

# INTERNAL CONTROL AND CASH

# 10

## THE NAVIGATOR ✓

- Understand *Concepts for Review*
- Read *Feature Story*
- Scan *Study Objectives*
- Read *Preview*
- Read text and answer *Before You Go On*  
p. 296  p. 301  p. 309
- Work *Demonstration Problem*
- Review *Summary of Study Objectives*
- Complete *Assignments*

## CONCEPTS FOR REVIEW

**Before studying this chapter, you should know or, if necessary, review:**

- a. The role ethics plays in proper financial reporting. (Ch. 1, p. 8)
- b. The qualitative characteristics of accounting information. (Ch. 2, pp. 34–35)
- c. Accrual basis versus cash basis of accounting. (Ch. 4, pp. 105–106)
- d. The limitations of financial statements analysis. (Ch. 7, pp. 222–223)

## F E A T U R E S T O R Y

### 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, 646 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."

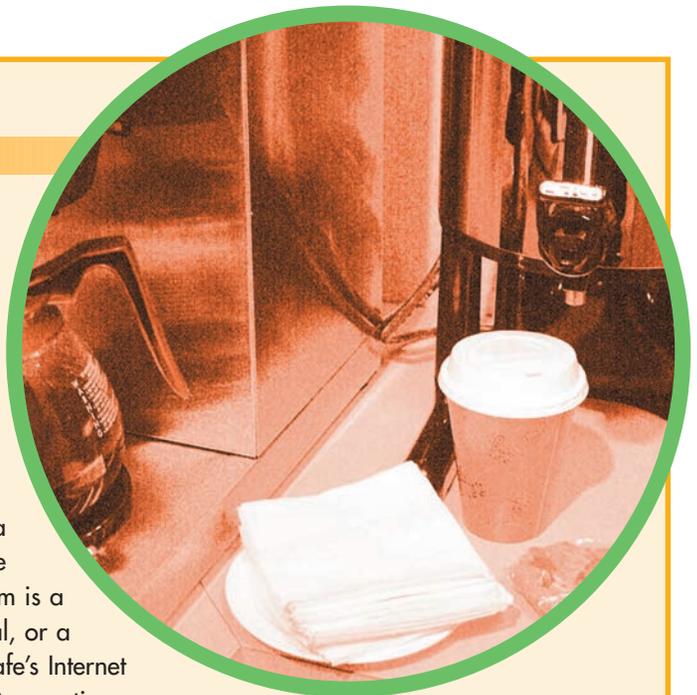
That means that the cashiers have to be efficient. Like most businesses where purchases are low-cost and high-volume, cash control has to be simple.

"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. All transactions are recorded on an internal tape in the machine; the customer receives a receipt only on 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. The cash in the register drawer is counted. That amount, minus the cash change carried forward (the float), should match the shift total on the register tape. If there's a dis-



crepancy, 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."



## S T U D Y O B J E C T I V E S

After studying this chapter, you should be able to

1. Define internal control.
2. Identify the principles of internal control.
3. Explain the applications of internal control principles to cash receipts.
4. Explain the applications of internal control principles to cash disbursements.
5. Indicate the control features of a bank account.
6. Prepare a bank reconciliation.

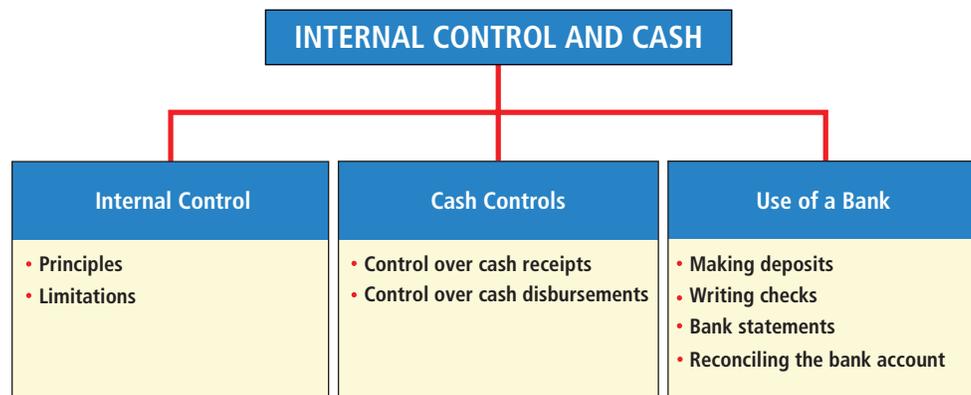


## PREVIEW OF CHAPTER 10

As the story about recording cash sales at **Stephanie's Gourmet Coffee and More** indicates, control of cash is important. Equally important is the control of inventories. Controls are needed to safeguard all types of assets. For example, Stephanie's undoubtedly has controls to prevent the theft of its food and supplies inventories and the theft of silverware and dishes from its kitchen.

In this chapter, we will explain the essential features of an internal control system and describe how those controls apply to cash. The applications include some controls with which you may already be familiar. Toward the end of the chapter we describe the use of a bank and explain how cash is reported on the balance sheet.

The content and organization of Chapter 10 are as follows.



## INTERNAL CONTROL

### STUDY OBJECTIVE 1

Define internal control.

Could there be dishonest employees where you work? Unfortunately, the answer sometimes is yes. For example, the press recently reported the following:<sup>1</sup>

- A restaurateur in New York was arrested along with his bookkeeper and charged with stealing \$185,000 by adding thousands of dollars in tips to credit card charges.
- A new manager, taking over a fast-food restaurant, took inventory of the food items in the freezer and found that the previous manager had filled four hamburger-patty boxes with rocks.
- A bar manager, after receiving complaints from guests about the diluted drinks, found that bottles of clear liquor were mostly water.
- A controller found “faked” invoices submitted for payment by a company that only exists at a post office box address.

These situations emphasize the need for a good system of internal control.

<sup>1</sup>Milford Prewitt, “In the Soup: Ruggerio Charged in Tip Fraud,” *Nation's Restaurant News* 32(46) (1998): 1, 2.

**Internal control** consists of the plan of organization and all the related methods and measures adopted within a business to do the following:

1. **Safeguard its assets** from employee theft, robbery, and unauthorized use.
2. **Enhance the accuracy and reliability of its accounting records.** This is done by reducing the risk of errors (unintentional mistakes) and irregularities (intentional mistakes and misrepresentations) in the accounting process.

The Foreign Corrupt Practices Act of 1977 requires all major U.S. corporations to maintain an adequate system of internal control. Companies that fail to comply are subject to fines, and company officers may be imprisoned. Also, the National Commission on Fraudulent Financial Reporting concluded that all companies whose stock is publicly traded should maintain internal controls that can provide reasonable assurance that fraudulent financial reporting will be prevented or subject to early detection.<sup>2</sup>

## ACCOUNTING IN ACTION *Ethics Insight*



Fraud takes many forms. Here are two of the dumbest: (1) In Wichita, Kansas, police arrested a 22-year-old male who tried to pass two counterfeit \$16 bills at an airport hotel. (2) And in Newport, Pennsylvania, a new-accounts bank clerk accepted for deposit a fake \$1 million bill, which was 10 times the value of the largest bill ever printed by the government (a \$100,000 bill existed for three weeks in the 1930s) and 10,000 times larger than the \$100 bill, which is the largest bill now in circulation. While the bank clerk learned a hard lesson, the fake bill passer learned about “hard time.”

What could the Newport, Pennsylvania, bank have done to prevent such an error?

*SOURCE:* Joseph R. Wells, “The World’s Dumbest Fraudsters,” *Journal of Accountancy*, May 2003, p. 55. Copyright © 2003 from the *Journal of Accountancy by the American Institute of Certified Public Accountants, Inc.* Opinions of the authors are their own and do not necessarily reflect policies of the AICPA. Reprinted with permission.

### INTERNATIONAL NOTE

U.S. companies also adopt model business codes that guide their international operations to provide for a safe and healthful workplace, avoid child and forced labor, abstain from bribes, and follow sound environmental practices.



## PRINCIPLES OF INTERNAL CONTROL

To safeguard its assets and to enhance the accuracy and reliability of its accounting records, a company follows specific control principles. Of course, internal control measures vary with the size and the nature of the business and with management’s control philosophy. The six principles listed in Illustration 10-1 apply to most enterprises. Each principle is explained in the following sections.

### Establishment of Responsibility

An essential characteristic of internal control is the assignment of 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 breakfast restaurant is \$10 short of the cash rung up on the cash register. If only one person has operated the register, responsibility for the shortage can be assessed quickly. If two or more individuals have worked the register, it may be impossible to determine who is responsible for the error unless each person is assigned a separate cash drawer and register key. The principle of establishing responsibility does not appear to be strictly applied by **Stephanie’s** (in the Feature

### STUDY OBJECTIVE 2

Identify the principles of internal control.

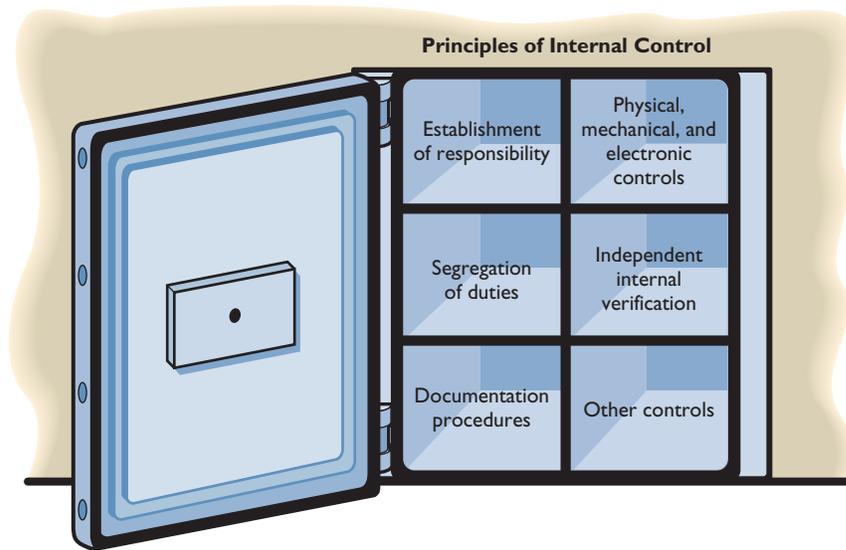


Transfer of cash drawers

<sup>2</sup>Report of the National Commission on Fraudulent Financial Reporting, October 1987, p. 11.

**Illustration 10-1**

Principles of internal control



Story) because three people operate the cash register on any given shift. To identify any shortages quickly at Stephanie’s, two cashouts are performed each day.

Establishing responsibility includes the authorization and approval of transactions. For example, the vice president of sales should have the authority to establish policies for making credit sales. The policies ordinarily will require written credit department approval of credit sales.

**Segregation of Duties**

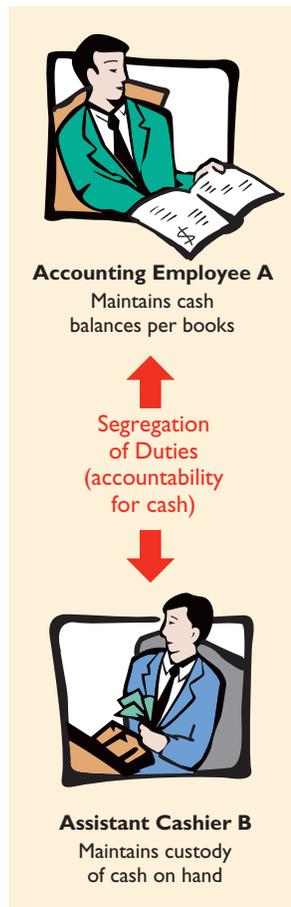
**Segregation of duties** (also called *separation of functions* or *division of work*) is indispensable in a system of internal control. There are two common applications of this principle:

1. Related activities should be assigned to different individuals.
2. Establishing the accountability (keeping the records) 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.**

**RELATED ACTIVITIES.** Related activities that should be assigned to different individuals arise in both purchasing and selling. **When one individual is responsible for all the related activities, the potential for errors and irregularities is increased.** Related purchasing activities include ordering merchandise, receiving the goods, and paying (or authorizing payment) for the merchandise. In purchasing, for example, orders could be placed with friends or with suppliers who give kick-backs. Or only a cursory count and inspection could be made on receiving the goods, which could lead to errors and poor-quality merchandise. Payment might be authorized without a careful review of the invoice. Even worse, fictitious invoices might be approved for payment. When the ordering, receiving, and paying are assigned to different individuals, the risk of such abuses is minimized.

Similarly, related sales activities should be assigned to different individuals. Related selling activities include making a sale, shipping (or delivering) the goods to the customer, billing the customer, and receiving payment. When one person handles related sales transactions, a salesperson could make sales at unauthorized prices to increase sales commissions; a shipping clerk could ship goods to himself; a billing clerk could understate the amount billed for sales made to friends and



relatives. These abuses are reduced by dividing 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.

**ACCOUNTABILITY FOR ASSETS.** To provide a valid basis of accountability for an asset, 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. **When one employee maintains the record of the asset that should be on hand and a different employee has physical custody of the asset, the custodian of the asset is not likely to convert the asset to personal use.** The separation of accounting responsibility from the custody of assets is especially important for cash and inventories because these assets are vulnerable to unauthorized use or misappropriation.

## TECHNOLOGY IN ACTION



### Saving Cash through Controls

If control is so important in the hospitality business and if technology is supposed to make things better, is technology used in helping operators and businesses control their costs? **Chevys**, a restaurant chain that owns 131 Chevys Fresh Mex restaurants, 33 Rio Bravos, and 9 Fuzio Universal Pasta restaurants, has the answer. They installed a system that has resulted in at least a 1 percent savings in food costs. With average sales at a Chevys Fresh Mex of over \$2.5 million a year, 1 percent of sales translates to \$25,000 and thus close to \$3.3 million just for the Fresh Mex brand. The system allows management to do correct pricing with updated information from the vendor.

There are many available technology systems of which restaurateurs, big or small, can take advantage and better operate their businesses. They can track menu additions, product mix, takeout orders, complimentary meals, voids, specialty requests, and so forth, so that management and owners can stay competitive.

*SOURCE:* E. Rubenstein, "The Menu Is Served," *Hospitality Technology* pp. 19–21 (April 2003); and D. Kelley, "Analyze This," *Hospitality Technology* pp. 32–32 (April 2003).

## Documentation Procedures

Documents provide evidence that transactions and events have occurred. At **Stephanie's Gourmet Coffee and More**, the cash register tape was the restaurant's documentation for the sale and the amount of cash received. Similarly, a shipping document indicates that goods have been shipped, and a sales invoice indicates that a customer has been billed for goods. By adding signatures (or initials) to the documents, the individual(s) responsible for the transaction or event can be identified. Documentation of transactions should be made when the transaction occurs. Documentation of events, such as those leading to adjusting entries, is generally developed when the adjustments are made.

Two procedures should be established for documents:

1. **Whenever possible, documents should be prenumbered, and all documents should be accounted for.** Prenumbering helps to prevent a transaction from being recorded more than once. It also helps to prevent the transactions from not being recorded.
2. **Documents that are source documents for accounting entries should be promptly forwarded to the accounting department.** This control measure helps to ensure timely recording of the transaction and contributes directly to the accuracy and the reliability of the accounting records.



Prenumbered invoices

### HELPFUL HINT

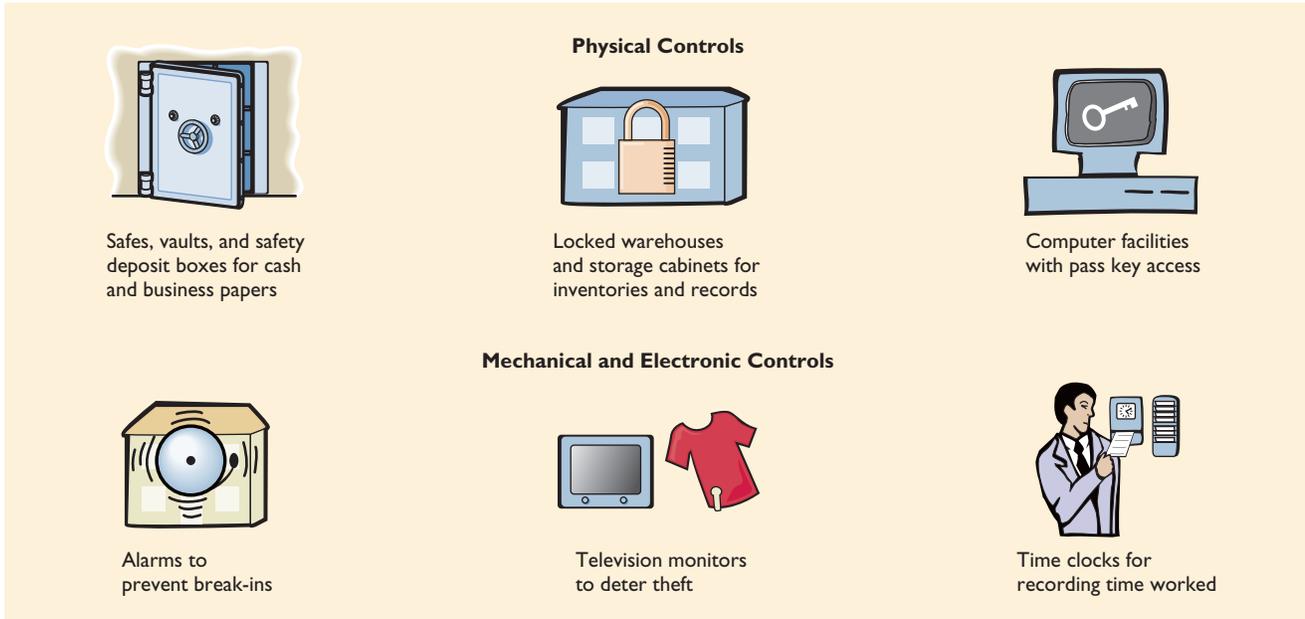
An important corollary to prenumbering is that voided documents be kept until all documents are accounted for.

### Physical, Mechanical, and Electronic Controls

Use of physical, mechanical, and electronic controls is essential. Physical controls relate primarily to the safeguarding of assets. Mechanical and electronic controls also safeguard assets; some enhance the accuracy and the reliability of the accounting records. Examples of these controls are shown in Illustration 10-2.

#### **Illustration 10-2**

Physical, mechanical, and electronic controls



## ACCOUNTING IN ACTION Business Insight

Unfortunately, computer-related frauds have become a major concern. The average computer fraud loss is \$650,000, compared with an average loss of only \$19,000 resulting from other types of white-collar crime.

Computer fraud can be perpetrated almost invisibly and with electronic speed. Psychologically, stealing with impersonal computer tools can seem far less criminal to some people. Therefore, the moral threshold to commit computer fraud is lower than that for fraud involving person-to-person contact.

Preventing and detecting computer fraud represent a major challenge. One of the best ways for a company to minimize the likelihood of computer fraud is to have a good system of internal control that allows the benefits of computerization to be gained without opening the possibility for rampant fraud.

Is a computer capable of committing fraud? Discuss.

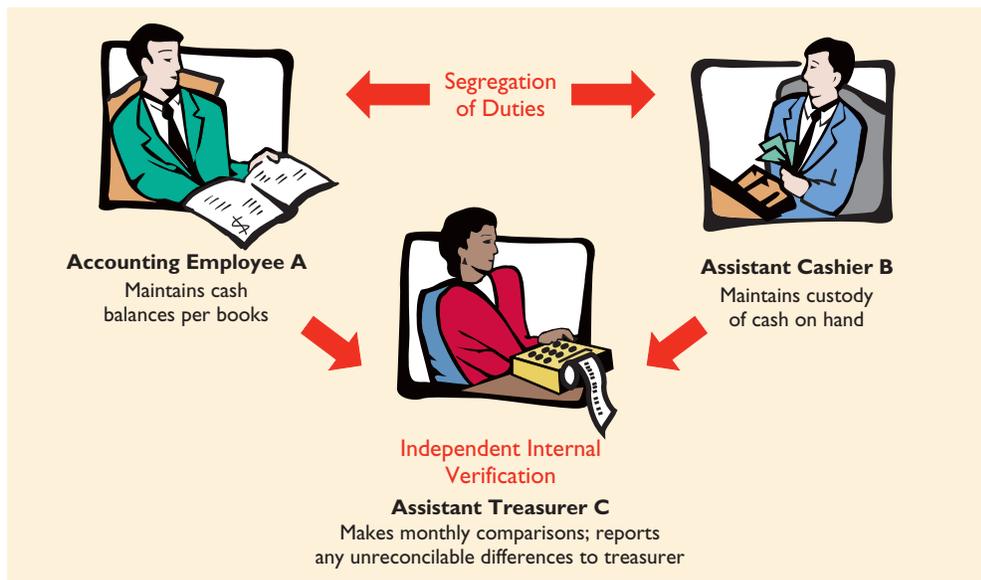
### Independent Internal Verification

Most internal control systems provide for **independent internal verification**. This principle involves the review, comparison, and reconciliation of data prepared by other employees. To obtain maximum benefit from independent internal verification, three features must be present:

1. The verification should be made periodically or on a surprise basis.
2. The verification should be done by someone who is independent of the employee responsible for the information.

- 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 by an independent person of the cash balance per books with the cash balance per bank. The relationship between this principle and the segregation of duties principle is shown graphically in Illustration 10-3.



**Illustration 10-3**

Comparison of segregation of duties principle with independent internal verification principle

In large companies, independent internal verification is often assigned to internal auditors. **Internal auditors** are company employees who evaluate on a continuous basis the effectiveness of the company's system of internal control. They periodically review the activities of departments and individuals to determine whether prescribed internal controls are being followed. They also recommend improvements when needed. The importance of this function is illustrated by the number of internal auditors employed by companies.

## **Other Controls**

Other control measures include the following:

- Bonding of employees who handle cash.** Bonding involves obtaining insurance protection against misappropriation of assets by dishonest employees. This measure 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.
- Rotating employees' duties and requiring employees to take vacations.** These measures are designed to deter employees from attempting any thefts because they will not be able to permanently conceal their improper actions. Many bank embezzlements, for example, have been discovered when the perpetrator was on vacation or assigned to a new position.



**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 stock room as low risk. Thus management would have stricter controls for cash.

**LIMITATIONS OF INTERNAL CONTROL**

A company's system of internal control is generally designed to provide *reasonable* assurance that assets are properly safeguarded and that the accounting records are reliable. **The concept of reasonable assurance rests on the premise that the costs of establishing control procedures should not exceed their expected benefit.** To illustrate, consider shoplifting losses in retail stores. Such losses could be eliminated by having a security guard stop and search customers as they leave the store. But store managers have concluded that the negative effects of adopting such a procedure cannot be justified. Instead, stores have attempted to “control” shoplifting losses by less costly procedures such as (1) posting signs saying, “We reserve the right to inspect all packages” and “All shoplifters will be prosecuted,” (2) using hidden TV cameras and store detectives to monitor customer activity, and (3) using sensing 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 might not bother to count goods received or might just “fudge” the counts. Occasionally, two or more individuals may work together to get around prescribed controls. Such collusion can significantly impair the effectiveness of a system, eliminating the protection offered by segregation of duties. If a supervisor and a cashier collaborate to understate cash receipts, the system of internal control may be negated (at least in the short run). No system of internal control is perfect.

In addition, the size of the business may impose limitations on internal control. In a small company, for example, it may be difficult to segregate duties or to provide for independent internal verification.

**BEFORE YOU GO ON...**▶ **REVIEW IT**

1. What are the two primary objectives of internal control?
2. Identify and describe the principles of internal control.
3. What are the limitations of internal control?

▶ **DO IT**

Li Song owns a small restaurant. Li wants to establish good internal control procedures but is confused about the difference between segregation of duties and independent internal verification. Explain the differences to Li.

**ACTION PLAN**

- Understand and explain the differences between (1) segregation of duties and (2) independent internal verification.

**SOLUTION**

Segregation of duties involves assigning responsibility so that the work of one employee evaluates the work of another employee. Segregation of duties occurs daily in executing and recording transactions. In contrast, independent internal verification involves reviewing, comparing, and reconciling data prepared by one or several employees. Independent internal verification occurs after the fact, as in the case of reconciling cash register totals at the end of the day with cash on hand.

**INTERNATIONAL NOTE**

Other countries also have control problems. For example, a judge in France has issued a thirty-six-page “book” detailing many of the scams that are widespread, such as kickbacks in public works contracts, the skimming of development aid money to Africa, and bribes on arms sales.

**CASH CONTROLS**

Just as cash is the beginning of a company's operating cycle, it is also usually the starting point for a company's system of internal control. Cash is the one asset that is readily convertible into any other type of asset. It is easily concealed and

transported, and it is highly desired. Because of these characteristics, **cash is the asset most susceptible to improper diversion and use**. Moreover, 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 imperative.

**Cash** consists of coins, currency (paper money), checks, money orders, and money on hand or on deposit in a bank or similar depository. The general rule is that if the bank will accept it for deposit, it is cash. Items such as postage stamps and postdated checks (checks payable in the future) are not cash. Stamps are a prepaid expense; the postdated checks are accounts receivable. In the following sections we explain the application of internal control principles to cash receipts and cash disbursements.

### INTERNAL CONTROL OVER CASH RECEIPTS

Cash receipts come from a variety of sources: cash sales; collections on account from customers; the receipt of interest, rent, and dividends; investments by owners; bank loans; and proceeds from the sale of noncurrent assets. Illustration 10-4 shows how the internal control principles explained earlier apply to cash receipts transactions.

### STUDY OBJECTIVE 3

Explain the applications of internal control principles to cash receipts.

#### Illustration 10-4

Application of internal control principles to cash receipts

**Internal Control over Cash Receipts**

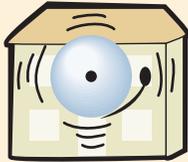
**Establishment of Responsibility**

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



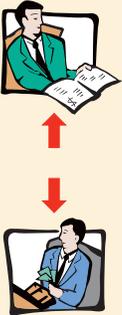
**Physical, Mechanical, and Electronic Controls**

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



**Other Controls**

Bond personnel who handle cash; require employees to take vacations; deposit all cash in bank daily



As might be expected, companies vary considerably in how they apply these principles. To illustrate internal control over cash receipts, we will examine control measures for a retail store with both over-the-counter and mail receipts.

### **Over-the-Counter Receipts**

Control of over-the-counter receipts in retail businesses is centered on cash registers that are visible to customers. In supermarkets and in variety stores, cash registers are placed in checkout lines near the exit. In hotels such as **Hilton** and **Marriott**, each department has its own cash register. A cash sale is “rung up” on a cash register *with the amount clearly visible to the customer*. This measure 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. A cash register tape is locked into the register until removed by a supervisor or manager. This tape accumulates the daily transactions and totals. When the tape is removed, the supervisor compares the total with the amount of cash in the register. The tape should show all registered receipts accounted for. The supervisor’s findings are reported on a cash count sheet, which is signed by both the cashier and the supervisor. The cash count sheet used by Al-rite Food is shown in Illustration 10-5.

#### **Illustration 10-5**

Cash count sheet

Store No. <u>  8  </u>	Date <u>  March 8, 2008  </u>
1. Opening cash balance	\$ 50.00
2. Cash sales per tape (attached)	<u>6,956.20</u>
3. Total cash to be accounted for	7,006.20
4. Cash on hand (see list)	<u>6,996.10</u>
5. Cash (short) or over	<u>\$ (10.10)</u>
6. Ending cash balance	<u>\$ 50.00</u>
7. Cash for deposit (Line 4 – Line 6)	<u>\$6,946.10</u>
Cashier <u>J. Cruise</u>	Supervisor <u>T. Braun</u>

The count sheets, register tapes, and cash are then given to the head cashier. This individual prepares a daily cash summary showing the total cash received and the amount from each source, such as cash sales and collections on account. The head cashier sends one copy of the summary to the accounting department for entry into the cash receipts journal. The other copy goes to the treasurer’s office for later comparison with the daily bank deposit.

Next, the head cashier prepares a deposit slip (see Illustration 10-8 on page 303) and makes the bank deposit. The total amount deposited should be equal to the total receipts on the daily cash summary. This will ensure that all receipts have been placed in the custody of the bank. In accepting the bank deposit, the bank stamps (authenticates) the duplicate deposit slip and sends it to the company treasurer, who makes the comparison with the daily cash summary.

These measures for cash sales are graphically presented in Illustration 10-6. The activities of the sales department are shown separately from those of the cashier’s department to indicate the segregation of duties in handling cash.

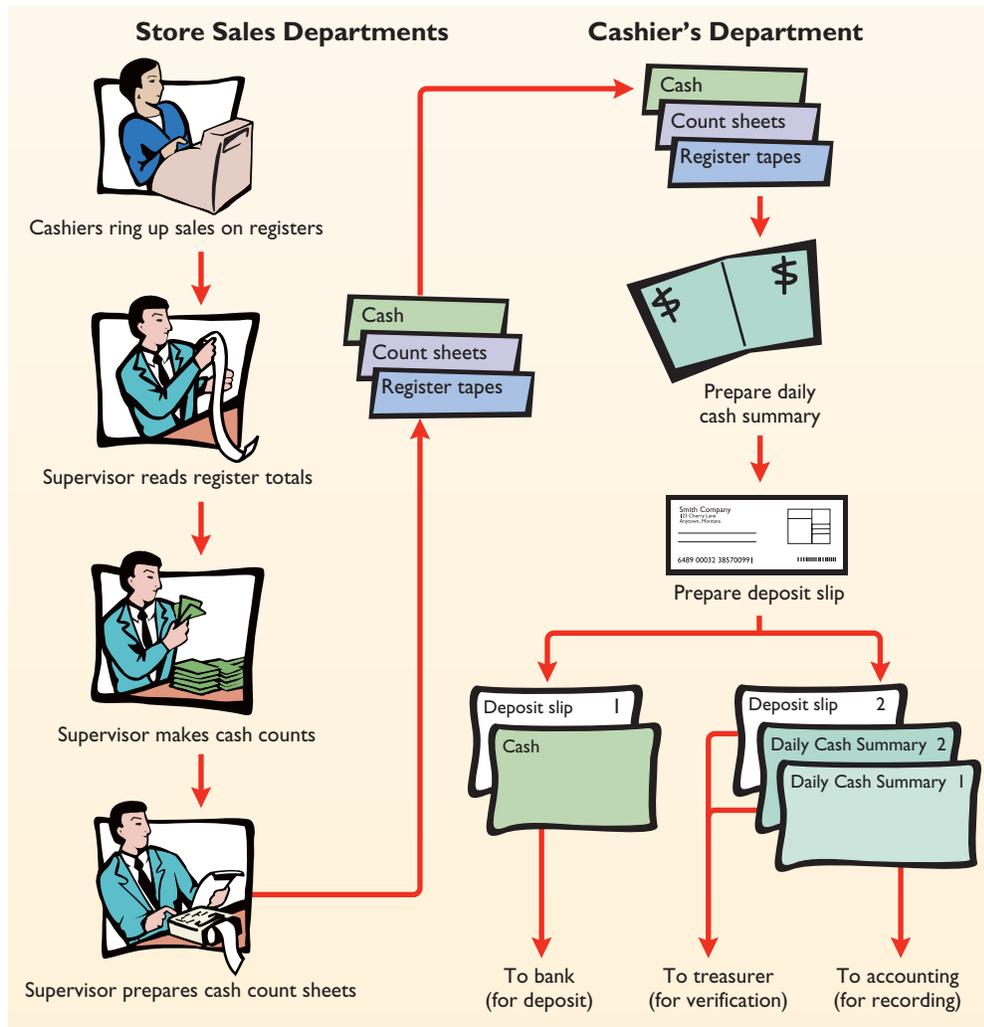


Illustration 10-6

Executing over-the-counter cash sales

**HELPFUL HINT**

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

## Mail Receipts

As an individual customer, you may be more familiar with over-the-counter receipts than with mail receipts. However, mail receipts resulting from billings and credit sales are by far the most common way cash is received by businesses. Think, for example, of the number of checks received through the mail daily by an international company such as **Disney, Marriott, Hilton, or Six Continents**.

All mail receipts should be opened in the presence of two mail clerks. These receipts are generally in the form of checks or money orders. They frequently are accompanied by a remittance advice stating the purpose of the check (sometimes attached to the check, but often a part of the bill that the customer tears off and returns). Each check should be promptly endorsed "For Deposit Only" by use of a company stamp. This **restrictive endorsement** reduces the likelihood that the check will be diverted to personal use. Banks will not give an individual any cash under this type of endorsement.

A list of the checks received each day should be prepared in duplicate. This list shows the name of the issuer of the check, the purpose of the payment, and the amount of the check. Each mail clerk should sign the list to establish responsibility for the data. The original copy of the list, along with the checks and remittance advices, are then sent to the cashier's department. There they are added to over-the-counter receipts (if any) in preparing the daily cash summary and in mak-

ing the daily bank deposit. Also, a copy of the list is sent to the treasurer’s office for comparison with the total mail receipts shown on the daily cash summary. This copy ensures that all mail receipts have been included.

### STUDY OBJECTIVE 4

Explain the applications of internal control principles to cash disbursements.

#### Illustration 10-7

Application of internal control principles to cash disbursements

## INTERNAL CONTROL OVER CASH DISBURSEMENTS

Cash may be disbursed 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 payments are made by check rather than by cash.** One exception is for incidental amounts that are paid out of *petty cash*. Payment by check generally occurs only after specified control procedures have been followed. In addition, the “paid” check provides proof of payment. Illustration 10-7 shows how principles of internal control apply to cash disbursements.

### Internal Control over Cash Disbursements

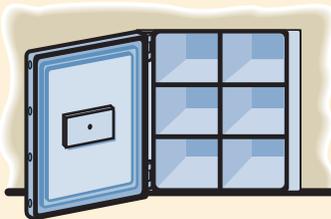
**Establishment of Responsibility**

Only designated personnel are authorized to sign checks (treasurer)



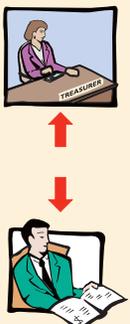
**Physical, Mechanical, and Electronic Controls**

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



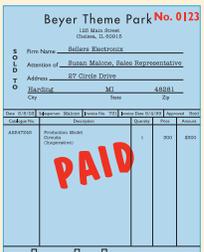
**Documentation Procedures**

Use prenumbered checks and account for them in sequence; each check must have approved invoice



**Other Controls**

Stamp invoices PAID



### Voucher System

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 an expense. It ends with the issuance of a check for the liability incurred. A **voucher** is an authorization form prepared for each expenditure. Vouchers are required for all types of cash disbursements except those from petty cash. The voucher generally is prepared in the accounts payable department.

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 the voucher must be recorded (in the journal called a **voucher register**) and filed according to the date on which it is to be paid. A check is sent on that date, the voucher is stamped "Paid," and 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, similar to any accounts payable transaction, one to issue the voucher and a second to pay the voucher.

### **Electronic Funds Transfer (EFT) System**

To account for and to control cash is an expensive and time-consuming process. It was estimated recently that the cost to process a check through a bank system ranges from \$0.55 to \$1.00 and is increasing. It is not surprising that new approaches are being developed to transfer funds among parties without the use of paper (deposit tickets, checks, etc.). Such a procedure is called **electronic funds transfer (EFT)**. This disbursement system uses wire, telephone, telegraph, or computer to transfer cash from one location to another. Use of EFT is quite common. For example, the authors receive no formal payroll checks from their universities, which instead send magnetic tapes to the appropriate banks for deposit. Regular payments, such as those for house, car, and utilities, are frequently made by EFT.

## ACCOUNTING IN ACTION *Business Insight*



A study by the Association of Certified Fraud Examiners indicates that businesses with fewer than 100 employees are most at risk for employee theft. Also, the average loss per incident for small companies—\$127,500—was actually higher than the average loss for larger companies. The high degree of trust often found in small companies makes them more vulnerable to dishonest employees. For example, in one small company, the employee responsible for paying bills would intentionally ask the owner to sign checks only when the owner was extremely busy. The employee would slip in one check that was made out to himself, and the owner didn't notice because he was too busy to carefully review each check.

Which principles of internal control should have prevented such fraud?

*SOURCE:* Joseph T. Wells, "Occupational Fraud: The Audit as Deterrent," *Journal of Accountancy*, April 2002, pp. 24–28.

### BEFORE YOU GO ON...

#### ▶ REVIEW IT

1. How do the principles of internal control apply to cash receipts?
2. How do the principles of internal control apply to cash disbursements?

#### ▶ DO IT

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 four to eight 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 electronic controls, and (3) providing for 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. At the end of each work shift, Cortez or a supervisor/manager should total the register and make a cash count to see whether all cash is accounted for.



## USE OF A BANK

### STUDY OBJECTIVE 5

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 checks written. Use of a bank minimizes the amount of currency that must be kept on hand. Also, the use of a bank facilitates the control of cash because it creates a double record of all bank transactions—one by the business and the other by the bank. The asset account Cash maintained by the depositor is the reciprocal of the bank's liability account for each depositor. It should be possible to *reconcile these accounts* (make them agree) at any time.

Opening a bank checking account is a relatively simple procedure. Typically, the bank makes a credit check on the new customer, and the depositor is required to sign a **signature card**. The card contains the signature of each person authorized to sign checks on the account. The signature card is used by bank employees to validate signatures on the checks.

Soon after an account is opened, the bank provides the depositor with serially numbered checks and deposit slips imprinted with the depositor's name and address. Each check and deposit slip is imprinted with both a bank and a depositor identification number. This number, printed in magnetic ink, permits computer processing of transactions.

Many companies have more than one bank account. For efficiency of operations and better control, national hospitality companies may have regional bank accounts. A large company such as **Starwood**, with more than 115,000 employees, may have a payroll bank account and 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

Bank deposits should be made by an authorized employee, such as the head cashier. Each deposit must be documented by a deposit slip (ticket), as shown in Illustration 10-8.

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

### WRITING CHECKS

A **check** is a written order signed by the depositor directing the bank to pay a specified sum of money to a designated recipient. There are three parties to a check: (1) the **maker** (or drawer), who issues the check, (2) the **bank** (or payer) on which the check is drawn, and (3) the **payee** to whom the check is payable. A check is a **negotiable instrument** that can be transferred to another party by endorsement.

Illustration 10-8

Deposit slip

**Bank code numbers**

**Front side**

**Reverse side**

CHECKS	LIST SINGLY	DOLLARS	CENTS
1	74 - 331/724	175	40
2	61 - 157/220	292	60
3	19 - 401/710	337	55
4	22 - 815/666	165	72
5	15 - 360/011	145	53
6			
7			
8			
9			
10			
11			
12			
13			
14			
15			
16			
17			
18			
19			
<b>TOTAL</b>		116	80

ENTER TOTAL ON THE FRONT OF THIS TICKET

Each check should be accompanied by an explanation of its purposes. In many businesses, this is done by a remittance advice attached to the check, as shown in Illustration 10-9

Illustration 10-9

Check with remittance advice

**Check**

Maker → W.A. LAIRD COMPANY  
77 West Central Avenue,  
Midland, Michigan 48654

No. 448  
April 16 2008 74-102724

Payee → Pay to the order of Watkins Wholesale Supply \$ 1525.00  
Fifteen hundred twenty-five and 00/100 Dollars

Payer → **NB National Bank & Trust**  
Midland, Michigan 48654  
W.F. Paine

Memo \_\_\_\_\_

**Remittance Advice**

Detach this portion before cashing.

Date	Description	Gross Amount	Discount	Net Amount
4-16-08	Invoice No. 27662	1525.00	----	1525.00

W. A. Laird Company, Midland, MI

It is important to know the balance in the checking account at all times. To keep the balance current, each deposit and check should be entered on running balance memorandum forms provided by the bank or on the check stubs contained in the checkbook.

## ACCOUNTING IN ACTION Business Insight



Cash is virtually obsolete. We use debit cards and credit cards to pay for most of our purchases. But debit cards are usable only at specified locations, and credit cards are cumbersome for small transactions. They are no good for transferring cash between individuals or to small companies that don't want to pay credit card fees. Digital cash is the next online wave.

There are many digital-cash companies. One of the most flexible appears to be **PayPal.com**. PayPal has become popular with users of the auction site **eBay** because it allows them to transfer funds to each other as easily as sending e-mail.

*SOURCE:* Mathew Ingram, "Will Digital Cash Work This Time?" *The Globe and Mail*, March 18, 2000, p. N4.

**HELPFUL HINT**

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

### BANK STATEMENTS

Each month, the depositor receives a bank statement from the bank. A **bank statement** shows the depositor's bank transactions and balances. A typical statement is presented in Illustration 10-10. It shows (1) checks paid and other debits that reduce the balance in the depositor's account, (2) deposits and other credits that

**Illustration 10-10**

Bank statement


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

**ACCOUNT STATEMENT**

W. A. LAIRD COMPANY  
 77 WEST CENTRAL AVENUE  
 MIDLAND, MICHIGAN 48654

Statement Date/Credit Line Closing Date  
 April 30, 2008

457923

ACCOUNT NUMBER

Balance Last Statement	Deposits and Credits		Checks and Debits		Balance This Statement	
	No.	Total Amount	No.	Total Amount		
13,256.90	20	34,806.10	26	32,164.65	15,907.45	
CHECKS AND DEBITS			DEPOSITS AND CREDITS		DAILY BALANCE	
Date	No.	Amount	Date	Amount	Date	Amount
4-2	435	644.95	4-2	4,276.85	4-2	16,888.80
4-5	436	3,260.00	4-3	2,137.50	4-3	18,249.65
4-4	437	1,185.79	4-5	1,350.47	4-4	17,063.86
4-3	438	776.65	4-7	982.46	4-5	15,154.33
4-8	439	1,781.70	4-8	1,320.28	4-7	14,648.89
4-7	440	1,487.90	4-9 CM	1,035.00	4-8	11,767.47
4-8	441	2,420.00	4-11	2,720.00	4-9	12,802.47
4-11	442	1,585.60	4-12	757.41	4-11	13,936.87
4-12	443	1,226.00	4-13	1,218.56	4-12	13,468.28
4-29	NSF	425.60	4-27	1,545.57	4-27	13,005.45
4-29	459	1,080.30	4-29	2,929.45	4-29	14,429.00
4-30	DM	30.00	4-30	2,128.60	4-30	15,907.45
4-30	461	620.15				

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

**HELPFUL HINT**

Every deposit received by the bank is *credited* to the customer's account. The reverse occurs when the bank "pays" a check issued by a company on its checking account balance: Payment reduces the bank's liability. Thus it is *debited* to the customer's account with the bank.

increase the balance in the depositor's account, and (3) the account balance after each day's transactions.

All "paid" checks are listed in numerical sequence on the bank statement along with the date the check was paid and its amount. On paying a check, the bank stamps the check "Paid"; a paid check is sometimes referred to as a **can-celed** check. Most banks offer depositors the option of receiving "paid" checks with their bank statements. For those who decline, the bank keeps a record of each check on microfilm.

The bank also includes on the bank statement memoranda explaining other debits and credits made by the bank to the depositor's account.

### **Debit Memorandum**

Banks charge a monthly fee for their services. Often the fee is charged only when the average monthly balance in a checking account falls below a specified amount. The fee, called a **bank service charge**, is identified on the bank statement by a code symbol such as SC. A debit memorandum explaining the charge is included with the bank statement and noted on the statement. Separate 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.

A debit memorandum is also used by the bank when a deposited check from a customer "bounces" because of insufficient funds. In such a case, the check is marked "NSF" (not sufficient funds) by the customer's bank and is returned to the depositor's bank. The bank then debits the depositor's account, as shown by the symbol NSF on the bank statement in Illustration 10-10. The bank sends the **NSF check** and debit memorandum to the depositor as notification of the charge. The NSF check creates an account receivable for the depositor and reduces cash in the bank account.

### **Credit Memorandum**

A depositor may ask 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 on the W. A. Laird Company bank statement by the symbol CM. The bank will issue a credit memorandum, which is sent with the statement to explain the entry. Many banks also offer interest on checking accounts. The interest earned may be indicated on the bank statement by the symbol CM or INT.

## **RECONCILING THE BANK ACCOUNT**

The bank and the depositor maintain independent records of the depositor's checking account. If you've never had a checking account, you might assume that the respective balances will always agree. In fact, the two balances are seldom the same at any given time. It is therefore 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 is due to

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

Time lags occur frequently. For example, several days may elapse between the time a check is mailed to a payee and the date the check is paid by the bank.

### **STUDY OBJECTIVE 6**

Prepare a bank reconciliation.



## ACCOUNTING IN ACTION *Ethics Insight*



During a class lecture, Mr. Alan E. Gallo, chief financial officer of Redstone Hospitality, shared some controls incidents with the students. He mentioned that a hotel received a complaint letter and a laundry bill from a guest. This guest claimed that food was spilled on his wife's dress, and he would like the hotel to pay for the laundry bill of an amount less than \$10. To make the case more convincing, the guest also mentioned that he was a friend of another frequent guest of this establishment. When investigating the matter, the controller called the number on the laundry bill, trying to confirm the incident with the cleaner, and found that the cleaner did not exist. Most people will pay the small bill to take care of the complaint and move on to the next issue. The moral of the story: It is not the amount that matters; it is the principle. Follow set procedures and catch those crooks.

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 receipts are recorded by the depositor and the time they are recorded by the bank. A time lag also occurs whenever the bank mails a debit or credit memorandum to the depositor.

Also, errors sometimes occur. 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 inadvertently record a \$450 check as \$45 or \$540. In addition, the bank might mistakenly charge a check drawn by C. D. Berg to the account of C. D. Burg.

### **Reconciliation Procedure**

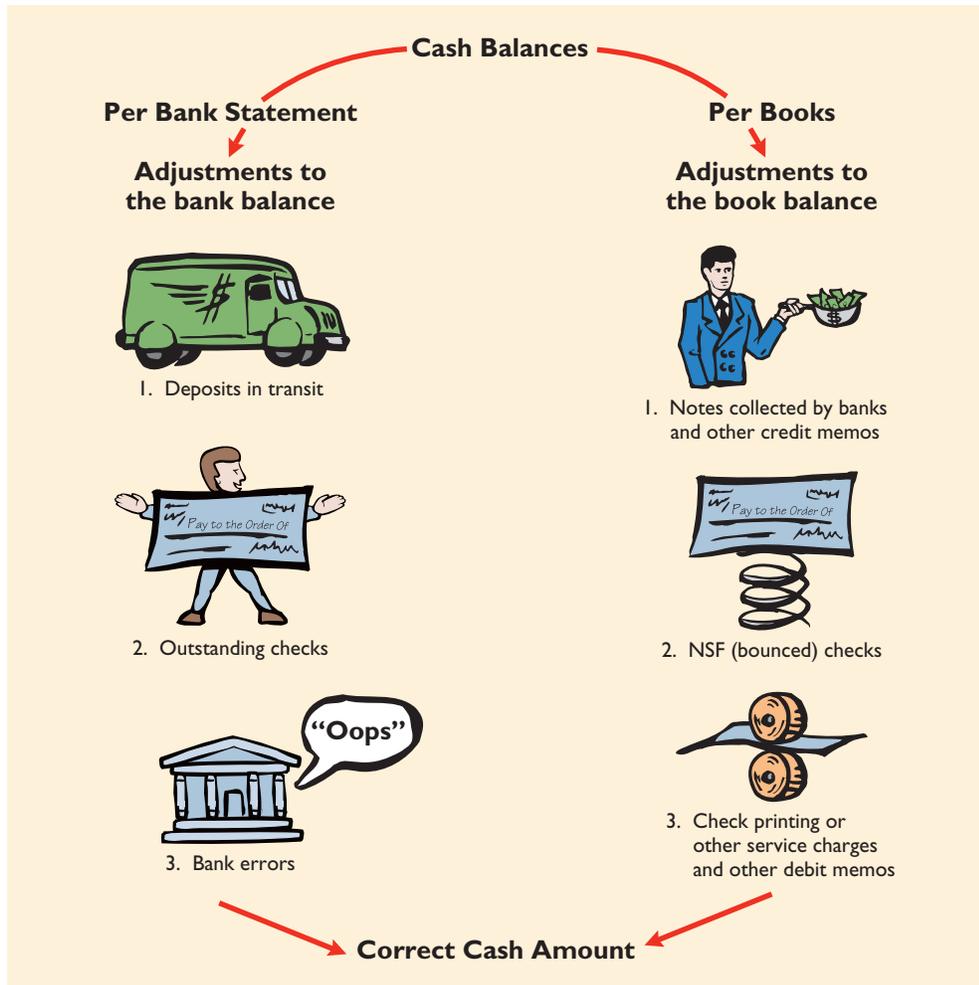
**To obtain maximum benefit from a bank reconciliation, the reconciliation should be prepared by an employee who has no other responsibilities pertaining to cash.** When the internal control principle of independent internal verification is not followed in preparing the reconciliation, cash embezzlements 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 the balance per bank to their adjusted (correct or true) cash balances. The reconciliation schedule is divided into two sections. The starting point in preparing the reconciliation is to enter the balance per bank statement and the balance per books on the schedule. Adjustments are then made to each section, as shown in Illustration 10-11. Four steps should reveal all the reconciling items that cause the difference between the two balances:

1. **Deposits in transit.** Compare the individual deposits 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 represent **deposits in transit**. They are added to the balance per bank.
2. **Outstanding checks.** Compare the paid checks shown on the bank statement or the paid checks returned with the bank statement with (a) checks outstanding from the preceding bank reconciliation and (b) checks issued by the company as recorded in the cash payments journal. Issued checks recorded by the company that have not been paid by the bank represent **outstanding checks**. They are deducted from the balance per bank.

#### **HELPFUL HINT**

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

**Illustration 10-11**

Bank reconciliation procedures

3. **Errors.** Note any errors discovered in the foregoing steps. List them in the appropriate section of the reconciliation schedule. For example, if a paid check correctly written by the company for \$195 was mistakenly recorded by the company for \$159, the error of \$36 is deducted from the balance per books. All errors made by the depositor are reconciling items in determining the adjusted cash balance per books. In contrast, all errors made by the bank are reconciling items in determining the adjusted cash balance per bank.
4. **Bank memoranda.** Trace bank memoranda to the depositor's records. Any unrecorded memoranda should be listed in the appropriate section of the reconciliation schedule. For example, a \$5 debit memorandum for bank service charges is deducted from the balance per books, and \$32 of interest earned is added to the balance per books.

### ***Bank Reconciliation Illustrated***

The bank statement for the W. A. Laird Company was shown in Illustration 10-10. It shows a balance per bank of \$15,907.45 on April 30, 2008. On this date, the balance of cash per books is \$11,589.45. From the foregoing steps, the following reconciling items are determined:

- |  |            |
|--|------------|
| <ol style="list-style-type: none"> <li>1. <b>Deposits in transit:</b> April 30 deposit (received by bank on May 1).</li> </ol> | \$2,201.40 |
|--|------------|

**HELPFUL HINT**

Note in the bank statement 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.

- 2. **Outstanding checks:** No. 453, \$3,000.00; no. 457, \$1,401.30; no. 460, \$1,502.70. 5,904.00
- 3. **Errors:** Check no. 443 was correctly written by Laird for \$1,226.00 and was correctly paid by the bank. However, it was recorded for \$1,262.00 by Laird Company. 36.00
- 4. **Bank memoranda:**
  - a. Debit—NSF check from J. R. Baron for \$425.60 425.60
  - b. Debit—Printing company checks charge \$30.00 30.00
  - c. Credit—Collection of note receivable for \$1,000 plus interest earned \$50, less bank collection fee \$15 1,035.00

The bank reconciliation is shown in Illustration 10-12.

**Illustration 10-12**

Bank reconciliation

**ALTERNATIVE TERMINOLOGY**

The terms *adjusted balance*, *true cash balance*, and *correct cash balance* may be used interchangeably.

<b>W. A. LAIRD COMPANY</b> <b>Bank Reconciliation</b> <b>April 30, 2008</b>			
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	
		\$12,204.85	←
<b>Adjusted cash balance per bank</b>			
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	
		\$12,204.85	←
<b>Adjusted cash balance per books</b>			

**Entries from Bank Reconciliation**

Each reconciling item in determining the **adjusted cash balance per books** should be recorded by the depositor. If these items are not journalized and posted, the Cash account will not show the correct balance. The entries for W. A. Laird Company on April 30 are as follows.

**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 looks like this:

**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 a bank reconciliation had not been explained.

A	=	L	+	SE
+1,035				-15
-1,000				+50

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

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

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

A	=	L	+	SE
+36		+36		

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

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

A	=	L	+	SE
+425.60				
-425.60				

**BANK SERVICE CHARGES.** Check printing charges (DM) and other bank service charges (SC) are debited to Miscellaneous Expense. They are usually nominal in amount. The entry looks like this:

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

A	=	L	+	SE
+30				-30

The foregoing four entries also could be combined into one compound entry. After the entries are posted, the cash account will look like Illustration 10-13.

Cash			
Apr. 30 Bal.	11,589.45	Apr. 30	425.60
30	1,035.00	30	30.00
30	36.00		
Apr. 30 Bal.	<b>12,204.85</b>		

**Illustration 10-13**

Adjusted balance in cash account

The adjusted cash balance in the ledger should agree with the adjusted cash balance per books in the bank reconciliation in Illustration 10-12.

What entries does the bank make? If any bank errors are discovered in preparing the reconciliation, the bank should be notified. It then can make the necessary corrections on its records. The bank does not make any entries for deposits in transit or for outstanding checks. Only when these items reach the bank will the bank record these items.

**BEFORE YOU GO ON...**

► **REVIEW IT**

1. Why is it necessary to reconcile a bank account?
2. What steps are involved in the reconciliation procedure?
3. What information is included in a bank reconciliation?

► **DO IT**

Sally Kist owns Linen Kist Fabrics, which supplies fabrics for table linen in hotels and restaurants. Sally asks you to explain how the following reconciling items should be treated in reconciling the 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**

In reconciling the bank account, the reconciling items are treated as follows:

- NSF check: Deducted from balance per books
- Collection of note: Added to balance per books
- Outstanding checks: Deducted from balance per bank
- Deposit in transit: Added to balance per bank



**LOOK BACK AT OUR FEATURE STORY**

Refer back to the Feature Story about **Stephanie’s Gourmet Coffee and More** at the beginning of the chapter, and answer the following questions:

1. Does Stephanie Mintenko have a valid basis for establishing responsibility for overages or shortages? Why or why not?
2. What internal control principles are applicable to reconciling the cash register tape and the amount of cash in the cash drawer at the end of each shift?
3. What internal control principle is violated by not printing a receipt for each customer who purchases beverages or a meal or uses the café’s computers?
4. Do you think cashiers are, or should be, bonded (insured against misappropriation of assets)?
5. What adjusting entry would the bookkeeper likely make to record a cash shortage of \$5?

**SOLUTION**

1. Establishing responsibility for overages or shortages occurs twice a day: at the end of the 5:00 P.M. shift and at closing. This procedure provides a valid basis for evaluation only if one person worked an assigned register since the last reconciliation. Since up to three people work a single register during a shift, there is no valid basis for establishing who is responsible for any overage or shortage.
2. Internal control principles are (a) authorization—not applicable because cashiers are not assigned to a specific cash register for their shift; (b) segregation of duties—cashiers (other than the owner/manager) are not involved in performing the reconciliation; (c) documentation—the cash register tape provides the documentation for total receipts for the shift; (d) safeguard assets—an electronic cash register is used with an internal tape, whose access presumably is restricted; (e) independent verification—a bookkeeper, in addition to Stephanie Mintenko, performs the reconciliation regularly.
3. The principle of documentation procedures is involved. If a customer making a purchase sees that a sale isn’t rung up or if the customer doesn’t request a receipt, there is a possibility that the transaction has not been recorded. But the internal control does not reside in the receipt itself. The control is forcing the cashier to ring up each sale so that a receipt is produced. Each receipt is recorded on an internal cash register tape. At the end of the day, the tape is used in determining overages or shortages.
4. It is doubtful that Stephanie’s café would bond part-time employees. From the employer’s standpoint, bonding is protection against major embezzlements by dishonest employees. The risk of this occurring in a small café, with the active participation of the owner/manager, is relatively low.

5. Cash Over and Short (miscellaneous expense account)	5	5
Cash		



## DEMONSTRATION PROBLEM

Trillo Beds and Mattresses sells beddings to resort and lodging operations. Its bank statement for May 2008 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 Hup Hotel Co., a customer.
2. The note collected by the bank was a \$500, three-month, 12 percent 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 Trillo check for \$352 dated May 10 cleared the bank on May 25. This check, which was a payment on account, was journalized for \$325.

### Instructions

- (a) Prepare a bank reconciliation at May 31.
- (b) Journalize the entries required by the reconciliation.

## SOLUTION TO DEMONSTRATION PROBLEM

### (a) TRILLO BEDS AND MATTRESSES Bank Reconciliation May 31, 2008

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

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

### ACTION PLAN

- Follow the four steps in the reconciliation procedure. (pp. 306–307).
- 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.

## SUMMARY OF STUDY OBJECTIVES

**1. Define internal control.** Internal control is the plan of organization and related methods and procedures adopted within a business to safeguard its assets and to enhance the accuracy and reliability of its accounting records.

**2. Identify the principles of internal control.** The principles of internal control are establishment of responsibility; segregation of duties; documentation procedures; physical, mechanical, and electronic controls; independent internal verification; and other controls.

**3. Explain the applications of internal control principles to cash receipts.** Internal controls over cash receipts include (a) designating only personnel such as cashiers to handle cash; (b) assigning the duties of receiving cash, recording cash, and custody of cash to different individuals; (c) obtaining 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 comparisons of total receipts with total deposits; and (f) bonding personnel who 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 only specified individuals such as the treasurer authorized to sign checks; (b) assigning the duties of approving items for payment, paying the items, and recording the payment to different individuals; (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 checkwriter 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) after payment, stamping each approved invoice "Paid."

**5. 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 must be kept on hand, and it creates a double record of a depositor's bank transactions.

**6. Prepare a bank reconciliation.** It is customary to reconcile the balance per books and the balance per bank to their adjusted balances. The steps in determining the reconciling items are to ascertain deposits in transit, outstanding checks, errors by the depositor or the bank, and unrecorded bank memoranda.



## GLOSSARY

**Bank service charge** A fee charged by a bank for the use of its services (p. 305).

**Bank statement** A statement received monthly from the bank that shows the depositor's bank transactions and balances (p. 304).

**Cash** Resources that consist of coins, currency, checks, money orders, and money on hand or on deposit in a bank or similar depository (p. 297).

**Check** A written order signed by the depositor directing the bank to pay a specified sum of money to a designated recipient (p. 302).

**Deposits in transit** Deposits recorded by the depositor that have not been recorded by the bank (p. 306).

**Electronic funds transfer (EFT)** A disbursement system that uses wire, telephone, telegraph, or computer to transfer cash from one location to another (p. 301).

**Internal auditors** Company employees who evaluate on a continuous basis the effectiveness of the company's system of internal control (p. 295).

**Internal control** The plan of organization and all the related methods and measures adopted within a business to safeguard its assets and to enhance the accuracy and reliability of its accounting records (p. 291).

**NSF check** A check that is not paid by a bank because of insufficient funds in a customer's bank account (p. 305).

**Outstanding checks** Checks issued and recorded by a company that have not been paid by the bank (p. 306).

**Segregation of duties** A separation of functions or a division of work so as to provide a reliable basis of evaluating the work of each employee (p. 292).

**Voucher** An authorization form prepared for each payment by check in a voucher system (p. 301).

**Voucher system** A network of approvals by authorized individuals acting independently to ensure that all disbursements by check are proper (p. 300).

## EXERCISES

Identify the internal control principles applicable to cash receipts.

(SO 3)

**10-1** Sycamore Resorts has the following internal control procedures over cash receipts. Identify the internal control principle that is applicable to each procedure.

- 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 having custody of cash are assigned to different individuals.
5. Only cashiers may operate cash registers.

**10-2** George Hunting Lodge 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 the assistant treasurer may sign checks.
5. Check signers are not allowed to record cash disbursement transactions.

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

(SO 4)

**10-3** Sue Ernesto is the owner of Ernesto's Pizza. Ernesto's is operated strictly on a carryout basis. Customers pick up their orders at a counter where a clerk exchanges the pizza for cash. While at the counter, the customer can see other employees making the pizzas and the large ovens in which the pizzas are baked.

*Identify the principles of internal control.*

(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.)

**10-4** The following control procedures are used at Sandwich 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.

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

(SO 2, 3)

### **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.

**10-5** The following control procedures are used in Morgan's Fishing Excursions 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, Morgan 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.

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

(SO 2, 4)

### **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.

Prepare bank reconciliation and adjusting entries. (SO 7)

**10-6** Lisa Ceja is unable to reconcile the bank balance for her catering company on January 31. Lisa’s reconciliation is as follows:

Cash balance per bank	\$3,660.20
Add: NSF check	590.00
Less: Bank service charge	25.00
Adjusted balance per bank	<u>\$4,225.20</u>
Cash balance per books	\$3,875.20
Less: Deposits in transit	530.00
Add: Outstanding checks	930.00
Adjusted balance per books	<u>\$4,275.20</u>

**Instructions**

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

Determine outstanding checks. (SO 7)

**10-7** On April 30, the bank reconciliation of Ottawa Travel shows three outstanding checks: no. 254, \$650; no. 255, \$720; and no. 257, \$410. The May bank statement and the May cash payments journal show the following:

<b>Bank Statement</b>			<b>Cash Payments Journal</b>		
<b>Checks Paid</b>			<b>Checks Issued</b>		
<u>Date</u>	<u>Check No.</u>	<u>Amount</u>	<u>Date</u>	<u>Check No.</u>	<u>Amount</u>
5/4	254	650	5/2	258	159
5/2	257	410	5/5	259	275
5/17	258	159	5/10	260	790
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 on May 31.

Prepare bank reconciliation and adjusting entries. (SO 7)

**10-8** The following information pertains to Worthy Tours:

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 \$800 note for Worthy in July, plus interest \$36, less collection fee \$20. The collection has not been recorded by Worthy, and no interest has been accrued.
6. Outstanding checks, July 31, \$691.

**Instructions**

- (a) Prepare a bank reconciliation at July 31.
- (b) Journalize the adjusting entries at July 31 on the books of Worthy Tours.

Prepare bank reconciliation and adjusting entries. (SO 7)

**10-9** The following information relates to the Cash account in the ledger of Dick Wasson 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	\$725
Interest earned on checking account	\$45	Safety deposit box rent	\$65

On September 30, deposits in transit were \$4,150, 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.

**10-10** The cash records of Sugar Land Country Club (SLCC) show the following four situations:

1. The June 30 bank reconciliation indicated that deposits in transit total \$920. During July the general ledger account Cash shows deposits of \$15,750, but the bank statement indicates that only \$15,600 in deposits was received during the month.
2. The June, 30 bank reconciliation also reported outstanding checks of \$880. During the month of July, SLCC 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 bank statement totaled \$26,700; deposits per books were \$25,400; and deposits in transit at September 30 were \$2,600.
4. In September, cash disbursements per books were \$23,700; checks clearing the banks were \$24,000; and outstanding checks at September 30 were \$2,100.

*Compute deposits in transit and outstanding checks for two bank reconciliations.*  
(SO 7)

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

#### 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?

### EXPLORING THE WEB

**10-11** 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](http://www.bc.edu/offices/audit/controls)

**Steps:** Go to the bc.edu site.

#### 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?

### ETHICS CASES

**10-12** You are the assistant controller in charge of general ledger accounting at Springtime 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.

On June 30, the cash balance is \$80,000, which you report to Anne Shirley, the financial vice president. Anne 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. Anne 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!” Anne continues, “I talked to Oconto Distributors (one of Spring-time’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 Anne Shirley’s instructions?  
Who will suffer if you do comply?
- (b) What are the ethical considerations in this case?
- (c) What alternatives do you have?



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