# Chapter 4

## Accounting for Cash

Cash is any medium of exchange that a bank will accept at face value. It includes bank deposit, currency, checks, bank drafts and money orders.

### Internal control over cash

Internal control is the methods that an organization uses to protect against the theft of assets, enhance the reliability of accounting information, promote efficient and effective operations, and ensure compliance with applicable laws, regulations, and codes of ethical conduct.

Internal control is especially needed to prevent fraud and theft relating to cash transaction. Internal control is necessary to assure that the cash is used for proper purpose of and wasted, misused or stolen. Thus, it is necessary to safeguard cash effectively because of the ease with which it can be transferred.

### Need for cash controls

Control over cash is important because:

1. It is highly liquid than other assets
2. It can be misappropriate easily
3. It is easily transferable to individuals without any legal document
4. It is readily convertible in to any other type of assets.

2. It is easily conceded and transported

3. It is highly desired

4. It affects large volume of transaction

Because of these characteristics, cash is the asset most vulnerable to improper diversion and use. Therefore, to safeguard cash & assure the accuracy of the accounting records for cash, effective internal control over cash is necessary.

### Internal control of cash receipts

The cash receipts may result from a variety of sources such as cash sales, collection on account receivable, the receipt of interest, rents, and dividends, investment by owners, bank loans, and proceeds from the sale of noncurrent assets.

The application of internal control principles to cash receipt transaction is as follows:-

| Principle | Application to cash receipts |
|---|---|
| 1. Establishment of Responsibility | only designate personnel such as cashier should be authorized to handle or have access to Cash receipt |
| 2. Segregation of Duties | The duties of receiving cash, recording cash receipt transaction, & having custody of cash should be assigned to different individual |
| 3. Documentation procedures | Documents should include<br>A. Remittance advice for mall receipts<br>B. Cash receipt vouchers for over the counter receipts<br>C. Deposit slips for bank deposits |
| 4. Physical control | Company safes and bank vaults should be for the storage areas should be limited to authorized personnel, cash register should be used in executing over the counter receipts |
| 5. Independent internal verification | Daily cash counts of register receipts should be made by internal auditor or any other authorized personnel |
| 6. Other controls | All personnel who handle cash receipts should be bonded and be required to take valuation, cash should be deposited in the bank in total daily |

**Internal control of cash payment**

Payments may be made for a variety of reasons such as to pay expenses, liabilities and dividends, or to purchase assets. It is generally recognized that the more effective internal control over cash disbursements results when that payment are made by check, except for incidental amounts that are paid out of petty cash (the operation of a petty cash fund is explained in the following sections of this chapter).Payments by check generally occur by only after specified control procedures have been followed. In addition, the "paid" checks provide documentary proof of payments.

The application of the principles of internal control to cash disbursements is as follows: -

| Principle | Application to cash receipts |
|---|---|
| 1. Establishment of Responsibility | Only specified individual should be authorized to sing checks |
| 2. Segregation of Duties | The duties of approving an item should be performed by different individuals, check signors should not record cash disbursement transaction |

| | |
|---|---|
| 3. Documentation procedures | Pre-numbered checked should be used and all checks in a series should be accounted for.<br>In recording each check should be supported by an approved invoice or other documentation.<br>Any spoiled check should be marked "Void" and field in sequence so that all numbers in the series can be Accounted |
| 4. Physical control | Blank checks should be stored in a safe with access restricted to authorized personnel, check writer should be used to imprint the amount of the check in indelible |
| 5. Independent internal verification | Each check should be compared with the approved internal verification invoice before it is issued, bank & book balance should be reconciled monthly. |

**Control over Cash**

Due to the reason that cash is the most likely transportable, easily hidden and used improperly by employees, it is necessary that cash be effectively safeguarded by a special control. The two controlling devices for controlling cash are:

a) The Bank Account and

b) Petty Cash Fund

**The Bank Account:** It is one of the major devices for maintaining control over cash. To get the most benefit from the bank account, all cash received must be deposited in the bank and all payments must be made by checks drawn on the bank or from special cash funds. When such system is strictly followed, there is a double record of cash, one maintained by the business and the other by the bank.

Three parties involved in a check:

1) **Maker (drawer**): One who signs on the check.
2) **Payer (drawee**): the bank on which the check is drawn.
3) **Payee**: the party to whom payment is made. Is the party to whose order the check is drawn

**Check register**: A modified form of the cash payment journal used to record all transaction paid by check. Usually in a check the address and the name of the depositor are printed.

I. **Record the checks drawn**: A memorandum record of the basic details of a check should be prepared at the time the check is written. Business firms may prepare a

copy of each check drawn and then use it as a basis for recording the transaction in the cash payment journal.

Checks issued to a creditor on account are usually accompanied by a notification of the specific invoice that is being paid. The purpose of such notification, sometimes called a remittance advice, is to make sure that proper credit is recorded in the accounts of the creditor.

**Bank Statement**

It's a monthly statement sent by the bank to the depositor. The bank statement usually indicates the beginning and ending cash balance of the depositor in the bank and the monthly transaction (additions and deductions), i.e., cancelled checks (paid checks) and which the bank has make payment on behalf of the depositor. It also includes the deposits made by the depositor and other things.

**Bank Reconciliation**

It's the schedule that accounts for any of the difference between the bank statement balance and the company's (depositor's) book balance. It is listing of items and amounts that cause the difference in the cash balance reported in the bank statement and the cash ledger of the depositor.

It might seem that the two balances should be equal but they are not likely to be equal on any specific date because of the following:

**a) Items recorded by the company but not yet recorded by the bank.**

1) **Deposit in transit**: is the deposit that the company has recorded but not recorded by the bank.
2) **Outstanding checks**: These have been issued by the company and recorded on its book but have not yet been paid by the bank.

**b) Items recorded by the bank only.**

1) **Bank collection**: notes receivable and interest accrued on notes receivable may be collected by the bank. The bank will notify (remind) the amount of collection whenever the bank is sending the bank statement to the depositor.
2) **Service charge**: the amount of banks fee for processing check. When the bank provides the bank statement to the depositor, the depositor will be notified of the charge.

**c) Not sufficient fund (NSF) received from customer.**

**d)** Interest revenue on checking account.

**e)** Checks collected, deposited and returned to payee by the bank for reason other than NSF

The bank return checks to the payee because

- ✓ If the maker's account is closed.
- ✓ If the signature is not authorized.
- ✓ If the check form is improper.
- ✓ If the check has been altered.

Accounting for all returned checks is the same with NSF.

f) The cost of printing check.

**3) Error by either the company or the bank or both.**

E.g. 1) A check written for $225 is drawn by the bank as $252.

**Bank credit memorandums**: are additions by bank not recorded by depositor. They are traced to the cash receipt journal that can be added to the balance according to depositor's record.

**Bank debit memorandums**: are the deductions by bank not recorded by the depositor. They are traced to the cash payment journals that have to be deducted from the balance according to depositor's record.

**Format for Bank Reconciliation**

| |
|---|
| **Bank balance according to bank record** ----------**xxx** |
| **Add**: Additions of depositor not in the bank (deposit in transit) ----------xx |
| Bank error that understate bank balance ----------xx xxx |
| **Ded**: deduction by the depositor not by bank (outstanding Checks) ------xx |
| Bank error that overstate bank balance ----------xx xxx |
| **Adjusted cash balance** ---------- xxx |
| Bank balance according to depositor records----------xxx |
| **Add**: additions by bank not recorded by depositor (credit memorandum : |
| Notes plus interest collection, interest revenue on checking accounts) ------xx |
| Depositor error that understate the depositor cash ledger balance----- xx xxx |
| Sub-total----------xxx |
| **Ded**: Deduction by bank not recorded by the depositor: |

| |
|---|
| (**Debit memorandum**: NSF checks, service charges) ----------xx |
| Depositor error that overstate cash ledger balance----------xx xxx |
| **Adjusted cash balance**----------xxx |

**Example:**

The bank statement for ABC Company indicates a balance of $3359.78 as of July 31.The balance in cash in ABC Company's ledger of same date is $2549.99.

**Additional information:**

- Deposit of July 31, not recorded in the bank ----------816.20
- Outstanding checks: #812----------1061.00
  #878----------435.39
  #883----------48.60
- Note plus interest of $8 collected by bank (credit memorandum) not recorded in cash receipt journal, $408.00.
- Bank service charge (debit memorandum) not recorded in cash payment journal, $18.
- Check #879 for $732.26 to "XYZ" company on account, recorded in cash payment journal as $723.26.
- NSF checks, $300.

**Instruction:**

a) Prepare bank reconciliation

b) Journalize the necessary entries.

### b. Petty Cash Fund

It's the small fund used to make payment for small expenditures. There are three steps involved in the operation of the petty cash.

1) Establishing the petty cash

2) Making payment from the petty cash.

3) Replenishing (reimbursing) the petty cash.

1) **Establishing the petty cash**: In establishing the petty cash fund, the first step is to estimate the amount of cash needed for disbursement of relatively small amounts during

certain period, such as week or a month and appointing the petty cash custodian, the one who is responsible for the operation of the petty cash fund and for making disbursements from the petty cash fund. Checks payable to the petty cash fund custodian will be issued.

Petty cash----------xx

Cash in bank----------xx

No entry will be made to the petty cash account unless the petty cash fund is changed (increased or decreased)

**2) Making payment from the petty cash:**

Petty cash receipt: The employee, who requests for payment and the petty cash custodian will sign on it. The petty cash custodian will make payment for the specified employee who request disbursement.

NB: No journal entry will be made at the time of disbursement (payment) from the petty cash fund.

3) **Replenishing (reimbursing) the petty cash**: When the money in the petty cash fund reaches a minimum level, the fund is replenished (reimbursed). Replenishing the petty cash fund restores to its original amount. The request for this is initiated by the petty cash custodian. The custodian will provide the summary of the petty cash payment with the petty cash receipt to the treasurer. Then the treasurer approves the request and check is prepared to restore the fund to its established amount. Journal entry will be made to restore the petty cash fund to previously established amount and to record all expenditures.

Example: If "X" company desires to establish a $100 petty cash fund on August 1, the entry will be:

August 1/ Petty cash----------100

Cash in bank----------100

Assume that on August 31, the petty cash custodian requests check number 3 for $87. The fund contains $13 cash and petty cash receipt for postage expense $44, freight in, $38 and miscellaneous expense, $5.

The entry to record the replenishment on August 31 will be:

August 31/ Postage expense----------44

Freight in----------38

Miscellaneous expense----------5

Cash in bank----------87