cash is spent or replenished)
- Account is used to pay for minor expenses.
- Account is debited when it is created or the balance is increased and credited when the balance is decreased.

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Voucher System:

- A set of control procedures designed to ensure the cash disbursements have been properly approved and are supported by the appropriate documents.

Days Sales Uncollected Ratio (Days Sales Outstanding Ratio)

Key Topics to Know

Bank Reconciliation

The balance according to the bank statement and the balance according to the depositor's records must be adjusted on the reconciliation properly determine the cash balance that should be in the general ledger. Both the bank balance and the ledger balance are adjusted for items not previously recorded as follows:

	<u>Bank Balance</u>	<u>Ledger Balance</u>
Add:	Deposits in Transit Errors	Notes collected by the bank Errors
Deduct:	Outstanding Checks Errors	Service Charges NSF checks Errors

** All adjustments to the ledger balance MUST be journalized in order for the cash account in the ledger to agree with the adjusted cash balance. **

Example #1

The cash account for Ace Co. on August 31, 2004, indicated a balance of \$9,420. The bank statement indicated a balance of \$12,785 on August 31, 2004. The following reconciling items were discovered.

- a) Checks outstanding totaled \$6,240.
- b) A deposit of \$5,375, representing cash receipts of August 31, had been made too late to appear on the bank statement.
- c) A check for \$240 had been incorrectly charged by the bank as \$420.
- d) A check for \$658 returned with the statement had been recorded by Ace as \$568. The check was for the payment of an obligation to Cahill Co. on account.
- e) The bank had collected for Ace \$2,800 on a note left for collection. The face of the note was \$2,000.
- f) Bank service charges for August amounted to \$30.

Additional information for the company's records:

- Checks outstanding totaled \$6,240.
- A deposit of \$5,375, representing cash receipts of August 31, had been made too late to appear on the bank statement.

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- A check for \$240 had been incorrectly charged by the bank as \$420.
- A check for \$658 returned with the statement had been recorded by Ace as \$568. The check was for the payment of an obligation to Cahill Co. on account.
- The bank had collected for Ace \$2,800 on a note left for collection. The face of the note was \$2,000.
- Bank service charges for August amounted to \$30.

Required: Prepare the bank reconciliation and journalize the necessary entries.

Solution #1

Cash balance according to bank statement		\$12,785
Add: Deposit of August 30 not recorded by bank	\$5,375	
Bank error	<u>180</u>	<u>5,555</u>
		\$18,340
Deduct: Outstanding checks		<u>6,240</u>
Adjusted balance		<u>\$12,100</u>
Cash balance according to depositor's records		\$9,420
Add: Proceeds of note and interest collected by bank		<u>2,800</u>
		12,220
Deduct: Error in recording check	\$90	
Bank service charges	<u>30</u>	<u>120</u>
Adjusted balance		<u>\$12,100</u>

Journal entries

Cash	2,800	
Notes Receivable		2,000
Interest Revenue		800
A/P-Cahill Co.	90	
Misc. Adm. Expense	30	
Cash		120

Practice Problem #1

The cash account for Kahn Inc. on November 30, 2003, indicated a balance of \$5,699. The bank statement indicated a balance of \$13,167 on November 30, 2003. The following reconciling items were discovered.

- a) Checks outstanding totaled \$5,175.
- b) A deposit of \$3,842, representing cash receipts of November 30, had been made too late to appear on the bank statement.
- c) The bank had collected for Kahn \$4,800 on a note left for collection. The face of the note was \$4,200.
- d) Kahn had recorded a check for \$2,040 returned with the statement as \$2,400. The check was for the payment of a 3-year insurance policy.
- e) A check for \$1,176 had been incorrectly charged by the bank as \$176.
- f) Bank service charges for November amounted to \$25.

Required: Prepare the bank reconciliation and journalize the necessary entries.

Petty Cash

A Petty Cash fund is used to provide small amounts of cash for common expenditures for which the company does not write a check or purchase on account. Examples include employee birthday cakes, office supplies or postage due on mail.

Petty cash funds are typically operated on an *imprest* basis, meaning that when cash is expended from the fund, it is replaced by a receipt in the same amount. The balance of an imprest fund should always equal the balance established for the fund.

The petty cash account always has an entry to establish the fund and perhaps a subsequent entry to increase or decrease the fund's balance. Replenishment entries are not recorded using the petty cash account. Any differences between the total of the receipts for funds expended and the amount necessary to replenish the fund balance are debited or credited to the Cash Short and Over account.

The replenishment entry can be prepared in three steps:

- Debit each expense account for the amount spent from the receipt
- Credit Cash for the difference between the imprest balance and actual cash remaining in the fund
- If the entry does not balance debit or credit the difference to Cash Over and Short as appropriate

Example #2:

In June, the Filbert Company established a petty cash account with a \$200 balance. During June, the following expenditures were made from petty cash: supplies \$95, FEDEX bills \$42, and miscellaneous other receipts \$38. When counted, there was \$25 of cash remaining in the petty cash fund. Journalize the entries for June.

Solution #2:

Petty Cash	200		
Cash		200	<i>To establish the fund</i>
Supplies	95		
Delivery Expense	42		
Misc. Adm. Expense	38		
Cash		175	<i>To replenish the fund and record all the expenses paid for in cash.</i>

Practice Problem #2

Journalize the following transactions. (Use Cash Short and Over if you are short or over in the petty cash fund.)

- June 1: Established a petty cash fund of \$500
- 22: Petty cash on hand was \$54. Replenish the petty cash fund for the following disbursements, each evidenced by a petty cash receipt:
- July 3: Store supplies \$120.75
- 5: Express charges on merchandise purchased F.O.B. shipping point, \$150.25
- 6: Postage stamps, \$44 (Office Supplies)
- 7: Office supplies, \$37.50.
- 8: Repair to computer, \$82
- 25: Increased the petty cash fund to \$600.

Cash Over and Short Account

The Cash Over and Short account has two purposes:

- It will be debited or credited for the difference between the total of the receipts and the cash required to replenish the petty cash account. If there are missing receipts, the account is debited and if there is too much cash in the account, the account is credited.

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- It is used to record shortages or overages in the cash register. The cash in the drawer represents a debit to cash. The cash register tape represents the credit to sales. If there is a shortage, it is debited Cash Short and Over. If there is an overage, it is credited Cash Short and Over.

Example #3:

In July, the Filbert Company made the following expenditures from petty cash: repairs \$85, FEDEX bills \$60, and postage \$13. When counted, there was \$40 of cash remaining in the petty cash fund. Journalize the entries for July.

Solution #3:

Supplies	85	
Delivery Expense	60	<i>from receipts</i>
Misc. Adm. Expense	13	
Cash Over and Short	2	$160 - 85 - 60 - 13 = 2$
Cash	160	$200 - 40 = 160$

Example #4:

On November 20, Cash-hew Inc. had cash sales of \$3,555 according to the cash register tape. However, when the cash in the register drawer was counted, \$3,560 was present. Journalize any required transactions.

Solution #4:

cash	3,560	<i>As counted</i>
Cash Over and Short	5	$3,560 - 3,555 = 5$
Sales	3,555	<i>Per register tape</i>

Practice Problem #3

Journalize the following transactions.

- a. The actual cash received from cash sales was \$15,362 and the amount indicated by the cash register tape was \$15,379.
- b. The cash sales for the day, according to the cash register tapes, totaled \$8,792. The actual cash received from cash sales was \$8,801.

Sample True / False Questions

1. Separation of duties refers to auditors not being allowed to perform both audit and nonaudit services for the same client.
True False
2. The internal control component of information and communication relates to the effectiveness of accurately measuring and communicating business transactions.
True False
3. Separation of duties occurs when two or more people act in coordination to circumvent internal controls.
True False
4. Cash on a company's balance sheet includes accounts receivable if the collection of cash is highly likely in the near future.
True False
5. Common examples of cash equivalents are money market funds, Treasury bills, and certificates of deposit.
True False
6. A bank reconciliation matches the balance of cash in the bank account with the balance of cash in the company's own records.
True False
7. The purchase of supplies with a check is a bank error that causes the company's balance and bank's balance of cash to differ.
True False
8. A company's cash receipts that have not been added to the bank's record of the company's balance are labeled outstanding checks.
True False
9. Outstanding checks are checks written by the company that the bank has not subtracted from the company's balance.
True False
10. A deposit outstanding will cause the bank's cash balance to be higher than the company's cash balance.
True False

11. A check outstanding will cause the bank's cash balance to be higher than the company's cash balance.
True False
12. An NSF check is an example of a cash transaction that is initially recorded by the bank and later by the company after notification.
True False
13. Interest earned on a bank account is a cash transaction recorded by the company prior to being recorded by the bank.
True False
14. The final step in reconciling the bank's cash balance and the company's cash balance is to update the company's cash balance for the items used to reconcile the bank's cash balance.
True False
15. The petty cash fund represents cash on hand and is used to pay for minor purchases.
True False
16. The petty cash fund should have just enough cash to make minor expenditures over a reasonable period (such as a week or a month).
True False
17. Opening mail and making a list of checks received once per week is considered a good internal control over cash receipts.
True False
18. Recording all cash receipts as soon as possible is considered a good internal control.
True False
19. Effective internal controls ensure a company's success and survival.
True False
20. Management needs to monitor the internal control system, just like any other system. Any control deficiencies spotted by employees should be reported immediately to management.
True False

Sample Multiple Choice Questions

1. Procedures designed to detect theft or misuse of cash are called:
 - a) Detective controls
 - b) Cash controls
 - c) Protective controls
 - d) Accounting controls

2. A debit or credit memorandum describing entries in the depositor's bank account may be enclosed with the bank statement. Which of the following items would be reported to the depositor on a credit memorandum?
 - a) Deposited checks returned for insufficient funds
 - b) A service charge
 - c) A promissory note collected by the bank
 - d) Notification that a customer's check for \$375 was recorded by the depositor as \$735 on the deposit ticket.

3. The bank reconciliation:
 - a) Should be prepared by an employee who records cash transactions
 - b) Is for information purposes only
 - c) Is part of the internal control system
 - d) Is sent to the bank for verification

4. Receipts from cash sales of \$7,500 were recorded incorrectly in the cash receipts journal as \$5,700. This item would be included on the bank reconciliation as:
 - a) An addition to the balance per depositor's records
 - b) An addition to the balance per bank statement
 - c) A deduction from the balance per bank statement
 - d) A deduction from the balance per depositor's records

5. Accompanying the bank statement was a debit memorandum for an NSF check received from a customer. What entry is required in the depositor's accounts?
 - a) Debit Other Income, credit Cash
 - b) Debit Cash, credit Other Income
 - c) Debit Accounts Receivable, credit Cash
 - d) Debit Cash, credit Accounts Receivable

6. A voucher is
 - a) Normally prepared in the Accounting Department
 - b) A document used to control cash receipts
 - c) Received from customers to explain the purpose of a payment
 - d) An internal control procedure to verify the assets in the ledger are the ones the company owns

7. A person authorized to write checks drawn on a checking account at a bank must sign and have on file with the bank a:
 - a) Bank card
 - b) Deposit ticket
 - c) Checkbook
 - d) Signature card

8. The credit recorded in the journal to reimburse the petty cash fund is to:
 - a) Petty Cash
 - b) Accounts Receivable
 - c) Cash
 - d) Various accounts for which the petty cash was disbursed

9. Cash equivalents:
 - a) Are illegal in some states
 - b) Are highly liquid investments
 - c) Will be converted to cash within one year
 - d) Are only available to large companies

10. A minimum cash balance required by a bank is called:
 - a) Cash in the bank
 - b) Cash equivalent
 - c) EFT
 - d) Compensating balance

11. The credit balance in Cash Short and Over at the end of an accounting period is reported as
 - a) Income on the income statement
 - b) An expense on the income statement
 - c) An asset on the balance sheet
 - d) A liability on the balance sheet

12. A check drawn by a depositor for \$195 in payment of a voucher was recorded in the journal as \$915. This item would be included on the bank reconciliation as a(n):
 - a) Addition to the balance per the bank statement
 - b) Addition to the balance per the depositor's records
 - c) Deduction from the balance per the bank statement
 - d) Deduction from the balance per the depositor's records

13. Which of the following is not a principle of internal control?
 - a) Segregation of duties
 - b) Documentation procedures
 - c) Collusion between employees
 - d) Bonding of employees

14. When the cashier also keeps the books for a company, which internal control principle is violated?
 - a) Rotating employee duties
 - b) Establishment of responsibility
 - c) Segregation of duties
 - d) Documentation procedures

15. Springer Company had outstanding checks totaling \$4,500 on its September bank reconciliation. In October, the company issued checks totaling \$45,700. The October bank statement shows that checks totaling \$39,800 cleared the bank. In addition, a check from one of Springer's customers in the amount of \$500 was returned as NSF. The outstanding checks on the October bank reconciliation should total
 - a) \$5,900
 - b) \$9,900
 - c) \$10,400
 - d) \$1,400

16. An adjusting entry is required for
 - a) Outstanding checks
 - b) Deposits in transit
 - c) Bank errors
 - d) NSF checks

17. Jones Company collected the following information to prepare its May bank reconciliation:

Cash balance per books, May 31	\$5,300
Deposits in transit	510
Notes Receivable with interest collected by bank	580
Bank Service Charges	30
Outstanding Checks	1,800
NSF check	150

The adjusted cash balance per books on May 31 is

- a) \$5,700
 - b) \$5,810
 - c) \$6,210
 - d) \$5,660
18. Barker Company collected the following information to prepare its November bank reconciliation:

Cash balance per bank, November 30	\$21,000
Note Receivable plus interest collected by bank	9,000
Outstanding checks	6,000
Deposit in Transit	5,400
Bank Service charges	85
NSF check	2,100

The cash balance per books, before adjustment, is

- a) \$20,400
- b) \$13,585
- c) \$6,815
- d) \$27,815

19. The following information was taken from the Carson Company cash budget for the month of April:

Beginning cash balance	45,000
Cash Receipts	27,000
Cash Disbursements	51,000

If the company has a policy of maintaining a minimum cash balance of \$37,000, the amount the company would have to borrow is:

- a) \$24,000
 - b) \$8,000
 - c) \$16,000
 - d) \$14,000
20. Journal entries and not required for reconciling items related to the bank balance because:
- a) The depositor cannot make entries on the bank's books
 - b) The amounts cannot be determined
 - c) Journal entries are never required for these items
 - d) The bank does not make errors

SOLUTIONS TO PRACTICE PROBLEMS

Practice Problem #1

July 1	Petty Cash	500.00	
	Cash		500.00
22	Store Supplies	120.75	
	Mdse Inventory	150.25	
	Office Supplies	81.50	
	Repair Expense	82.00	
	Cash Short & Over	11.50	
	Cash		446.00
25	Petty Cash	100.00	
	Cash		100.00

Practice Problem #2

a.	Cash	15,362	
	Cash Short & Over	17	
	Sales		15,379
b.	Cash	8,801	
	Cash Short & Over		9
	Sales		8,792

Practice Problem #3

Cash balance according to bank statement		\$13,167
Add: Deposit of November 30 not recorded by bank		<u>3,842</u>
		\$17,009
Deduct: Outstanding checks	\$5,175	
Bank error	<u>1,000</u>	<u>6,175</u>
Adjusted balance		<u>\$10,834</u>
Cash balance according to depositor's records		\$5,699
Add: Proceeds of note and interest collected by bank	4,800	
Error recording check for insurance policy	<u>360</u>	<u>5,160</u>
		10,859
Deduct: Bank service charges		<u>25</u>
Adjusted balance		<u>\$10,834</u>

Journal entries

Cash	5,160	
Notes Receivable		4,200
Interest Income		600
Prepaid Insurance		360
Misc. Adm. Expense	25	
Cash		25

SOLUTIONS TO TRUE / FALSE QUESTIONS

1. False - separation of duties is where individuals who have physical responsibility for assets should not also have access to accounting records.
2. True
3. False - this is the act of collusion.
4. Accounts receivable is a separately reported asset from cash.
5. True
6. True
7. False - this is not an error but a difference in timing between when the depositor records the check and when the bank records the check.
8. False - these are referred to as deposits outstanding.
9. True
10. False - the company's balance will be higher.
11. True
12. True
13. False - interest earned is initially recorded by the bank.
14. False - the cash balance needs to be updated for items used to reconcile the company's cash balance.
15. True
16. True
17. False - these tasks should be performed each day.
18. True
19. False - effective internal controls improve the company's likelihood of success and survival, but do not provide a guarantee.
20. True

SOLUTIONS TO MULTIPLE CHOICE QUESTIONS

1. A
2. C
3. C
4. A
5. C
6. A
7. D
8. C
9. B
10. D
11. A
12. D
13. C
14. C
15. C
16. D
17. A
18. B
19. C
20. A