# 8 Fraud, Internal Control, and Cash

**CHAPTER PREVIEW** As the Feature Story about recording cash sales at Barriques indicates below, control of cash is important to ensure that fraud does not occur. Companies also need controls to safeguard other types of assets. For example, Barriques undoubtedly has controls to prevent the theft of food and supplies, and controls to prevent the theft of tableware and dishes from its kitchen.

In this chapter, we explain the essential features of an internal control system and how it prevents fraud. We also describe how those controls apply to a specific asset—cash. The applications include some controls with which you may be already familiar, such as the use of a bank.

**FEATURE STORY**

## Minding the Money in Madison

For many years, Barriques in Madison, Wisconsin, has been named the city's favorite coffeehouse. Barriques not only does a booming business in coffee but also has wonderful baked goods, delicious sandwiches, and a fine selection of wines.

"Our customer base ranges from college students to neighborhood residents as well as visitors to our capital city," says bookkeeper Kerry Stoppleworth, who joined the company shortly after it was founded in 1998. "We are unique because we have customers who come in early on their way to work for a cup of coffee and then will stop back after work to pick up a bottle of wine for dinner. We stay very busy throughout all three parts of the day."

Like most businesses where purchases are low-cost and high-volume, cash control has to be simple. "We use a computerized point-of-sale (POS) system to keep track of our inventory and allow us to efficiently ring through an order for a customer," explains Stoppleworth. "You can either scan a barcode for an item or enter in a code for items that don't have a barcode such as cups of coffee or bakery items." The POS system also automatically tracks sales by department and maintains an electronic journal of all the sales transactions that occur during the day.

"There are two POS stations at each store, and throughout the day any of the staff may operate them," says Stoppleworth. At the end of the day, each POS station is reconciled separately. The staff counts the cash in the drawer and enters this amount into the closing totals in the POS system. The POS system then compares the cash and credit amounts, less the cash being carried forward to the next day (the float), to the shift total in the electronic journal. If there are discrepancies, a recount is done and the journal is reviewed transaction by transaction to identify the problem. The staff then creates a deposit ticket for the cash less the float and puts this in a drop safe with the electronic journal summary report for the manager to review and take to the bank the next day. Ultimately, the bookkeeper reviews all of these documents as well as the deposit receipt that the bank produces to make sure they are all in agreement.

As Stoppleworth concludes, "We keep the closing process and accounting simple so that our staff can concentrate on taking care of our customers and making great coffee and food."

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## CHAPTER OUTLINE

### Learning Objectives

**1** **Discuss fraud and the principles of internal control.**
- Fraud
- The Sarbanes-Oxley Act
- Internal control
- Principles of internal control activities
- Limitations of internal control

DO IT! 1 Control Activities

**2** **Apply internal control principles to cash.**
- Cash receipts controls
- Cash disbursements controls
- Petty cash fund

DO IT! 2a Control over Cash Receipts; 2b Petty Cash Fund

**3** **Identify the control features of a bank account.**
- Making bank deposits
- Writing checks
- Bank statements
- Reconciling the bank account
- EFT system

DO IT! 3 Bank Reconciliation

**4** **Explain the reporting of cash.**
- Cash equivalents
- Restricted cash

DO IT! 4 Reporting Cash

Go to the ***REVIEW AND PRACTICE*** section at the end of the chapter for a review of key concepts and practice applications with solutions.

Visit **WileyPLUS with ORION** for additional tutorials and practice opportunities.

LEARNING OBJECTIVE 1

## Discuss fraud and the principles of internal control.

The Feature Story describes many of the internal control procedures used by Barriques. These procedures are necessary to discourage employees from fraudulent activities.

### Fraud

A **fraud** is a dishonest act by an employee that results in personal benefit to the employee at a cost to the employer. Examples of fraud reported in the financial press include the following.

- A bookkeeper in a small company diverted $750,000 of bill payments to a personal bank account over a three-year period.
- A shipping clerk with 28 years of service shipped $125,000 of merchandise to himself.
- A computer operator embezzled $21 million from Wells Fargo Bank over a two-year period.
- A church treasurer "borrowed" $150,000 of church funds to finance a friend's business dealings.

Why does fraud occur? The three main factors that contribute to fraudulent activity are depicted by the **fraud triangle** in Illustration 8-1 (in the margin).

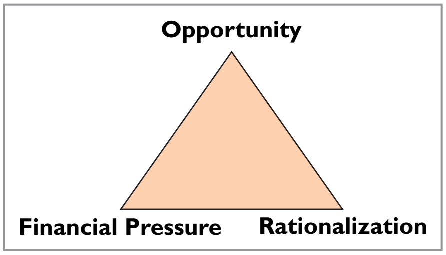


**Illustration 8-1**
Fraud triangle

The most important element of the fraud triangle is **opportunity**. For an employee to commit fraud, the workplace environment must provide opportunities that an employee can take advantage of. Opportunities occur when the workplace lacks sufficient controls to deter and detect fraud. For example, inadequate monitoring of employee actions can create opportunities for theft and can embolden employees because they believe they will not be caught.

A second factor that contributes to fraud is **financial pressure**. Employees sometimes commit fraud because of personal financial problems caused by too much debt. Or, they might commit fraud because they want to lead a lifestyle that they cannot afford on their current salary.

The third factor that contributes to fraud is **rationalization**. In order to justify their fraud, employees rationalize their dishonest actions. For example, employees sometimes justify fraud because they believe they are underpaid while the employer is making lots of money. Employees feel justified in stealing because they believe they deserve to be paid more.

### The Sarbanes-Oxley Act

What can be done to prevent or to detect fraud? After numerous corporate scandals came to light in the early 2000s, Congress addressed this issue by passing the **Sarbanes-Oxley Act (SOX)**. Under SOX, all publicly traded U.S. corporations are required to maintain an adequate system of internal control. Corporate executives and boards of directors must ensure that these controls are reliable and effective. In addition, independent outside auditors must attest to the adequacy of the internal control system. Companies that fail to comply are subject to fines, and company officers can be imprisoned. SOX also created the Public Company Accounting Oversight Board (PCAOB) to establish auditing standards and regulate auditor activity.

One poll found that 60% of investors believe that SOX helps safeguard their stock investments. Many say they would be unlikely to invest in a company that fails to follow SOX requirements. Although some corporate executives have criticized the time and expense involved in following the SOX requirements, SOX appears to be working well. For example, the chief accounting officer of Eli Lily noted that SOX triggered a comprehensive review of how the company documents its controls. This review uncovered redundancies and pointed out controls that needed to be added. In short, it added up to time and money well spent.

## Internal Control

**Internal control** is a process designed to provide reasonable assurance regarding the achievement of objectives related to operations, reporting, and compliance. In more detail, it consists of all the related methods and measures adopted within an organization to safeguard assets, enhance the reliability of accounting records, increase efficiency of operations, and ensure compliance with laws and regulations. Internal control systems have five primary components as listed below.[1]

- **A control environment.** It is the responsibility of top management to make it clear that the organization values integrity and that unethical activity will not be tolerated. This component is often referred to as the "tone at the top."
- **Risk assessment.** Companies must identify and analyze the various factors that create risk for the business and must determine how to manage these risks.
- **Control activities.** To reduce the occurrence of fraud, management must design policies and procedures to address the specific risks faced by the company.
- **Information and communication.** The internal control system must capture and communicate all pertinent information both down and up the organization, as well as communicate information to appropriate external parties.
- **Monitoring.** Internal control systems must be monitored periodically for their adequacy. Significant deficiencies need to be reported to top management and/or the board of directors.

### People, Planet, and Profit Insight

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**And the Controls Are . . .**

Internal controls are important for an effective financial reporting system. The same is true for sustainability reporting. An effective system of internal controls for sustainability reporting will help in the following ways: (1) prevent the unauthorized use of data; (2) provide reasonable assurance that the information is accurate, valid, and complete; and (3) report information that is consistent with overall sustainability accounting policies. With these types of controls, users will have the confidence that they can use the sustainability information effectively.

Some regulators are calling for even more assurance through audits of this information. Companies that potentially can cause environmental damage through greenhouse gases, as well as companies in the mining and extractive industries, are subject to reporting requirements. And, as demand for more information in the sustainability area expands, the need for audits of this information will grow.

Why is sustainability information important to investors? (Go to **WileyPLUS** for this answer and additional questions.)

[1]The Committee of Sponsoring Organizations of the Treadway Commission, "Internal Control—Integrated Framework," *www.coso.org/documents/990025P_executive_summary_final_May20_e.pdf.*

## Principles of Internal Control Activities

Each of the five components of an internal control system is important. Here, we will focus on one component, the control activities. The reason? These activities are the backbone of the company's efforts to address the risks it faces, such as fraud. The specific control activities used by a company will vary, depending on management's assessment of the risks faced. This assessment is heavily influenced by the size and nature of the company.

The six principles of control activities are as follows.

- Establishment of responsibility
- Segregation of duties
- Documentation procedures
- Physical controls
- Independent internal verification
- Human resource controls

We explain these principles in the following sections. You should recognize that they apply to most companies and are relevant to both manual and computerized accounting systems.

### ESTABLISHMENT OF RESPONSIBILITY

**Transfer of cash drawers**

An essential principle of internal control is to assign responsibility to specific employees. **Control is most effective when only one person is responsible for a given task.**

To illustrate, assume that the cash on hand at the end of the day in a Safeway supermarket is $10 short of the cash entered in the cash register. If only one person has operated the register, the shift manager can quickly determine responsibility for the shortage. If two or more individuals have worked the register, it may be impossible to determine who is responsible for the error.

Many retailers solve this problem by having registers with multiple drawers. This makes it possible for more than one person to operate a register but still allows identification of a particular employee with a specific drawer. Only the signed-in cashier has access to his or her drawer.

Establishing responsibility often requires limiting access only to authorized personnel, and then identifying those personnel. For example, the automated systems used by many companies have mechanisms such as identifying passcodes that keep track of who made a journal entry, who entered a sale, or who went into an inventory storeroom at a particular time. Use of identifying passcodes enables the company to establish responsibility by identifying the particular employee who carried out the activity.

**ANATOMY OF A FRAUD**

Maureen Frugali was a training supervisor for claims processing at Colossal Healthcare. As a standard part of the claims-processing training program, Maureen created fictitious claims for use by trainees. These fictitious claims were then sent to the accounts payable department. After the training claims had been processed, she was to notify Accounts Payable of all fictitious claims, so that they would not be paid. However, she did not inform Accounts Payable about every fictitious claim. She created some fictitious claims for entities that she controlled (that is, she would receive the payment), and she let Accounts Payable pay her.

Total take: $11 million

**THE MISSING CONTROL**

***Establishment of responsibility.*** The healthcare company did not adequately restrict the responsibility for authorizing and approving claims transactions. The training supervisor should not have been authorized to create claims in the company's "live" system.

*Source:* Adapted from Wells, *Fraud Casebook* (2007), pp. 61–70.

## SEGREGATION OF DUTIES

Segregation of duties is indispensable in an internal control system. There are two common applications of this principle:

1. Different individuals should be responsible for related activities.
2. The responsibility for recordkeeping for an asset should be separate from the physical custody of that asset.

The rationale for segregation of duties is this: **The work of one employee should, without a duplication of effort, provide a reliable basis for evaluating the work of another employee.** For example, the personnel that design and program computerized systems should not be assigned duties related to day-to-day use of the system. Otherwise, they could design the system to benefit them personally and conceal the fraud through day-to-day use.

**SEGREGATION OF RELATED ACTIVITIES** **Making one individual responsible for related activities increases the potential for errors and irregularities.** Instead, companies should, for example, assign related **purchasing activities** to different individuals. Related purchasing activities include ordering merchandise, order approval, receiving goods, authorizing payment, and paying for goods or services. Various frauds are possible when one person handles related purchasing activities:

- If a purchasing agent is allowed to order goods without obtaining supervisory approval, the likelihood of the purchasing agent receiving kickbacks from suppliers increases.
- If an employee who orders goods also handles the invoice and receipt of the goods, as well as payment authorization, he or she might authorize payment for a fictitious invoice.

These abuses are less likely to occur when companies divide the purchasing tasks.

Similarly, companies should assign related **sales activities** to different individuals. Related selling activities include making a sale, shipping (or delivering) the goods to the customer, billing the customer, and receiving payment. Various frauds are possible when one person handles related sales activities:

- If a salesperson can make a sale without obtaining supervisory approval, he or she might make sales at unauthorized prices to increase sales commissions.
- A shipping clerk who also has access to accounting records could ship goods to himself.
- A billing clerk who handles billing and receipt could understate the amount billed for sales made to friends and relatives.

These abuses are less likely to occur when companies divide the sales tasks. The salespeople make the sale, the shipping department ships the goods on the basis of the sales order, and the billing department prepares the sales invoice after comparing the sales order with the report of goods shipped.

**ANATOMY OF A FRAUD**

Lawrence Fairbanks, the assistant vice-chancellor of communications at Aesop University, was allowed to make purchases of under $2,500 for his department without external approval. Unfortunately, he also sometimes bought items for himself, such as expensive antiques and other collectibles. How did he do it? He replaced the vendor invoices he received with fake vendor invoices that he created. The fake invoices had descriptions that were more consistent with the communications department's purchases. He submitted these fake invoices to the accounting department as the basis for their journal entries and to the accounts payable department as the basis for payment.

Total take: $475,000

**THE MISSING CONTROL**

***Segregation of duties.*** The university had not properly segregated related purchasing activities. Lawrence was ordering items, receiving the items, and receiving the invoice. By receiving the invoice, he had control over the documents that were used to account for the purchase and thus was able to substitute a fake invoice.

*Source:* Adapted from Wells, *Fraud Casebook* (2007), pp. 3–15.

**Accounting employee A**
Maintains cash balances per books

**Segregation of duties**
(Accountability for assets)

**Assistant cashier B**
Maintains custody of cash on hand

**SEGREGATION OF RECORDKEEPING FROM PHYSICAL CUSTODY** The accountant should have neither physical custody of the asset nor access to it. Likewise, the custodian of the asset should not maintain or have access to the accounting records. **The custodian of the asset is not likely to convert the asset to personal use when one employee maintains the record of the asset, and a different employee has physical custody of the asset.** The separation of accounting responsibility from the custody of assets is especially important for cash and inventories because these assets are very vulnerable to fraud.

**ANATOMY OF A FRAUD**

Angela Bauer was an accounts payable clerk for Aggasiz Construction Company. Angela prepared and issued checks to vendors and reconciled bank statements. She perpetrated a fraud in this way: She wrote checks for costs that the company had not actually incurred (e.g., fake taxes). A supervisor then approved and signed the checks. Before issuing the check, though, Angela would "white-out" the payee line on the check and change it to personal accounts that she controlled. She was able to conceal the theft because she also reconciled the bank account. That is, nobody else ever saw that the checks had been altered.

Total take: $570,000

**THE MISSING CONTROL**

***Segregation of duties.*** Aggasiz Construction Company did not properly segregate recordkeeping from physical custody. Angela had physical custody of the checks, which essentially was control of the cash. She also had recordkeeping responsibility because she prepared the bank reconciliation.

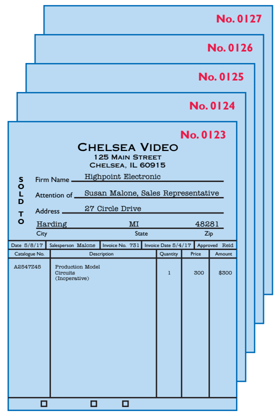
*Source:* Adapted from Wells, *Fraud Casebook* (2007), pp. 100–107.

## DOCUMENTATION PROCEDURES

Documents provide evidence that transactions and events have occurred. For example, Barriques' point-of-sale terminals are networked with the company's computing and accounting records, which results in direct documentation.

Similarly, a shipping document indicates that the goods have been shipped, and a sales invoice indicates that the company has billed the customer for the goods. By requiring signatures (or initials) on the documents, the company can identify the individual(s) responsible for the transaction or event. Companies should document transactions when they occur.

Companies should establish procedures for documents. First, whenever possible, companies should use **prenumbered documents, and all documents should be accounted for**. Prenumbering helps to prevent a transaction from being recorded more than once, or conversely, from not being recorded at all. Second, the control system should require that employees **promptly forward source documents for accounting entries to the accounting department**. **This control measure helps to ensure timely recording of the transaction** and contributes directly to the accuracy and reliability of the accounting records.




**Prenumbered invoices**

## ANATOMY OF A FRAUD

To support their reimbursement requests for travel costs incurred, employees at Mod Fashions Corporation's design center were required to submit receipts. The receipts could include the detailed bill provided for a meal, the credit card receipt provided when the credit card payment is made, or a copy of the employee's monthly credit card bill that listed the item. A number of the designers who frequently traveled together came up with a fraud scheme: They submitted claims for the same expenses. For example, if they had a meal together that cost $200, one person submitted the detailed meal bill, another submitted the credit card receipt, and a third submitted a monthly credit card bill showing the meal as a line item. Thus, all three received a $200 reimbursement.

Total take: $75,000

**THE MISSING CONTROL**

***Documentation procedures.*** Mod Fashions should require the original, detailed receipt. It should not accept photocopies, and it should not accept credit card statements. In addition, documentation procedures could be further improved by requiring the use of a corporate credit card (rather than a personal credit card) for all business expenses.

*Source:* Adapted from Wells, *Fraud Casebook* (2007), pp. 79–90.

## PHYSICAL CONTROLS

Use of physical controls is essential. **Physical controls** relate to the safeguarding of assets and enhance the accuracy and reliability of the accounting records. Illustration 8-2 shows examples of these controls.

**Illustration 8-2**
Physical controls

**Physical Controls**


Safes, vaults, and safety deposit boxes for cash and business papers

Locked warehouses and storage cabinets for inventories and records

Computer facilities with pass key access or fingerprint or eyeball scans

Alarms to prevent break-ins

Television monitors and garment sensors to deter theft

Time clocks for recording time worked

### ANATOMY OF A FRAUD

At Centerstone Health, a large insurance company, the mailroom each day received insurance applications from prospective customers. Mailroom employees scanned the applications into electronic documents before the applications were processed. Once the applications were scanned, they could be accessed online by authorized employees.

Insurance agents at Centerstone Health earn commissions based upon successful applications. The sales agent's name is listed on the application. However, roughly 15% of the applications are from customers who did not work with a sales agent. Two friends—Alex, an employee in recordkeeping, and Parviz, a sales agent—thought up a way to perpetrate a fraud. Alex identified scanned applications that did not list a sales agent. After business hours, he entered the mailroom and found the hard-copy applications that did not show a sales agent. He wrote in Parviz's name as the sales agent and then rescanned the application for processing. Parviz received the commission, which the friends then split.

Total take: $240,000

**THE MISSING CONTROL**

***Physical controls.*** Centerstone Health lacked two basic physical controls that could have prevented this fraud. First, the mailroom should have been locked during non-business hours, and access during business hours should have been tightly controlled. Second, the scanned applications supposedly could be accessed only by authorized employees using their passwords. However, the password for each employee was the same as the employee's user ID. Since employee user-ID numbers were available to all other employees, all employees knew all other employees' passwords. Unauthorized employees could access the scanned applications. Thus, Alex could enter the system using another employee's password and access the scanned applications.

*Source:* Adapted from Wells, *Fraud Casebook* (2007), pp. 316–326.

## INDEPENDENT INTERNAL VERIFICATION

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

1. Companies should verify records periodically or on a surprise basis.
2. An employee who is independent of the personnel responsible for the information should make the verification.
3. Discrepancies and exceptions should be reported to a management level that can take appropriate corrective action.

Independent internal verification is especially useful in comparing recorded accountability with existing assets. The reconciliation of the electronic journal with the cash in the point-of-sale terminal at Barriques is an example of this internal control principle. Other common examples are the reconciliation of a company's cash balance per books with the cash balance per bank, and the verification of the perpetual inventory records through a count of physical inventory. Illustration 8-3 shows the relationship between this principle and the segregation of duties principle.

### ANATOMY OF A FRAUD

Bobbi Jean Donnelly, the office manager for Mod Fashions Corporation's design center, was responsible for preparing the design center budget and reviewing expense reports submitted by design center employees. Her desire to upgrade her wardrobe got the better of her, and she enacted a fraud that involved filing expense-reimbursement requests for her own personal clothing purchases. Bobbi Jean was able to conceal the fraud because she was responsible for reviewing all expense reports, including her

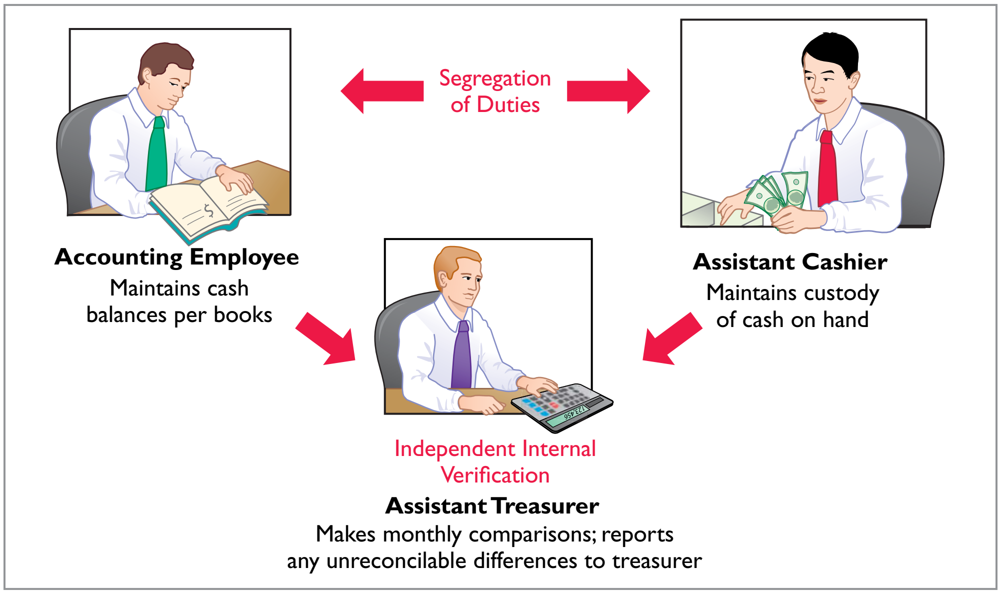



**Illustration 8-3**
Comparison of segregation of duties principle with independent internal verification principle

own. In addition, she sometimes was given ultimate responsibility for signing off on the expense reports when her boss was "too busy." Also, because she controlled the budget, when she submitted her expenses, she coded them to budget items that she knew were running under budget, so that they would not catch anyone's attention.

Total take: $275,000

**THE MISSING CONTROL**

***Independent internal verification.*** Bobbi Jean's boss should have verified her expense reports. When asked what he thought her expenses for a year were, the boss said about $10,000. At $115,000 per year, her actual expenses were more than 10 times what would have been expected. However, because he was "too busy" to verify her expense reports or to review the budget, he never noticed.

*Source:* Adapted from Wells, *Fraud Casebook* (2007), pp. 79–90.

Large companies often assign independent internal verification to internal auditors. **Internal auditors** are company employees who continuously evaluate the effectiveness of the company's internal control systems. They review the activities of departments and individuals to determine whether prescribed internal controls are being followed. They also recommend improvements when needed. For example, **WorldCom** was at one time the second largest U.S. telecommunications company. The fraud that caused its bankruptcy (the largest ever when it occurred) involved billions of dollars. It was uncovered by an internal auditor.


## HUMAN RESOURCE CONTROLS

Human resource control activities include the following.

1. **Bond employees who handle cash. Bonding** involves obtaining insurance protection against theft by employees. It contributes to the safeguarding of cash in two ways. First, the insurance company carefully screens all individuals before adding them to the policy and may reject risky applicants. Second, bonded employees know that the insurance company will vigorously prosecute all offenders.
2. **Rotate employees' duties and require employees to take vacations.** These measures deter employees from attempting thefts since they will not be able to permanently conceal their improper actions. Many banks, for example,

have discovered employee thefts when the employee was on vacation or assigned to a new position.

3. **Conduct thorough background checks.** Many believe that the most important and inexpensive measure any business can take to reduce employee theft and fraud is for the human resources department to conduct thorough background checks. Two tips: (1) Check to see whether job applicants actually graduated from the schools they list. (2) Never use telephone numbers for previous employers provided by the applicant. Always look them up yourself.

## ANATOMY OF A FRAUD

Ellen Lowry was the desk manager and Josephine Rodriguez was the head of housekeeping at the Excelsior Inn, a luxury hotel. The two best friends were so dedicated to their jobs that they never took vacations, and they frequently filled in for other employees. In fact, Ms. Rodriguez, whose job as head of housekeeping did not include cleaning rooms, often cleaned rooms herself, "just to help the staff keep up." These two "dedicated" employees, working as a team, found a way to earn a little more cash. Ellen, the desk manager, provided significant discounts to guests who paid with cash. She kept the cash and did not register the guest in the hotel's computerized system. Instead, she took the room out of circulation "due to routine maintenance." Because the room did not show up as being used, it did not receive a normal housekeeping assignment. Instead, Josephine, the head of housekeeping, cleaned the rooms during the guests' stay.

Total take: $95,000

**THE MISSING CONTROL**

***Human resource controls.*** Ellen, the desk manager, had been fired by a previous employer after being accused of fraud. If the Excelsior Inn had conducted a thorough background check, it would not have hired her. The hotel fraud was detected when Ellen missed work for a few days due to illness. A system of mandatory vacations and rotating days off would have increased the chances of detecting the fraud before it became so large.

*Source:* Adapted from Wells, *Fraud Casebook* (2007), pp. 145–155.

## Accounting Across the Organization

Stockbyte/Getty Images, Inc.

### SOX Boosts the Role of Human Resources

Under SOX, a company needs to keep track of employees' degrees and certifications to ensure that employees continue to meet the specified requirements of a job. Also, to ensure proper employee supervision and proper separation of duties, companies must develop and monitor an organizational chart. When one corporation went through this exercise, it found that out of 17,000 employees, there were 400 people who did not report to anyone. The corporation also had 35 people who reported to each other. In addition, if an employee complains of an unfair firing and mentions financial issues at the company, HR should refer the case to the company audit committee and possibly to its legal counsel.

Why would unsupervised employees or employees who report to each other represent potential internal control threats? (Go to **WileyPLUS** for this answer and additional questions.)

## Limitations of Internal Control

Companies generally design their systems of internal control to provide **reasonable assurance** of proper safeguarding of assets and reliability of the accounting records. The concept of reasonable assurance rests on the premise that the costs of establishing control procedures should not exceed their expected benefit.

To illustrate, consider shoplifting losses in retail stores. Stores could eliminate such losses by having a security guard stop and search customers as they leave the store. But store managers have concluded that the negative effects of such a procedure cannot be justified. Instead, they have attempted to control shoplifting losses by less costly procedures. They post signs saying, "We reserve the right to inspect all packages" and "All shoplifters will be prosecuted." They use hidden cameras and store detectives to monitor customer activity, and they install sensor equipment at exits.

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

The **human element** is an important factor in every system of internal control. A good system can become ineffective as a result of employee fatigue, carelessness, or indifference. For example, a receiving clerk may not bother to count goods received and may just "fudge" the counts. Occasionally, two or more individuals may work together to get around prescribed controls. Such **collusion** can significantly reduce the effectiveness of a system, eliminating the protection offered by segregation of duties. No system of internal control is perfect.

The **size of the business** also may impose limitations on internal control. Small companies often find it difficult to segregate duties or to provide for independent internal verification. A study by the Association of Certified Fraud Examiners (*Report to the Nation on Occupational Fraud and Abuse*) indicates that businesses with fewer than 100 employees are most at risk for employee theft. In fact, 29% of frauds occurred at companies with fewer than 100 employees. The median loss at small companies was $154,000, which was close to the median fraud at companies with more than 10,000 employees ($160,000). A $154,000 loss can threaten the very existence of a small company.

## DO IT! 1 Control Activities

Identify which control activity is violated in each of the following situations, and explain how the situation creates an opportunity for a fraud.

1. The person with primary responsibility for reconciling the bank account and making all bank deposits is also the company's accountant.
2. Wellstone Company's treasurer received an award for distinguished service because he had not taken a vacation in 30 years.
3. In order to save money spent on order slips and to reduce time spent keeping track of order slips, a local bar/restaurant does not buy prenumbered order slips.

### Solution

1. Violates the control activity of segregation of duties. Recordkeeping should be separate from physical custody. As a consequence, the employee could embezzle cash and make journal entries to hide the theft.
2. Violates the control activity of human resource controls. Key employees must take vacations. Otherwise, the treasurer, who manages the company's cash, might embezzle cash and use his position to conceal the theft.
3. Violates the control activity of documentation procedures. If prenumbered documents are not used, then it is virtually impossible to account for the documents. As a consequence, an employee could write up a dinner sale, receive the cash from the customer, and then throw away the order slip and keep the cash.

**Action Plan**

✔ Familiarize yourself with each of the control activities summarized on page 358.

✔ Understand the nature of the frauds that each control activity is intended to address.

Related exercise material: **BE8-1, BE8-2, BE8-3, BE8-4, E8-1, and DO IT! 8-1.**

LEARNING OBJECTIVE 2

## Apply internal control principles to cash.

Cash is the one asset that is readily convertible into any other type of asset. It also is easily concealed and transported, and is highly desired. Because of these characteristics, **cash is the asset most susceptible to fraudulent activities**. In addition, because of the large volume of cash transactions, numerous errors may occur in executing and recording them. To safeguard cash and to ensure the accuracy of the accounting records for cash, effective internal control over cash is critical.

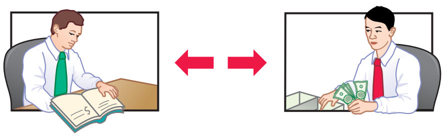
### Cash Receipts Controls

Illustration 8-4 shows how the internal control principles explained earlier apply to cash receipts transactions. As you might expect, companies vary considerably in how they apply these principles. To illustrate internal control over cash receipts, we will examine control activities for a retail store with both over-the-counter and mail receipts.

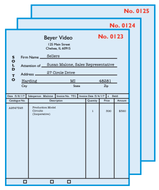
**Illustration 8-4**
Application of internal control principles to cash receipts

**Cash Receipts Controls**

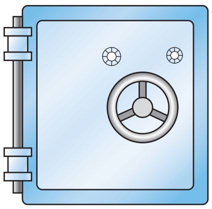
**Establishment of Responsibility**
Only designated personnel are authorized to handle cash receipts (cashiers)



**Segregation of Duties**
Different individuals receive cash, record cash receipts, and hold the cash

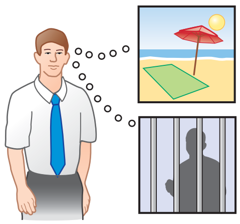


**Documentation Procedures**
Use remittance advice (mail receipts), cash register tapes or computer records, and deposit slips



**Physical Controls**
Store cash in safes and bank vaults; limit access to storage areas; use cash registers

**Independent Internal Verification**
Supervisors count cash receipts daily; assistant treasurer compares total receipts to bank deposits daily



**Human Resource Controls**
Bond personnel who handle cash; require employees to take vacations; conduct background checks

#### OVER-THE-COUNTER RECEIPTS

In retail businesses, control of over-the-counter receipts centers on cash registers that are visible to customers. A cash sale is entered in a cash register (or point-of-sale terminal), with the amount clearly visible to the customer. This activity prevents the sales clerk from entering a lower amount and pocketing the difference. The customer receives an itemized cash register receipt slip and is expected to count the change received. (One weakness at Barriques in the Feature Story is that customers are only given a receipt if requested.) The cash register's tape is locked in the register until a supervisor removes it. This tape accumulates the daily transactions and totals.

At the end of the clerk's shift, the clerk counts the cash and sends the cash and the count to the cashier. The cashier counts the cash, prepares a deposit slip, and deposits the cash at the bank. The cashier also sends a duplicate of the deposit slip to the accounting department to indicate cash received. The supervisor removes the cash register tape and sends it to the accounting department as the basis for a journal entry to record the cash received. (For point-of-sale systems, the accounting department receives information on daily transactions and totals through the computer network.) Illustration 8-5 summarizes this process.

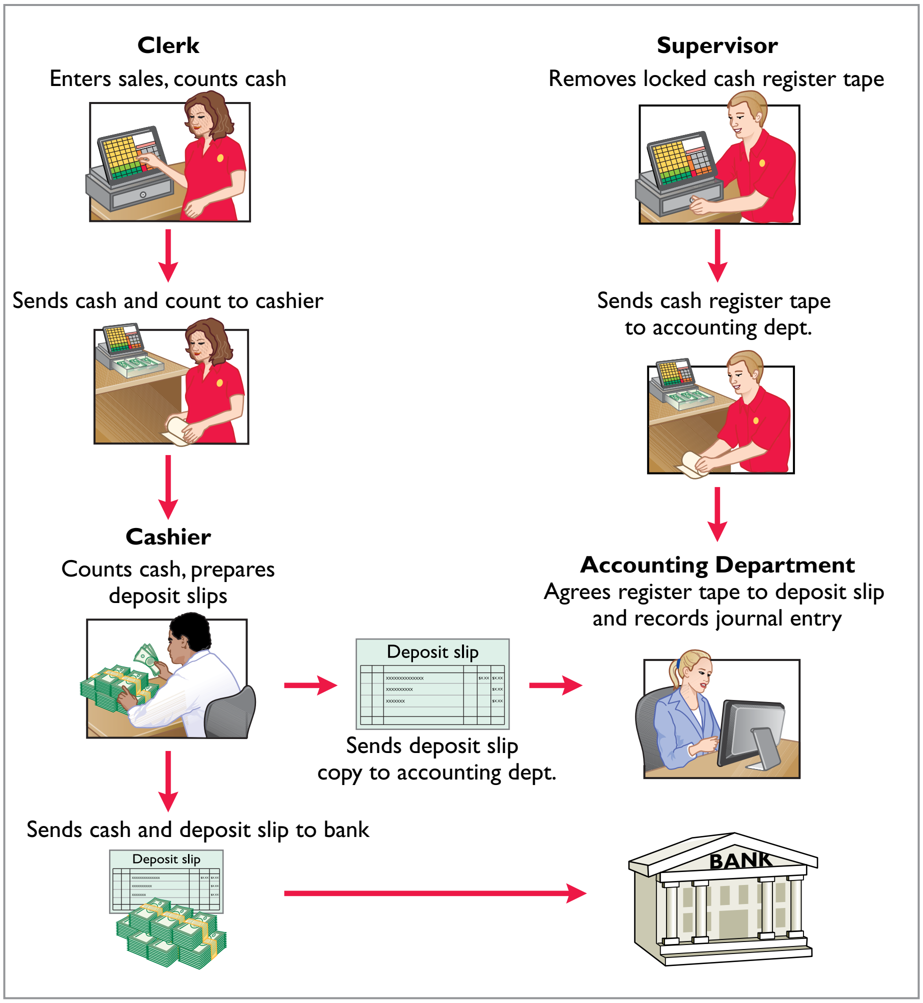



**Illustration 8-5**
Control of over-the-counter receipts

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

This system for handling cash receipts uses an important internal control principle—segregation of recordkeeping from physical custody. The supervisor has access to the cash register tape but **not** to the cash. The clerk and the cashier have access to the cash but **not** to the register tape. In addition, the cash register tape provides documentation and enables independent internal verification. Use of these three principles of internal control (segregation of recordkeeping from physical custody, documentation, and independent internal verification) provides an effective system of internal control. Any attempt at fraudulent activity should be detected unless there is collusion among the employees.

In some instances, the amount deposited at the bank will not agree with the cash recorded in the accounting records based on the cash register tape. These differences often result because the clerk hands incorrect change back to the retail customer. In this case, the difference between the actual cash and the amount reported on the cash register tape is reported in a Cash Over and Short account. For example, suppose that the cash register tape indicated sales of \$6,956.20 but the amount of cash was only \$6,946.10. A cash shortfall of \$10.10 exists. To account for this cash shortfall and related cash, the company makes the following entry.

| A | = | L | + | OE |
|---|---|---|---|---|
| +6,946.10 | | | | |
| | | | | −10.10 |
| | | | | +6,956.20 |

**Cash Flows**
+6,946.10

| | | |
|---|---|---|
| Cash | 6,946.10 | |
| Cash Over and Short | 10.10 | |
| Sales Revenue | | 6,956.20 |
| (To record cash shortfall) | | |

Cash Over and Short is an income statement item. It is reported as miscellaneous expense when there is a cash shortfall, and as miscellaneous revenue when there is an overage. Clearly, the amount should be small. Any material amounts in this account should be investigated.

### MAIL RECEIPTS

All mail receipts should be opened in the presence of at least two mail clerks. These receipts are generally in the form of checks. A mail clerk should endorse each check "For Deposit Only." This restrictive endorsement reduces the likelihood that someone could divert the check to personal use. Banks will not give an individual cash when presented with a check that has this type of endorsement.

The mail clerks prepare, in triplicate, a list of the checks received each day. This list shows the name of the check issuer, the purpose of the payment, and the amount of the check. Each mail clerk signs the list to establish responsibility for the data. The original copy of the list, along with the checks, is then sent to the cashier's department. A copy of the list is sent to the accounting department for recording in the accounting records. The clerks also keep a copy.

This process provides excellent internal control for the company. By employing two clerks, the chance of fraud is reduced. Each clerk knows he or she is being observed by the other clerk(s). To engage in fraud, they would have to collude. The customers who submit payments also provide control because they will contact the company with a complaint if they are not properly credited for payment. Because the cashier has access to cash but not the records, and the accounting department has access to records but not cash, neither can engage in undetected fraud.

## DO IT! 2a Control over Cash Receipts

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

**Action Plan**

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

### Solution

Cortez should assign a separate cash register drawer to each employee at the start of each work shift, with register totals set at zero. Each employee should have access to only the assigned register drawer to enter all sales. Each customer should be given a receipt. At the end of the shift, the employee should do a cash count. A separate employee should compare the cash count with the register tape to be sure they agree. In addition, Cortez should install an automated system that would enable the company to compare orders entered in the register to orders processed by the kitchen.

Related exercise material: **BE8-5, BE8-6, BE8-7, E8-2, and DO IT! 8-2a.**

## Cash Disbursements Controls

Companies disburse cash for a variety of reasons, such as to pay expenses and liabilities or to purchase assets. **Generally, internal control over cash disbursements is more effective when companies pay by check or electronic funds transfer (EFT) rather than by cash.** One exception is **payments for incidental amounts that are paid out of petty cash**.[2]

Companies generally issue checks only after following specified control procedures. Illustration 8-6 shows how principles of internal control apply to cash disbursements.

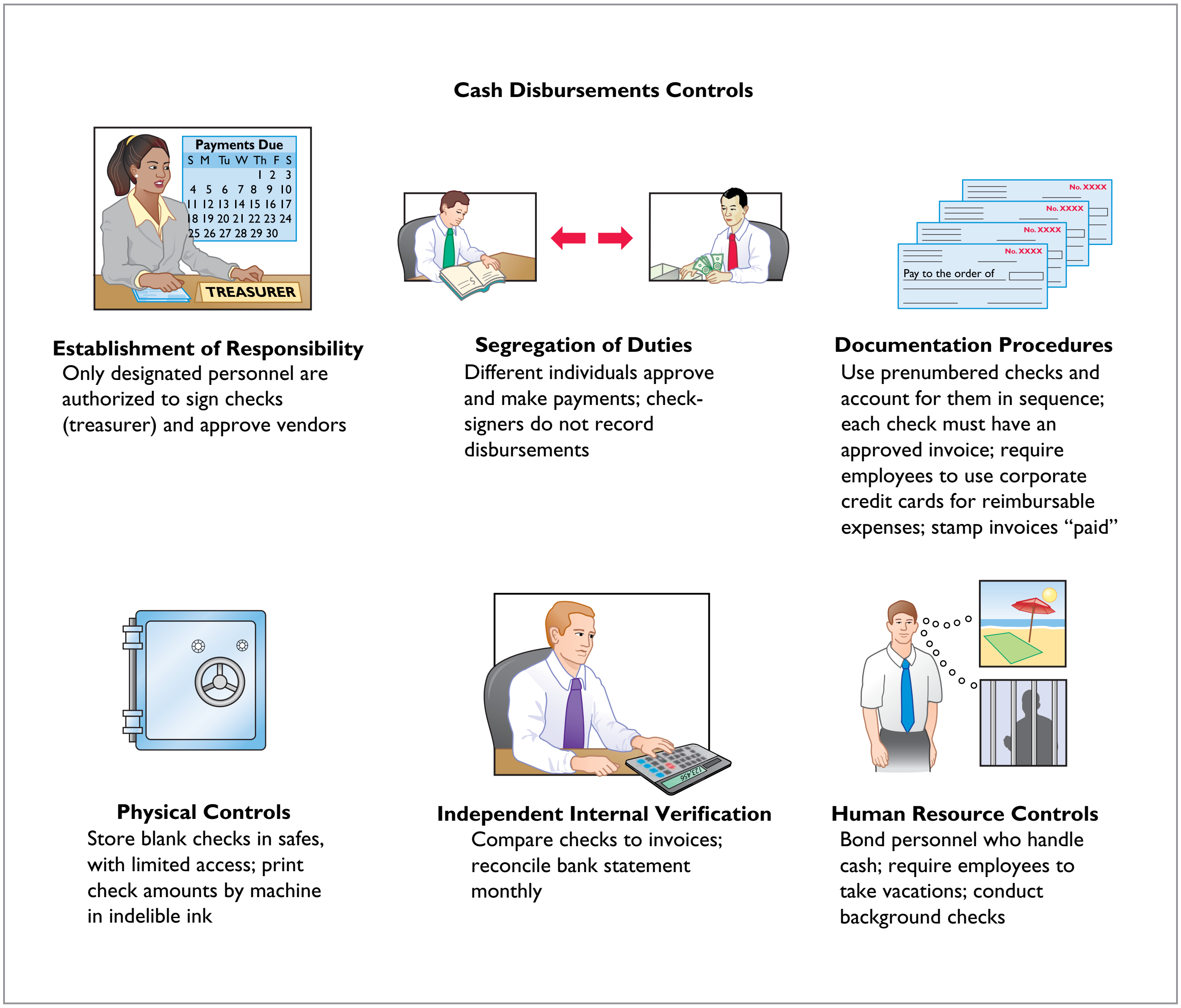



**Illustration 8-6**
Application of internal control principles to cash disbursements

### VOUCHER SYSTEM CONTROLS

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

The system begins with the authorization to incur a cost or expense. It ends with the issuance of a check for the liability incurred. A **voucher** is an authorization form prepared for each expenditure. Companies require vouchers for all types of cash disbursements except those from petty cash.

---

[2]We explain the operation of a petty cash fund on pages 370–372.

The starting point in preparing a voucher is to fill in the appropriate information about the liability on the face of the voucher. The vendor's invoice provides most of the needed information. Then, an employee in accounts payable records the voucher (in a journal called a **voucher register**) and files it according to the date on which it is to be paid. The company issues and sends a check on that date, and stamps the voucher "paid." The paid voucher is sent to the accounting department for recording (in a journal called the **check register**). A voucher system involves two journal entries, one to record the liability when the voucher is issued and a second to pay the liability that relates to the voucher.

The use of a voucher system, whether done manually or electronically, improves internal control over cash disbursements. First, the authorization process inherent in a voucher system establishes responsibility. Each individual has responsibility to review the underlying documentation to ensure that it is correct. In addition, the voucher system keeps track of the documents that back up each transaction. By keeping these documents in one place, a supervisor can independently verify the authenticity of each transaction. Consider, for example, the case of Aesop University presented on page 360. Aesop did not use a voucher system for transactions under $2,500. As a consequence, there was no independent verification of the documents, which enabled the employee to submit fake invoices to hide his unauthorized purchases.

## Petty Cash Fund

As you just learned, better internal control over cash disbursements is possible when companies make payments by check. However, using checks to pay small amounts is both impractical and a nuisance. For instance, a company would not want to write checks to pay for postage due, working lunches, or taxi fares. A common way of handling such payments, while maintaining satisfactory control, is to use a **petty cash fund** to pay relatively small amounts. The operation of a petty cash fund, often called an **imprest system**, involves (1) establishing the fund, (2) making payments from the fund, and (3) replenishing the fund.[3]

### ESTABLISHING THE PETTY CASH FUND

Two essential steps in establishing a petty cash fund are (1) appointing a petty cash custodian who will be responsible for the fund, and (2) determining the size of the fund. Ordinarily, a company expects the amount in the fund to cover anticipated disbursements for a three- to four-week period.

To establish the fund, a company issues a check payable to the petty cash custodian for the stipulated amount. For example, if Laird Company decides to establish a $100 fund on March 1, the general journal entry is:

| A | = | L | + | OE |
|---|---|---|---|---|
| +100 | | | | |
| −100 | | | | |

**Cash Flows**
no effect

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

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

**ETHICS NOTE**

Petty cash funds are authorized and legitimate. In contrast, "slush" funds are unauthorized and hidden (under the table).

### MAKING PAYMENTS FROM THE PETTY CASH FUND

The petty cash custodian has the authority to make payments from the fund that conform to prescribed management policies. Usually, management limits the size of

[3]The term "imprest" means an advance of money for a designated purpose.

expenditures that come from petty cash. Likewise, it may not permit use of the fund for certain types of transactions (such as making short-term loans to employees).

Each payment from the fund must be documented on a prenumbered petty cash receipt (or petty cash voucher), as shown in Illustration 8-7. The signatures of both the fund custodian and the person receiving payment are required on the receipt. If other supporting documents such as a freight bill or invoice are available, they should be attached to the petty cash receipt.

**Helpful Hint**
The petty cash receipt satisfies two internal control procedures: (1) establishing responsibility (signature of custodian), and (2) documentation procedures.

**Illustration 8-7**
Petty cash receipt

No. 7

LAIRD COMPANY
Petty Cash Receipt

Date 3/6/17

Paid to Acme Express Agency

Amount $18.00

For Collect Express Charges

CHARGE TO Freight-in

Approved

L. A. Bird Custodian

Received Payment

R. E. Meins

The petty cash custodian keeps the receipts in the petty cash box until the fund is replenished. The sum of the petty cash receipts and the money in the fund should equal the established total at all times. Management can (and should) make surprise counts at any time to determine whether the fund is being maintained correctly.

The company does not make an accounting entry to record a payment when it is made from petty cash. It is considered both inexpedient and unnecessary to do so. Instead, the company recognizes the accounting effects of each payment when it replenishes the fund.

**ETHICS NOTE**

Internal control over a petty cash fund is strengthened by (1) having a supervisor make surprise counts of the fund to confirm whether the paid petty cash receipts and fund cash equal the imprest amount, and (2) canceling or mutilating the paid petty cash receipts so they cannot be resubmitted for reimbursement.

## REPLENISHING THE PETTY CASH FUND

When the money in the petty cash fund reaches a minimum level, the company replenishes the fund. The petty cash custodian initiates a request for reimbursement. 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. The treasurer's office examines the receipts and supporting documents to verify that proper payments from the fund were made. The treasurer then approves the request and issues a check to restore the fund to its established amount. 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 Laird's petty cash custodian requests a check for $87. The fund contains $13 cash and petty cash receipts for postage $44, freight-out $38, and miscellaneous expenses $5. The general journal entry to record the check is as follows.

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

| A | = | L | + | OE |
|---|---|---|---|---|
| | | | | −44 Exp |
| | | | | −38 Exp |
| | | | | −5 Exp |
| −87 | | | | |

Cash Flows
−87

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

Occasionally, in replenishing a petty cash fund, the company may need to recognize a cash shortage or overage. This results when the total of the cash plus receipts in the petty cash box does not equal the established amount of the petty cash fund. To illustrate, assume that Laird's petty cash custodian has only $12 in cash in the fund plus the receipts as listed. The request for reimbursement would therefore be for $88, and Laird would make the following entry.

| A | = | L | + | OE |
|---|---|---|---|---|
| | | | | −44 Exp |
| | | | | −38 Exp |
| | | | | −5 Exp |
| | | | | −1 Exp |
| −88 | | | | |

**Cash Flows**
−88

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

Conversely, if the custodian has $14 in cash, the reimbursement request would be for $86. The company would credit Cash Over and Short for $1 (overage). A company reports a debit balance in Cash Over and Short in the income statement as miscellaneous expense. It reports a credit balance in the account as miscellaneous revenue. The company closes Cash Over and Short to Income Summary at the end of the year.

Companies should replenish a petty cash fund at the end of the accounting period, regardless of the cash in the fund. Replenishment at this time is necessary in order to recognize the effects of the petty cash payments on the financial statements.

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

## Ethics Insight

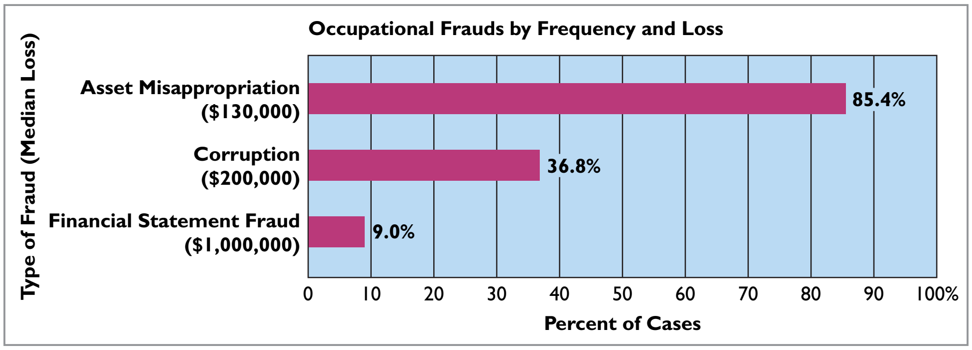
© Chris Fernig/iStockphoto

### How Employees Steal

Occupational fraud is using your own occupation for personal gain through the misuse or misapplication of the company's resources or assets. This type of fraud is one of three types:

1. **Asset misappropriation**, such as theft of cash on hand, fraudulent disbursements, false refunds, ghost employees, personal purchases, and fictitious employees. This fraud is the most common but the least costly.
2. **Corruption**, such as bribery, illegal gratuities, and economic extortion. This fraud generally falls in the middle between asset misappropriation and financial statement fraud as regards frequency and cost.
3. **Financial statement fraud**, such as fictitious revenues, concealed liabilities and expenses, improper disclosures, and improper asset values. This fraud occurs less frequently than other types of fraud but it is the most costly.

The graph below shows the frequency and the median loss for each type of occupational fraud.




*Source: 2014 Report to the Nations on Occupational Fraud and Abuse*, Association of Certified Fraud Examiners, pp. 10–12.

How can companies reduce the likelihood of occupational fraud? (Go to **WileyPLUS** for this answer and additional questions.)

## DO IT! 2b Petty Cash Fund

Bateer Company established a $50 petty cash fund on July 1. On July 30, the fund had $12 cash remaining and petty cash receipts for postage $14, office supplies $10, and delivery expense $15. Prepare journal entries to establish the fund on July 1 and to replenish the fund on July 30.

### Solution

| | | | |
|---|---|---|---|
| July 1 | Petty Cash | 50 | |
| | Cash | | 50 |
| | (To establish petty cash fund) | | |
| 30 | Postage Expense | 14 | |
| | Supplies | 10 | |
| | Delivery Expense | 15 | |
| | Cash Over and Short | | 1 |
| | Cash ($50 − $12) | | 38 |
| | (To replenish petty cash) | | |

Related exercise material: **BE8-9, E8-7, E8-8, and DO IT! 8-2b.**

**Action Plan**

- ✔ To establish the fund, set up a separate general ledger account.
- ✔ Determine how much cash is needed to replenish the fund: subtract the cash remaining from the petty cash fund balance.
- ✔ Total the petty cash receipts. Determine any cash over or short—the difference between the cash needed to replenish the fund and the total of the petty cash receipts.
- ✔ Record the expenses incurred according to the petty cash receipts when replenishing the fund.

## LEARNING OBJECTIVE 3 Identify the control features of a bank account.

**The use of a bank contributes significantly to good internal control over cash.** A company can safeguard its cash by using a bank as a depository and as a clearinghouse for checks received and written. Use of a bank minimizes the amount of currency that a company must keep on hand. Also, use of a bank facilitates the control of cash because it creates a double record of all bank transactions—one by the company and the other by the bank. The asset account Cash maintained by the company should have the same balance as the bank's liability account for that company. A **bank reconciliation** compares the bank's balance with the company's balance and explains any differences to make them agree.

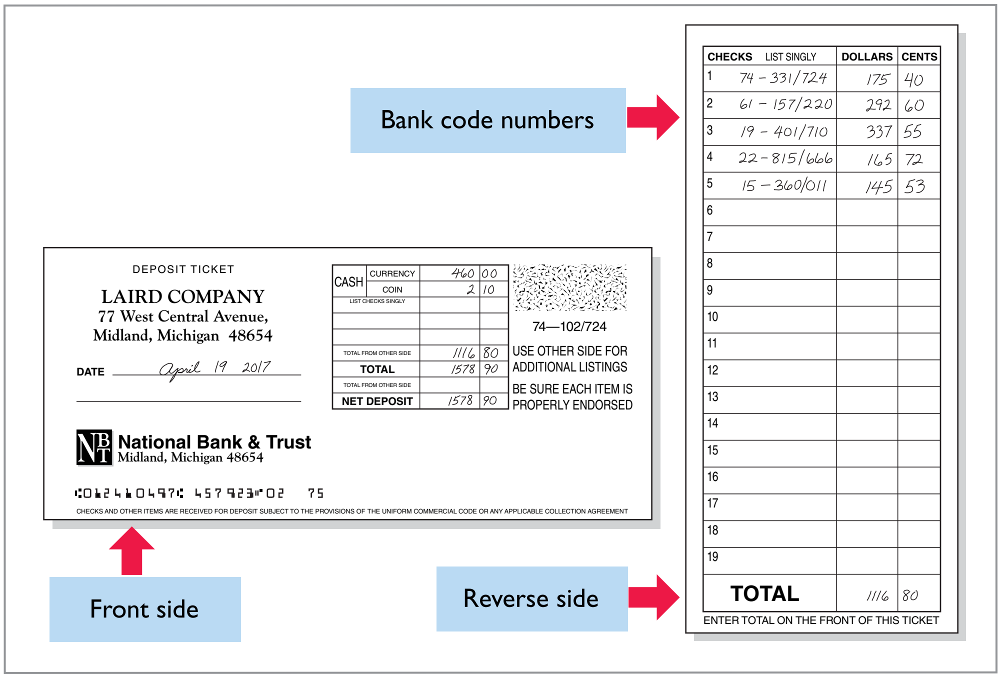
Many companies have more than one bank account. For efficiency of operations and better control, national retailers like Wal-Mart Stores, Inc. and Target may have regional bank accounts. Large companies, with tens of thousands of employees, may have a payroll bank account, as well as one or more general bank accounts. Also, a company may maintain several bank accounts in order to have more than one source for short-term loans when needed.

### Making Bank Deposits

An authorized employee, such as the head cashier, should make a company's bank deposits. Each deposit must be documented by a deposit slip (ticket), as shown in Illustration 8-8 (page 374).

Deposit slips are prepared in duplicate. The bank retains the original; the depositor keeps the duplicate, machine-stamped by the bank to establish its authenticity.

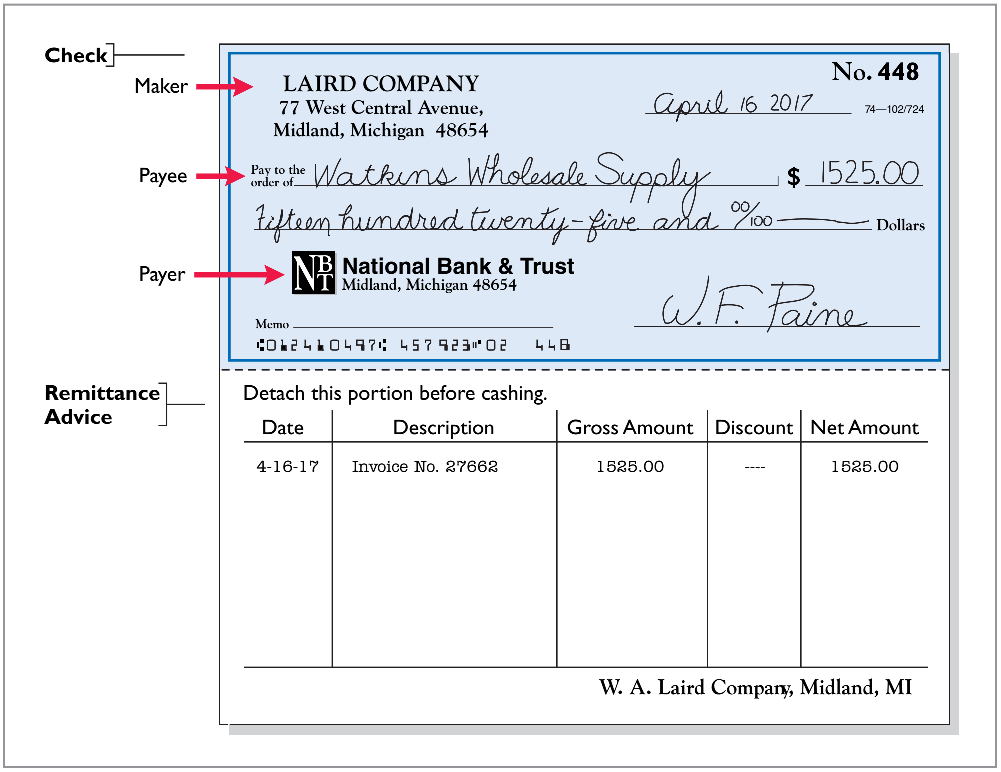
**Illustration 8-8**
Deposit slip




## Writing Checks

A **check** is a written order signed by the depositor directing the bank to pay a specified sum of money to a designated recipient. There are three parties to a check: (1) the **maker** (or drawer) who issues the check, (2) the **bank** (or payer) on which the check is drawn, and (3) the **payee** to whom the check is payable. A check is a **negotiable instrument** that one party can transfer to another party by endorsement. Each check should be accompanied by an explanation of its purpose. In many companies, a remittance advice attached to the check, as shown in Illustration 8-9, explains the check's purpose.

**Illustration 8-9**
Check with remittance advice



It is important to know the balance in the checking account at all times. To keep the balance current, the depositor should enter each deposit and check on running-balance memo forms (or online statements) provided by the bank or on the check stubs in the checkbook.

## Bank Statements

If you have a personal checking account, you are probably familiar with bank statements. A **bank statement** shows the depositor's bank transactions and balances.[4] Each month, a depositor receives a statement from the bank. Illustration 8-10 presents a typical bank statement for Laird Company. It shows (1) checks paid and other debits (such as debit card transactions or direct withdrawals for bill payments) 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.

**Helpful Hint**
Essentially, the bank statement is a copy of the bank's records sent to the customer (or available online) for review.

**Illustration 8-10**
Bank statement

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

**ACCOUNT STATEMENT**

LAIRD COMPANY
77 WEST CENTRAL AVENUE
MIDLAND, MICHIGAN 48654

Statement Date/Credit Line Closing Date: April 30, 2017

457923
ACCOUNT NUMBER

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

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

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

Reconcile Your Account Promptly

**Helpful Hint**
The bank *credits* to the customer's account every deposit it receives. The reverse occurs when the bank "pays" a check issued by a company on its checking account balance. Payment reduces the bank's liability. Thus, the bank *debits* check payments to the customer's account with the bank.

The bank statement lists in numerical sequence all "paid" checks, along with the date the check was paid and its amount. Upon paying a check, the bank stamps the check "paid"; a paid check is sometimes referred to as a **canceled** check. On the statement, the bank also includes memoranda explaining other debits and credits it made to the depositor's account.

[4] Our presentation assumes that the depositor makes all adjustments at the end of the month. In practice, a company may also make journal entries during the month as it reviews information from the bank regarding its account.

### DEBIT MEMORANDUM

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

Banks also use a debit memorandum when a deposited check from a customer "bounces" because of insufficient funds. For example, assume that J. R. Baron, a customer of Laird Company, sends a check for $425.60 to Laird Company for services performed. Unfortunately, Baron does not have sufficient funds at its bank to pay for these services. In such a case, Baron's bank marks the check **NSF** (not sufficient funds) and returns it to Laird's (the depositor's) bank. Laird's bank then debits Laird's account, as shown by the symbol NSF on the bank statement in Illustration 8-10. The bank sends the NSF check and debit memorandum to Laird as notification of the charge. Laird then records an Account Receivable from J. R. Baron (the writer of the bad check) and reduces cash for the NSF check.

### CREDIT MEMORANDUM

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

## Reconciling the Bank Account

The bank and the depositor maintain independent records of the depositor's checking account. People tend to assume that the respective balances will always agree. In fact, the two balances are seldom the same at any given time, and both balances differ from the "correct" or "true" balance. Therefore, it is necessary to make the balance per books and the balance per bank agree with the correct or true amount—a process called **reconciling the bank account**. The need for agreement has two causes:

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

Time lags occur frequently. For example, several days may elapse between the time a company mails a check to a payee and the date the bank pays the check. Similarly, when the depositor uses the bank's night depository to make its deposits, there will be a difference of at least one day between the time the depositor records the deposit and the time the bank does so. A time lag also occurs whenever the bank mails a debit or credit memorandum to the depositor.

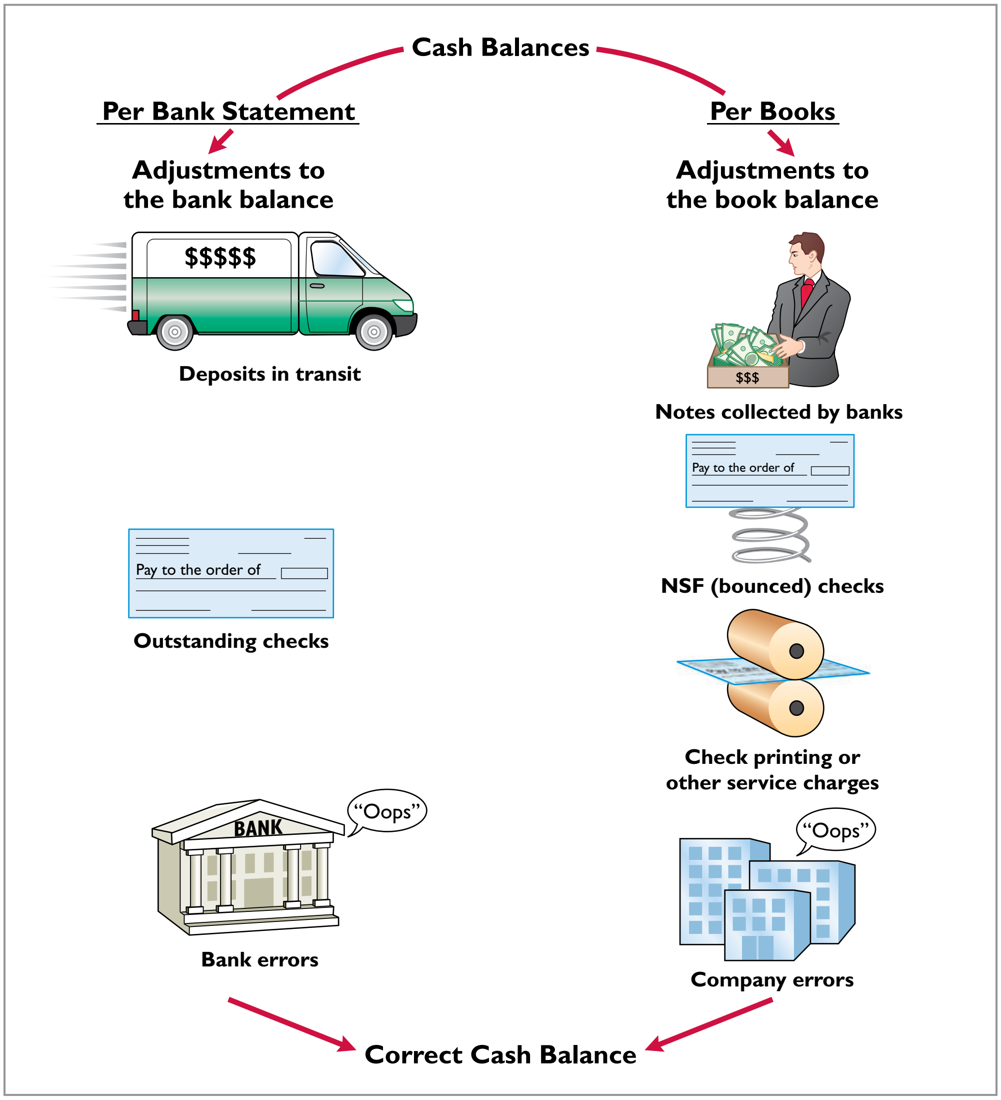
The incidence of errors depends on the effectiveness of the internal controls maintained by the company and the bank. Bank errors are infrequent. However, either party could accidentally record a $450 check as $45 or $540. In addition, the bank might mistakenly charge a check drawn by C. D. Berg to the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

### RECONCILIATION PROCEDURE

**The bank reconciliation should be prepared by an employee who has no other responsibilities pertaining to cash.** If a company fails to follow this internal control principle of independent internal verification, cash embezzlements may go unnoticed. For example, a cashier who prepares the reconciliation can embezzle cash and conceal the embezzlement by misstating the reconciliation. Thus, the bank accounts would reconcile, and the embezzlement would not be detected.

In reconciling the bank account, it is customary to reconcile the balance per books and balance per bank to their adjusted (correct or true) cash balances. The starting point in preparing the reconciliation is to enter the balance per bank statement and balance per books on the reconciliation schedule. The company then makes various adjustments, as shown in Illustration 8-11.

**Illustration 8-11**
Bank reconciliation adjustments




The following steps should reveal all the reconciling items that cause the difference between the two balances.

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

**Step 1. Deposits in transit.** Compare the individual deposits listed on the bank statement with deposits in transit from the preceding bank reconciliation and with the deposits per company records or duplicate deposit slips. Deposits recorded by the depositor that have not been recorded by the bank are the **deposits in transit**. Add these deposits to the balance per bank.

**Step 2. Outstanding checks.** Compare the paid checks shown on the bank statement with (a) checks outstanding from the previous bank reconciliation, and (b) checks issued by the company as recorded in the cash payments journal (or in the check register in your personal checkbook). Issued checks recorded by the company but that have not yet been paid by the bank are **outstanding checks**. Deduct outstanding checks from the balance per bank.

**Step 3.** **Errors.** Note any errors discovered in the foregoing steps and list them in the appropriate section of the reconciliation schedule. For example, if the company mistakenly recorded as $169 a paid check correctly written for $196, it would deduct the error of $27 from the balance per books. All errors made by the depositor are reconciling items in determining the adjusted cash balance per books. In contrast, all errors made by the bank are reconciling items in determining the adjusted cash balance per bank.

**Step 4.** **Bank memoranda.** Trace bank memoranda to the depositor's records. List in the appropriate section of the reconciliation schedule any unrecorded memoranda. For example, the company would deduct from the balance per books a $5 debit memorandum for bank service charges. Similarly, it would add to the balance per books $32 of interest earned.

## BANK RECONCILIATION ILLUSTRATED

**Helpful Hint**
Note in the bank statement in Illustration 8-10 that checks no. 459 and 461 have been paid but check no. 460 is not listed. Thus, this check is outstanding. If a complete bank statement were provided, checks no. 453 and 457 would also not be listed. The amounts for these three checks are obtained from the company's cash payments records.

The bank statement for Laird Company (Illustration 8-10) shows a balance per bank of $15,907.45 on April 30, 2017. On this date the balance of cash per books is $11,589.45. Using the four reconciliation steps, Laird determines the following reconciling items.

| | | |
|---|---|---|
| **Step 1.** | **Deposits in transit:** April 30 deposit (received by bank on May 1). | $2,201.40 |
| **Step 2.** | **Outstanding checks:** No. 453, $3,000.00; no. 457, $1,401.30; no. 460, $1,502.70. | 5,904.00 |
| **Step 3.** | **Errors:** Laird wrote check no. 443 for $1,226.00 and the bank correctly paid that amount. However, Laird recorded the check as $1,262.00. | 36.00 |
| **Step 4.** | **Bank memoranda:** | |
| | **a.** Debit—NSF check from J. R. Baron for $425.60. | 425.60 |
| | **b.** Debit—Charge for printing company checks $30.00. | 30.00 |
| | **c.** Credit—Collection of note receivable for $1,000 plus interest earned $50, less bank collection fee $15.00. | 1,035.00 |

Illustration 8-12 shows Laird's bank reconciliation.

**Illustration 8-12**
Bank reconciliation

**LAIRD COMPANY**
Bank Reconciliation
April 30, 2017

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

**Alternative Terminology**
The terms *adjusted cash balance, true cash balance,* and *correct cash balance* are used interchangeably.

## ENTRIES FROM BANK RECONCILIATION

The company records each reconciling item used to determine the **adjusted cash balance per books**. **If the company does not journalize and post these items, the Cash account will not show the correct balance.** Laird Company would make the following entries on April 30.

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

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

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

| A | = | L | + | OE |
|---|---|---|---|---|
| +1,035 | | | | |
| | | | | −15 Exp |
| −1,000 | | | | |
| | | | | +50 Rev |

**Cash Flows**
+1,035

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

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

| A | = | L | + | OE |
|---|---|---|---|---|
| +36 | | | | |
| | | +36 | | |

**Cash Flows**
+36

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

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

| A | = | L | + | OE |
|---|---|---|---|---|
| +425.60 | | | | |
| −425.60 | | | | |

**Cash Flows**
−425.60

**BANK SERVICE CHARGES** Depositors debit check printing charges (DM) and other bank service charges (SC) to Miscellaneous Expense because they are usually nominal in amount. The entry is:

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

| A | = | L | + | OE |
|---|---|---|---|---|
| | | | | −30 Exp |
| −30 | | | | |

**Cash Flows**
−30

Instead of making four separate entries, Laird could combine them into one compound entry.

After Laird has posted the entries, the Cash account will show the following.

**Illustration 8-13** Adjusted balance in Cash account

| Cash | | | |
|---|---|---|---|
| Apr. 30 Bal. | 11,589.45 | Apr. 30 | 425.60 |
| 30 | 1,035.00 | 30 | 30.00 |
| 30 | 36.00 | | |
| Apr. 30 Bal. | **12,204.85** | | |

The adjusted cash balance in the ledger should agree with the adjusted cash balance per books in the bank reconciliation in Illustration 8-12 (page 378).

What entries does the bank make? If the company discovers any bank errors in preparing the reconciliation, it should notify the bank. The bank then can make the necessary corrections in its records. The bank does not make any entries for deposits in transit or outstanding checks. Only when these items reach the bank will the bank record these items.

## Electronic Funds Transfer (EFT) System

It is not surprising that companies and banks have developed approaches to transfer funds among parties without the use of paper (deposit tickets, checks, etc.). Such procedures, called **electronic funds transfers (EFT)**, are disbursement systems that use wire, telephone, or computers to transfer cash balances from one location to another. Use of EFT is quite common. For example, many employees receive no formal payroll checks from their employers. Instead, employers send electronic payroll data to the appropriate banks. Also, individuals and companies now frequently make regular payments such as those for house, car, and utilities by EFT.

EFT transactions normally result in better internal control since no cash or checks are handled by company employees. This does not mean that opportunities for fraud are eliminated. In fact, the same basic principles related to internal control apply to EFT transfers. For example, without proper segregation of duties and authorizations, an employee might be able to redirect electronic payments into a personal bank account and conceal the theft with fraudulent accounting entries.

### Investor Insight

Mary Altaffer/©AP/Wide World Photos

**Madoff's Ponzi Scheme**

No recent fraud has generated more interest and rage than the one perpetrated by Bernard Madoff. Madoff was an elite New York investment fund manager who was highly regarded by securities regulators. Investors flocked to him because he delivered very steady returns of between 10% and 15%, no matter whether the market was going up or going down. However, for many years, Madoff did not actually invest the cash that people gave to him. Instead, he was running a Ponzi scheme: He paid returns to existing investors using cash received from new investors. As long as the size of his investment fund continued to grow from new investments at a rate that exceeded the amounts that he needed to pay out in returns, Madoff was able to operate his fraud smoothly.

To conceal his misdeeds, Madoff fabricated false investment statements that were provided to investors. In addition, Madoff hired an auditor that never verified the accuracy of the investment records but automatically issued unqualified opinions each year. Although a competing fund manager warned the SEC a number of times over a nearly 10-year period that he thought Madoff was engaged in fraud, the SEC never aggressively investigated the allegations. Investors, many of which were charitable organizations, lost more than $18 billion. Madoff was sentenced to a jail term of 150 years.

How was Madoff able to conceal such a giant fraud? (Go to **WileyPLUS** for this answer and additional questions.)

### DO IT! 3 Bank Reconciliation

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

**Solution**

Sally should treat the reconciling items as follows.
(1) NSF check: Deduct from balance per books.
(2) Collection of note: Add to balance per books.
(3) Outstanding checks: Deduct from balance per bank.
(4) Deposit in transit: Add to balance per bank.

Related exercise material: **BE8-11, BE8-12, BE8-13, BE8-14, E8-9, E8-10, E8-11, E8-12, E8-13, and DO IT! 8-3.**

**Action Plan**

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

LEARNING OBJECTIVE 4

## Explain the reporting of cash.

**Cash** consists of coins, currency (paper money), checks, money orders, and money on hand or on deposit in a bank or similar depository. Companies report cash 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. The statement of cash flows was introduced in Chapter 1 and will be discussed in much detail in Chapter 17. In this section, we discuss some important points regarding the presentation of cash in the balance sheet.

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 assets section of the balance sheet.

### Cash Equivalents

Many companies use the designation "Cash and cash equivalents" in reporting cash. (See Illustration 8-14 for an example.) **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. Generally, only investments with original maturities of three months or less qualify under this definition.

**Illustration 8-14**
Balance sheet presentation of cash

Real World

**DELTA AIR LINES, INC.**
Balance Sheet (partial)
December 31, 2013 (in millions)

| | |
|---|---|
| **Assets** | |
| Current assets | |
| **Cash and cash equivalents** | **$2,844** |
| Short-term investments | 959 |
| **Restricted cash** | **122** |

Examples of cash equivalents are Treasury bills, commercial paper (short-term corporate notes), and money market funds. All typically are purchased with cash that is in excess of immediate needs.

**ETHICS NOTE**

Recently, some companies were forced to restate their financial statements because they had too broadly interpreted which types of investments could be treated as cash equivalents. By reporting these items as cash equivalents, the companies made themselves look more liquid.

Occasionally, a company will have a net negative balance in its bank account. In this case, the company should report the negative balance among current liabilities. For example, farm equipment manufacturer Ag-Chem recently reported "Checks outstanding in excess of cash balances" of $2,145,000 among its current liabilities.

## Restricted Cash

A company may have **restricted cash**, cash that is not available for general use but rather is restricted for a special purpose. For example, landfill companies are often required to maintain a fund of restricted cash to ensure they will have adequate resources to cover closing and clean-up costs at the end of a landfill site's useful life. McKesson Corp. recently reported restricted cash of $962 million to be paid out as the result of investor lawsuits.

Cash restricted in use should be reported separately on the balance sheet as restricted cash. If the company expects to use the restricted cash within the next year, it reports the amount as a current asset. When this is not the case, it reports the restricted funds as a noncurrent asset.

Illustration 8-14 shows restricted cash reported in the financial statements of Delta Air Lines. The company is required to maintain restricted cash as collateral to support insurance obligations related to workers' compensation claims. Delta does not have access to these funds for general use, and so it must report them separately, rather than as part of cash and cash equivalents.

## DO IT! 4 Reporting Cash

Indicate whether each of the following statements is true or false.

1. Cash and cash equivalents are comprised of coins, currency (paper money), money orders, and NSF checks.
2. Restricted cash is classified as either a current asset or noncurrent asset, depending on the circumstances.
3. A company may have a negative balance in its bank account. In this case, it should offset this negative balance against cash and cash equivalents on the balance sheet.
4. Because cash and cash equivalents often includes short-term investments, accounts receivable should be reported as the first item on the balance sheet.

**Action Plan**

✔ Understand how companies present cash and restricted cash on the balance sheet.

✔ Review the designations of cash equivalents and restricted cash, and how companies typically handle them.

### Solution

**1.** False. NSF checks should be reported as receivables, not cash and cash equivalents. **2.** True. **3.** False. Companies that have a negative balance in their bank accounts should report the negative balance as a current liability. **4.** False. Cash equivalents are readily convertible to known amounts of cash, and so near maturity (less than 3 months) that they are considered more liquid than accounts receivable and therefore are reported before accounts receivable on the balance sheet.

Related exercise material: **E8-14, E8-15, and DO IT! 8-4.**

# REVIEW AND PRACTICE

## LEARNING OBJECTIVES REVIEW

**1 Discuss fraud and the principles of internal control.** A fraud is a dishonest act by an employee that results in personal benefit to the employee at a cost to the employer. The fraud triangle refers to the three factors that contribute to fraudulent activity by employees: opportunity, financial pressure, and rationalization. Internal control consists of all the related methods and measures adopted within an organization to safeguard its assets, enhance the reliability of its accounting records, increase efficiency of operations, and ensure compliance with laws and regulations.

The principles of internal control are establishment of responsibility, segregation of duties, documentation procedures, physical controls, independent internal verification, and human resource controls such as bonding and requiring employees to take vacations.

2 **Apply internal control principles to cash.** Internal controls over cash receipts include (a) designating specific personnel to handle cash; (b) assigning different individuals to receive cash, record cash, and maintain custody of cash; (c) using remittance advices for mail receipts, cash register tapes for over-the-counter receipts, and deposit slips for bank deposits; (d) using company safes and bank vaults to store cash with access limited to authorized personnel, and using cash registers in executing over-the-counter receipts; (e) making independent daily counts of register receipts and daily comparison of total receipts with total deposits; and (f) bonding personnel that handle cash and requiring them to take vacations.

Internal controls over cash disbursements include (a) having specific individuals such as the treasurer authorized to sign checks and approve vendors; (b) assigning different individuals to approve items for payment, make the payment, and record the payment; (c) using prenumbered checks and accounting for all checks, with each check supported by an approved invoice; (d) storing blank checks in a safe or vault with access restricted to authorized personnel, and using a check-writing machine to imprint amounts on checks; (e) comparing each check with the approved invoice before issuing the check, and making monthly reconciliations of bank and book balances; and (f) bonding personnel who handle cash, requiring employees to take vacations, and conducting background checks.

Companies operate a petty cash fund to pay relatively small amounts of cash. They must establish the fund, make payments from the fund, and replenish the fund when the cash in the fund reaches a minimum level.

3 **Identify the control features of a bank account.** A bank account contributes to good internal control by providing physical controls for the storage of cash. It minimizes the amount of currency that a company must keep on hand, and it creates a double record of a depositor's bank transactions. It is customary to reconcile the balance per books and balance per bank to their adjusted balances. The steps in the reconciling process are to determine deposits in transit, outstanding checks, errors by the depositor or the bank, and unrecorded bank memoranda.

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

## GLOSSARY REVIEW

**Bank reconciliation** The process of comparing the bank's balance of an account with the company's balance and explaining any differences to make them agree. (p. 373).

**Bank service charge** A fee charged by a bank for the use of its services. (p. 376).

**Bank statement** A monthly statement from the bank that shows the depositor's bank transactions and balances. (p. 375).

**Bonding** Obtaining insurance protection against theft by employees. (p. 363).

**Cash** Resources that consist of coins, currency, checks, money orders, and money on hand or on deposit in a bank or similar depository. (p. 381).

**Cash equivalents** Short-term, highly liquid investments that can be converted to a specific amount of cash. (p. 381).

**Check** A written order signed by a bank depositor, directing the bank to pay a specified sum of money to a designated recipient. (p. 374).

**Deposits in transit** Deposits recorded by the depositor but not yet recorded by the bank. (p. 377).

**Electronic funds transfer (EFT)** A disbursement system that uses wire, telephone, or computers to transfer funds from one location to another. (p. 380).

**Fraud** A dishonest act by an employee that results in personal benefit to the employee at a cost to the employer. (p. 356).

**Fraud triangle** The three factors that contribute to fraudulent activity by employees: opportunity, financial pressure, and rationalization. (p. 356).

**Internal auditors** Company employees who continuously evaluate the effectiveness of the company's internal control system. (p. 363).

**Internal control** A process designed to provide reasonable assurance regarding the achievement of objectives related to operations, reporting, and compliance. (p. 357).

**NSF check** A check that is not paid by a bank because of insufficient funds in a customer's bank account. (p. 376).

**Outstanding checks** Checks issued and recorded by a company but not yet paid by the bank. (p. 377).

**Petty cash fund** A cash fund used to pay relatively small amounts. (p. 370).

**Restricted cash** Cash that must be used for a special purpose. (p. 382).

**Sarbanes-Oxley Act (SOX)** Regulations passed by Congress to try to reduce unethical corporate behavior. (p. 356).

**Voucher** An authorization form prepared for each payment in a voucher system. (p. 369).

**Voucher system** A network of approvals by authorized individuals acting independently to ensure that all disbursements by check are proper. (p. 369).

## PRACTICE MULTIPLE-CHOICE QUESTIONS

(LO 1) 1. Which of the following is **not** an element of the fraud triangle?
(a) Rationalization.
(b) Financial pressure.
(c) Segregation of duties.
(d) Opportunity.

(LO 1) 2. An organization uses internal control to enhance the accuracy and reliability of accounting records and to:
(a) safeguard assets.
(b) prevent fraud.
(c) produce correct financial statements.
(d) deter employee dishonesty.

(LO 1) 3. Which of the following was **not** a result of the Sarbanes-Oxley Act?
(a) Companies must file financial statements with the Internal Revenue Service.
(b) All publicly traded companies must maintain adequate internal controls.
(c) The Public Company Accounting Oversight Board was created to establish auditing standards and regulate auditor activity.
(d) Corporate executives and board of directors must ensure that controls are reliable and effective, and they can be fined or imprisoned for failure to do so.

(LO 1) 4. The principles of internal control do **not** include:
(a) establishment of responsibility.
(b) documentation procedures.
(c) management responsibility.
(d) independent internal verification.

(LO 1) 5. Physical controls do **not** include:
(a) safes and vaults to store cash.
(b) independent bank reconciliations.
(c) locked warehouses for inventories.
(d) bank safety deposit boxes for important papers.

(LO 1) 6. Which of the following control activities is **not** relevant when a company uses a computerized (rather than manual) accounting system?
(a) Establishment of responsibility.
(b) Segregation of duties.
(c) Independent internal verification.
(d) All of these control activities are relevant to a computerized system.

(LO 2) 7. Permitting only designated personnel to handle cash receipts is an application of the principle of:
(a) segregation of duties.
(b) establishment of responsibility.
(c) independent internal verification.
(d) human resource controls.

8. The use of prenumbered checks in disbursing cash is an application of the principle of: (LO 2)
(a) establishment of responsibility.
(b) segregation of duties.
(c) physical controls.
(d) documentation procedures.

9. A company writes a check to replenish a \$100 petty cash fund when the fund contains receipts of \$94 and \$4 in cash. In recording the check, the company should: (LO 2)
(a) debit Cash Over and Short for \$2.
(b) debit Petty Cash for \$94.
(c) credit Cash for \$94.
(d) credit Petty Cash for \$2.

10. The control features of a bank account do **not** include: (LO 3)
(a) having bank auditors verify the correctness of the bank balance per books.
(b) minimizing the amount of cash that must be kept on hand.
(c) providing a double record of all bank transactions.
(d) safeguarding cash by using a bank as a depository.

11. In a bank reconciliation, deposits in transit are: (LO 3)
(a) deducted from the book balance.
(b) added to the book balance.
(c) added to the bank balance.
(d) deducted from the bank balance.

12. The reconciling item in a bank reconciliation that will result in an adjusting entry by the depositor is: (LO 3)
(a) outstanding checks. (c) a bank error.
(b) deposit in transit. (d) bank service charges.

13. Which of the following items in a cash drawer at November 30 is **not** cash? (LO 4)
(a) Money orders.
(b) Coins and currency.
(c) An NSF check.
(d) A customer check dated November 28.

14. Which of the following statements correctly describes the reporting of cash? (LO 4)
(a) Cash cannot be combined with cash equivalents.
(b) Restricted cash funds may be combined with cash.
(c) Cash is listed first in the current assets section.
(d) Restricted cash funds cannot be reported as a current asset.

## Solutions

**1. (c)** Segregation of duties is not an element of the fraud triangle. The other choices are fraud triangle elements.

**2. (a)** Safeguarding assets is one of the purposes of using internal control. The other choices are incorrect because while internal control can help to (b) prevent fraud, (c) produce correct financial statements, and (d) deter employee dishonesty, it is not one of the main purposes of using it.

**3. (a)** Filing financial statements with the IRS is not a result of the Sarbanes-Oxley Act (SOX); SOX focuses on the prevention or detection of fraud. The other choices are results of SOX.

**4. (c)** Management responsibility is not one of the principles of internal control. The other choices are true statements.

**5. (b)** Independent bank reconciliations are not a physical control. The other choices are true statements.

**6. (d)** Establishment of responsibility, segregation of duties and independent internal verification are all relevant to a computerized system.

**7. (b)** Permitting only designated personnel to handle cash receipts is an application of the principle of establishment of responsibility, not (a) segregation of duties, (c) independent internal verification, or (d) human resource controls.

**8. (d)** The use of prenumbered checks in disbursing cash is an application of the principle of documentation procedures, not (a) establishment of responsibility, (b) segregation of duties, or (c) physical controls.

**9. (a)** When this check is recorded, the company should debit Cash Over and Short for the shortage of $2 (total of the receipts plus cash in the drawer ($98) versus $100), not (b) debit Petty Cash for $94, (c) credit Cash for $94, or (d) credit Petty Cash for $2.

**10. (a)** Having bank auditors verify the correctness of the bank balance per books is not one of the control features of a bank account. The other choices are true statements.

**11. (c)** Deposits in transit are added to the bank balance on a bank reconciliation, not (a) deducted from the book balance, (b) added to the book balance, or (d) deducted from the bank balance.

**12. (d)** Because the depositor does not know the amount of the bank service charges until the bank statements is received, an adjusting entry must be made when the statement is received. The other choices are incorrect because (a) outstanding checks do not require an adjusting entry by the depositor because the checks have already been recorded in the depositor's books, (b) deposits in transit do not require an adjusting entry by the depositor because the deposits have already been recorded in the depositor's books, and (c) bank errors do not require an adjusting entry by the depositor, but the depositor does need to inform the bank of the error so it can be corrected.

**13. (c)** An NSF check should not be considered cash. The other choices are true statements.

**14. (c)** Cash is listed first in the current assets section. The other choices are incorrect because (a) cash and cash equivalents can be appropriately combined when reporting cash on the balance sheet, (b) restricted cash is not to be combined with cash when reporting cash on the balance sheet, and (d) restricted funds can be reported as current assets if they will be used within one year.

## PRACTICE EXERCISES

*Indicate good or weak internal control procedures.* (LO 1, 2)

**1.** Listed below are five procedures followed by Viel Company.

1. Total cash receipts are compared to bank deposits daily by Vonda Marshall, who receives cash over the counter.
2. Employees write down hours worked and turn in the sheet to the cashier's office.
3. As a cost-saving measure, employees do not take vacations.
4. Only the sales manager can approve credit sales.
5. Three different employees are assigned one task each related to inventory: ship goods to customers, bill customers, and receive payment from customers.

### Instructions

Indicate whether each procedure is an example of good internal control or of weak internal control. If it is an example of good internal control, indicate which internal control principle is being followed. If it is an example of weak internal control, indicate which internal control principles is violated. Use the table below.

| Procedure | IC Good or Weak? | Related Internal Control Principle |
|---|---|---|
| 1. | | |
| 2. | | |
| 3. | | |
| 4. | | |
| 5. | | |

## Solution

1.

| Procedure | IC Good or Weak? | Related Internal Control Principle |
|---|---|---|
| 1. | Weak | Independent internal verification |
| 2. | Weak | Physical controls |
| 3. | Weak | Human resource controls |
| 4. | Good | Establishment of responsibility |
| 5. | Good | Segregation of duties |

*Prepare bank reconciliation and adjusting entries.*
(LO 3)

**2.** The information below relates to the Cash account in the ledger of Hillfarms Company.

Balance June 1—$9,947; Cash deposited—$37,120.
Balance June 30—$10,094; Checks written—$36,973.

The June bank statement shows a balance of $9,525 on June 30 and the following memoranda.

| Credits | | Debits | |
|---|---|---|---|
| Collection of $850 note plus interest $34 | $884 | NSF check: R. Doll | $245 |
| Interest earned on checking accounts | $26 | Safety deposit box rent | $35 |

At June 30, deposits in transit were $2,581, and outstanding checks totaled $1,382.

## Instructions

(a) Prepare the bank reconciliation at June 30.

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

## Solution

2. (a)

**HILLFARMS COMPANY**
**Bank Reconciliation**
**June 30**

| | | |
|---|---|---|
| Cash balance per bank statement | | $ 9,525 |
| Add: Deposits in transit | | 2,581 |
| | | 12,106 |
| Less: Outstanding checks | | 1,382 |
| Adjusted cash balance per bank | | $10,724 |
| Cash balance per books | | $10,094 |
| Add: Collection of note receivable ($850 + $34) | $884 | |
| Interest earned | 26 | 910 |
| | | 11,004 |
| Less: NSF check | 245 | |
| Safety deposit box rent | 35 | 280 |
| Adjusted cash balance per books | | $10,724 |

(b)

| Date | Account | Debit | Credit |
|---|---|---|---|
| June 30 | Cash | 884 | |
| | Notes Receivable | | 850 |
| | Interest Revenue | | 34 |
| 30 | Cash | 26 | |
| | Interest Revenue | | 26 |
| 30 | Miscellaneous Expense | 35 | |
| | Cash | | 35 |
| 30 | Accounts Receivable (R. Doll) | 245 | |
| | Cash | | 245 |

## PRACTICE PROBLEM

*Prepare bank reconciliation and journalize entries.*

(LO 3)

Poorten Company's bank statement for May 2017 shows the following data.

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

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

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

### Instructions

(a) Prepare a bank reconciliation at May 31.

(b) Journalize the entries required by the reconciliation.

### Solution

(a)

**POORTEN COMPANY**
**Bank Reconciliation**
**May 31, 2017**

| | | |
|---|---|---|
| Cash balance per bank statement | | $14,280 |
| Add: Deposits in transit | | 1,752 |
| | | 16,032 |
| Less: Outstanding checks | | 2,410 |
| Adjusted cash balance per bank | | $13,622 |
| Cash balance per books | | $13,319 |
| Add: Collection of note receivable $500, plus $15 interest, less collection fee $10 | | 505 |
| | | 13,824 |
| Less: NSF check | $175 | |
| Error in recording check | 27 | 202 |
| Adjusted cash balance per books | | $13,622 |

(b)

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

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## QUESTIONS

1. A local bank reported that it lost $150,000 as the result of an employee fraud. Edward Jasso is not clear on what is meant by an "employee fraud." Explain the meaning of fraud to Edward and give an example of frauds that might occur at a bank.
2. Fraud experts often say that there are three primary factors that contribute to employee fraud. Identify the three factors and explain what is meant by each.
3. Identify and describe the five components of a good internal control system.
4. "Internal control is concerned only with enhancing the accuracy of the accounting records." Do you agree? Explain.
5. What principles of internal control apply to most organizations?
6. At the corner grocery store, all sales clerks make change out of one cash register drawer. Is this a violation of internal control? Why?
7. Liz Kelso is reviewing the principle of segregation of duties. What are the two common applications of this principle?
8. How do documentation procedures contribute to good internal control?
9. What internal control objectives are met by physical controls?
10. (a) Explain the control principle of independent internal verification. (b) What practices are important in applying this principle?
11. The management of Nickle Company asks you, as the company accountant, to explain (a) the concept of reasonable assurance in internal control and (b) the importance of the human factor in internal control.
12. Riverside Fertilizer Co. owns the following assets at the balance sheet date.

| | |
|---|---|
| Cash in bank savings account | $ 8,000 |
| Cash on hand | 850 |
| Cash refund due from the IRS | 1,000 |
| Checking account balance | 14,000 |
| Postdated checks | 500 |

What amount should Riverside report as cash in the balance sheet?

13. What principle(s) of internal control is (are) involved in making daily cash counts of over-the-counter receipts?
14. Seaton Department Stores has just installed new electronic cash registers in its stores. How do cash registers improve internal control over cash receipts?
15. At Kellum Wholesale Company, two mail clerks open all mail receipts. How does this strengthen internal control?
16. "To have maximum effective internal control over cash disbursements, all payments should be made by check." Is this true? Explain.
17. Ken Deangelo Company's internal controls over cash disbursements provide for the treasurer to sign checks imprinted by a check-writing machine in indelible ink after comparing the check with the approved invoice. Identify the internal control principles that are present in these controls.
18. How do the principles of (a) physical controls and (b) documentation controls apply to cash disbursements?
19. (a) What is a voucher system? (b) What principles of internal control apply to a voucher system?
20. What is the essential feature of an electronic funds transfer (EFT) procedure?
21. (a) Identify the three activities that pertain to a petty cash fund, and indicate an internal control principle that is applicable to each activity. (b) When are journal entries required in the operation of a petty cash fund?
22. "The use of a bank contributes significantly to good internal control over cash." Is this true? Why or why not?
23. Anna Korte is confused about the lack of agreement between the cash balance per books and the balance per bank. Explain the causes for the lack of agreement to Anna, and give an example of each cause.
24. What are the four steps involved in finding differences between the balance per books and balance per bank?
25. Heather Kemp asks your help concerning an NSF check. Explain to Heather (a) what an NSF check is, (b) how it is treated in a bank reconciliation, and (c) whether it will require an adjusting entry.
26. (a) "Cash equivalents are the same as cash." Do you agree? Explain. (b) How should restricted cash funds be reported on the balance sheet?
27. At what amount does Apple report cash and cash equivalents in its 2013 consolidated balance sheet?

## BRIEF EXERCISES

*Identify fraud triangle concepts.*

(LO 1)

**BE8-1** Match each situation with the fraud triangle factor—opportunity, financial pressure, or rationalization—that best describes it.

1. An employee's monthly credit card payments are nearly 75% of his or her monthly earnings.
2. An employee earns minimum wage at a firm that has reported record earnings for each of the last five years.

3. An employee has an expensive gambling habit.
4. An employee has check-writing and signing responsibilities for a small company, as well as reconciling the bank account.

**BE8-2** Shelly Eckert has prepared the following list of statements about internal control.

*Indicate internal control concepts.*

**(LO 1)**

1. One of the objectives of internal control is to safeguard assets from employee theft, robbery, and unauthorized use.
2. One of the objectives of internal control is to enhance the accuracy and reliability of the accounting records.
3. No laws require U.S. corporations to maintain an adequate system of internal control.

Identify each statement as true or false. If false, indicate how to correct the statement.

**BE8-3** Jessica Mahan is the new owner of Penny Parking. She has heard about internal control but is not clear about its importance for her business. Explain to Jessica the four purposes of internal control and give her one application of each purpose for Penny Parking.

*Explain the importance of internal control.*

**(LO 1)**

**BE8-4** The internal control procedures in Valentine Company provide that:

*Identify internal control principles.*

**(LO 1)**

1. Employees who have physical custody of assets do not have access to the accounting records.
2. Each month, the assets on hand are compared to the accounting records by an internal auditor.
3. A prenumbered shipping document is prepared for each shipment of goods to customers.

Identify the principles of internal control that are being followed.

**BE8-5** Rosenquist Company has the following internal control procedures over cash receipts. Identify the internal control principle that is applicable to each procedure.

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

**(LO 2)**

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

**BE8-6** The cash register tape for Bluestem Industries reported sales of $6,871.50. Record the journal entry that would be necessary for each of the following situations. (a) Cash to be accounted for exceeds cash on hand by $50.75. (b) Cash on hand exceeds cash to be accounted for by $28.32.

*Make journal entries for cash overage and shortfall.*

**(LO 2)**

**BE8-7** While examining cash receipts information, the accounting department determined the following information: opening cash balance $160, cash on hand $1,125.74, and cash sales per register tape $980.83. Prepare the required journal entry based upon the cash count sheet.

*Make journal entry using cash count sheet.*

**(LO 2)**

**BE8-8** Pennington Company has the following internal control procedures over cash disbursements. Identify the internal control principle that is applicable to each procedure.

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

**(LO 2)**

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

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

*Prepare entry to replenish a petty cash fund.*

**(LO 2)**

**BE8-10** Lance Bachman is uncertain about the control features of a bank account. Explain the control benefits of (a) a check and (b) a bank statement.

*Identify the control features of a bank account.*

**(LO 3)**

*Indicate location of reconciling items in a bank reconciliation.*
(LO 3)

**BE8-11** The following reconciling items are applicable to the bank reconciliation for Ellington Company: (1) outstanding checks, (2) bank debit memorandum for service charge, (3) bank credit memorandum for collecting a note for the depositor, and (4) deposits in transit. Indicate how each item should be shown on a bank reconciliation.

*Identify reconciling items that require adjusting entries.*
(LO 3)

**BE8-12** Using the data in BE8-11, indicate (a) the items that will result in an adjustment to the depositor's records and (b) why the other items do not require adjustment.

*Prepare partial bank reconciliation.*
(LO 3)

**BE8-13** At July 31, Ramirez Company has the following bank information: cash balance per bank $7,420, outstanding checks $762, deposits in transit $1,620, and a bank service charge $20. Determine the adjusted cash balance per bank at July 31.

*Prepare partial bank reconciliation.*
(LO 3)

**BE8-14** At August 31, Pratt Company has a cash balance per books of $9,500 and the following additional data from the bank statement: charge for printing Pratt Company checks $35, interest earned on checking account balance $40, and outstanding checks $800. Determine the adjusted cash balance per books at August 31.

*Explain the statement presentation of cash balances.*
(LO 4)

**BE8-15** Zhang Company has the following cash balances: Cash in Bank $15,742, Payroll Bank Account $6,000, and Plant Expansion Fund Cash $25,000 to be used two years from now. Explain how each balance should be reported on the balance sheet.

## DO IT! Exercises

*Identify violations of control activities.*
(LO 1)

**DO IT! 8-1** Identify which control activity is violated in each of the following situations, and explain how the situation creates an opportunity for fraud or inappropriate accounting practices.

1. Once a month, the sales department sends sales invoices to the accounting department to be recorded.
2. Leah Hutcherson orders merchandise for Rice Lake Company; she also receives merchandise and authorizes payment for merchandise.
3. Several clerks at Great Foods use the same cash register drawer.

*Design system of internal control over cash receipts.*
(LO 2)

**DO IT! 8-2a** Gary Stanten is concerned with control over mail receipts at Gary's Sporting Goods. All mail receipts are opened by Al Krane. Al sends the checks to the accounting department, where they are stamped "For Deposit Only." The accounting department records and deposits the mail receipts weekly. Gary asks for your help in installing a good system of internal control over mail receipts.

*Make journal entries for petty cash fund.*
(LO 2)

**DO IT! 8-2b** Wilkinson Company established a $100 petty cash fund on August 1. On August 31, the fund had $7 cash remaining and petty cash receipts for postage $31, office supplies $42, and miscellaneous expense $16. Prepare journal entries to establish the fund on August 1 and replenish the fund on August 31.

*Explain treatment of items in bank reconciliation.*
(LO 3)

**DO IT! 8-3** Roger Richman owns Richman Blankets. He asks you to explain how he should treat the following reconciling items when reconciling the company's bank account.

1. Outstanding checks.
2. A deposit in transit.
3. The bank charged to the company account a check written by another company.
4. A debit memorandum for a bank service charge.

*Analyze statements about the reporting of cash.*
(LO 4)

**DO IT! 8-4** Indicate whether each of the following statements is true or false.

1. A company has the following assets at the end of the year: cash on hand $40,000, cash refund due from customer $30,000, and checking account balance $22,000. Cash and cash equivalents is therefore $62,000.
2. A company that has received NSF checks should report these checks as a current liability on the balance sheet.
3. Restricted cash that is a current asset is reported as part of cash and cash equivalents.
4. A company has cash in the bank of $50,000, petty cash of $400, and stock investments of $100,000. Total cash and cash equivalents is therefore $50,400.

## EXERCISES

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

*Identify the principles of internal control.*

(LO 1)

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

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

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

(LO 1, 2)

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

***Instructions***
(a) For each procedure, explain the weakness in internal control, and identify the control principle that is violated.
(b) For each weakness, suggest a change in procedure that will result in good internal control.

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

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

(LO 1, 2)

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

***Instructions***
(a) For each procedure, explain the weakness in internal control, and identify the internal control principle that is violated.
(b) For each weakness, suggest a change in the procedure that will result in good internal control.

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

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

(LO 2)

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

*Indicate whether procedure is good or weak internal control.*
**(LO 1, 2)**

**E8-5** Listed below are five procedures followed by Eikenberry Company.

1. Several individuals operate the cash register using the same register drawer.
2. A monthly bank reconciliation is prepared by someone who has no other cash responsibilities.
3. Joe Cockrell writes checks and also records cash payment journal entries.
4. One individual orders inventory, while a different individual authorizes payments.
5. Unnumbered sales invoices from credit sales are forwarded to the accounting department every four weeks for recording.

***Instructions***
Indicate whether each procedure is an example of good internal control or of weak internal control. If it is an example of good internal control, indicate which internal control principle is being followed. If it is an example of weak internal control, indicate which internal control principle is violated. Use the table below.

| Procedure | IC Good or Weak? | Related Internal Control Principle |
|---|---|---|
| 1. | | |
| 2. | | |
| 3. | | |
| 4. | | |
| 5. | | |

*Indicate whether procedure is good or weak internal control.*
**(LO 1, 2)**

**E8-6** Listed below are five procedures followed by Gilmore Company.

1. Employees are required to take vacations.
2. Any member of the sales department can approve credit sales.
3. Paul Jaggard ships goods to customers, bills customers, and receives payment from customers.
4. Total cash receipts are compared to bank deposits daily by someone who has no other cash responsibilities.
5. Time clocks are used for recording time worked by employees.

***Instructions***
Indicate whether each procedure is an example of good internal control or of weak internal control. If it is an example of good internal control, indicate which internal control principle is being followed. If it is an example of weak internal control, indicate which internal control principle is violated. Use the table below.

| Procedure | IC Good or Weak? | Related Internal Control Principle |
|---|---|---|
| 1. | | |
| 2. | | |
| 3. | | |
| 4. | | |
| 5. | | |

*Prepare journal entries for a petty cash fund.*
**(LO 2)**

**E8-7** Setterstrom Company established a petty cash fund on May 1, cashing a check for $100. The company reimbursed the fund on June 1 and July 1 with the following results.

June 1: Cash in fund $1.75. Receipts: delivery expense $31.25, postage expense $39.00, and miscellaneous expense $25.00.
July 1: Cash in fund $3.25. Receipts: delivery expense $21.00, entertainment expense $51.00, and miscellaneous expense $24.75.

On July 10, Setterstrom increased the fund from $100 to $130.

***Instructions***
Prepare journal entries for Setterstrom Company for May 1, June 1, July 1, and July 10.

*Prepare journal entries for a petty cash fund.*
**(LO 2)**

**E8-8** Horvath Company uses an imprest petty cash system. The fund was established on March 1 with a balance of $100. During March, the following petty cash receipts were found in the petty cash box.

| Date | Receipt No. | For | Amount |
|---|---|---|---|
| 3/5 | 1 | Stamp Inventory | $39 |
| 7 | 2 | Freight-Out | 21 |
| 9 | 3 | Miscellaneous Expense | 6 |
| 11 | 4 | Travel Expense | 24 |
| 14 | 5 | Miscellaneous Expense | 5 |

The fund was replenished on March 15 when the fund contained $2 in cash. On March 20, the amount in the fund was increased to $175.

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

*Prepare bank reconciliation and adjusting entries.*
(LO 3)

**E8-9** Don Wyatt is unable to reconcile the bank balance at January 31. Don's reconciliation is as follows.

| | |
|---|---|
| Cash balance per bank | $3,560.20 |
| Add: NSF check | 490.00 |
| Less: Bank service charge | 25.00 |
| Adjusted balance per bank | $4,025.20 |
| | |
| Cash balance per books | $3,875.20 |
| Less: Deposits in transit | 530.00 |
| Add: Outstanding checks | 730.00 |
| Adjusted balance per books | $4,075.20 |

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

*Determine outstanding checks.*
(LO 3)

**E8-10** On April 30, the bank reconciliation of Westbrook Company shows three outstanding checks: no. 254, $650; no. 255, $620; and no. 257, $410. The May bank statement and the May cash payments journal show the following.

**Bank Statement**
**Checks Paid**

| Date | Check No. | Amount |
|---|---|---|
| 5/4 | 254 | $650 |
| 5/2 | 257 | 410 |
| 5/17 | 258 | 159 |
| 5/12 | 259 | 275 |
| 5/20 | 261 | 500 |
| 5/29 | 263 | 480 |
| 5/30 | 262 | 750 |

**Cash Payments Journal**
**Checks Issued**

| Date | Check No. | Amount |
|---|---|---|
| 5/2 | 258 | $159 |
| 5/5 | 259 | 275 |
| 5/10 | 260 | 890 |
| 5/15 | 261 | 500 |
| 5/22 | 262 | 750 |
| 5/24 | 263 | 480 |
| 5/29 | 264 | 560 |

***Instructions***
Using Step 2 in the reconciliation procedure, list the outstanding checks at May 31.

*Prepare bank reconciliation and adjusting entries.*
(LO 3)

**E8-11** The following information pertains to Crane Video Company.

1. Cash balance per bank, July 31, $7,263.
2. July bank service charge not recorded by the depositor $28.
3. Cash balance per books, July 31, $7,284.
4. Deposits in transit, July 31, $1,300.
5. Bank collected $700 note for Crane in July, plus interest $36, less fee $20. The collection has not been recorded by Crane, and no interest has been accrued.
6. Outstanding checks, July 31, $591.

***Instructions***

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

*Prepare bank reconciliation and adjusting entries.*

(LO 3)

**E8-12** The information below relates to the Cash account in the ledger of Minton Company.

Balance September 1—$17,150; Cash deposited—$64,000.
Balance September 30—$17,404; Checks written—$63,746.

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

| Credits | | Debits | |
|---|---|---|---|
| Collection of $2,500 note plus interest $30 | $2,530 | NSF check: Richard Nance | $425 |
| Interest earned on checking account | $45 | Safety deposit box rent | $65 |

At September 30, deposits in transit were $5,450, and outstanding checks totaled $2,383.

***Instructions***

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

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

(LO 3)

**E8-13** The cash records of Dawes Company show the following four situations.

1. The June 30 bank reconciliation indicated that deposits in transit total $920. During July, the general ledger account Cash shows deposits of $15,750, but the bank statement indicates that only $15,600 in deposits were received during the month.
2. The June 30 bank reconciliation also reported outstanding checks of $680. During the month of July, Dawes Company's books show that $17,200 of checks were issued. The bank statement showed that $16,400 of checks cleared the bank in July.
3. In September, deposits per the bank statement totaled $26,700, deposits per books were $26,400, and deposits in transit at September 30 were $2,100.
4. In September, cash disbursements per books were $23,700, checks clearing the bank were $25,000, and outstanding checks at September 30 were $2,100.

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

***Instructions***

Answer the following questions.

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

*Show presentation of cash in financial statements.*

(LO 4)

**E8-14** Wynn Company has recorded the following items in its financial records.

| | |
|---|---|
| Cash in bank | $ 42,000 |
| Cash in plant expansion fund | 100,000 |
| Cash on hand | 12,000 |
| Highly liquid investments | 34,000 |
| Petty cash | 500 |
| Receivables from customers | 89,000 |
| Stock investments | 61,000 |

The highly liquid investments had maturities of 3 months or less when they were purchased. The stock investments will be sold in the next 6 to 12 months. The plant expansion project will begin in 3 years.

***Instructions***

(a) What amount should Wynn report as "Cash and cash equivalents" on its balance sheet?
(b) Where should the items not included in part (a) be reported on the balance sheet?

## EXERCISES: SET B AND CHALLENGE EXERCISES

Visit the book's companion website, at **www.wiley.com/college/weygandt**, and choose the Student Companion site to access Exercises: Set B and Challenge Exercises.

## PROBLEMS: SET A

*Identify internal control principles over cash disbursements.*

(LO 1, 2)

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

Instead of being unnumbered and manually prepared, all checks must now be prenumbered and prepared by using the new accounts payable software purchased by the company. Before a check can be issued, each invoice must have the approval of Kathy Moon, the purchasing agent, and Robin Self, the receiving department supervisor. Checks must be signed by either Jennifer Edwards, the treasurer, or Rich Woodruff, the assistant treasurer. Before signing a check, the signer is expected to compare the amount of the check with the amount on the invoice.

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

Blank checks are stored in a safe in the treasurer's office. The combination to the safe is known only by the treasurer and assistant treasurer. Each month, the bank statement is reconciled with the bank balance per books by the assistant chief accountant. All employees who handle or account for cash are bonded.

***Instructions***

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

*Journalize and post petty cash fund transactions.*

(LO 2)

GLS

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

July 1 Established petty cash fund by writing a check on Scranton Bank for $200.

15 Replenished the petty cash fund by writing a check for $196.00. On this date the fund consisted of $4.00 in cash and the following petty cash receipts: freight-out $92.00, postage expense $42.40, entertainment expense $46.60, and miscellaneous expense $11.20.

31 Replenished the petty cash fund by writing a check for $192.00. At this date, the fund consisted of $8.00 in cash and the following petty cash receipts: freight-out $82.10, charitable contributions expense $45.00, postage expense $25.50, and miscellaneous expense $39.40.

Aug. 15 Replenished the petty cash fund by writing a check for $187.00. On this date, the fund consisted of $13.00 in cash and the following petty cash receipts: freight-out $77.60, entertainment expense $43.00, postage expense $33.00, and miscellaneous expense $37.00.

16 Increased the amount of the petty cash fund to $300 by writing a check for $100.

31 Replenished the petty cash fund by writing a check for $284.00. On this date, the fund consisted of $16 in cash and the following petty cash receipts: postage expense $140.00, travel expense $95.60, and freight-out $47.10.

***Instructions***

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

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

*Prepare a bank reconciliation and adjusting entries.*

(LO 3)

**P8-3A** On May 31, 2017, Reber Company had a cash balance per books of $6,781.50. The bank statement from New York State Bank on that date showed a balance of $6,404.60. A comparison of the statement with the Cash account revealed the following facts.

1. The statement included a debit memo of $40 for the printing of additional company checks.

2. Cash sales of $836.15 on May 12 were deposited in the bank. The cash receipts journal entry and the deposit slip were incorrectly made for $886.15. The bank credited Reber Company for the correct amount.
3. Outstanding checks at May 31 totaled $576.25. Deposits in transit were $2,416.15.
4. On May 18, the company issued check No. 1181 for $685 to Lynda Carsen on account. The check, which cleared the bank in May, was incorrectly journalized and posted by Reber Company for $658.
5. A $3,000 note receivable was collected by the bank for Reber Company on May 31 plus $80 interest. The bank charged a collection fee of $20. No interest has been accrued on the note.
6. Included with the cancelled checks was a check issued by Stiner Company to Ted Cress for $800 that was incorrectly charged to Reber Company by the bank.
7. On May 31, the bank statement showed an NSF charge of $680 for a check issued by Sue Allison, a customer, to Reber Company on account.

***Instructions***

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

(a) Prepare the bank reconciliation at May 31, 2017.
(b) Prepare the necessary adjusting entries for Reber Company at May 31, 2017.

*Prepare a bank reconciliation and adjusting entries from detailed data.*

**(LO 3)**

**P8-4A** The bank portion of the bank reconciliation for Langer Company at November 30, 2017, was as follows.

**LANGER COMPANY**
**Bank Reconciliation**
**November 30, 2017**

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

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

The December bank statement showed the following checks and deposits.

**Bank Statement**

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

The cash records per books for December showed the following.

**Cash Payments Journal**

| Date | Number | Amount | Date | Number | Amount |
|---|---|---|---|---|---|
| 12-1 | 3475 | $1,640.70 | 12-20 | 3482 | $ 475.50 |
| 12-2 | 3476 | 1,300.00 | 12-22 | 3483 | 1,140.00 |
| 12-2 | 3477 | 2,130.00 | 12-23 | 3484 | 798.00 |
| 12-4 | 3478 | 621.30 | 12-24 | 3485 | 450.80 |
| 12-8 | 3479 | 3,080.00 | 12-30 | 3486 | 889.50 |
| 12-10 | 3480 | 600.00 | Total | | $13,933.20 |
| 12-17 | 3481 | 807.40 | | | |

**Cash Receipts Journal**

| Date | Amount |
|---|---|
| 12-3 | $ 1,211.60 |
| 12-7 | 2,365.10 |
| 12-15 | 2,672.70 |
| 12-20 | 2,954.00 |
| 12-25 | 2,567.30 |
| 12-28 | 2,836.00 |
| 12-30 | 1,025.00 |
| 12-31 | 1,690.40 |
| Total | $17,322.10 |

The bank statement contained two memoranda:

1. A credit of $5,145 for the collection of a $5,000 note for Langer Company plus interest of $160 and less a collection fee of $15. Langer Company has not accrued any interest on the note.
2. A debit of $572.80 for an NSF check written by L. Rees, a customer. At December 31, the check had not been redeposited in the bank.

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

***Instructions***

(a) Using the four steps in the reconciliation procedure, prepare a bank reconciliation at December 31.

(a) Adjusted balance per books $16,958.40

(b) Prepare the adjusting entries based on the reconciliation. (*Hint:* The correction of any errors pertaining to recording checks should be made to Accounts Payable. The correction of any errors relating to recording cash receipts should be made to Accounts Receivable.)

**P8-5A** Rodriguez Company maintains a checking account at the Imura Bank. At July 31, selected data from the ledger balance and the bank statement are shown below.

*Prepare a bank reconciliation and adjusting entries.*

**(LO 3)**

| | Cash in Bank | |
|---|---|---|
| | **Per Books** | **Per Bank** |
| Balance, July 1 | $17,600 | $15,800 |
| July receipts | 81,400 | |
| July credits | | 83,470 |
| July disbursements | 77,150 | |
| July debits | | 74,756 |
| Balance, July 31 | $21,850 | $24,514 |

Analysis of the bank data reveals that the credits consist of $79,000 of July deposits and a credit memorandum of $4,470 for the collection of a $4,400 note plus interest revenue of $70. The July debits per bank consist of checks cleared $74,700 and a debit memorandum of $56 for printing additional company checks.

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

The June 30 bank reconciliation contained only two reconciling items: deposits in transit $8,000 and outstanding checks of $6,200.

***Instructions***

(a) Prepare a bank reconciliation at July 31, 2017.

(a) Adjusted balance per books $26,354

(b) Journalize the adjusting entries to be made by Rodriguez Company. Assume that interest on the note has not been accrued.

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

(LO 1, 2)

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

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

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

The day of the dance, Matt wrote a check from the account to pay the DJ. D.J. Sound, however, said that he accepted only cash and did not give receipts. So Matt took $200 out of the cash box and gave it to D.J. At the dance, Matt had Sam Copper working at the entrance to the gymnasium, collecting tickets from students, and selling tickets to those who had not prepurchased them. Matt estimated that 400 students attended the dance.

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

***Instructions***

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

## PROBLEMS: SET B AND SET C

Visit the book's companion website, at **www.wiley.com/college/weygandt**, and choose the Student Companion site to access Problems: Set B and Set C.

## COMPREHENSIVE PROBLEM

**CP8** On December 1, 2017, Fullerton Company had the following account balances.

| | Debit | | Credit |
|---|---|---|---|
| Cash | $18,200 | Accumulated Depreciation— Equipment | $ 3,000 |
| Notes Receivable | 2,200 | Accounts Payable | 6,100 |
| Accounts Receivable | 7,500 | Owner's Capital | 64,400 |
| Inventory | 16,000 | | $73,500 |
| Prepaid Insurance | 1,600 | | |
| Equipment | 28,000 | | |
| | $73,500 | | |

During December, the company completed the following transactions.

Dec. 7 Received $3,600 cash from customers in payment of account (no discount allowed).
12 Purchased merchandise on account from Vance Co. $12,000, terms 1/10, n/30.
17 Sold merchandise on account $16,000, terms 2/10, n/30. The cost of the merchandise sold was $10,000.
19 Paid salaries $2,200.
22 Paid Vance Co. in full, less discount.
26 Received collections in full, less discounts, from customers billed on December 17.
31 Received $2,700 cash from customers in payment of account (no discount allowed).

Adjustment data:

1. Depreciation $200 per month.
2. Insurance expired $400.

***Instructions***

(a) Journalize the December transactions. (Assume a perpetual inventory system.)
(b) Enter the December 1 balances in the ledger T-accounts and post the December transactions. Use Cost of Goods Sold, Depreciation Expense, Insurance Expense, Salaries and Wages Expense, Sales Revenue, and Sales Discounts.
(c) The statement from Jackson County Bank on December 31 showed a balance of $26,130. A comparison of the bank statement with the Cash account revealed the following facts.
   1. The bank collected a note receivable of $2,200 for Fullerton Company on December 15.
   2. The December 31 receipts were deposited in a night deposit vault on December 31. These deposits were recorded by the bank in January.
   3. Checks outstanding on December 31 totaled $1,210.
   4. On December 31, the bank statement showed an NSF charge of $680 for a check received by the company from L. Bryan, a customer, on account.

   Prepare a bank reconciliation as of December 31 based on the available information. (*Hint:* The cash balance per books is $26,100. This can be proven by finding the balance in the Cash account from parts (a) and (b).)
(d) Journalize the adjusting entries resulting from the bank reconciliation and adjustment data.
(e) Post the adjusting entries to the ledger T-accounts.
(f) Prepare an adjusted trial balance.
(g) Prepare an income statement for December and a classified balance sheet at December 31.

## CONTINUING PROBLEM

### COOKIE CREATIONS: AN ENTREPRENEURIAL JOURNEY

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

**CC8** **Part 1** Natalie is struggling to keep up with the recording of her accounting transactions. She is spending a lot of time marketing and selling mixers and giving her cookie classes. Her friend John is an accounting student who runs his own accounting service. He has asked Natalie if she would like to have him do her accounting. John and Natalie meet and discuss her business.

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

*Go to the book's companion website,* **www.wiley.com/college/weygandt**, *to see the completion of this problem.*



# BROADENING YOUR PERSPECTIVE

## FINANCIAL REPORTING AND ANALYSIS

### Financial Reporting Problem: Apple Inc.

**BYP8-1** The financial statements of Apple Inc. are presented in Appendix A at the end of this textbook. Instructions for accessing and using the company's complete annual report, including the notes to the financial statements, are also provided in Appendix A.

***Instructions***

(a) What comments, if any, are made about cash in the report of the independent registered public accounting firm?
(b) What data about cash and cash equivalents are shown in the consolidated balance sheet?
(c) In its notes to Consolidated Financial Statements, how does Apple define cash equivalents?
(d) In management's Annual Report on Internal Control over Financial Reporting (Item 9A), what does Apple's management say about internal control?

## Comparative Analysis Problem: PepsiCo, Inc. vs. The Coca-Cola Company

**BYP8-2** PepsiCo's financial statements are presented in Appendix B. Financial statements of The Coca-Cola Company are presented in Appendix C. Instructions for accessing and using the complete annual reports of PepsiCo and Coca-Cola, including the notes to the financial statements, are also provided in Appendices B and C, respectively.

***Instructions***

(a) Based on the information contained in these financial statements, determine each of the following for each company:

  (1) Cash and cash equivalents balance at December 28, 2013, for PepsiCo and at December 31, 2013, for Coca-Cola.

  (2) Increase (decrease) in cash and cash equivalents from 2012 to 2013.

  (3) Cash provided by operating activities during the year ended December 2013 (from statement of cash flows).

(b) What conclusions concerning the management of cash can be drawn from these data?

## Comparative Analysis Problem: Amazon.com, Inc. vs. Wal-Mart Stores, Inc.

**BYP8-3** Amazon.com, Inc.'s financial statements are presented in Appendix D. Financial statements of Wal-Mart Stores, Inc. are presented in Appendix E. Instructions for accessing and using the complete annual reports of Amazon and Wal-Mart, including the notes to the financial statements, are also provided in Appendices D and E, respectively.

***Instructions***

(a) Based on the information contained in these financial statements, determine each of the following for each company:

  (1) Cash and cash equivalents balance at December 31, 2013, for Amazon and at January 31, 2014, for Wal-Mart.

  (2) Increase (decrease) in cash and cash equivalents from 2012 to 2013.

  (3) Net cash provided by operating activities during the year ended December 31, 2013, for Amazon and January 31, 2014, for Wal-Mart from statement of cash flows.

(b) What conclusions concerning the management of cash can be drawn from these data?

## Real-World Focus

**BYP8-4** All organizations should have systems of internal control. Universities are no exception. This site discusses the basics of internal control in a university setting.

***Address:*** **www.bc.edu/offices/audit/controls**, or go to **www.wiley.com/college/weygandt**

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

***Instructions***

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

(a) In a university setting, who has responsibility for evaluating the adequacy of the system of internal control?

(b) What do reconciliations ensure in the university setting? Who should review the reconciliation?

(c) What are some examples of physical controls?

(d) What are two ways to accomplish inventory counts?

# CRITICAL THINKING

## Decision-Making Across the Organization

**BYP8-5** The board of trustees of a local church is concerned about the internal accounting controls for the offering collections made at weekly services. The trustees ask you to serve on a three-person audit team with the internal auditor of a local college and a CPA who has just joined the church.

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

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

***Instructions***

With the class divided into groups, answer the following.

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

## Communication Activity

**BYP8-6** As a new auditor for the CPA firm of Eaton, Quayle, and Hale, you have been assigned to review the internal controls over mail cash receipts of Pritchard Company. Your review reveals the following. Checks are promptly endorsed "For Deposit Only," but no list of the checks is prepared by the person opening the mail. The mail is opened either by the cashier or by the employee who maintains the accounts receivable records. Mail receipts are deposited in the bank weekly by the cashier.

***Instructions***

Write a letter to Danny Peak, owner of Pritchard Company, explaining the weaknesses in internal control and your recommendations for improving the system.

## Ethics Case

**BYP8-7** You are the assistant controller in charge of general ledger accounting at Linbarger Bottling Company. Your company has a large loan from an insurance company. The loan agreement requires that the company's cash account balance be maintained at $200,000 or more, as reported monthly.

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

***Instructions***

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

## All About You

**BYP8-8** The print and electronic media are full of stories about potential security risks that may arise from your computer or smartphone. It is important to keep in mind, however, that there are also many other ways that your identity can be stolen. The federal government provides many resources to help protect you from identity thieves.

***Instructions***

Go to **http://onguardonline.gov/idtheft.html**, click **Video and Media**, and then click on **ID Theft Faceoff**. Complete the quiz provided there.

## FASB Codification Activity

**BYP8-9** If your school has a subscription to the FASB Codification, go to **http://aaahq.org/ascLogin.cfm** to log in and prepare responses to the following.

(a) How is cash defined in the Codification?
(b) How are cash equivalents defined in the Codification?
(c) What are the disclosure requirements related to cash and cash equivalents?

# A Look at IFRS

LEARNING OBJECTIVE 5 **Compare the accounting for fraud, internal control, and cash under GAAP and IFRS.**

Fraud can occur anywhere. Because the three main factors that contribute to fraud are universal in nature, the principles of internal control activities are used globally by companies. While Sarbanes-Oxley (SOX) does not apply to international companies, most large international companies have internal controls similar to those indicated in the chapter. IFRS and GAAP are also very similar in accounting for cash. *IAS No. 1 (revised)*, "Presentation of Financial Statements," is the only standard that discusses issues specifically related to cash.

## Relevant Facts

Following are the key similarities and differences between GAAP and IFRS related to fraud, internal control, and cash.

### Similarities

- The fraud triangle discussed in this chapter is applicable to all international companies. Some of the major frauds on an international basis are Parmalat (Italy), Royal Ahold (the Netherlands), and Satyam Computer Services (India).
- Rising economic crime poses a growing threat to companies, with nearly one-third of all organizations worldwide being victims of fraud in a recent 12-month period.
- Accounting scandals both in the United States and internationally have re-ignited the debate over the relative merits of GAAP, which takes a "rules-based" approach to accounting, versus IFRS, which takes a "principles-based" approach. The FASB announced that it intends to introduce more principles-based standards.
- On a lighter note, at one time the Ig Nobel Prize in Economics went to the CEOs of those companies involved in the corporate accounting scandals of that year for "adapting the mathematical concept of imaginary numbers for use in the business world." A parody of the Nobel Prizes, the Ig Nobel Prizes (read Ignoble, as not noble) are given each year in early October for 10 achievements that "first make people laugh, and then make them think." Organized by the scientific humor magazine *Annals of Improbable Research* (*AIR*), they are presented by a group that includes genuine Nobel laureates at a ceremony at Harvard University's Sanders Theater. (See **en.wikipedia.org/wiki/Ig_Nobel_Prize**.)
- The accounting and internal control procedures related to cash are essentially the same under both IFRS and this textbook. In addition, the definition used for cash equivalents is the same.
- Most companies report cash and cash equivalents together under IFRS, as shown in this textbook. In addition, IFRS follows the same accounting policies related to the reporting of restricted cash.

### Differences

- The SOX internal control standards apply only to companies listed on U.S. exchanges. There is continuing debate over whether foreign issuers should have to comply with this extra layer of regulation.

## Looking to the Future

Ethics has become a very important aspect of reporting. Different cultures have different perspectives on bribery and other questionable activities, and consequently penalties for engaging in such activities vary considerably across countries.

High-quality international accounting requires both high-quality accounting standards and high-quality auditing. Similar to the convergence of GAAP and IFRS, there is movement to improve international auditing standards. The International Auditing and Assurance Standards Board (IAASB) functions as an independent standard-setting body. It works to establish high-quality auditing and assurance and quality-control standards throughout the world. Whether the IAASB adopts internal control provisions similar to those in SOX remains to be seen. You can follow developments in the international audit arena at **http://www.ifac.org/iaasb/**.

# IFRS Practice

## IFRS Self-Test Questions

**1.** Non-U.S companies that follow IFRS:
  (a) do not normally use the principles of internal control activities described in this textbook.
  (b) often offset cash with accounts payable on the balance sheet.
  (c) are not required to follow SOX.
  (d) None of the above.

**2.** The Sarbanes-Oxley Act applies to:
  (a) all U.S. companies listed on U.S. exchanges.
  (b) all companies that list stock on any stock exchange in any country.
  (c) all European companies listed on European exchanges.
  (d) Both (a) and (c).

**3.** High-quality international accounting requires both high-quality accounting standards and:
  (a) a reconsideration of SOX to make it less onerous.
  (b) high-quality auditing standards.
  (c) government intervention to ensure that the public interest is protected.
  (d) the development of new principles of internal control activities.

# IFRS Exercise

**IFRS8-1** Some people argue that the internal control requirements of the Sarbanes-Oxley Act (SOX) put U.S. companies at a competitive disadvantage to companies outside the United States. Discuss the competitive implications (both pros and cons) of SOX.

## International Financial Reporting Problem: Louis Vuitton

**IFRS8–2** The financial statements of Louis Vuitton are presented in Appendix F. Instructions for accessing and using the company's complete annual report, including the notes to its financial statements, are also provided in Appendix F.

***Instructions***
Using the notes to the company's financial statements, what are Louis Vuitton's accounting policies related to cash and cash equivalents?

### Answers to IFRS Self-Test Questions

**1.** c **2.** a **3.** b

# 9 Accounting for Receivables

**CHAPTER PREVIEW** As indicated in the Feature Story below, receivables are a significant asset for many pharmaceutical companies. Because a large portion of sales in the United States are credit sales, receivables are important to companies in other industries as well. As a consequence, companies must pay close attention to their receivables and manage them carefully. In this chapter, you will learn what journal entries companies make when they sell products, when they collect cash from those sales, and when they write off accounts they cannot collect.

**FEATURE STORY**

## A Dose of Careful Management Keeps Receivables Healthy

"Sometimes you have to know when to be very tough, and sometimes you can give them a bit of a break," said Vivi Su. She wasn't talking about her children but about the customers of a subsidiary of former pharmaceutical company Whitehall-Robins, where she worked as supervisor of credit and collections.

For example, while the company's regular terms were 1/15, n/30 (1% discount if paid within 15 days), a customer might have asked for and received a few days of grace and still got the discount. Or a customer might have placed orders above its credit limit, in which case, depending on its payment history and the circumstances, Ms. Su might have authorized shipment of the goods anyway.

"It's not about drawing a line in the sand, and that's all," she explained. "You want a good relationship with your customers—but you also need to bring in the money."

"The money," in Whitehall-Robins' case, amounted to some $170 million in sales a year. Nearly all of it came in through the credit accounts Ms. Su managed. The process started with the decision to grant a customer an account in the first place. The sales rep gave the customer a credit application. "My department reviews this application very carefully; a customer needs to supply three good references, and we also run a check with a credit firm like Equifax. If we accept them, then based on their size and history, we assign a credit limit," Ms. Su explained.

Once accounts were established, "I get an aging report every single day," said Ms. Su. "The rule of thumb is that we should always have at least 85% of receivables current—meaning they were billed less than 30 days ago," she continued. "But we try to do even better than that—I like to see 90%."

At 15 days overdue, Whitehall-Robins phoned the client. After 45 days, Ms. Su noted, "I send a letter. Then a second notice is sent in writing. After the third and final notice, the client has 10 days to pay, and then I hand it over to a collection agency, and it's out of my hands."

Ms. Su's boss, Terry Norton, recorded an estimate for bad debts every year, based on a percentage of receivables. The percentage depended on the current aging history. He also calculated and monitored the company's accounts receivable turnover, which the company reported in its financial statements.

Ms. Su knew that she and Mr. Norton were crucial to the profitability of Whitehall-Robins. "Receivables are generally the second-largest asset of any company (after its capital assets)," she pointed out. "So it's no wonder we keep a very close eye on them."