Chapter 8

Fraud, Internal Control, and Cash

STUDY OBJECTIVES

After studying this chapter, you should be able to:

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

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Scan **Study Objectives**
Read **Feature Story**
Read **Preview**
Read text and answer **DO IT!** p. 356 p. 360 p. 364 p. 371
Work **Comprehensive DO IT!** p. 374
Review **Summary of Study Objectives**
Answer **Self-Study Questions**
Complete **Assignments**

Feature Story

MINDING THE MONEY IN MOOSE JAW

If you're ever looking for a cappuccino in Moose Jaw, Saskatchewan, stop by Stephanie's Gourmet Coffee and More, located on Main Street. Staff there serve, on average, 650 cups of coffee a day, including both regular and specialty coffees, not to mention soups, Italian sandwiches, and a wide assortment of gourmet cheesecakes.

"We've got high school students who come here, and students from the community college," says owner/manager Stephanie Mintenko, who has run the place since opening it in 1995. "We have customers who are retired,

and others who are working people and have only 30 minutes for lunch. We have to be pretty quick."

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

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

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

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

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

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Inside Chapter 8...

Preview of Chapter 8

As the story about recording cash sales at Stephanie's Gourmet Coffee and More indicates, control of cash is important to ensure that fraud does not occur. Companies also need controls to safeguard other types of assets. For example, Stephanie's undoubtedly has controls to prevent the theft of food and supplies, and controls to prevent the theft of 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.

The content and organization of Chapter 8 are as follows.

Fraud, Internal Control, and Cash

Fraud and Internal Control
- Fraud
- The Sarbanes-Oxley Act
- Internal control
- Principles of internal control activities
- Limitations

Cash Controls
- Cash receipts controls
- Cash disbursements controls

Control Features: Use of a Bank
- Making deposits
- Writing checks
- Bank statements
- Reconciling the bank account
- Electronic funds transfer (EFT) system

Reporting Cash
- Cash equivalents
- Restricted cash
- Compensating balances

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FRAUD AND INTERNAL CONTROL

STUDY OBJECTIVE 1
Define fraud and internal control.

The Feature Story describes many of the internal control procedures used by Stephanie's Gourmet Coffee and More. 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:

- 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.

The most important element of the fraud triangle is **opportunity**. For an employee to commit fraud, the workplace environment must provide opportunities

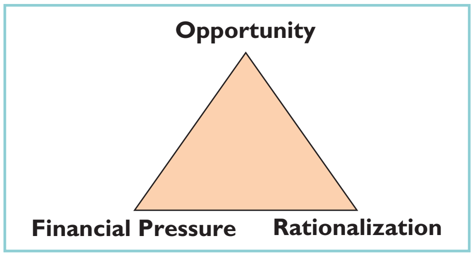


Illustration 8-1
Fraud triangle

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.

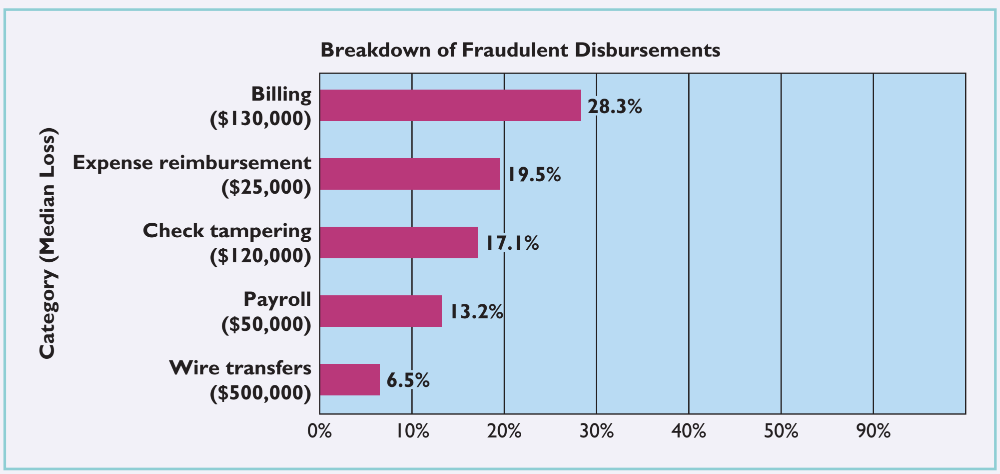
A second factor that contributes to fraud is **financial pressure**. Employees sometimes commit fraud because of personal financial problems caused by too much debt. Or they might commit fraud because they want to lead a lifestyle that they cannot afford on their current salary.

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.

ETHICS INSIGHT

How Do Employees Steal?

A recent study by the Association of Certified Fraud Examiners found that two-thirds of all employee thefts involved a fraudulent disbursement by an employee. The most common form (28.3% of cases) was fraudulent billing schemes. In these, the employee causes the company to issue a payment to the employee by submitting a bill for nonexistent goods or services, purchases of personal goods by the employee, or inflated invoices. The following graph shows various types of fraudulent disbursements and the median loss from each.



Source: 2006 Report to the Nation on Occupational Fraud and Abuse, Association of Certified Fraud Examiners, *www.acfe.com/documents/2006_rttn.pdf*, p. 14.

? How can companies reduce the likelihood of fraudulent disbursements?

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 of 2002 (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 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. And the finance chief at General Electric noted, "We have seen value in SOX. It helps build investors' trust and gives them more confidence."[1]

Internal Control

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. Internal control systems have five primary components as listed below.[2]

- **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.

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[1]"Corporate Regulation Must Be Working—There's a Backlash," *Wall Street Journal,* June 16, 2004, p. C1; and Judith Burns, "Is Sarbanes-Oxley Working?" *Wall Street Journal,* June 21, 2004, pp. R8–R9.

[2]The Committee of Sponsoring Organizations of the Treadway Commission, "Internal Control—Integrated Framework," *www.coso.org/publications/executive_summary_integrated_framework.htm* (accessed March 2008).

Principles of Internal Control Activities

STUDY OBJECTIVE 2

Identify the 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

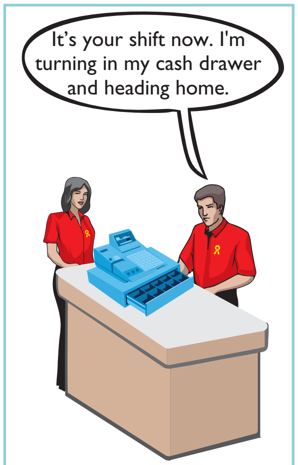
We explain these principles in the following sections. You should recognize that they apply to most companies and are relevant to both manual and computerized accounting systems.

In the explanations that follow, we have added "Anatomy of a Fraud" stories that describe some recent real-world frauds. At the end of each story, we discuss the missing control activity that, had it been it place, is likely to have prevented or uncovered the fraud.[3]

ESTABLISHMENT OF RESPONSIBILITY

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 rung up on 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. In the Feature Story, the principle of establishing responsibility does not appear to be strictly applied by Stephanie's, since three people operate the cash register on any given shift.



Transfer of cash drawers

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 rang up a sale, or who entered 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.

[3]The "Anatomy of a Fraud" stories on pages 350–355 are adapted from *Fraud Casebook: Lessons from the Bad Side of Business*, edited by Joseph T. Wells (Hoboken, NJ: John Wiley & Sons, Inc., 2007). Used by permission. The names of some of the people and organizations in the stories are fictitious, but the facts in the stories are true.

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 Accounts Payable. After the training claims had been processed, she was to notify the accounts payable department 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 authoring 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 record-keeping 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.** For example, companies should 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. For example:

- If a purchasing agent can 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 receipt of the goods (and invoice) 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 transactions. For example:

- 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 for his department of under $2,500 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 operations. He submitted these fake invoices to the accounting department as the basis for their journal entries and to Accounts Payable as the basis for payment.

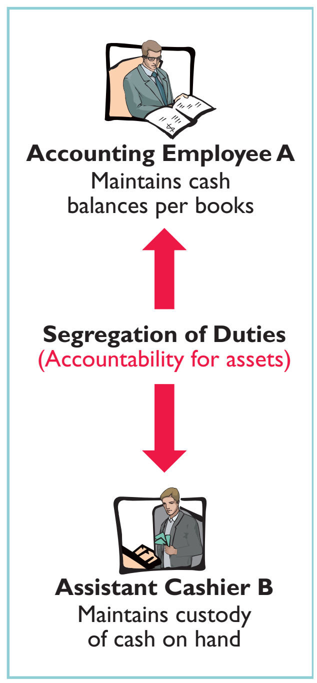
Total take: $475,000

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.

Segregation of Record-Keeping 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 fraudulent activities.



ANATOMY OF A FRAUD

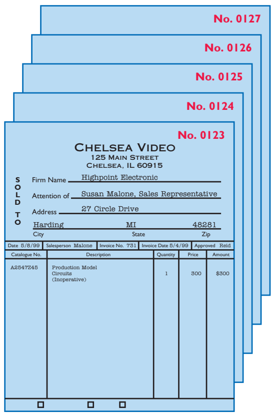
Angela Bauer was an accounts payable clerk for Aggasiz Construction Company. She prepared and issued checks to vendors and reconciled bank statements. She perpetrated a fraud in this way: She wrote checks for costs that the company had not actually incurred (e.g., fake taxes). A supervisor then approved and signed the checks. Before issuing the check, though, she 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 record-keeping from physical custody. Angela had physical custody of the checks, which essentially was control of the cash. She also had recording-keeping responsibility because she prepared the bank reconciliation.

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



Prenumbered invoices

DOCUMENTATION PROCEDURES

Documents provide evidence that transactions and events have occurred. At Stephanie's Gourmet Coffee and More, the cash register tape is the restaurant's documentation for the sale and the amount of cash received. 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 the transaction occurs.

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.

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, or 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

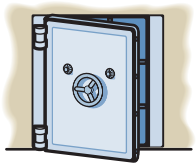
Use of physical controls is essential. *Physical controls* relate to the safeguarding of assets and enhance the accuracy and reliability of the accounting records. Illustration 8-2 (page 353) shows examples of these controls.

ANATOMY OF A FRAUD

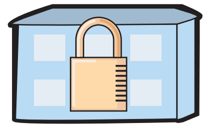
At Centerstone Health, a large insurance company, the mailroom each day received insurance applications from prospective customers. Mailroom employees scanned the applications into electronic documents before the applications were processed. Once the applications are scanned they can be accessed online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

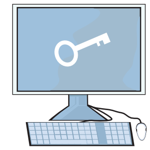
Physical Controls



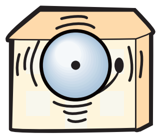
Safes, vaults, and safety deposit boxes for cash and business papers



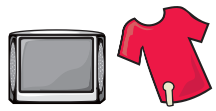
Locked warehouses and storage cabinets for inventories and records



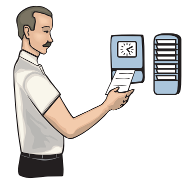
Computer facilities with pass key access or fingerprint or eyeball scans



Alarms to prevent break-ins



Television monitors and garment sensors to deter theft



Time clocks for recording time worked

Illustration 8-2
Physical controls

of the applications are from customers who did not work with a sales agent. Two friends—Alex, an employee in record keeping, 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 hardcopy 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 nonbusiness 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 pretending to be any other employee.

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

INDEPENDENT INTERNAL VERIFICATION

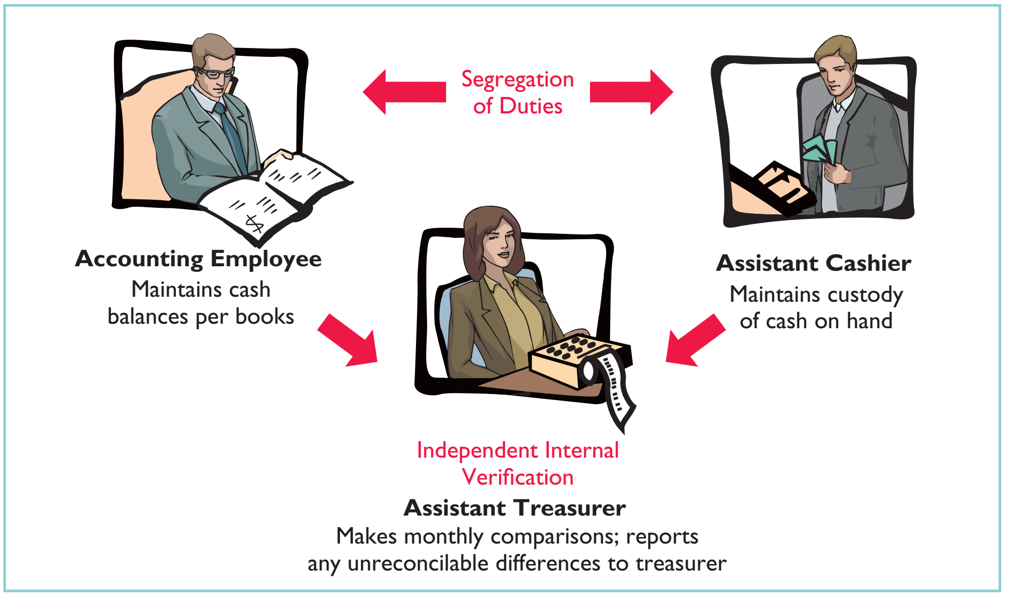
Most internal control systems provide for **independent internal verification**. This principle involves the review of data prepared by employees. To obtain maximum benefit from independent internal verification:

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 cash register tape with the cash in the register at Stephanie's Gourmet Coffee and More is an example of this internal control principle. Another common example is the reconciliation 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.

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



ANATOMY OF A FRAUD

Bobbi Jean Donnelly, the office manager for Mod Fashions Corporations 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. She was able to conceal the fraud because she was responsible for reviewing all expense reports, including her 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 ten 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. In fact, most fraud is discovered by the company through internal mechanisms such as existing internal controls and internal audits. For example, the alleged fraud at WorldCom, involving billions of dollars, 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 the telephone numbers for previous employers given on the reference sheet; always look them up yourself.

ANATOMY OF A FRAUD

Ellen Lowry was the desk manager and Josephine Rodriquez 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. Rodriquez, 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

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, and they 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 must 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?

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.

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.

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, stores 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 TV cameras and store detectives to monitor customer activity, and they install sensor equipment at exits.

The **human element** is an important factor in every system of internal control. A good system can become ineffective as a result of employee fatigue, carelessness, or indifference. For example, a receiving clerk may not bother to count goods received 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. A small company, for example, may find it difficult to segregate duties or to provide for independent internal verification.

DO IT!

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 is also the company's accountant and makes all bank deposits.
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. Record-keeping 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 pre-numbered 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 349.

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

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

✔ The Navigator

CASH CONTROLS

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

STUDY OBJECTIVE 3

Explain the applications of internal control principles to cash receipts.

Illustration 8-4 (page 358) 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.

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 rung up on a cash register, with the amount clearly visible to the customer. This activity prevents the cashier from ringing up a lower amount and pocketing the difference. The customer receives an itemized cash register receipt slip and is expected to count the change received. 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. Illustration 8-5 (page 359) summarizes this process.

This system for handling cash receipts uses an important internal control principle—segregation of record-keeping 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 record-keeping from

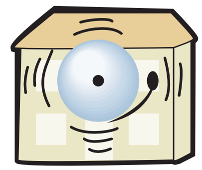
Cash Receipts Controls

Establishment of Responsibility

Only designated personnel are authorized to handle cash receipts (cashiers)

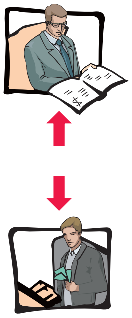
Physical Controls

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



Segregation of Duties

Different individuals receive cash, record cash receipts, and hold the cash

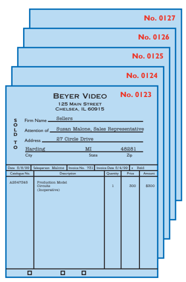


Independent Internal Verification

Supervisors count cash receipts daily; treasurer compares total receipts to bank deposits daily

Documentation Procedures

Use remittance advice (mail receipts), cash register tapes, and deposit slips



Human Resource Controls

Bond personnel who handle cash; require employees to take vacations; conduct background checks

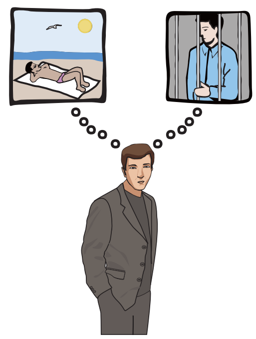


Illustration 8-4
Application of internal control principles to cash receipts

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

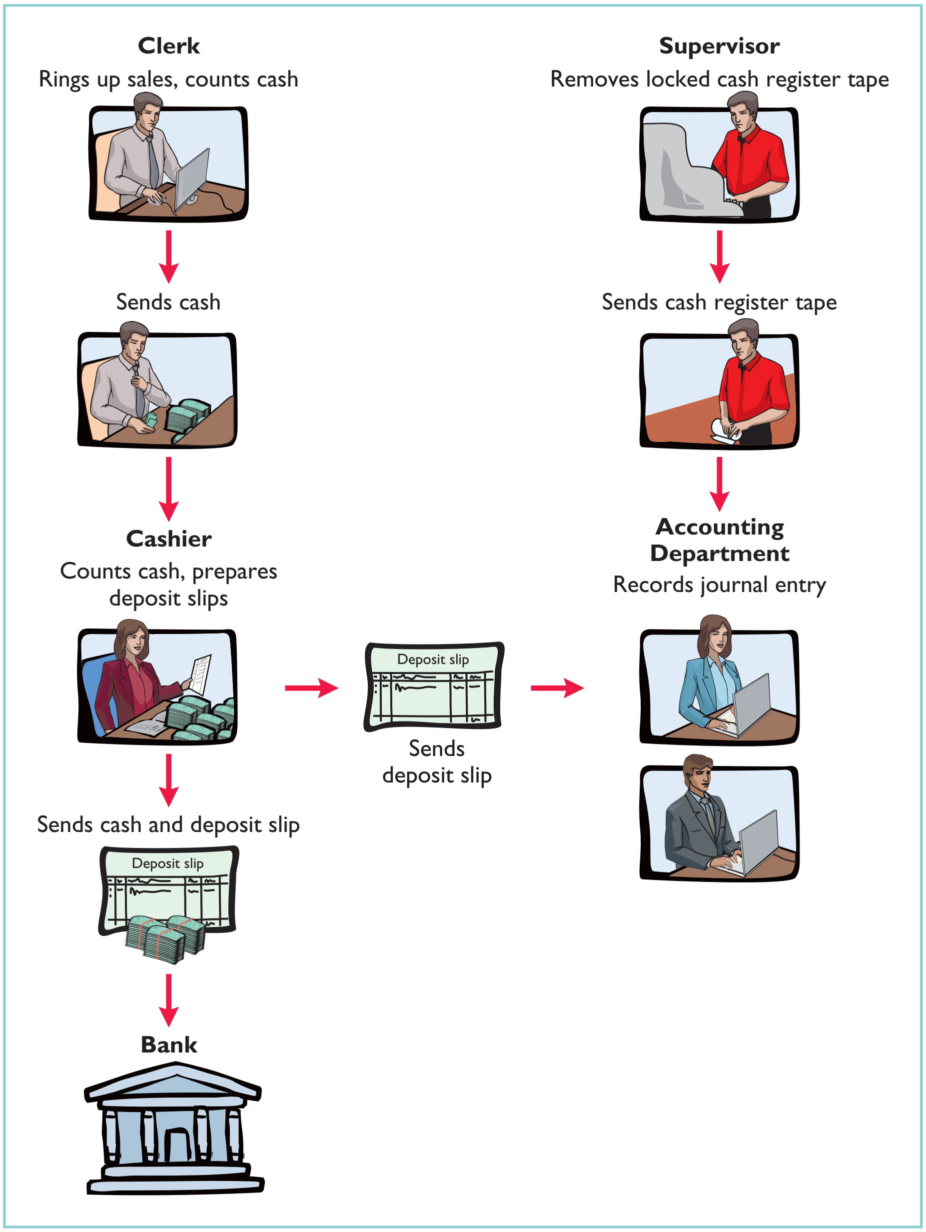


Illustration 8-5
Control of over-the-counter receipts

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

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-receipt 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!

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 ring up sales. Work shifts for employees range from 4 to 8 hours. Cortez asks your help in installing a good system of internal control over cash receipts.

action plan

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

Solution

Cortez should assign a cash register to each employee at the start of each work shift, with register totals set at zero. Each employee should be instructed to use only the assigned register and to ring up all sales. 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 rung up on the register to orders processed by the kitchen.

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

✔ *The Navigator*

Cash Disbursements Controls

STUDY OBJECTIVE 4

Explain the applications of internal control principles to cash disbursements.

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, rather than by cash.** One exception is **for incidental amounts that are paid out of petty cash.**[4]

Companies generally issue checks only after following specified control procedures. Illustration 8-6 (page 361) shows how principles of internal control apply 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.

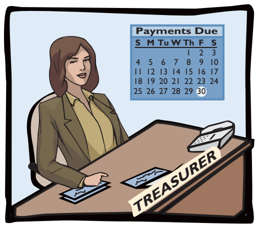
The system begins with the authorization to incur a cost or expense. It ends with the issuance of a check for the liability incurred. A **voucher** is an authorization form prepared for each expenditure. Companies require vouchers for all types of cash disbursements except those from petty cash.

[4] We explain the operation of a petty cash fund on pages 362–364.

Cash Disbursements Controls

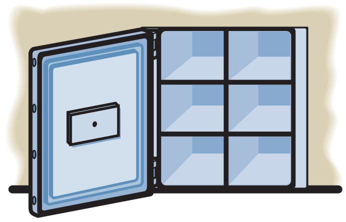
Establishment of Responsibility

Only designated personnel are authorized to sign checks (treasurer) and approve vendors



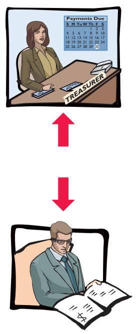
Physical Controls

Store blank checks in safes, with limited access; print check amounts by machine in indelible ink



Segregation of Duties

Different individuals approve and make payments; check signers do not record disbursements

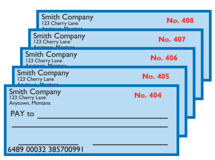


Independent Internal Verification

Compare checks to invoices; reconcile bank statement monthly

Documentation Procedures

Use prenumbered checks and account for them in sequence; each check must have an approved invoice; require employees to use corporate credit cards for reimbursable expenses; stamp invoices "paid"



Human Resource Controls

Bond personnel who handle cash; require employees to take vacations; conduct background checks

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

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 issue the voucher and a second to pay the voucher.

The use of a voucher system 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 351. 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 CONTROLS

STUDY OBJECTIVE 5

Describe the operation of a petty cash fund.

As you learned earlier in the chapter, 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 three steps: (1) establishing the fund, (2) making payments from the fund, and (3) replenishing the fund.[5]

Establishing The Fund. In establishing a petty cash fund, a company appoints a petty cash custodian who will be responsible for the fund. Next it determines 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 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.

Making Payments from the Fund. The petty cash fund custodian has the authority to make payments from the fund that conform to prescribed management policies. Usually, management limits the size of 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 (page 363). Note that 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.

The fund 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. Instead, the company recognizes the accounting effects of each payment when it replenishes the fund.

Replenishing the Fund. When the money in the petty cash fund reaches a minimum level, the company replenishes the fund. The petty cash custodian initiates

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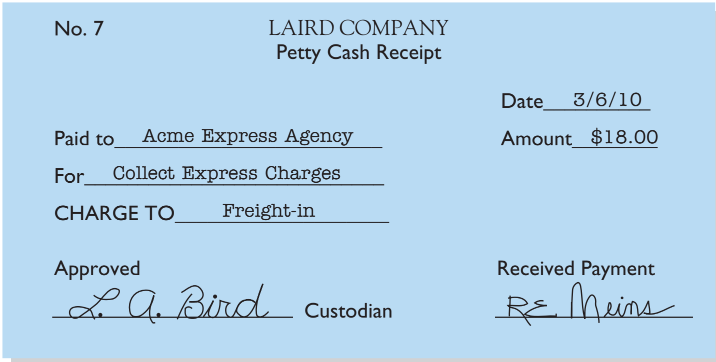
[5]The term “imprest” means an advance of money for a designated purpose.


No. 7
LAIRD COMPANY
Petty Cash Receipt

Date 3/6/10

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

Illustration 8-7
Petty cash receipt

a request for reimbursement. He or she 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. Someone in the treasurer's office examines the receipts and supporting documents to verify that they were proper payments from the fund. 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:

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.

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

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:

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

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

Cash Flows
−88

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

Conversely, if the custodian has $14 in cash, the reimbursement request would be for $86, and 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.

DO IT!

PETTY CASH FUND

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.

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	
	Office 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! 8-3.**

✔ *The Navigator*

CONTROL FEATURES: USE OF A BANK

STUDY OBJECTIVE 6

Indicate 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 clearing house 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 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.

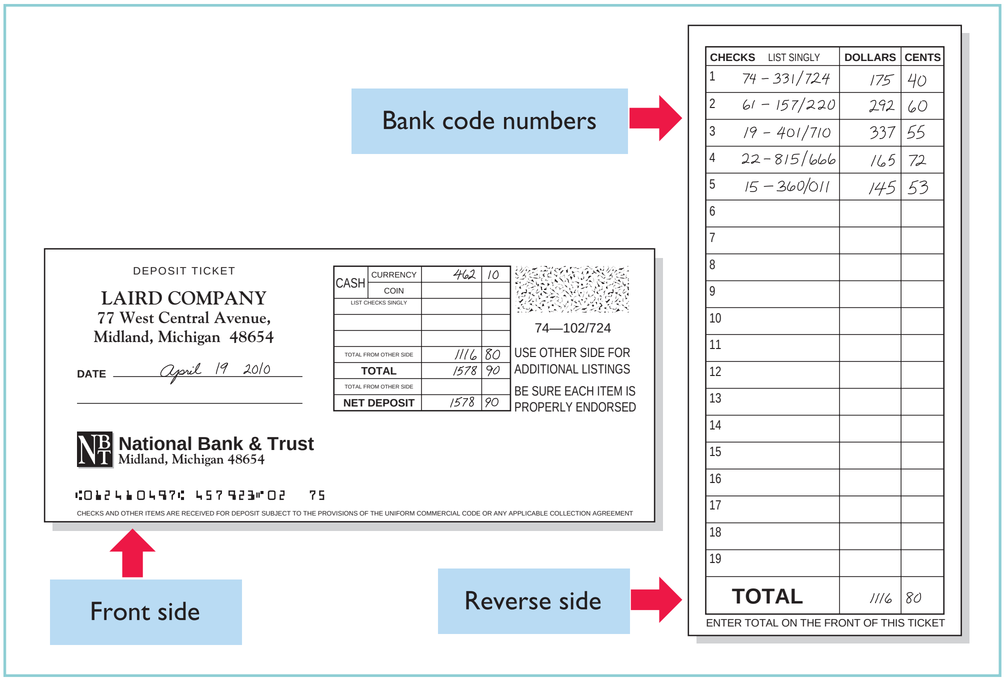


Illustration 8-8
Deposit slip

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.

Writing Checks

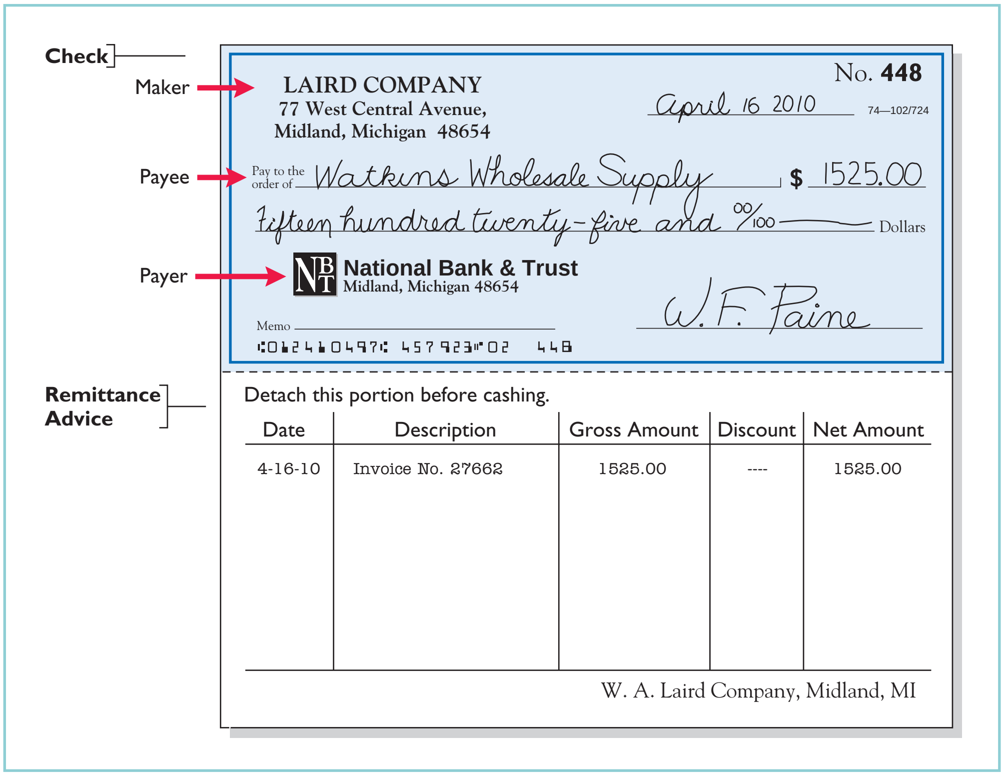
Most of us write checks, without thinking very much about them. A **check** is a written order signed by the depositor directing the bank to pay a specified sum of money to a designated recipient. There are three parties to a check: (1) the **maker** (or drawer) who issues the check, (2) the **bank** (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 (page 366) explains the check's purpose.

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 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

Illustration 8-9
Check with remittance advice



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

balances.[6] Each month, a depositor receives a statement from the bank. Illustration 8-10 (page 367) presents a typical bank statement. It shows: (1) checks paid and other debits that reduce the balance in the depositor's account, (2) deposits and other credits that increase the balance in the account, and (3) the account balance after each day's transactions.

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.

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 Scott Company, a customer of Laird Company, sends a check for $800 to Laird Company for services provided. Unfortunately, Scott does not have sufficient funds at its bank to pay

[6]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 receives information from the bank regarding its account.

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, 2010

457923
ACCOUNT NUMBER

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

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

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

for these services. In such a case, Scott'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 (above). The bank sends the NSF check and debit memorandum to Laird as notification of the charge. Laird then records an Account Receivable from Scott Company (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

STUDY OBJECTIVE 7
Prepare a bank reconciliation.

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. Therefore it is necessary to make the balance per books agree with the balance per bank—a process called **reconciling the bank account**. The lack of agreement between the two balances 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 of the depositor and the bank. Bank errors are infrequent. However, either party could accidentally record a $450 check as $45 or $540. In addition, the bank might mistakenly charge a check to a wrong account by keying in an incorrect account name or number.

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 (page 369).

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 the 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 the 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.

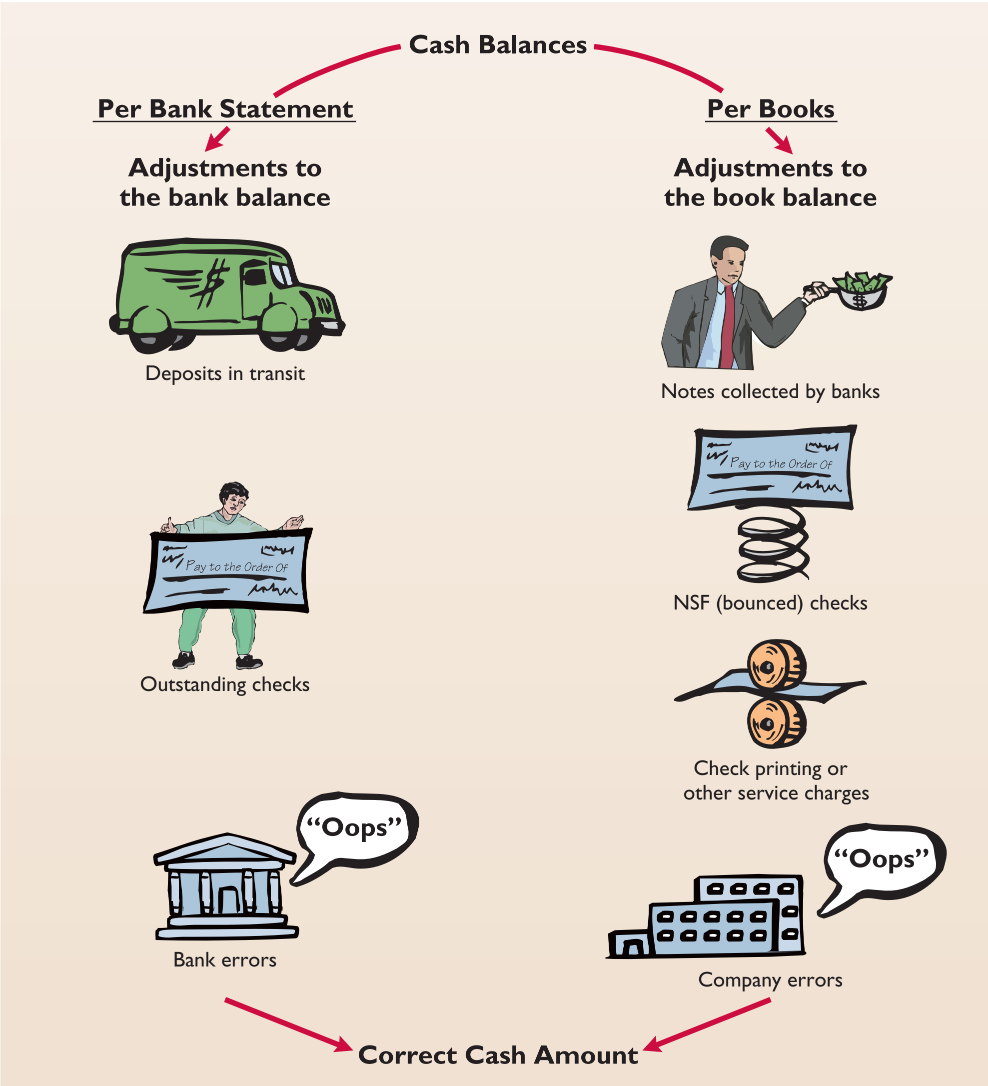


Illustration 8-11
Bank reconciliation adjustments

BANK RECONCILIATION ILLUSTRATED

The bank statement for Laird Company, in Illustration 8-10, shows a balance per bank of $15,907.45 on April 30, 2010. 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 (next page) shows Laird's bank reconciliation.

HELPFUL HINT

Note in the bank statement on page 367 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.

Illustration 8-12
Bank reconciliation

LAIRD COMPANY
Bank Reconciliation
April 30, 2010

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 balance, true cash balance,* and *correct cash balance* are used interchangeably.

HELPFUL HINT

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

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.

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				

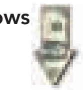
Cash Flows
−425.60

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.

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 now frequently make regular payments such as those for house, car, and utilities by EFT.

EFT transfers 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.

DO IT!

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.

action plan

✔ Understand the purpose of a bank reconciliation.

✔ Identify time lags and explain how they cause reconciling items.

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! 8-4.**

The Navigator

REPORTING CASH

STUDY OBJECTIVE 8
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. On the balance sheet, companies therefore combine cash on hand, cash in banks, and petty cash and report the total simply as **Cash**. Because it is the most liquid asset owned by a company, cash is listed first in the current assets section of the balance sheet. Some companies use the term "Cash and cash equivalents" in reporting cash, as shown in Illustration 8-14.

Illustration 8-14
Presentation of cash and cash equivalents

EASTMAN KODAK COMPANY
Balance Sheets (partial)

	2006	2005
Current assets (in millions)		
Cash and cash equivalents	$1,469	$1,665

Cash equivalents are short-term, highly liquid investments that can be converted into a specific amount of cash. At the time of purchase, they typically have maturities of three months or less. They include money market funds, bank certificates of deposit, and U.S. Treasury bills and notes.

A company may have cash that is restricted for a special purpose. An example is a payroll bank account for paying salaries and wages. Another would be a plant expansion cash fund for financing new construction. Companies should report **restricted cash** separately on the balance sheet. If a company expects to use the restricted cash **within the next year**, the amount should be reported as a current asset. Otherwise, it should be reported as a noncurrent asset. Since a payroll bank account will be used as early as the next payday, it is reported as a current asset. In contrast, unless the new construction will begin within the next year, cash for plant expansion would be classified as a noncurrent asset (long-term investment).

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

Be sure to read **ALL ABOUT YOU: *Protecting Yourself from Identity Theft*** on page 373 for information on how topics in this chapter apply to your personal life.

all about YOU

Protecting Yourself from Identity Theft

As a result of the Sarbanes-Oxley Act, companies have done a lot to improve their internal controls to help protect themselves from both internal and external thieves. What have you done lately to shore up your own personal internal controls? You've heard the stories about hackers cleaning out people's online investment accounts or running up credit card bills that would take you most of your life to pay off. (If you don't have a credit card, they'll open an account for you.) The identity thieves aren't going away. So what can you do to protect yourself? Many of the same common-sense controls discussed in this chapter can be implemented in your personal life.

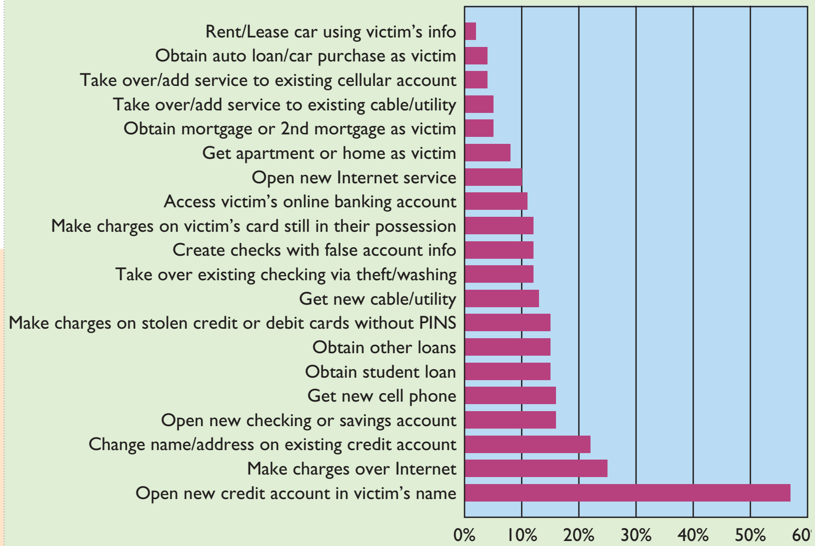
Some Facts

* Identity thieves determine your identity by going through your mail or trash, stealing your credit cards, redirecting mail through change of address forms, or acquiring personal information you share on unsecured sites. In a recent year, more than 7 million people were victims of identity theft.
* During a single computer-virus outbreak, called the "Hearse," thieves stole 90,000 pieces of personal data.
* The average identity-theft victim spends 600 hours clearing up his or her finances and financial and other records to recover from the crime.
* Victims incur an average of $1,400 in out-of-pocket expenses.
* Consumers have $1.7 trillion worth of assets with online brokerage firms. Many of the largest identity theft losses have been the result of thieves completely cleaning out online brokerage accounts.
* The Federal Trade Commission reports identify theft is the No. 1 fraud complaint among consumers. Phoenix and Las Vegas top the list for identity theft per capita.

About the Numbers

The following chart shows the most common survey responses from victims of identity theft when asked how their information was used by the thieves. (Note that respondents chose more than one type of use.)

Common Ways That Thieves Use Stolen Identity Information



Source: The Identity Theft Resource Center, *Identity Theft: The Aftermath 2007*, *www.idtheftcenter.org/idaftermath.pdf* (accessed May 2008).

What Do You Think

Do you feel it is safe to store personal financial data (such as Social Security numbers and bank and credit account numbers) on your computer?

YES: I have anti-virus software that will detect and stop any intruder.

NO: Even the best anti-virus software does not detect every kind of intruder.

Sources: Amy Borrus, "Invasion of the Stock Hackers," *Business Week*, November 14, 2005, pp. 38-40; Brian Grow, "Nasty, Brutish, and Sneaky," *Business Week*, April 10, 2006, p. 37; Federal Trade Commission, *www.consumer.gov/idtheft/*.

The authors' comments on this situation appear on page 394.

Comprehensive DO IT!

Poorten Company's bank statement for May 2010 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.

action plan

- ✔ Follow the four steps in the reconciliation procedure (p. 368).
- ✔ Make sure the adjusted cash balance per bank is equal to the adjusted cash balance per books.
- ✔ Work carefully to minimize mathematical errors in the reconciliation.
- ✔ Prepare adjusting entries from reconciling items per books.
- ✔ Make sure the cash ledger balance after posting the reconciling entries agrees with the adjusted cash balance per books.

Solution to Comprehensive DO IT!

(a)

POORTEN COMPANY
Bank Reconciliation
May 31, 2010

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)		

The Navigator

SUMMARY OF STUDY OBJECTIVES

1 **Define fraud and 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.

2 **Identify the principles of internal control.** 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.

3 **Explain the applications of internal control principles to cash receipts.** 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.

4 **Explain the applications of internal control principles to cash disbursements.** Internal controls over cash disbursements include: (a) having specific individuals such as the treasurer authorized to sign checks and approve invoices; (b) assigning different individuals to approve items for payment, pay the items, 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 checkwriting 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.

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

6 **Indicate the control features of a bank account.** A bank account contributes to good internal control by providing physical controls for the storage of cash. It minimizes the amount of currency that a company must keep on hand, and it creates a double record of a depositor's bank transactions.

7 **Prepare a bank reconciliation.** It is customary to reconcile the balance per books and balance per bank to their 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.

8 **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.

The Navigator

GLOSSARY

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. 364).

Bank service charge A fee charged by a bank for the use of its services. (p. 366).

Bank statement A monthly statement from the bank that shows the depositor's bank transactions and balances. (p. 365).

Bonding Obtaining insurance protection against misappropriation of assets by employees. (p. 355).

Cash Resources that consist of coins, currency, checks, money orders, and money on hand or on deposit in a bank or similar depository. (p. 372).

Cash equivalents Short-term, highly liquid investments that can be converted to a specific amount of cash. (p. 372).

Check A written order signed by a bank depositor, directing the bank to pay a specified sum of money to a designated recipient. (p. 365).

Compensating balances Minimum cash balances required by a bank in support of bank loans. (p. 372).

Deposits in transit Deposits recorded by the depositor but not yet been recorded by the bank. (p. 368).

Electronic funds transfer (EFT) A disbursement system that uses wire, telephone, or computers to transfer funds from one location to another. (p. 371).

Fraud A dishonest act by an employee that results in personal benefit to the employee at a cost to the employer. (p. 346).

Fraud triangle The three factors that contribute to fraudulent activity by employees: opportunity, financial pressure, and rationalization. (p. 346).

Internal auditors Company employees who continuously evaluate the effectiveness of the company's internal control system. (p. 355).

Internal control All of the related methods and activities adopted within an organization to safeguard its assets and enhance the accuracy and reliability of its accounting records. (p. 348).

NSF check A check that is not paid by a bank because of insufficient funds in a customer's bank account. (p. 367).

Outstanding checks Checks issued and recorded by a company but not yet paid by the bank. (p. 368).

Petty cash fund A cash fund used to pay relatively small amounts. (p. 362).

Restricted cash Cash that must be used for a special purpose. (p. 372).

Sarbanes-Oxley Act of 2002 (SOX) Regulations passed by Congress to try to reduce unethical corporate behavior. (p. 348).

Voucher An authorization form prepared for each payment in a voucher system. (p. 360).

Voucher system A network of approvals by authorized individuals acting independently to ensure that all disbursements by check are proper. (p. 360).

SELF-STUDY QUESTIONS

Answers are at the end of the chapter.

(SO 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.

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

(SO 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.

(SO 2) **4.** The principles of internal control do *not* include:
- **a.** establishment of responsibility.
- **b.** documentation procedures.
- **c.** management responsibility.
- **d.** independent internal verification.

(SO 2) **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.

(SO 3) **6.** Permitting only designated personnel to handle cash receipts is an application of the principle of:
- **a.** segregation of duties.
- **b.** establishment of responsibility.
- **c.** independent check.
- **d.** human resource controls.

7. Which of the following control activities is *not* relevant to when a company uses a computerized (rather than manual) accounting system? (SO 3)
- **a.** Establishment of responsibility.
- **b.** Segregation of duties.
- **c.** Independent internal verification.
- **d.** All of these control activities are relevant to a computerized system.

8. The use of prenumbered checks in disbursing cash is an application of the principle of: (SO 4)
- **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 $3 in cash. In recording the check, the company should: (SO 5)
- **a.** debit Cash Over and Short for $3.
- **b.** debit Petty Cash for $94.
- **c.** credit Cash for $94.
- **d.** credit Petty Cash for $3.

10. The control features of a bank account do *not* include: (SO 6)
- **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: (SO 7)
- **a.** deducted from the book balance.
- **b.** added to the book balance.
- **c.** added to the bank balance.
- **d.** deducted from the bank balance.

12. The reconciling item in a bank reconciliation that will result in an adjusting entry by the depositor is: (SO 7)
- **a.** outstanding checks.
- **b.** deposit in transit.
- **c.** a bank error.
- **d.** bank service charges.

(SO 8) **13.** Which of the following items in a cash drawer at November 30 is *not* cash?
a. Money orders.
b. Coins and currency.
c. A customer check dated December 1.
d. A customer check dated November 28.

(SO 8) **14.** Which of the following statements correctly describes the reporting of cash?
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.

Go to the book's companion website, **www.wiley.com/college/weygandt**, for Additional Self-Study questions.

The Navigator

QUESTIONS

1. A local bank reported that it lost $150,000 as the result of an employee fraud. Randal Smith is not clear on what is meant by an "employee fraud." Explain the meaning of fraud to Randal 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. Meg Lucas 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 Sewell 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. McCartney 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	12,000
Postdated checks	500

What amount should McCartney 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. Jacobs Department Stores has just installed new electronic cash registers in its stores. How do cash registers improve internal control over cash receipts?
15. At Hummel 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. Joe Griswold Company's internal controls over cash disbursements provide for the treasurer to sign checks imprinted by a checkwriting 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. Lori Figgs is confused about the lack of agreement between the cash balance per books and the balance per the bank. Explain the causes for the lack of agreement to Lori, 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. Kristen Hope asks your help concerning an NSF check. Explain to Kristen (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. PEPSICO At what amount does PepsiCo report cash and cash equivalents in its 2007 consolidated balance sheet?

BRIEF EXERCISES

Identify fraud-triangle concepts. (SO 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 their 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.

Indicate internal control concepts. (SO 1)

BE8-2 Jim Gaffigan has prepared the following list of statements about internal control.

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.

Explain the importance of internal control. (SO 1)

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

Identify internal control principles. (SO 2)

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

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.

Identify the internal control principles applicable to cash receipts. (SO 3)

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

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

Make journal entries for cash overage and shortfall. (SO 3)

BE8-6 The cash register tape for Leprechaun Industries reported sales of $6,891.56. 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 entry using cash count sheet. (SO 3)

BE8-7 While examining cash receipts information, the accounting department determined the following information: opening cash balance $150, cash on hand $1,125.74, and cash sales per register tape $990.83. Prepare the required journal entry based upon the cash count sheet.

Identify the internal control principles applicable to cash disbursements. (SO 4)

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

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

Prepare entry to replenish a petty cash fund. (SO 5)

BE8-9 On March 20, Terrell's petty cash fund of $100 is replenished when the fund contains $7 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.

Identify the control features of a bank account. (SO 6)

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

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

Indicate location of reconciling items in a bank reconciliation.

(SO 7)

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.

Identify reconciling items that require adjusting entries.

(SO 7)

BE8-13 At July 31, Kuhlmann Company has the following bank information: cash balance per bank $7,420, outstanding checks $762, deposits in transit $1,120, and a bank service charge $20. Determine the adjusted cash balance per bank at July 31.

Prepare partial bank reconciliation.

(SO 7)

BE8-14 At August 31, Felipe Company has a cash balance per books of $8,500 and the following additional data from the bank statement: charge for printing Felipe Company checks $35, interest earned on checking account balance $40, and outstanding checks $800. Determine the adjusted cash balance per books at August 31.

Prepare partial bank reconciliation.

(SO 7)

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

Explain the statement presentation of cash balances.

(SO 8)

DO IT! REVIEW

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.

Identify violations of control activities.

(SO 2)

1. Once a month the sales department sends sales invoices to the accounting department to be recorded.
2. Jay Margan orders merchandise for Rice Lake Company; he also receives merchandise and authorizes payment for merchandise.
3. Several clerks at Dick's Groceries use the same cash register drawer.

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

Design system of internal control over cash receipts.

(SO 3)

DO IT! 8-3 Mengke Company established a $100 petty cash fund on August 1. On August 30, the fund had $9 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 30.

Make journal entries for petty cash fund.

(SO 5)

DO IT! 8-4 Linus Hugt owns Linus Blankets. Linus asks you to explain how he should treat the following reconciling items when reconciling the company's bank account.

Explain treatment of items in bank reconciliation.

(SO 7)

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

EXERCISES

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

Identify the principles of internal control.

(SO 2)

Instructions

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

Identify internal control weaknesses over cash receipts and suggest improvements.

(SO 2, 3)

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

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

Instructions

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

Identify internal control weaknesses over cash disbursements and suggest improvements.

(SO 2, 4)

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

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, Benton leaves 100 company checks in an unmarked envelope on a shelf behind the cash register.
4. After payment, bills are filed in a paid invoice folder.
5. The company checks are unnumbered.

Instructions

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

Identify internal control weaknesses for cash disbursements and suggest improvements.

(SO 4)

E8-4 At Hutchingson Company, checks are not prenumbered because both the puchasing 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, 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. Hutchingson Company maintains one checking account that is reconciled by the treasurer.

Instructions

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

Indicate whether procedure is good or weak internal control.

(SO 2, 3, 4)

E8-5 Listed below are five procedures followed by The Beat 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. Ellen May 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.

(SO 2, 3, 4)

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

1. Employees are required to take vacations.
2. Any member of the sales department can approve credit sales.
3. Jethro Bodine 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.

(SO 5)

E8-7 James Hughes 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 $2.75. 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, James Hughes increased the fund from $100 to $150.

Instructions

Prepare journal entries for James Hughes Company for May 1, June 1, July 1, and July 10.

Prepare journal entries for a petty cash fund.

(SO 5)

E8-8 Lincolnville 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 $3 in cash. On March 20, the amount in the fund was increased to $150.

Instructions

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

Prepare bank reconciliation and adjusting entries. (SO 7)

E8-9 Anna Pelo is unable to reconcile the bank balance at January 31. Anna's reconciliation is as follows.

Cash balance per bank	$3,560.20
Add: NSF check	690.00
Less: Bank service charge	25.00
Adjusted balance per bank	$4,225.20
Cash balance per books	$3,875.20
Less: Deposits in transit	530.00
Add: Outstanding checks	930.00
Adjusted balance per books	$4,275.20

Instructions

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

Determine outstanding checks. (SO 7)

E8-10 On April 30, the bank reconciliation of Galena Company shows three outstanding checks: no. 254, $650, no. 255, $820, and no. 257, $410. The May bank statement and the May cash payments journal show the following.

Bank Statement Checks Paid			Cash Payments Journal Checks Issued		
Date	**Check No.**	**Amount**	**Date**	**Check No.**	**Amount**
5/4	254	650	5/2	258	159
5/2	257	410	5/5	259	275
5/17	258	159	5/10	260	890
5/12	259	275	5/15	261	500
5/20	261	500	5/22	262	750
5/29	263	480	5/24	263	480
5/30	262	750	5/29	264	560

Instructions

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

Prepare bank reconciliation and adjusting entries. (SO 7)

E8-11 The following information pertains to Family Video Company.

1. Cash balance per bank, July 31, $7,263.
2. July bank service charge not recorded by the depositor $28.
3. Cash balance per books, July 31, $7,284.
4. Deposits in transit, July 31, $1,500.
5. Bank collected $900 note for Family in July, plus interest $36, less fee $20. The collection has not been recorded by Family, 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 Family Video Company.

Prepare bank reconciliation and adjusting entries. (SO 7)

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

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

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

Credits		Debits	
Collection of $1,500 note plus interest $30	$1,530	NSF check: J. E. Hoover	$425
Interest earned on checking account	$45	Safety deposit box rent	$65

At September 30, deposits in transit were $4,450, 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.

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

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

(SO 7)

1. The June 30 bank reconciliation indicated that deposits in transit total $720. 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, Givens Company books show that $17,200 of checks were issued. The bank statement showed that $16,400 of checks cleared the bank in July.
3. In September, deposits per the bank statement totaled $26,700, deposits per books were $25,400, and deposits in transit at September 30 were $2,100.
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 Givens 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?

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

Show presentation of cash in financial statements.

(SO 8)

Cash in bank	$ 47,000
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 cash in bank is subject to a compensating balance of $5,000. 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 Lipkus 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?

(c) What disclosures should Lipkus make in its financial statements concerning "cash and cash equivalents"?

EXERCISES: SET B

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

PROBLEMS: SET A

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

Identify internal control principles over cash disbursements.

(SO 2, 4)

Instead of being unnumbered and manually prepared, all checks must now be prenumbered and written by using the new checkwriting machine purchased by the company. Before a check can be issued, each invoice must have the approval of Sally Morgan, the purchasing agent, and John Countryman, the receiving department supervisor. Checks must be signed by either Ann

Lynn, the treasurer, or Bob Skabo, the assistant treasurer. Before signing a check, the signer is expected to compare the amount of the check with the amount on the invoice.

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

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

Instructions

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

Journalize and post petty cash fund transactions.

(SO 5)

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

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

15 Replenished the petty cash fund by writing a check for $196.00. On this date the fund consisted of $4.00 in cash and the following petty cash receipts: freight-out $94.00, postage expense $42.40, entertainment expense $46.60, and miscellaneous expense $11.20.

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 $75.60, entertainment expense $43.00, postage expense $33.00, and miscellaneous expense $37.00.

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

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

Instructions

(a) 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 $1.80

(b) Aug. 31 balance $300

Prepare a bank reconciliation and adjusting entries.

(SO 7)

P8-3A On May 31, 2010, James Logan Company had a cash balance per books of $6,781.50. The bank statement from Farmers State Bank on that date showed a balance of $6,404.60. 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 Logan Company for the correct amount.
3. Outstanding checks at May 31 totaled $576.25. Deposits in transit were $1,916.15.
4. On May 18, the company issued check No. 1181 for $685 to Barry Trest, on account. The check, which cleared the bank in May, was incorrectly journalized and posted by Logan Company for $658.
5. A $2,500 note receivable was collected by the bank for Logan Company on May 31 plus $80 interest. The bank charged a collection fee of $20. No interest has been accrued on the note.
6. Included with the cancelled checks was a check issued by Bridgetown Company to Tom Lujak for $800 that was incorrectly charged to Logan Company by the bank.
7. On May 31, the bank statement showed an NSF charge of $680 for a check issued by Sandy Grifton, a customer, to Logan Company on account.

Instructions

(a) Prepare the bank reconciliation at May 31, 2010.

(b) Prepare the necessary adjusting entries for Logan Company at May 31, 2010.

(a) Adjusted cash balance per bank $8,544.50

Prepare a bank reconciliation and adjusting entries from detailed data.

(SO 7)

P8-4A The bank portion of the bank reconciliation for Backhaus Company at November 30, 2010, was as follows.

BACKHAUS COMPANY
Bank Reconciliation
November 30, 2010

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	1,889.50
12-10	3480	600.00	Total		$14,933.20
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 $4,145 for the collection of a $4,000 note for Backhaus Company plus interest of $160 and less a collection fee of $15. Backhaus Company has not accrued any interest on the note.

2. A debit of $572.80 for an NSF check written by D. Chagnon, a customer. At December 31, the check had not been redeposited in the bank.

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

Instructions

(a) Adjusted balance per books $15,958.40

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

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

Prepare a bank reconciliation and adjusting entries.

(SO 7)

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

	Cash in Bank	
	Per Books	**Per Bank**
Balance, July 1	$17,600	$16,800
July receipts	81,400	
July credits		82,470
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 $3,470 for the collection of a $3,400 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 $7,000 and outstanding checks of $6,200.

Instructions

(a) Adjusted balance per books $25,354

(a) Prepare a bank reconciliation at July 31.

(b) Journalize the adjusting entries to be made by Haverman Company at July 31, 2010. Assume that interest on the note has not been accrued.

Identify internal control weaknesses in cash receipts and cash disbursements.

(SO 2, 3, 4)

P8-6A Emporia Middle School wants to raise money for a new sound system for its auditorium. The primary fund-raising event is a dance at which the famous disc jockey Obnoxious Ed will play classic and not-so-classic dance tunes. Tom Wickman, the music and theater instructor, has been given the responsibility for coordinating the fund-raising efforts. This is Tom'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.

Tom 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 Tom, 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. Tom 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 Tom asked Luke Gilmor to count the money, prepare a deposit slip, and deposit the money in a bank account Tom had opened.

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

The following day Tom closed out the bank account, which had $250 in it, and gave that amount plus the $180 in the cash box to Principal Foran. Principal Foran seemed surprised that, after generating roughly $2,000 in sales, the dance netted only $430 in cash. Tom 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

Identify internal control weaknesses over cash receipts.

(SO 2, 3)

P8-1B Discount Theater is located in the Mishawaka Mall. A cashier's booth is located near the entrance to the theater. Three cashiers are employed. One works from 1–5 P.M., another from 5–9 P.M. The shifts are rotated among the three cashiers. The cashiers receive cash from customers and operate a machine that ejects serially numbered tickets. The rolls of tickets are inserted and locked into the machine by the theater manager at the beginning of each cashier's shift.

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

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

Instructions

(a) Identify the internal control principles and their application to the cash receipts transactions of the Discount Theater.

(b) If the usher and cashier decide to collaborate to misappropriate cash, what actions might they take?

Journalize and post petty cash fund transactions.

(SO 5)

P8-2B Loganberry 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 Rock Point Bank for $100.
	15	Replenished the petty cash fund by writing a check for $96.90. On this date the fund consisted of $3.10 in cash and the following petty cash receipts: freight-out $51.00, postage expense $20.50, entertainment expense $23.10, and miscellaneous expense $4.10.
	31	Replenished the petty cash fund by writing a check for $95.90. At this date, the fund consisted of $4.10 in cash and the following petty cash receipts: freight-out $43.50, charitable contributions expense $20.00, postage expense $20.10, and miscellaneous expense $12.30.
Aug.	15	Replenished the petty cash fund by writing a check for $98.00. On this date, the fund consisted of $2.00 in cash and the following petty cash receipts: freight-out $40.20, entertainment expense $21.00, postage expense $14.00, and miscellaneous expense $19.80.
	16	Increased the amount of the petty cash fund to $150 by writing a check for $50.
	31	Replenished petty cash fund by writing a check for $137.00. On this date, the fund consisted of $13 in cash and the following petty cash receipts: freight-out $74.00, entertainment expense $43.20, and postage expense $17.70.

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 over $1.80
(b) Aug. 31 balance $150

Prepare a bank reconciliation and adjusting entries.
(SO 7)

P8-3B Wolverine Genetics Company of Flint, Michigan, spreads herbicides and applies liquid fertilizer for local farmers. On May 31, 2010, the company's cash account per its general ledger showed the following balance.

CASH NO. 101

Date	Explanation	Ref.	Debit	Credit	Balance
May 31	Balance				13,287

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

FLINT STATE BANK

Checks and Debits	Deposits and Credits	Daily Balance
XXX	XXX	5/31 13,332

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

1. The statement included a debit memo of $35 for the printing of additional company checks.
2. Cash sales of $1,720 on May 12 were deposited in the bank. The cash receipts journal entry and the deposit slip were incorrectly made for $1,820. The bank credited Wolverine Genetics Company for the correct amount.
3. Outstanding checks at May 31 totaled $1,225, and deposits in transit were $2,100.
4. On May 18, the company issued check no. 1181 for $911 to G. Fischer, on account. The check, which cleared the bank in May, was incorrectly journalized and posted by Wolverine Genetics Company for $119.
5. A $4,000 note receivable was collected by the bank for Wolverine Genetics Company on May 31 plus $80 interest. The bank charged a collection fee of $25. No interest has been accrued on the note.
6. Included with the cancelled checks was a check issued by Carr Company to Henry Ford for $900 that was incorrectly charged to Wolverine Genetics Company by the bank.
7. On May 31, the bank statement showed an NSF charge of $1,308 for a check issued by Bo Sclembech, a customer, to Wolverine Genetics Company on account.

Instructions

(a) Adj. cash bal. $15,107

(a) Prepare the bank reconciliation at May 31, 2010.
(b) Prepare the necessary adjusting entries for Wolverine Genetics Company at May 31, 2010.

Prepare a bank reconciliation and adjusting entries from detailed data.
(SO 7)

P8-4B The bank portion of the bank reconciliation for Chapin Company at October 31, 2010, was as follows.

CHAPIN COMPANY
Bank Reconciliation
October 31, 2010

Cash balance per bank			$6,000
Add: Deposits in transit			842
			6,842
Less: Outstanding checks			
	Check Number	Check Amount	
	2451	$700	
	2470	396	
	2471	464	
	2472	270	
	2474	578	2,408
Adjusted cash balance per bank			$4,434

The adjusted cash balance per bank agreed with the cash balance per books at October 31.

The November bank statement showed the following checks and deposits:

Bank Statement

Checks Date	Checks Number	Checks Amount	Deposits Date	Deposits Amount
11-1	2470	$ 396	11-1	$ 842
11-2	2471	464	11-4	666
11-5	2474	578	11-8	545
11-4	2475	903	11-13	1,416
11-8	2476	1,556	11-18	810
11-10	2477	330	11-21	1,624
11-15	2479	980	11-25	1,412
11-18	2480	714	11-28	908
11-27	2481	382	11-30	652
11-30	2483	317	Total	$8,875
11-29	2486	495		
	Total	$7,115		

The cash records per books for November showed the following.

Cash Payments Journal

Date	Number	Amount	Date	Number	Amount
11-1	2475	$ 903	11-20	2483	$ 317
11-2	2476	1,556	11-22	2484	460
11-2	2477	330	11-23	2485	525
11-4	2478	300	11-24	2486	495
11-8	2479	890	11-29	2487	210
11-10	2480	714	11-30	2488	635
11-15	2481	382	Total		$8,067
11-18	2482	350			

Cash Receipts Journal

Date	Amount
11-3	$ 666
11-7	545
11-12	1,416
11-17	810
11-20	1,642
11-24	1,412
11-27	908
11-29	652
11-30	1,541
Total	$9,592

The bank statement contained two bank memoranda:

1. A credit of $1,375 for the collection of a $1,300 note for Chapin Company plus interest of $91 and less a collection fee of $16. Chapin Company has not accrued any interest on the note.

2. A debit for the printing of additional company checks $34.

At November 30, the cash balance per books was $5,958, and the cash balance per the bank statement was $9,100. The bank did not make any errors, but two errors were made by Chapin Company.

Instructions

(a) Using the four steps in the reconciliation procedure described on page 368, prepare a bank reconciliation at November 30.

(a) Adjusted cash balance per bank $7,191

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

Prepare a bank reconciliation and adjusting entries.

(SO 7)

P8-5B Bummer Company's bank statement from Fifth National Bank at August 31, 2010, shows the information on the next page.

Balance, August 1	$11,284	Bank credit memoranda:	
August deposits	47,521	Collection of note receivable plus $105 interest	$4,505
Checks cleared in August	46,475	Interest earned	41
Balance, August 31	16,856	Bank debit memorandum:	
		Safety deposit box rent	20

A summary of the Cash account in the ledger for August shows: Balance, August 1, $10,959; receipts $50,050; disbursements $47,794; and balance, August 31, $13,215. Analysis reveals that the only reconciling items on the July 31 bank reconciliation were a deposit in transit for $2,600 and outstanding checks of $2,925. The deposit in transit was the first deposit recorded by the bank in August. In addition, you determine that there were two errors involving company checks drawn in August: (1) A check for $340 to a creditor on account that cleared the bank in August was journalized and posted for $430. (2) A salary check to an employee for $275 was recorded by the bank for $277.

(a) Adjusted balance per books $17,831

Instructions

(a) Prepare a bank reconciliation at August 31.

(b) Journalize the adjusting entries to be made by Bummer Company at August 31. Assume that interest on the note has not been accrued by the company.

Prepare a comprehensive bank reconciliation with theft and internal control deficiencies.

(SO 2, 3, 4, 7)

P8-6B Gazarra Company is a very profitable small business. It has not, however, given much consideration to internal control. For example, in an attempt to keep clerical and office expenses to a minimum, the company has combined the jobs of cashier and bookkeeper. As a result, Johnny Stacatto handles all cash receipts, keeps the accounting records, and prepares the monthly bank reconciliations.

The balance per the bank statement on October 31, 2010, was $15,453. Outstanding checks were: no. 62 for $107.74, no. 183 for $127.50, no. 284 for $215.26, no. 862 for $162.10, no. 863 for $192.78, and no. 864 for $140.49. Included with the statement was a credit memorandum of $340 indicating the collection of a note receivable for Gazarra Company by the bank on October 25. This memorandum has not been recorded by Gazarra Company.

The company's ledger showed one cash account with a balance of $18,608.81. The balance included undeposited cash on hand. Because of the lack of internal controls, Stacatto took for personal use all of the undeposited receipts in excess of $3,226.18. He then prepared the following bank reconciliation in an effort to conceal his theft of cash.

BANK RECONCILIATION

Cash balance per books, October 31		$18,608.81
Add: Outstanding checks		
No. 862	$162.10	
No. 863	192.78	
No. 864	140.49	410.31
		19,019.18
Less: Undeposited receipts		3,226.18
Unadjusted balance per bank, October 31		15,793.00
Less: Bank credit memorandum		340.00
Cash balance per bank statement, October 31		$15,453.00

(a) Adjusted balance per books $17,733.31

Instructions

(a) Prepare a correct bank reconciliation. (*Hint*: Deduct the amount of the theft from the adjusted balance per books.)

(b) Indicate the three ways that Stacatto attempted to conceal the theft and the dollar amount pertaining to each method.

(c) What principles of internal control were violated in this case?

PROBLEMS: SET C

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

CONTINUING COOKIE CHRONICLE

(Note: This is a continuation of the Cookie Chronicle from Chapters 1 through 6.)

CCC8 **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: PepsiCo, Inc.

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

Instructions

(a) What comments, if any, are made about cash in the report of the independent auditors?
(b) What data about cash and cash equivalents are shown in the consolidated balance sheet?
(c) In its notes to Consolidated Financial Statements, how does PepsiCo define cash equivalents?
(d) In management's letter that assumes "Responsibility for Financial Reporting," what does PepsiCo's management say about internal control? (See page A32 in Appendix A of the back of the book.)

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

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

Instructions

(a) Based on the information contained in these financial statements, determine each of the following for each company:
   (1) Cash and cash equivalents balance at December 29, 2007, for PepsiCo and at December 30, 2007, for Coca-Cola.
   (2) Increase (decrease) in cash and cash equivalents from 2006 to 2007.
   (3) Cash provided by operating activities during the year ended December 2007 (from statement of cash flows).
(b) What conclusions concerning the management of cash can be drawn from these data?

Exploring the Web

BYP8-3 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 front page of this site provides links to pages that answer six critical questions. Use these links to answer the following questions.

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

CRITICAL THINKING

Decision Making Across the Organization

BYP8-4 The board of trustees of a local church is concerned about the internal accounting controls for the offering collections made at weekly services. The trustees ask you to serve on a three-person audit team with the internal auditor of a local college and a CPA who has just joined the church.

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

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

Instructions
With the class divided into groups, answer the following.

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

Communication Activity

BYP8-5 As a new auditor for the CPA firm of Croix, Marais, and Kale, you have been assigned to review the internal controls over mail cash receipts of Manhattan 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 Jerry Mays, owner of the Manhattan Company, explaining the weaknesses in internal control and your recommendations for improving the system.

Ethics Case

BYP8-6 You are the assistant controller in charge of general ledger accounting at Riverside 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 Gena Schmitt, the financial vice president. Gena 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. Gena 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!" Gena continues, "I talked to Oconto Distributors (one of Riverside'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 Gena Schmitt'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" Activity

BYP8-7 The **All About You** feature in this chapter (page 373) indicates potential security risks that may arise from your personal computer. It is important to keep in mind, however, that there are also many other ways that your identity can be stolen other than from your computer. The federal government provides many resources to help protect you from identity thieves.

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

Answers to Insight and Accounting Across the Organization Questions

p. 347 How Do Employees Steal?
Q: How can companies reduce the likelihood of fraudulent disbursements?
A: *Some common-sense approaches are to make sure only certain designated individuals can sign checks. In addition, make sure that different personnel approve payments and make payments.*

p. 356 SOX Boosts the Role of Human Resources
Q: Why would unsupervised employees or employees who report to each other represent potential internal control threats?
A. *An unsupervised employee may have a fraudulent job (or may even be a fictitious person—e.g., a person drawing a paycheck without working). Or, if two employees supervise each other, there is no real separation of duties, and they can conspire to defraud the company.*

Authors' Comments on *All About You:* Protecting Yourself from Identity Theft (p. 373)

Most experts discourage storing sensitive financial information on your computer. In recent years there have been countless examples of hackers penetrating sophisticated corporate systems to steal personal data. If hackers can beat sophisticated systems, it is unlikely that you can do better.

The Federal Trade Commission recommends that you frequently update your anti-virus software. Use a firewall program and a secure browser that encrypts all online transactions. If you do store financial information on your computer, make sure that it is password-protected with a password that is an unrecognizable combination of upper- and lower-case letters, numbers, and symbols. Change the password periodically. When you dispose of your old computer, make sure that you use a wiping utility to destroy all information on the hard drive.

Be careful, too, not to focus all of your internal control efforts on your computer. Most identity theft still derives from very non-technical sources—such as your trash can. You should take the following steps to minimize non-computer-related risks: Use passwords on your credit card, bank, and phone accounts. Make sure that all personal information in your home is in a secure place, especially if you have roommates or employ outside help. Don't give out personal information unless you initiated the contact or you are sure you know whom you are dealing with. Deposit outgoing mail in post-office collection boxes (not in your mailbox with the red flag up), and promptly remove all mail from your mailbox. Use a cross-cut shredder to shred all charge receipts, insurance forms, bank statements, etc. that might reveal personal information.

Answers to Self-Study Questions

1. c **2.** a **3.** a **4.** c **5.** b **6.** b **7.** d **8.** d **9.** a **10.** a **11.** c **12.** d **13.** c **14.** c

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