

Internal Control and Cash

Study Objectives

- Identify the principles of internal control.
- Explain the applications of internal control to cash receipts.
- Explain the applications of internal control to cash disbursements.
- Prepare a bank reconciliation.
- Explain the reporting of cash.
- Discuss the basic principles of cash management.
- Identify the primary elements of a cash budget.

Chapter Outline

Study Objective 1 - Identify the Principles of Internal Control

1. **Internal control** consists of all of the related methods and measures adopted within a business to:
 - a. **Safeguard assets** from employee theft, robbery, and unauthorized use; and
 - b. **Enhance the accuracy and reliability of its accounting records** by reducing the risk of errors (unintentional mistakes) and irregularities (intentional mistakes and misrepresentations) in the accounting process.
 - i. To safeguard assets and enhance the accuracy and reliability of its accounting records, a company follows internal control principles. The following six internal control principles apply to most companies:
 1. **Establishment of Responsibility:** An essential characteristic of internal control is the assignment of responsibility to specific individuals.
 - a. Control is most effective when only one person is responsible for a given task.
 - b. Establishing responsibility includes the authorization and approval of transactions.
 2. **Segregation of Duties:** Segregation of duties is indispensable in a system of internal control.
 - a. The rationale for segregation of duties is that the work of one employee should, without a duplication of effort, provide a reliable basis for evaluating the work of another employee.
 - i. There are two common applications of this principle:
 1. The responsibility for related activities should be assigned to different individuals.
 2. The responsibility for record keeping for an asset should be separate from the physical custody of an asset.
- **Related Activities - When one individual is responsible for all of the related activities, the potential for errors and irregularities is increased.**
 - Related purchasing activities should be assigned to different individuals. Related purchasing activities include ordering merchandise, receiving goods, and paying (or authorizing payment) for merchandise.

- Related sales activities also should be assigned to different individuals. Related sales activities include making a sale, shipping (or delivering) the goods to the customer, and billing the customer.
 - **Record Keeping Separate from Physical Custody - The custodian of the asset is not likely to convert the assets to personal use if one employee maintains the record of the asset that should be on hand and a different employee has physical custody of the asset.**
3. Documentation Procedures - Documents provide evidence that transactions and events have occurred.
 - a. Documents should be pre-numbered and all documents should be accounted for.
 - i. Examples would be numbers on checks and invoices (like restaurant receipts).
 - b. Source documents for accounting entries should be promptly forwarded to the accounting department to help ensure timely recording of the transaction and event.
 4. Physical, Mechanical, and Electronic Controls - Physical controls relate primarily to the safeguarding of assets. Mechanical and electronic controls safeguard assets and enhance the accuracy and reliability of the accounting records. Use of physical, mechanical, and electronic controls is essential. Examples of these controls include:
 - a. Safes, vaults, and safety deposit boxes for cash and business papers.
 - b. Locked warehouses and storage cabinets for inventory and records.
 - c. Computer facilities with pass key access or fingerprint or eyeball scans.
 - d. Alarms to prevent break-ins.
 - e. Television monitors and garment sensors to deter theft.
 - f. Time clocks for recording time worked.

Why do you receive a cash register receipt at a fast food restaurant, a grocery store, or a department store?

5. Independent Internal Verification - Independent internal verification involves the review, comparison, and reconciliation of data prepared by employees.
 - a. Verification should be made periodically or on a surprise basis.
 - b. Verification should be done by an employee independent of the personnel responsible for the information.
 - c. Discrepancies and exceptions should be reported to a management level that can take appropriate corrective action.
 - d. In large companies, independent internal verification is often assigned to internal auditors.
 - e. Internal auditors are employees of the company who evaluate on a continuous basis the effectiveness of the company's system of internal control.
 - i. They periodically review the activities of departments and individuals to determine whether prescribed internal controls are being followed.

Would the cashier count the money in the cash drawer at the end of the workday? Would the person writing the checks prepare the bank reconciliation? Why or why not?

6. Other Controls:

- a. Bonding of employees who handle cash.
- b. Rotating employees' duties and requiring employees to take vacations.

2. **Limitations of Internal Control**

- a. Internal control is designed to provide **reasonable assurance** that assets are properly safeguarded and that the accounting records are reliable (they are not fool-proof; a cost-benefit relationship must be observed between controls and security)
 - i. The concept of reasonable assurance rests on the premise that the costs of establishing control procedures should not exceed their expected benefit.
- b. The **human element** is important in internal control.
 - i. A good system can become ineffective as a result of employee fatigue, carelessness, or indifference. Employees may become tired and not bother to count inventory. Occasionally two or more employees may work together in order to get around prescribed controls.
- c. The size of the business may impose limitations on internal control. In a small company, for example, it may be difficult to apply the principles of segregation of duties and independent internal verification.
- d. An important and inexpensive measure any business can take to reduce employee theft and fraud is to conduct thorough background checks. Two tips include:
 - i. Check to see whether job applicants actually graduated from the schools they list
 - ii. Never use the telephone numbers for previous employers given on the reference sheet; always look them up yourself.

Study Objective 2 - Explain the Applications of Internal Control to Cash Receipts

1. Cash receipts may result from cash sales; collections on account from customers; the receipt of interest, rents, and dividends; investments by owners; bank loans; and proceeds from the sale of non-current assets.
 - a. The following internal control principles explained earlier apply to cash receipts transactions as shown:
 - i. Establishment of responsibility - Only designated personnel (cashiers) are authorized to handle cash receipts.
 - ii. Segregation of duties - Different individuals receive cash, record cash receipts, and hold the cash.
 - iii. Documentation procedures - Use remittance advice (mail receipts), cash register tapes, and deposit slips.
 - iv. Physical, mechanical, and electronic controls - Store cash in safes and bank vaults; limit access to storage areas; use cash registers.
 - v. Independent internal verification - Supervisors count cash receipts daily; treasurer compares total receipts to bank deposits daily.
 - vi. Other controls - Bond personnel who handle cash; require vacations; deposit all cash in bank daily.

Consider how cash registers can greatly enhance control over cash sales.

Study Objective 3 - Explain the Applications of Internal Control to Cash Disbursement

1. Cash is disbursed to pay expenses and liabilities or to purchase assets.
 - a. Internal control over cash disbursements is more effective when payments are made by check, rather than by cash, except for incidental amounts that are paid out of petty cash.
 - b. Cash payments are generally made only after specific control procedures have been followed.
 - c. The paid check provides proof of payment.
 - d. The principles of internal control apply to cash disbursements as follows:
 - i. Establishment of responsibility - Only designated personnel (treasurer) are authorized to sign checks.
 - ii. Segregation of duties - Different individuals approve and make payments; check signers do not record disbursements.
 - iii. Documentation procedures - Use pre-numbered checks and account for them in sequence; each check must have approved invoice.
 - iv. Physical, mechanical, and electronic controls - Store blank checks in safes with limited access; print check amounts by machine with indelible ink.
 - v. Independent internal verification - Compare checks to invoices; reconcile bank statement monthly.
 - vi. Other controls - Stamp invoices PAID.
2. Methods of Disbursing and/or safeguarding Cash:
 - a. Electronic Funds Transfer (EFT) System: A new approach developed to transfer funds among parties without the use of paper (deposit tickets, checks, etc.). The approach, called **electronic funds transfers (EFT)**, uses wire, telephone, telegraph, or computer to transfer cash from one location to another.
 - b. Petty Cash Fund - A cash fund used to pay relatively small amounts. Information on the operation of a petty cash fund is provided in the Appendix to this chapter.
 - c. Use of a Bank
 - i. Contributes significantly to good internal control over cash by creating a separate set of records (bank and books).
 - ii. The asset account Cash maintained by the company is the "flip-side" of the bank's liability account for that company. It should be possible to **reconcile these accounts**—make them agree—at any time.
 1. Bank statements - Each month the company receives a **bank statement** showing its bank transactions and balances. For example, some transactions and balances shown include:
 2. Checks paid and other debits that reduce the balance in the depositor's account.
 3. Deposits and other credits that increase the balance in the depositor's account.
 4. The account balance after each day's transactions.
 - d. Minimizes the amount of cash that must be kept on hand

Study Objective 4 - Prepare a Bank Reconciliation

1. The bank and the company maintain independent records of the checking account. The two balances are seldom the same because of:
 - a. **Time lags** that prevent one of the parties from recording the transaction in the same period.
 - i. Days elapse between the time a check is written and dated and the date it is paid by the bank.
 - ii. A day may pass between the time receipts are recorded by the company and the time they are recorded by the bank.
 - iii. A time lag may occur when the bank mails a debit or credit memo to the company.
 - b. **Errors** by either party in recording transactions. The incidence of errors depends on the effectiveness of internal controls maintained by the company and the bank.

2. **Reconciliation procedure** - 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.
- a. **To obtain maximum benefit from a bank reconciliation, the reconciliation should be prepared by an employee who has no other responsibilities related to cash.**
 - b. The reconciliation schedule is divided into two sections :
 - i. balance per bank and
 - ii. balance per books.
 - c. Adjustments are made to correct what was not recorded on either set of books.
 - i. Remember: only correct bank or books for the items that were unknown on that particular record on the date of the reconciliation.
 - d. The following steps should reveal all the reconciling items causing the difference between the two balances:
 - i. Compare the individual deposits on the bank statement with the deposits in transit from the preceding bank reconciliation and with the deposits per company records or copies of duplicate deposit slips.
 1. Deposits recorded by the depositor that have not been recorded by the bank represent **deposits in transit** and are added to the balance per bank.
 2. 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 the cash payments journal. Issued checks recorded by the company that have not been paid by the bank represent **outstanding checks** that are deducted from the balance per bank.
 3. Note any **errors** discovered in the foregoing steps and list them in the appropriate section of the reconciliation schedule. 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 bank.
 4. Trace **bank memoranda** to the depositor's records. Any unrecorded memoranda should be listed in the appropriate section of the reconciliation schedule.

The Bank Reconciliation process illustrated

Consider the following example:

The April bank statement for Laird Company indicates a balance on April 30 of \$15,907.45. On that date the balance of cash per books is \$11,589.45. From the foregoing steps, the following reconciling items are determined:

Facts:

1.	Deposits in transit: April 30 deposit (received by bank on May 1)	\$	2,201.40
2.	Outstanding checks: No. 453, \$3,000.00;		
	No. 457, \$1,401.30;		
	No. 460, \$1,502.70		5,904.00
3.	Errors: Check No. 443 was correctly written by Laird for \$1,226.00 and was correctly paid by the bank, but recorded for \$1,262.00 by Laird.		36.00
4.	Bank memoranda:		
	a. Debit—NSF check from J. R. Baron for \$425.60		425.60
	b. Debit—Printing company checks charge, \$30		30.00
	c. Credit—Collection of note receivable for \$1,000 plus interest earned \$50, less bank collection fee \$15		1,035.00

The bank reconciliation is shown below:

Cash balance per bank statement

Add:	Deposits in transit		
Less:	Outstanding checks		
	No. 453	\$3,000.00	
	No. 457	1,401.30	
	No. 460	<u>1,502.70</u>	
	Adjusted cash balance per bank		

\$15,907.45
2,201.40

Items not known by the bank at the reconciliation date of April 30

(5,904.00)
\$12,204.85

Cash balance per books

Add:	Collection of note receivable for \$1,000 plus interest earned \$50, less collection fee \$15	\$1,035.00	
	Error in recording check No. 443	<u>36.00</u>	
Less:	Bank service charge	30.00	
	NSF Check	<u>425.60</u>	
	Adjusted cash balance per books		

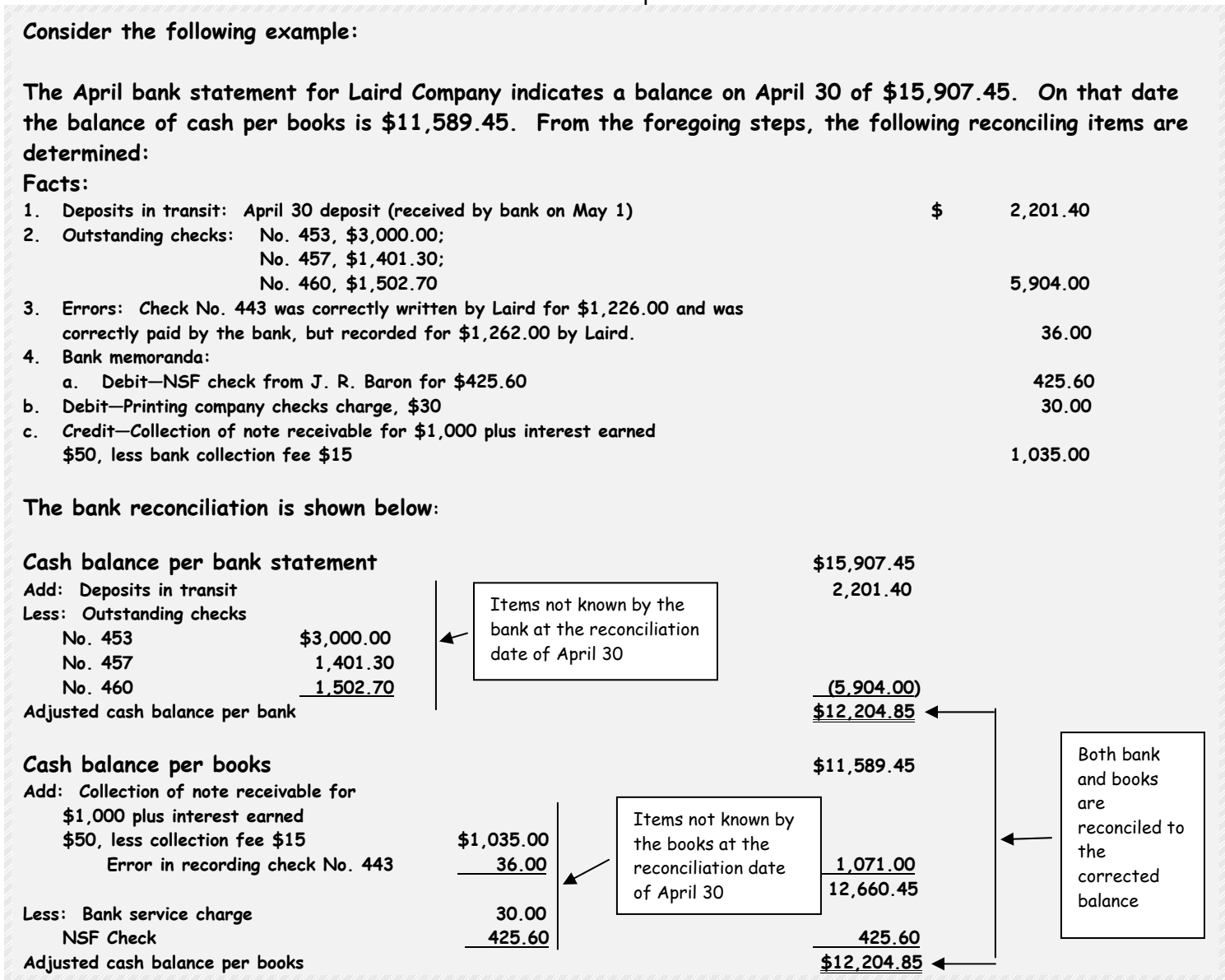
\$11,589.45

Items not known by the books at the reconciliation date of April 30

1,071.00
12,660.45





425.60
\$12,204.85

Both bank and books are reconciled to the corrected balance



Entries from Bank Reconciliation - Each reconciling item used in determining **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.

Teaching suggestion - Illustrate the process of making adjusting entries from the bank reconciliation using the entries to adjust Laird Company's cash account:

	Apr. 30	Cash	1,035	
		Miscellaneous Expense		15
		Notes Receivable		1,000
		Interest Revenue		50
			(To record collection of note receivable by bank)	
	Apr. 30	Cash	36	
		Accounts Payable		36
			(To correct error in recording check No. 443)	
	Apr. 30	Accounts Receivable - J. R. Baron	425.60	
		Cash		425.60
			(To record NSF check)	
	Apr. 30	Miscellaneous Expense	30.00	
		Cash		30.00
		(To record charge for printing company checks)	

Study Objective 5 - Explain the Reporting of Cash

Cash is recorded in both the balance sheet and the statement of cash flows.

1. The balance sheet shows the amount of cash available at a given point in time.
2. The statement of cash flows shows the sources and uses of cash during a period of time.
3. Cash on hand, cash in banks, and petty cash are often combined and reported simply as **Cash**.
4. Cash is the most liquid asset and listed first in the current assets section of the balance sheet.
5. Some companies use the designation "Cash and cash equivalents" in reporting cash.
 - a. **Cash equivalents** are short-term, highly liquid investments that are both:
 - i. Readily convertible to known amounts of cash, and
 - ii. So near their maturity that their market value is relatively insensitive to changes in interest rates.
6. In case of a negative balance in the cash account, it should be reported among current liabilities.
7. Restricted Cash: A company may have cash that is not available for general use but rather is restricted for a special purpose.
 - a. Cash restricted in use should be reported separately on the balance sheet as **restricted cash**.
 - b. If the restricted cash is expected to be used within the next year, the amount should be reported as a current asset.
 - c. When this is not the case the restricted funds should be reported as a noncurrent asset.

Study Objective 6 - Discuss the Basic Principles of Cash Management

1. Management of cash is the responsibility of the company **treasurer**.
 - a. A company can improve its chances of having adequate cash by following five basic principles of cash management:
 - i. **Increase the speed of collection on receivables.**
 1. The more quickly customers pay the more quickly a company can use those funds.

2. Any attempt to force customers to pay earlier must be carefully weighted against the possibility of angering or alienating customers.
 3. One common way to encourage customers to pay more quickly is to offer cash discounts for early payment.
- ii. **Keep inventory levels low** - Maintaining large inventories ties up large amounts of cash, as well as warehouse space.
 1. Increasingly, firms are using techniques to reduce the inventory on hand, thus conserving their cash.
 - iii. **Delay payment of liabilities** - A company should use the full payment period, but not "stretch" payment past the point that could damage its credit rating. (note: is what your authors state; I think this is an exceedingly poor policy both in economic and ethical terms)
 - iv. **Plan the timing of major expenditures** - In order to increase the likelihood of obtaining outside financing, a company should carefully consider the timing of major expenditures in light of its operating cycle. If at all possible, the expenditure should be made when the company normally has excess cash—usually during the off-season.
 - v. **Invest idle cash.**
 1. Cash on hand earns nothing.
 - a. An important part of the treasurer's job is to ensure that any excess cash is invested, even if it is only overnight.
 - b. A *liquid investment* is one with a market in which someone is always willing to buy or sell the investment.
 - c. A *risk-free investment* means there is no concern that the party will default on its promise to pay its principal and interest.

Study Objective 7 - Identify the Primary Elements of a Cash Budget

Cash is vital and **planning the company's cash needs** is a key business activity. The **cash budget** shows the anticipated cash flows, over a one- to two-year period. The cash budget contains the following three sections:

- ◆ **Cash receipts section**—includes expected receipts from the company's principal source(s) of revenue, such as cash sales and collections from customers on credit sales. This section also shows anticipated receipts of interest and dividends, and proceeds from planned sales of investments, plant assets, and the company's capital stock.
- ◆ **Cash disbursements section**—shows expected payments for direct materials, direct labor, manufacturing overhead, and selling and administrative expenses. This section also includes projected payments for income taxes, dividends, investments, and plant assets.
- ◆ **Financing section**—shows expected borrowings and the repayment of the borrowed funds and interest.
- ◆ Data in the cash budget must be prepared in sequence because the ending cash balance of one period becomes the beginning cash balance for the next period.
- ◆ Data for preparing the cash budget are obtained from other budgets and from information provided by management
- ◆ **A cash budget contributes to more effective cash management.**

Appendix - Operation of the Petty Cash Fund

Remember from our class discussion that the only time that the account petty cash is used is (A) When the fund is created and (B) if the balance in the petty cash fund is changed.

Recall: (1). At any given point in time the balance of the petty cash fund should consist of cash and receipts totaling the fund balance and (2) that the entry to replenish the fund is a debit to expense and a credit to cash (not petty cash).

Operation of a petty cash fund involves three steps

1. establishing the fund

- a. Two essential steps in establishing a petty cash fund are
 - i. appointing a petty cash custodian who will be responsible for the fund, and
 - ii. determining the size of the fund.
- b. When a fund is established, a check payable to the petty cash custodian is issued for the stipulated amount.

For example, if Laird Company decides to establish a \$100 fund on March 1, the entry in general journal form is:

Mar. 1	Petty Cash	100.00			
	Cash		100.00	←	

Note the debit to Petty Cash to establish the fund.

REMEMBER: The only time the account petty cash will be used is when the account is created and if/when the balance of the petty cash fund is changed.

(To establish a petty cash fund)

- c. Ordinarily, the amount is expected to cover anticipated disbursements for a three- to four-week period

2. making payments from the fund

- a. The custodian of the petty cash fund has the authority to make payments from the fund that conform to prescribed management policies.
- b. The receipts are kept in the petty cash box until the fund is replenished; as a result, **the sum of the petty cash receipts and money in the fund should equal the established total at all times.**
- c. No accounting entry is made to record a payment at the time it is taken from petty cash. Instead, the account effects of each payment are recognized when the fund is replenished

3. replenishing the fund.

- a. When the money in the petty cash fund reaches a minimum level, the fund is replenished.
- b. The request for reimbursement is initiated by the petty cash custodian.
- c. The 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 who then approves the request and a check is prepared to restore the fund to its established amount.
- d. At the same time, all supporting documentation 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, supplies \$38, and miscellaneous expenses \$5. The entry, in general journal form, to record the check is:

Mar. 15	Postage Expense	44			
	Supplies	38			
	Miscellaneous Expense	5			
	Cash		87	←	

(To replenish petty cash fund)

Note that the Petty Cash account is not affected by the reimbursement; the journal entry simply records the expenses paid with petty cash and a credit to cash to replenish the fund

Cash over/short

Occasionally, in replenishing a petty cash fund it may be necessary to recognize a cash shortage or overage due to human error or theft.

- To illustrate, assume in the preceding example that the custodian had only \$12 in cash in the fund plus the receipts. The request for reimbursement would therefore be for \$88, and the following entry would be made:

Mar. 15	Postage Expense	44	
	Supplies	38	
	Miscellaneous Expense	5	
	Cash Over and Short	1	
	Cash		88

(To replenish petty cash fund)

A petty cash fund should be replenished at the end of the accounting period, regardless of the cash in the fund in order to recognize and book the expenses paid with the use of petty cash.

Review:

- ✓ Identify five principles of internal control.

- ✓ List six internal controls over cash receipts.

- ✓ List six internal controls over cash disbursements.

- ✓ List the steps in preparing a bank reconciliation.

- ✓ In which financial statement(s) is cash reported?

- ✓ Discuss the five basic principles of cash management.

- ✓ What are the primary elements of a cash budget and what types of items would one find in each of the elements?
Be specific in your answer.

Internal Control and Cash

Each month, the company receives from the bank a _____ showing its bank transactions and balances. For example, the statement shows (1) _____ paid and other _____ that reduce the balance in the depositor's account, (2) _____ and other _____ that increase the balance in the depositor's account, and (3) the _____ after each day's transactions. Remember that the bank statements are prepared from the _____ perspective. Therefore, every deposit received by the bank is _____ to the customer's account. The reverse occurs when the bank "pays" a check issued by a company on its checking account balance: Payment _____ the bank's liability and is therefore _____ to the customer's account with the bank.

All paid checks are listed in _____ on the bank statement along with the _____ the check was paid and its _____. Upon paying a check, the bank stamps the check "paid"; a paid check is sometimes referred to as a _____. In addition, the bank includes with the bank statement memoranda explaining other _____ and _____ made by the bank to the depositor's account.

A _____ is used by the bank when a previously deposited customer's check "bounces" because of _____. In such a case, the check is marked _____ (non sufficient funds) by the customer's bank and is returned to the _____ bank. The bank then _____ (decreases) the depositor's account, as shown by the symbol NSF on the bank statement and sends the NSF check and _____ memorandum to the depositor as notification of the charge.

Solutions to Reading Comprehension Check I

Internal Control and Cash

Each month, the company receives from the bank statement showing its bank transactions and balances. For example, the statement 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. Remember that the bank statements are prepared from the bank's perspective. Therefore, 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 and is therefore debited to the customer's account with the bank.

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 anceled check. In addition, the bank includes with the bank statement memoranda explaining other debits and credits made by the bank to the depositor's account.

A debit memorandum is used by the bank when a previously deposited customer's check "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 (decreases) the depositor's account, as shown by the symbol NSF on the bank statement and sends the NSF check and debit memorandum to the depositor as notification of the charge.

Internal Control and Cash

Cash is reported in two different statements: the _____ and the _____ of _____. The _____ reports the amount of cash available at a given point in time. The _____ of _____ shows the _____ and _____ of cash during a period of time.

When presented in a balance sheet, cash on hand, cash in banks, and petty cash are often combined and reported simply as _____. Because it is the most _____ owned by the company, cash is listed first in the _____ section of the _____.

Many companies use the designation "cash and cash equivalents" in reporting cash. _____ are short-term, highly liquid investments that are both:

1. Readily _____ to known amounts of _____, and
2. So near their _____ that their _____ is relatively insensitive to changes in interest rates.

Examples of cash equivalents are _____, _____, _____, and _____. All typically are purchased with _____ that is in excess of immediate needs.

Solutions to Reading Comprehension Check II

Internal Control and Cash

Cash is reported in two different statements: the balance sheet and the statement of cash flows. The balance sheet reports the amount of cash available at a given point in time. The statement of cash flows shows the sources and uses of cash during a period of time.

When presented in a balance sheet, 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 the company, cash is listed first in the current asset section of the balance sheet.

Many companies use the designation "cash and cash equivalents" in reporting cash. Cash equivalents are short-term, highly liquid investments that are both:

1. Readily convertible to known amounts of cash, and
2. So near their maturity that their market value is relatively insensitive to changes in interest rates.

Examples of cash equivalents are Treasury bills, commercial paper, and money market funds. All typically are purchased with cash that is in excess of immediate needs.

Internal Control and Cash

1. The plan of organization and all the related methods adopted within a business to safeguard its assets and enhance the accuracy and reliability of its accounting records.

2. Resources that consist of coins, currency, checks, money orders, and money on hand or on deposit in a bank or similar depository.

3. A cash fund used to pay relatively small amounts.

4. Deposits recorded by the depositor that have not been recorded by the bank.

5. Highly liquid investments, with maturities of three months or less when purchased, that can be converted to a specific amount of cash.

6. A projection of anticipated cash flows, usually over a one- to two-year period.

7. Company employees who evaluate on a continuous basis the effectiveness of the company's system of internal control.

8. A check that is not paid by a bank because of insufficient funds in a customer's bank account.

9. Checks issued and recorded by a company that have not been paid by the bank.

10. Cash that is not available for general use, but instead is restricted for a particular purpose.

Solutions to Vocabulary Quiz

Internal Control and Cash

1. Internal control
2. Cash
3. Petty cash fund
4. Deposits in transit
5. Cash equivalents
6. Cash budget
7. Internal auditors
8. NSF check
9. Outstanding checks
10. Restricted cash

Internal Control and Cash

1. The principles of internal control consist of all of the following except:
 - a. establishment of responsibility.
 - b. segregation of duties.
 - c. generally accepted accounting principles.
 - d. documentation procedures.

2. The following measure is recommended to obtain maximum benefit from independent internal verification:
 - a. The verification should be made periodically or on a surprise basis.
 - b. The verification should be done by an employee who is independent of the personnel responsible for the information.
 - c. Discrepancies and exceptions should be reported to a management level that can take appropriate corrective action.
 - e. all of the above.

3. The concept of reasonable assurance rests on the premise that:
 - a. rotating employees duties.
 - b. requiring employees to take vacations.
 - c. the cost of establishing control procedures should not exceed their expected benefit.
 - d. physical, mechanical, and electronic controls.

4. Cash consists of:
 - a. coin, currency, and postage stamps.
 - b. coins, currency, checks, money orders, money on hand or on deposit in a bank or similar depository.
 - c. coins, currency, postage stamps, money on deposit in a bank.
 - d. all of the above.

5. Internal control over cash disbursements is more effective when payments are made by:
 - a. check.
 - b. cash.
 - c. both a and b above.
 - d. none of the above.

6. The bank would debit the customer's account for all of the following items except:
 - a. checks drawn on the account.
 - b. monthly service charge.
 - c. collection of a note receivable.
 - d. NSF check deposited by customer.

7. Examples of cash equivalents include:
 - a. Treasury bills, commercial paper, money market funds, and bonds.
 - b. Treasury bills, stocks, bonds, and money market funds.
 - c. Currency, treasury bills, commercial paper, and money market funds.
 - d. Treasury bills, commercial paper, and money market funds.

8. A cash budget contains three sections:
 - a. financing, investing, and operating.
 - b. cash receipts, cash disbursements, and financing.
 - c. cash receipts, investing, and financing.
 - d. cash receipts, cash disbursements, and operating.

9. The cash receipts section of the cash budget contains:
 - a. expected receipts from the company's principal source(s) of revenue.
 - b. anticipated receipts of interest.
 - c. anticipated receipts of dividends.
 - d. all of the above.

10. The cash disbursements section of the cash budget contains:
 - a. expected payments for direct materials, direct labor, manufacturing overhead.
 - b. expected payments for selling and administrative expenses.
 - c. expected payments for income taxes, dividends, investments, and plant assets.
 - d. all of the above.

Solutions to Multiple Choice Quiz

Internal Control and Cash

1. c

2. d

3. c

4. b

5. a

6. c

7. d

8. b

9. d

10. d

Exercise 1 - Internal Control Activity

Internal Control and Cash

Peachville is a small rural town in the southeastern part of the United States. Peachville has only one bank. The Bank of Peachville closes its doors to the public at 2:00 p.m. every afternoon. After closing, the two tellers go into the back room where they perform the bookkeeping functions.

1. Does the practice followed in The Bank of Peachville provide an adequate system of internal control? Why or why not?

2. Why does the Board of Directors of The Bank of Peachville tolerate the inadequate system of internal control?

Solutions:

1. No. The internal control system is clearly inadequate.

2. A firm'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.

Exercise 2 - World Wide Web Research and Internal Control Activity

Internal Control and Cash

Chapter 3 of the Departmental Accounting Manual contains the internal control policy for the U. S. Department of the Interior (DOI). Go to www.doi.gov/pfm/am_ch3.html to find the information necessary to answer the following questions:

1. List the four internal control objectives found in the DOI policy.
2. The internal control standards of the DOI presented in two groups: general standards and accounting standards. List standards found in each group.
3. How do the standards listed in part 2 compare with the principles of internal control found in Internal Control and Cash of your text?

Solutions: Information available on Wiley student website.

Note: The Wiley student website is constantly being updated. Please check to see that the information requested in this exercise is available.

Exercise 3 - World Wide Web Research and Internal Auditor Activity

Internal Control and Cash

The Institute of Internal Auditors (IIA) was established in 1941. The organization serves over 80,000 members in internal auditing, governance and internal control, IT audit, education, and security from more than 120 countries. The world's leader in certification, education, research, and technological guidance for the profession, The Institute serves as the profession's watchdog and resource on significant auditing issues around the globe. Go to theiaa.org to obtain information about the organization and answer the following questions.

1. Summarize The Institute's mission. What are four areas to which The Institute is committed?
2. Ethics and the prevention of fraud are important to most companies. Good internal control is one important measure in deterring white-collar crime. What are five proactive steps the IIA suggests that all companies should take to deter white-collar crime?
3. What is a CIA and how many internal auditors hold the CIA designation?
4. What other professional certifications are available through the IIA?

Solutions: Information available on Wiley student website.

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Exercise 4 - Internal Control Activity

Internal Control and Cash

Take an independent field trip to a fast food restaurant and observe the internal control features. If possible you may want to talk to the manager about the company's internal control policies and whether the policies are strictly enforced.

Exercise 5 - World Wide Web Research and Business Insight Activity

Internal Control and Cash

One of the Business Insight features in Internal Control and Cash focuses on John Patterson and his brother Frank who bought a tiny cash register company for \$6,500 and transformed it into the corporate giant known as NCR. To learn more about John Patterson and NCR visit NCR at www.ncr.com.

1. What does the NCR logo represent?
2. When was the first NCR Tower supermicrocomputer system launched?
3. Look at career information for recent graduates. List some of the attributes that NCR seeks in its employees.
4. Could business, as we know it today, exist if the cash register had never been invented?
5. Why do you suppose the name was changed from National Cash Register?

Solutions: Information available on Wiley student website.

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Exercise 6 - World Wide Web Bank Reconciliation Activity

Internal Control and Cash

Reconciling a bank account is an internal control measure. A company's cash account and its bank balance are seldom the same at any given time. Answer the following questions regarding reconciling the bank account.

1. What are two reasons that account for the lack of agreement between the balance in a company's cash account and its bank account?

2. What are the steps involved in revealing all the reconciling items that cause the difference between the balances?

Solutions:

1. The lack of agreement between the two balances has two causes: (1) time lags that prevent one of the parties from recording the transaction in the same period, and (2) errors by either party in recording transactions.
2. The following steps should reveal all the reconciling items that cause the differences:
 - a. Compare the individual deposits on the bank statement with the deposits in transit from the preceding bank reconciliation and with the deposits per company records or copies of duplicate deposits.
 - b. 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 the cash payments journal. Issued checks recorded by the company that have not been paid by the bank represent outstanding checks that are deducted from the balance per bank.
 - c. Note any errors discovered in the foregoing steps and list them in the appropriate section of the reconciliation schedule. 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 bank.
 - d. Trace bank memoranda to the depositor's records. Any unrecorded memoranda should be listed in the appropriate section of the reconciliation schedule.

Exercise 7 - World Wide Web Accounting Careers and Communication Activity

Internal Control and Cash

Your cousin, who has a degree in accounting, has written you saying that she has applied for a job as an internal auditor. She asked you for advise on the duties she would have as an internal auditor. Write a letter to your cousin explaining some of the responsibilities of an internal auditor.

Solution:

Dear Cousin:

I am sure you are excited about the possibility of becoming an internal auditor. Internal auditors are employees of a company 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. The importance of this function is illustrated by the fact that most fraud is discovered by the company through internal mechanisms, such as existing controls and internal audits.

I hope the information I have provided will help you in making your decision on a career in internal auditing. I believe this career choice offers a challenging and rewarding opportunity to use your accounting and investigative skills.

8 - World Wide Web Research, Cash Equivalents, and Internal Control Activity

Internal Control and Cash

Founded in 1850, the American Express Company is a global travel, financial and network services provider. Find the Annual Report for American Express at www.americanexpress.com and use the information found there to answer the following questions.

1. Read the Notes to the Financial Statements to determine the criteria for cash equivalents.

2. The internal control policy of American Express is described in the Report of Management. Summarize this policy.

3. Which CPA firm conducts the external audit of American Express?

Solutions: Information available on Wiley student website.

Note: The Wiley student website is constantly being updated. Please check to see that the information requested in this exercise is available.