

Chapter Four

Internal Control and Accounting for Cash

FUNDAMENTAL FINANCIAL
ACCOUNTING CONCEPTS

Fifth Edition



Edmonds / Edmonds / McNair / Olds

Objectives

1. Define what Internal Control is.
2. Describe the importance of internal control.
2. Summarize basic procedures for achieving internal control over cash receipts.
3. Summarize basic procedures for achieving internal control over cash payments.
4. Describe the nature of a bank account and its use in controlling cash.
5. Prepare a bank reconciliation and journalize any necessary entries.
6. Account for small cash transactions using a petty cash fund.

After studying this chapter, you should be able to:



Definition of Internal control

- Is a process for assuring achievement of an organization's objectives:
 - in operational effectiveness and efficiency,
 - reliable financial reporting, and
 - compliance with laws, regulations and policies.



Purpose of Internal Control

C 1

Managers use policies and procedures to:

- 1. Protect assets.**
- 2. Ensure reliable accounting.**
- 3. Promote efficient operations.**
- 4. Urge adherence to company policies.**

Key Features of Internal Control

1. Separation of Duties
2. Quality of Employees
3. Required Absences
4. Procedures Manual
- 5. *Pre-numbered Documents***
6. Physical Control
7. Performance Evaluations



Separation of Duties

- *When duties are separated, the work of one employee can act as a check on the work of another employee.*
- *The likelihood of fraud or theft is greatly reduced.*



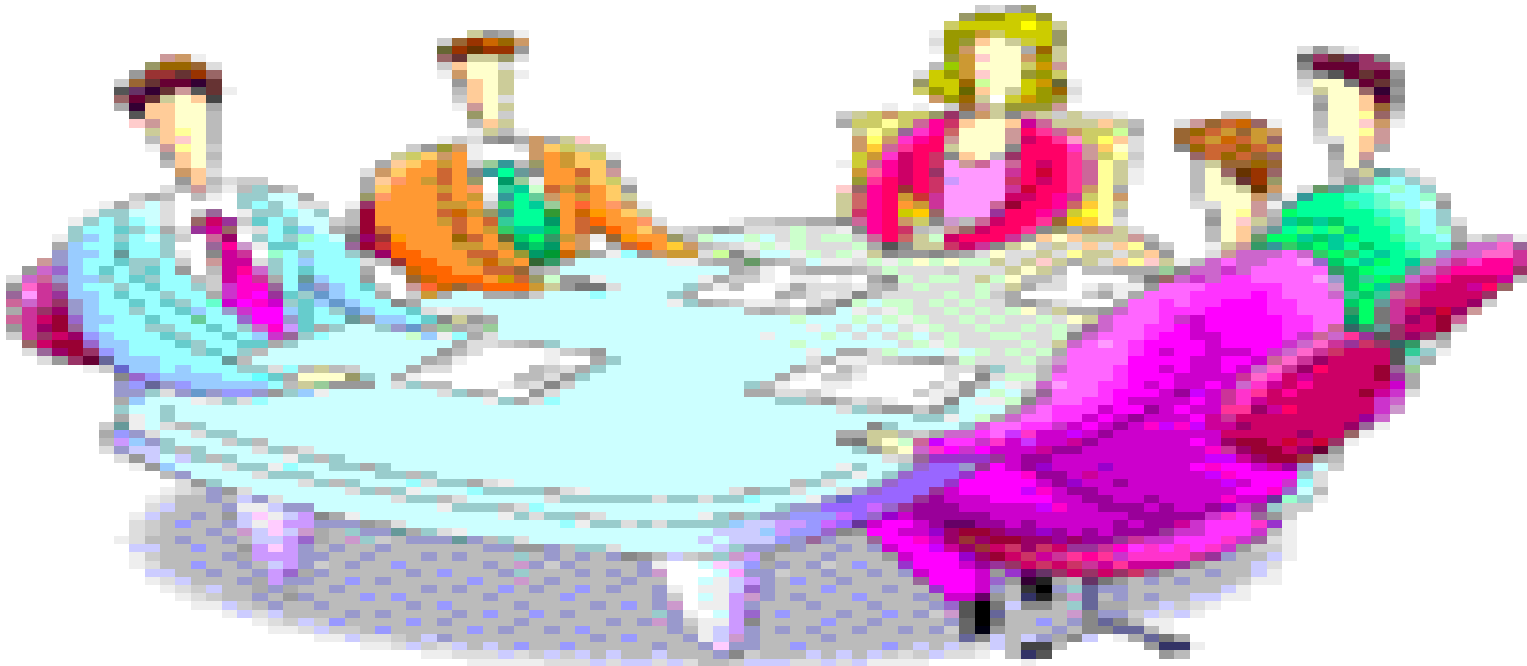
Required Absences

- An employee may be able to cover up fraudulent activities if they are always present at work.
- All employees should be required to take regular vacations and their duties should be rotated periodically.



Procedures Manual

- Accounting and other important procedures should be written in a procedures manual.
- Periodically, **management should conduct an investigation to see that required procedures are actually being followed.**



Pre-numbered Documents.

- Pre-numbered forms are **used for all important documents such as checks, purchase orders, receiving reports, and invoices.**
- The use of **pre-numbered forms helps keep track of all forms issued during a particular period.**



Physical Control

- All companies should maintain adequate physical control over valuable assets that may be misappropriated.
- For example, inventory should be properly stored in a secure location.
- Serial numbers should be placed on all valuable assets to assist in a physical count of these assets.



Performance Evaluation

- Internal controls should include independent **verification of employee performance**.
- A **physical inventory** should be taken at least annually.
- An independent reconciliation between the general ledger balance and inventory should be compared to the inventory count.
- Auditors should evaluate the **effectiveness** of the control system.



Principles of Internal Control

1. Establish **responsibilities**.
2. Maintain adequate records.
3. **Insure assets** and bond key employees.
4. **Separate** recordkeeping from custody of assets.
5. Divide **responsibility** for related transactions.
6. Apply **technological** controls.
7. Perform regular and **independent** reviews.

Limitations of Internal Control

C1

Human Error



Negligence
Fatigue
Misjudgment
Confusion

Human Fraud



Intent to
defeat internal
controls for
personal gain

Limitations

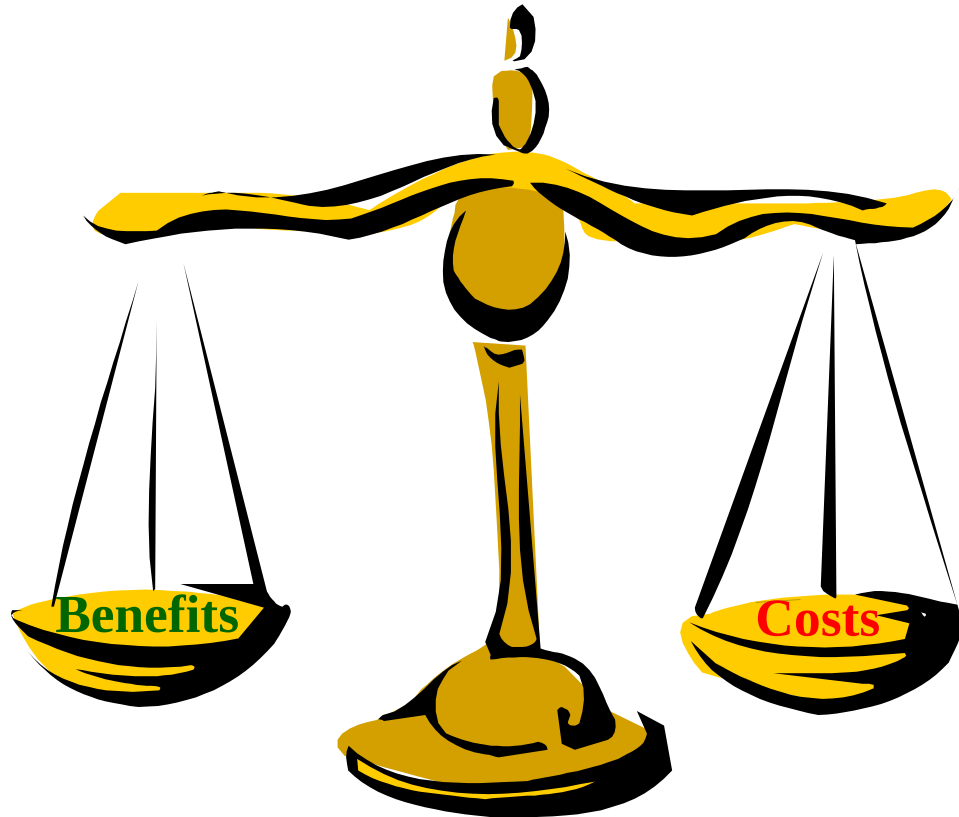
- Internal controls can be circumvented by collusion among employees.
- **Two or more employees working together can hide embezzlement/misuse by covering for each other.**
- No system can prevent fraud.



General principle of Internal Control

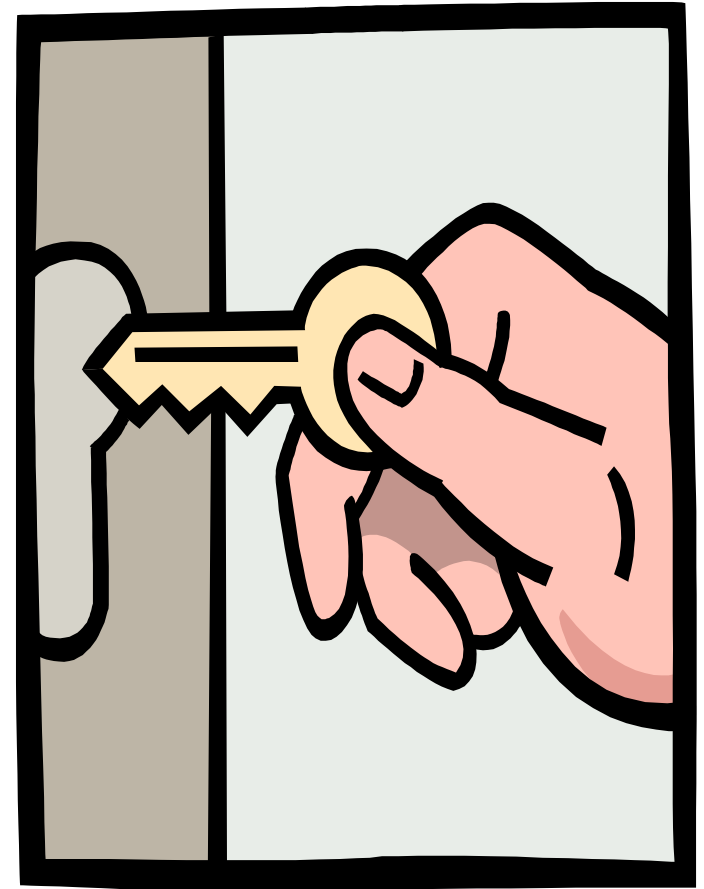
C1

The costs of internal controls
must not exceed their benefits.



Internal Control for Cash

Because Cash is a highly desirable asset and is readily transferable, **internal control** over cash is **especially important.**



Define cash

What is cash?

What does it include?



Cash

- Cash is one of the most **important** assets a business **owns**.
- Cash is **the primary asset used to acquire** other assets as well as to pay for operating expenses.



What is Cash?

- ◆ Most liquid asset
- ◆ Standard **medium** of exchange
- ◆ That **Banks accept** for immediate deposit
- ◆ Current asset
- ◆ **Examples:** **Coin, currency**, deposit at the bank, checks, bank **drafts check** and savings accounts.

Bank Overdrafts

Company **writes a check for more than the amount** in its cash account.

- ◆ **Generally reported as a current liability.**
- ◆ **Offset against other cash accounts only** when accounts are with the same bank.

Discussion Question

- Holding Cash doesn't generate a profit, so why a firm holds it?

Cash doesn't earn a profit, so why hold it?

1. **Transactions** – must have some cash to operate.
2. **Compensating** balances – for loans and/or services provided.
3. **Speculation** – to take advantage of bargains and to take discounts. Reduced by credit lines and marketable securities.

For controlling Cash

Company should

- ◆ **Minimize the cash on hand.**
 - ◆ **Only have on hand petty cash and current day's receipts**
- ◆ **Use cash register machines**
- ◆ **Use sequentially numbered receipts**
- ◆ **Keep funds in a safe, or locked cash drawer.**
- ◆ **Transmit/deposit each day's receipts to the bank as soon as practicable/possible.**
- ◆ **Periodically prove the balance: bank reconciliation**

Accounting for Cash

Up to date signature card should be maintained.

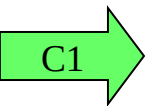
Cash receipts should be recorded immediately upon receipt and deposited together daily.

**Controlling
Cash**

A monthly bank reconciliation should be prepared by an independent party.

A deposit ticket should be used for all deposits.

Cash disbursements should be made by pre-numbered check.



Control of Cash

An effective system of internal control that protects cash and cash equivalents should meet three basic guidelines:

Handling cash is separate from recordkeeping of cash.

Cash receipts are promptly deposited in a bank.

Cash disbursements are made by check.

CASH CONTROLS

Using Bank Accounts

Using Bank accounts has several advantages such as:

1. Cash is **physically** protected
2. **Double** record of cash is maintained (one by the **bank** and the other by the **business**)
3. Check and control (**errors can be identified through reconciliation**)

Bank Reconciliation

- Purpose
 - Double records for the same cash (by the depositor and by the bank)
 - The **two records should have equal balance on a specific date, but they may be different because of:**
 - **Delay by either party in recording transactions**
 - **Errors by either party in recording transactions**
 - Thus, the balances must be reconciled using reconciliation statement.

Reconciliation of Bank Balances

Schedule explaining any differences between the bank's and the company's records of cash.

Reconciling Items:

- 1. Deposits in transit.**
- 2. Outstanding checks.**
- 3. Bank charges and credits.**
- 4. Bank or Depositor errors.**



Time Lags

Reconciling the Bank Statement

The bank reconciliation reports on the differences between the balance on the bank statement and the balance in the general ledger cash account. The reconciliation results in the *true cash balance* that will appear on the balance sheet.

Adjustment to the Bank Balance

Unadjusted bank balance

Add + Deposits in transit

Deduct - Outstanding checks

Equals = True cash balance

Adjustments to the Book Balance

Unadjusted book balance

Add + Accounts receivable collections

Add + Interest earned

Deduct - Bank service charges

Deduct - Non-sufficient funds (NSF) check

Equals = True cash balance

Reconciling Items

P3

Bank Statement Balance

- **Add:**
Deposits in transit.
- **Deduct:** Outstanding Checks
- **Add or Deduct:** Bank errors.

Book Balance

- **Add:** Collections made by the bank.
- **Add:** Interest earned on checking account.
- **Deduct:** Nonsufficient funds check (NSF).
- **Deduct:** Bank service charge.
- **Add or Deduct:** Book errors.

Bank Reconciliation

Two sections:

1. Reconcile bank statement balance to the adjusted bank balance.
2. Reconcile book balance to the adjusted book balance.

The adjusted balances should be equal.



Reconciling the Bank Statement

- If an error is found on the bank statement, an adjustment for it is made to the unadjusted bank balance to determine the true cash balance.
- An error made on our books requires an adjusting journal entry to correct.



Bank Reconciliation

Matrix Co. is preparing the bank reconciliation for the month of June.

1. The June 30th balance on the bank statement is \$4,892.56, and the Cash general ledger balance on this date is \$4,240.54.
2. There was a deposit in transit in the amount of \$475.
3. The bank erroneously deducted a \$200 check drawn on the books of **Matters** Inc. from our (**Matrix**) account.
4. At June 30th there were three checks outstanding. **Check 1078 dated 6/28**, for \$372.33; **Check 1080 dated 6/29**, for \$402.41; and **Check 1081 dated 6/30**, for \$66.89.



Bank Reconciliation

5. During the month of June the bank collected an account receivable for us in the amount of \$875.
6. A check actually **written for \$146.88 for** supplies was erroneously recorded in **our records** by the bookkeeper as **\$173.88**.
7. Matrix **earned interest** of \$9.25 on its checking account.
8. The bank **assessed a service charge of \$12.75** for June and
9. **Matrix** deposited a NSF check in the amount of \$413.11.

Let's prepare the bank reconciliation

Bank Reconciliation

Matrix, Inc.

Bank Reconciliation Statement

June 30, 2006

Unadjusted bank balance, June 30

\$ 4,892.56

Add: Deposits in transit

475.00

[illegible]

Bank Reconciliation

Matrix, Inc. Bank Reconciliation Statement June 30, 2006

Unadjusted bank balance, June 30		\$ 4,892.56
Add: Deposits in transit		475.00
Bank error		200.00
Less: Outstanding checks		
Check No. 1078 - June 28	372.33	
Check No. 1080 - June 29	402.41	
Check No. 1081 - June 30	66.89	(841.63)
True Cash balance, June 30		\$ 4,725.93

Bank Reconciliation

Matrix, Inc. Bank Reconciliation Statement June 30, 2006

Unadjusted bank balance, June 30		\$ 4,892.56
Add: Deposits in transit		475.00
Bank error		200.00
Less: Outstanding checks		
Check No. 1078 - June 28	372.33	
Check No. 1080 - June 29	402.41	
Check No. 1081 - June 30	66.89	(841.63)
True Cash balance, June 30		\$ 4,725.93
Unadjusted Book Balance, June 30		\$ 4,240.54
Add: Account collected by bank		875.00

Bank Reconciliation

Matrix, Inc. Bank Reconciliation Statement June 30, 2006

Unadjusted bank balance, June 30		\$ 4,892.56
Add: Deposits in transit		475.00
Bank error		200.00
Less: Outstanding checks		
Check No. 1078 - June 28	372.33	
Check No. 1080 - June 29	402.41	
Check No. 1081 - June 30	66.89	(841.63)
True Cash balance, June 30		\$ 4,725.93
Unadjusted Book Balance, June 30		\$ 4,240.54
Add: Account collected by bank		875.00
Bookkeeping error		27.00
Interest earned on checking account		9.25

Bank Reconciliation

Matrix, Inc. Bank Reconciliation Statement June 30, 2006

Unadjusted Bank Balance, June 30		\$ 4,892.56
Add: Deposits in transit		475.00
Bank error		200.00
Less: Outstanding checks		
Check No. 1078 - June 28	372.33	
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True Cash balance, June 30		\$ 4,725.93
Unadjusted Book Balance, June 30		\$ 4,240.54
Add: Account collected by bank		875.00
Bookkeeping error		27.00
Interest earned on checking account		9.25
Less: Bank service charge		(12.75)
NSF Check		(413.11)
True Cash balance, June 30		\$ 4,725.93

Adjusting the Books

Every reconciling item that appears on the unadjusted book balance section requires a journal entry to adjust the general ledger cash balance to the true cash balance.

Account Title	Debit	Credit
Cash	911.25	
Accounts receivable		875.00
Supplies expense		27.00
Interest revenue		9.25
Bank service charge expense	12.75	
Accounts receivable	413.11	
Cash		425.86

Bank Reconciliation Example

P3

Let's prepare a July 31 bank reconciliation statement for the Simmons Company.

The July 31 bank statement indicated a balance of \$9,610.

- **The cash general ledger account on that date shows a balance of \$7,430.**

Additional information necessary for the reconciliation is shown on the next screen.

Bank Reconciliation Example

1. **Outstanding** checks totaled \$2,417.
2. A \$500 check mailed to the **bank for deposit had not reached the bank at** the statement date.
3. The **bank returned a customer's NSF check for \$225** received as payment on account receivable.
4. The bank statement showed **\$30 interest earned** during July.
5. **Check No. 781 for supplies expense cleared** the bank for \$268 but was **erroneously** recorded in our books as \$240.
6. A **\$486 deposit by Acme Company** was erroneously credited to **our account by the bank**.

Bank Reconciliation Example

Simmons Company Bank Reconciliation July 31, 2011		
Bank Balance, July 31		\$ 9,610
Add: Deposit in Transit		500
Less: Bank Error	\$ 486	
Outstanding Checks	2,417	(2,903)
Adjusted Balance, July 31		\$ 7,207
Book Balance, July 31		\$ 7,430
Add: Interest		30
Less: Recording Error	\$ 28	
NSF Check	225	(253)
Adjusted Balance, July 31		\$ 7,207

Adjusting Entries from a Bank Reconciliation

P3

Only amounts shown on the book portion of the reconciliation require an adjusting entry.

		Dr.	Cr.
July 31	Cash	30	
	Interest revenue		30
July 31	Supplies expense	28	
	Accounts receivable	225	
	Cash		253

Adjusting Entries from a Bank Reconciliation

P3

After posting the reconciling entries the cash account looks like this:

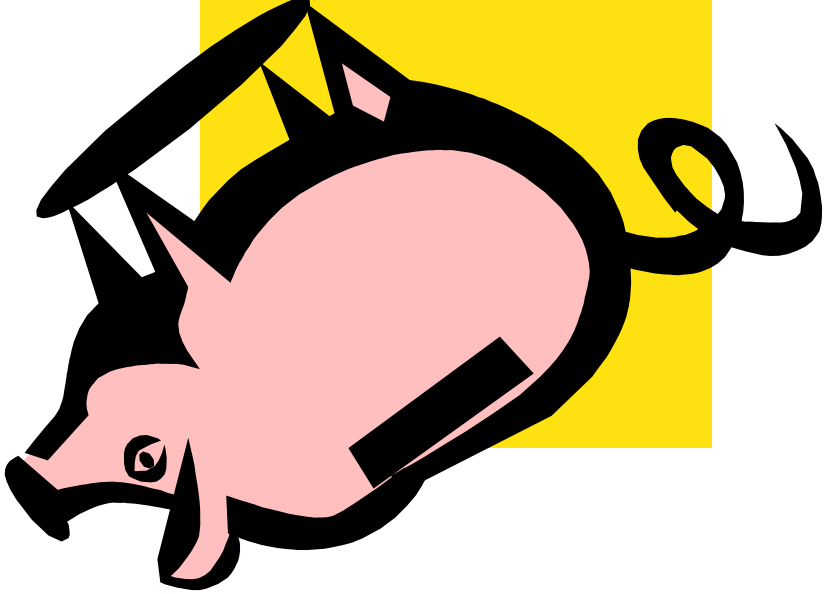
GENERAL LEDGER

Account: **Cash**

Acct. No. **101**

						Balance
Date		Item	PR	Debit	Credit	DR (CR)
July	31	Balance				7,430
	31	Adjusting entry		30		7,460
	31	Adjusting entry			253	7,207

Adjusted balance on July 31.



Petty Cash



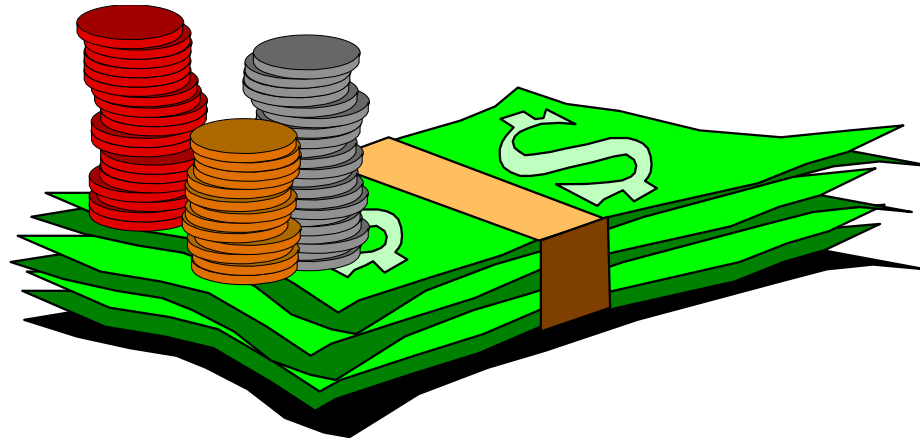
Petty cash

- **Another internal control is to keep as little cash on hand as possible.**
- **It is often necessary, however, to keep some cash on hand.**
- **Cash kept on hand at a business to pay for small items such as postage due, supplies, or miscellaneous expenses is known as Petty Cash.**



Petty Cash System of Control

Small payments required in most companies for items such as postage, courier fees, repairs and supplies.



Establishing A Petty Cash Fund

A Petty Cash fund is established by cashing a check for the amount determined to be included in the Petty Cash fund.

This amount varies by company and may be as small as \$25 or as large as \$500 depending on the company's needs.



Journal Entry for Establishing A Petty Cash Fund

Assume that JCC has determined that \$125 cash should be kept on hand for miscellaneous expenses. A check will be written on JCC's checking account and JCC will put \$125 cash in a Petty Cash drawer. The following journal entry should be recorded for this transaction.

Petty Cash	125	
Cash		125
Established Petty Cash Fund		



Internal Control Over Petty Cash

- **Petty Cash is paid out in exchange for a petty cash voucher signed by both the recipient of the cash and the petty cash controller.**

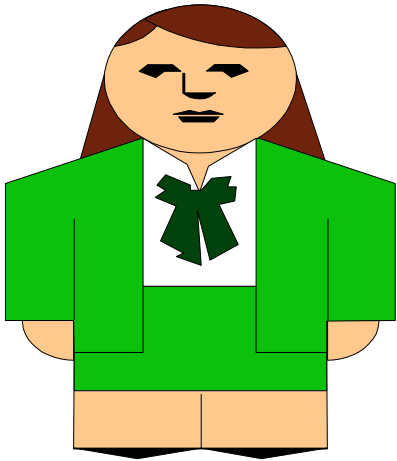
- The voucher should indicate the amount of cash paid out and the purpose of the disbursement.

- The recipient of the cash should provide a receipt for the purchase made out of petty cash which will be attached to the petty cash voucher.



Operating a Petty Cash Fund

P2



**Company
Cashier**

BOB JONES 2048

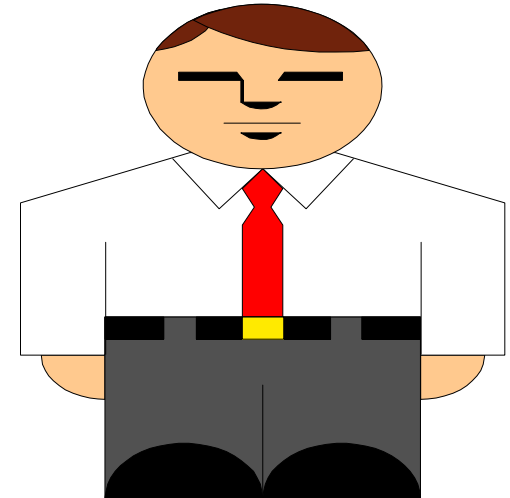
Petty Cash DATE _____

PAY TO THE ORDER OF _____ \$ _____

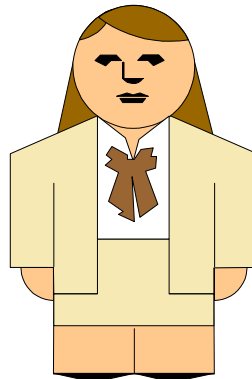
DOLLARS

FIRST NATIONAL BANK

⑆00 2100 66⑆ 77011 964076⑈ 2121



**Petty
Cashier**

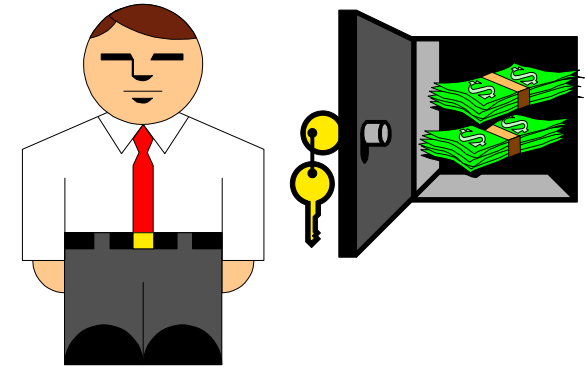


Accountant

May 1	Petty cash	400	
	Cash		400

Operating a Petty Cash Fund

P2



**Petty
Cashier**

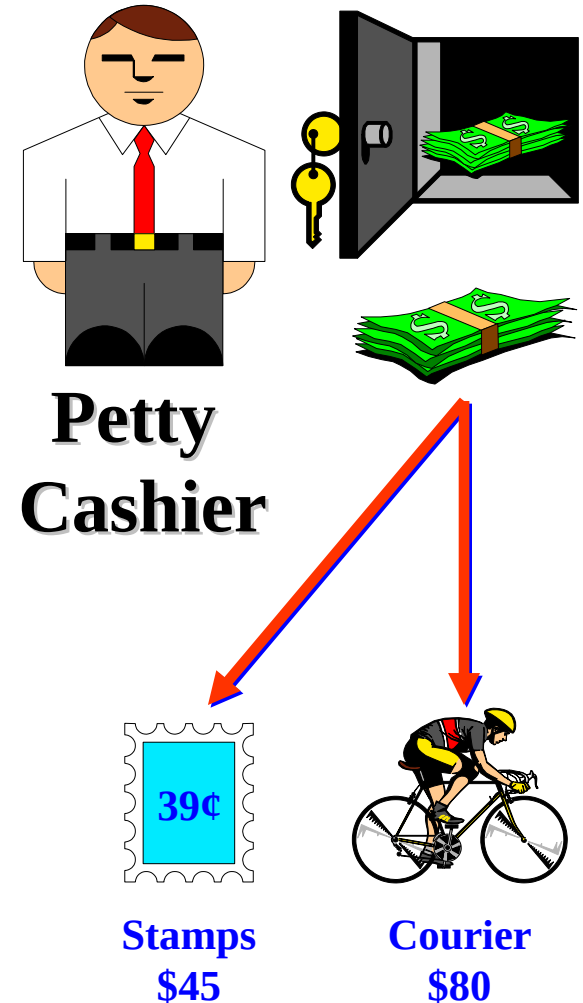
BOB JONES		2048
DATE _____		
PAY TO THE ORDER OF Petty Cash		\$ _____
FIRST NATIONAL BANK		DOLLARS
⑆00 2100 66⑆ 770⑆ 964076⑆ 212⑆		



Operating a Petty Cash Fund

P2

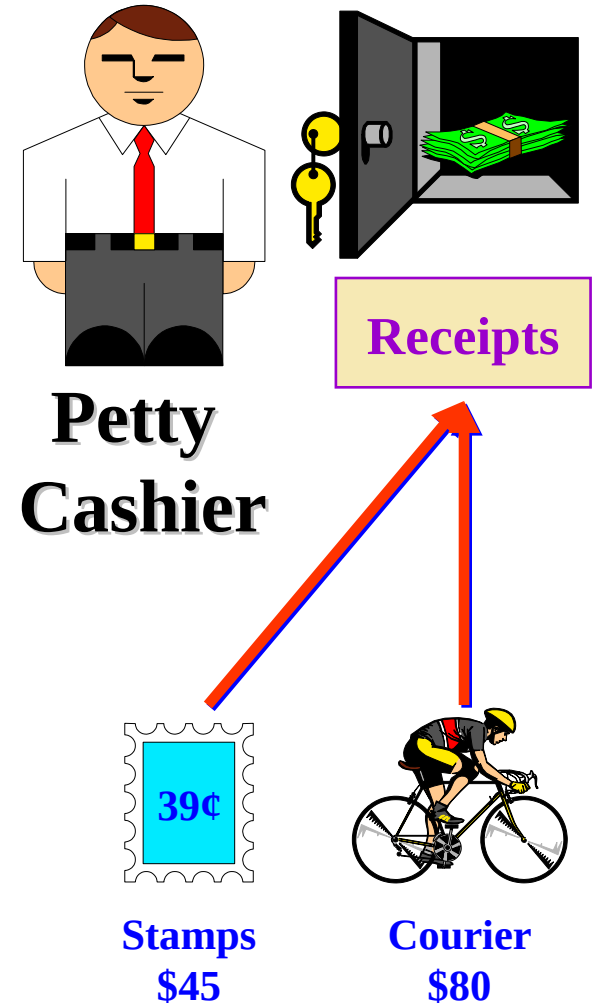
A petty cash fund is used only for business expenses.



Operating a Petty Cash Fund

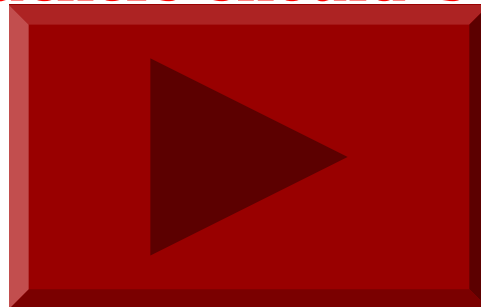
P2

Petty cash receipts with either no signature or a forged signature usually indicate misuse of petty cash.



Replenishing Petty Cash

- At some point the Petty Cash fund must be replenished.
 - It is at this point that the petty cash fund will also be reconciled.
- The procedure to replenish and reconcile petty cash begins by counting the cash remaining in the Petty Cash drawer.
- Next, all vouchers are totaled.
 - The combined total of remaining cash and Petty Cash Vouchers should equal the established value of the Petty Cash fund.
- Finally, the Petty Cash vouchers should be organized into expense categories.

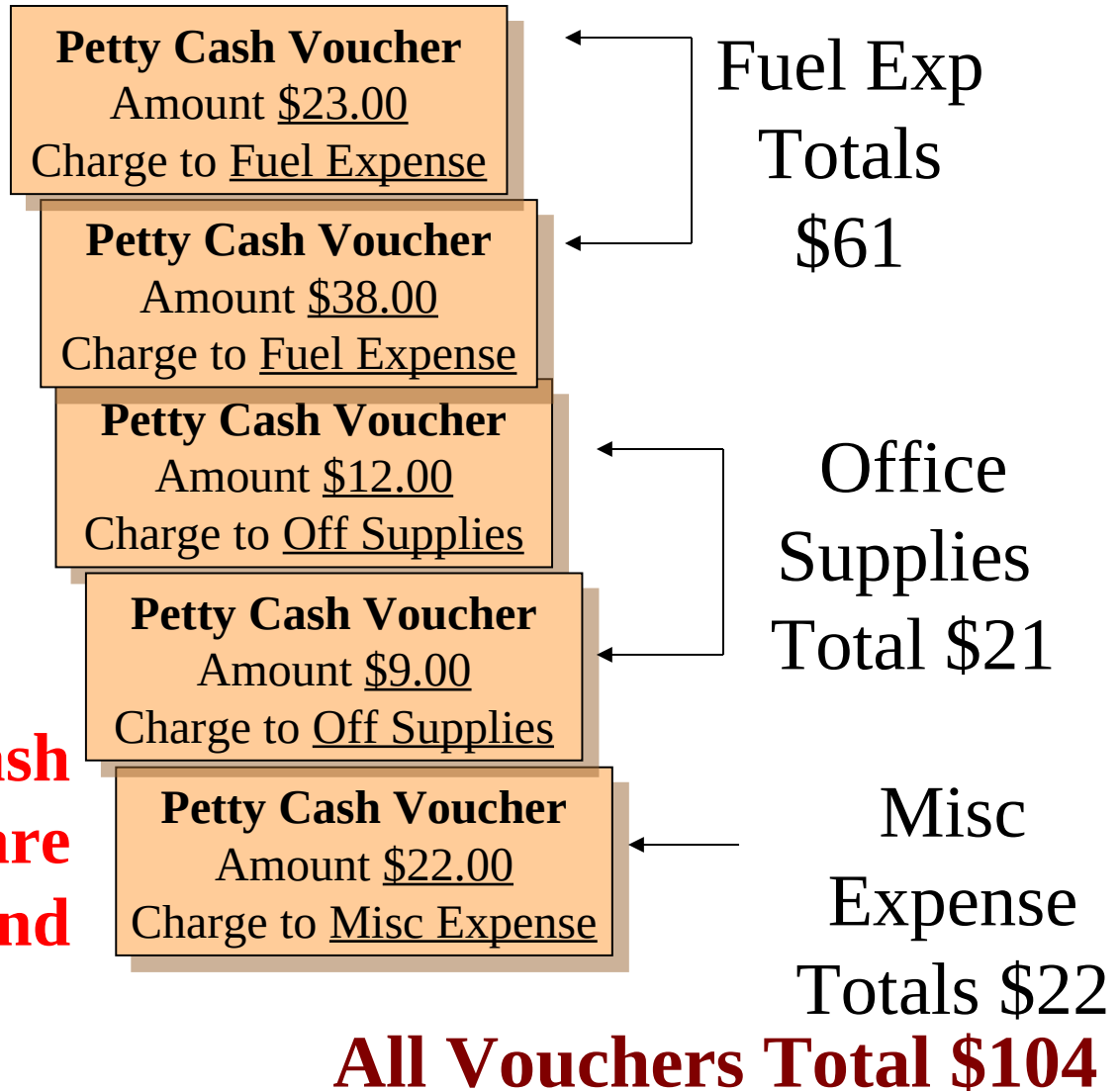


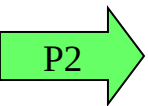
Replenishing Petty Cash: An Example

- The cash in the Petty Cash Drawer is counted.

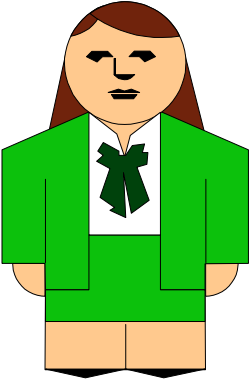


- The Petty Cash Vouchers are organized and totaled.





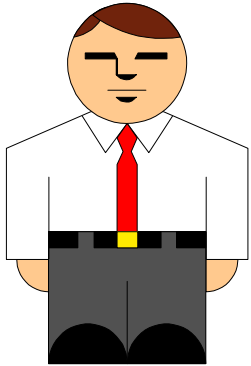
Operating a Petty Cash Fund



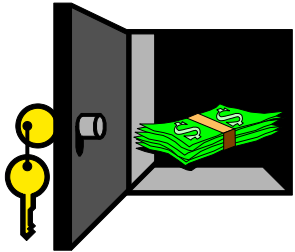
**Company
Cashier**



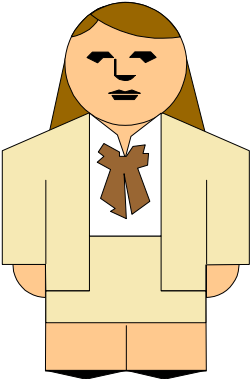
**To reimburse
petty cash fund**



**Petty
Cashier**



**Use a Cash
Over and Short
account if needed.**



Accountant

May 31	Postage expense	45	
	Delivery expense	80	
	Cash		125

Petty Cash Example

P2

Tension Co. maintains a petty cash fund of \$400. The following summary information was taken from petty cash vouchers for July:

Travel Expenses	\$79.30
Customer Business Lunches	93.42
Express Mail Postage	55.00
Miscellaneous Office Supplies	32.48

Let's look at replenishing the fund if the balance on July 31 was \$137.80.

Petty Cash Example

P2

What amount of cash will be required to replenish the petty cash fund?

- a. \$260.20
- b. \$262.20
- c. \$139.80
- d. \$137.80

Petty Cash Example

P2

What amount of cash will be required to replenish the petty cash fund?

- a. \$260.20
- ☒ b. \$262.20
- c. \$139.80
- d. \$137.80

Desired Balance	\$ 400.00
Actual Balance	137.80
Amount Needed	<u>\$ 262.20</u>

Let's prepare the journal entry to replenish the petty cash fund.

Petty Cash Example

Journal entry to replenish petty cash fund

	Dr.	Cr.
July 31 Travel Expense	79.30	
Entertainment Expense	93.42	
Postage Expense	55.00	
Office Supplies Expense	32.48	
Cash Over and Short	2.00	
Cash		262.20

End of Chapter Four



End of the Course

