After studying this chapter, you should be able to:

1. Define fraud and internal control.
2. Identify the principles of internal control activities.
3. Explain the applications of internal control principles to cash receipts.
4. Explain the applications of internal control principles to cash disbursements.
5. Prepare a bank reconciliation.
6. Explain the reporting of cash.
7. Discuss the basic principles of cash management.
8. Identify the primary elements of a cash budget.
If you’re ever looking for a cappuccino in Moose Jaw, Saskatchewan, stop by Stephanie’s Gourmet Coffee and More, located on Main Street. Staff there serve, on average, 650 cups of coffee a day, including both regular and specialty coffees, not to mention soups, Italian sandwiches, and a wide assortment of gourmet cheesecakes.

“We’ve got high school students who come here, and students from the community college,” says owner/manager Stephanie Mintenko, who has run the place since opening it in 1995. “We have customers who are retired, and others who are working people and have only 30 minutes for lunch. We have to be pretty quick.”

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

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

There is only one cash register. “Up to three of us might operate it on any given shift, including myself,” says Ms. Mintenko. She and her staff do two “cashouts” each day—one with the shift change at 5:00 p.m. and one when the shop closes at 10:00 p.m. At each cashout, they count the cash in the register drawer. That amount, minus the cash change carried forward (the float), should match the shift total on the register tape. If there’s a discrepancy, they do another count. Then, if necessary, “we go through the whole tape to find the mistake,” she explains. “It usually turns out to be someone who punched in $18 instead of $1.80, or something like that.”

Ms. Mintenko sends all the cash tapes and float totals to a bookkeeper, who double-checks everything and provides regular reports. “We try to keep the accounting simple, so we can concentrate on making great coffee and food.”
As the story about recording cash sales at Stephanie’s Gourmet Coffee and More indicates, control of cash is important to ensure that fraud does not occur. Companies also need controls to safeguard other types of assets. For example, Stephanie’s undoubtedly has controls to prevent the theft of food and supplies, and controls to prevent the theft of tableware and dishes from its kitchen.

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

The content and organization of Chapter 7 are as follows.

**Fraud, Internal Control, and Cash**

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**Fraud and Internal Control**

The Feature Story describes many of the internal control procedures used by Stephanie’s Gourmet Coffee and More. These procedures are necessary to discourage employees from fraudulent activities.

**FRAUD**

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

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

Why does fraud occur? The three main factors that contribute to fraudulent activity are depicted by the **fraud triangle** in Illustration 7-1.

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

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

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

**THE SARBANES-OXLEY ACT**

What can be done to prevent or to detect fraud? After numerous corporate scandals came to light in the early 2000s, Congress addressed this issue by passing the Sarbanes-Oxley Act of 2002 (SOX). Under SOX, all publicly traded U.S. corporations are required to maintain an adequate system of internal control. Corporate executives and boards of directors must ensure that these controls are reliable and effective. In addition, independent outside auditors must attest to the adequacy of the internal control system. Companies that fail to comply are subject to fines, and company officers can be imprisoned. SOX also created the Public Company Accounting Oversight Board (PCAOB) to establish auditing standards and regulate auditor activity.

One poll found that 60% of investors believe that SOX helps safeguard their stock investments. Many say they would be unlikely to invest in a company that fails to follow SOX requirements. Although some corporate executives have criticized the time and expense involved in following the SOX requirements, SOX appears to be working well. For example, the chief accounting officer of Eli Lilly noted that SOX triggered a comprehensive review of how the company documents controls. This review uncovered redundancies and pointed out controls that needed to be added. In short, it added up to time and money well spent. And the finance chief at General Electric noted, “We have seen value in SOX. It helps build investors’ trust and gives them more confidence.”

**INTERNAL CONTROL**

Internal control consists of all the related methods and measures adopted within an organization to safeguard its assets, enhance the reliability of its accounting records, increase efficiency of operations, and ensure compliance with laws and regulations. Internal control systems have five primary components as listed below:

- **A control environment.** It is the responsibility of top management to make it clear that the organization values integrity and that unethical activity will not be tolerated. This component is often referred to as the “tone at the top.”

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• **Risk assessment.** Companies must identify and analyze the various factors that create risk for the business and must determine how to manage these risks.

• **Control activities.** To reduce the occurrence of fraud, management must design policies and procedures to address the specific risks faced by the company.

• **Information and communication.** The internal control system must capture and communicate all pertinent information both down and up the organization, as well as communicate information to appropriate external parties.

• **Monitoring.** Internal control systems must be monitored periodically for their adequacy. Significant deficiencies need to be reported to top management and/or the board of directors.

### PRINCIPLES OF INTERNAL CONTROL ACTIVITIES

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

The six principles of control activities are as follows.

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

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

### Establishment of Responsibility

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

To illustrate, assume that the cash on hand at the end of the day in a Safeway supermarket is $10 short of the cash rung up on the cash register. If only one person has operated the register, the shift manager can quickly determine responsibility for the shortage. If two or more individuals have worked the register, it may be impossible to determine who is responsible for the error. In the Feature Story, the principle of establishing responsibility does not appear to be strictly applied by Stephanie’s, since three people operate the cash register on any given shift.

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

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

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

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

SEgregation of Related Activities. Making one individual responsible for related activities increases the potential for errors and irregularities.

For example, companies should assign related purchasing activities to different individuals. Related purchasing activities include ordering merchandise, order approval, receiving goods, authorizing payment, and paying for goods or services. Various frauds are possible when one person handles related purchasing activities. For example:

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

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

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

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

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

**ANATOMY OF A FRAUD**

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

Total take: $475,000

**THE MISSING CONTROL**

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


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

**ANATOMY OF A FRAUD**

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

Total take: $570,000
Documentation Procedures

Documents provide evidence that transactions and events have occurred. At Stephanie’s Gourmet Coffee and More, the cash register tape is the restaurant’s documentation for the sale and the amount of cash received. Similarly, a shipping document indicates that the goods have been shipped, and a sales invoice indicates that the company has billed the customer for the goods. By requiring signatures (or initials) on the documents, the company can identify the individual(s) responsible for the transaction or event. Companies should document transactions when the transaction occurs.

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

ANATOMY OF A FRAUD

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

Total take: $75,000

THE MISSING CONTROL

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

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

Physical Controls

Use of physical controls is essential. Physical controls relate to the safeguarding of assets and enhance the accuracy and reliability of the accounting records. Illustration 7-2 (page 342) shows examples of these controls.
Chapter 7  Fraud, Internal Control, and Cash

Illustration 7-2  Physical Controls

<table>
<thead>
<tr>
<th>Physical Controls</th>
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<tbody>
<tr>
<td>Safes, vaults, and safety deposit</td>
</tr>
<tr>
<td>boxes for cash and business papers</td>
</tr>
<tr>
<td>Locked warehouses and storage</td>
</tr>
<tr>
<td>cabinets for inventories and</td>
</tr>
<tr>
<td>records</td>
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<tr>
<td>Computer facilities with pass key</td>
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<tr>
<td>access or fingerprint or</td>
</tr>
<tr>
<td>eyeball scans</td>
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<tr>
<td>Alarms to prevent break-ins</td>
</tr>
<tr>
<td>Television monitors and garment</td>
</tr>
<tr>
<td>sensors to deter theft</td>
</tr>
<tr>
<td>Time clocks for recording time</td>
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<tr>
<td>worked</td>
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</tbody>
</table>

ANATOMY OF A FRAUD

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

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

Total take: $240,000

THE MISSING CONTROL

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

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

Independent Internal Verification

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

1. Companies should verify records periodically or on a surprise basis.
2. An employee who is independent of the personnel responsible for the information should make the verification.
3. Discrepancies and exceptions should be reported to a management level that can take appropriate corrective action.
Independent internal verification is especially useful in comparing recorded transactions with existing assets. The reconciliation of the cash register tape with the cash in the register at Stephanie's Gourmet Coffee and More is an example of this internal control principle. Another common example is the reconciliation of a company's cash balance per books with the cash balance per bank and the verification of the perpetual inventory records through a count of physical inventory. Illustration 7-3 shows the relationship between this principle and the segregation of duties principle.

Large companies often assign independent internal verification to internal auditors. Internal auditors are company employees who continuously evaluate the effectiveness of the company's internal control systems. They review the activities of departments and individuals to determine whether prescribed internal controls are being followed. They also recommend improvements when needed. In fact, most fraud is discovered by the company through internal mechanisms such as existing internal controls and internal audits. For example, the fraud at WorldCom, involving billions of dollars, was uncovered by an internal auditor.

ANATOMY OF A FRAUD

Bobbi Jean Donnelly, the office manager for Mod Fashions Corporation's design center, was responsible for preparing the design center budget and reviewing expense reports submitted by design center employees. Her desire to upgrade her wardrobe got the better of her, and she enacted a fraud that involved filing expense-reimbursement requests for her own personal clothing purchases. She was able to conceal the fraud because she was responsible for reviewing all expense reports, including her own. In addition, she sometimes was given ultimate responsibility for signing off on the expense reports when her boss was “too busy.” Also, because she controlled the budget, when she submitted her expenses, she coded them to budget items that she knew were running under budget, so that they would not catch anyone's attention.

Total take: $275,000
Human Resource Controls

Human resource control activities include the following.

1. **Bond employees who handle cash.** Bonding involves obtaining insurance protection against theft by employees. It contributes to the safeguarding of cash in two ways: First, the insurance company carefully screens all individuals before adding them to the policy and may reject risky applicants. Second, bonded employees know that the insurance company will vigorously prosecute all offenders.

2. **Rotate employees’ duties and require employees to take vacations.** These measures deter employees from attempting thefts since they will not be able to permanently conceal their improper actions. Many banks, for example, have discovered employee thefts when the employee was on vacation or assigned to a new position.

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

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**ANATOMY OF A FRAUD**

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

**Total take:** $95,000

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**THE MISSING CONTROL**

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

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

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

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

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

The size of the business also may impose limitations on internal control. A small company, for example, may find it difficult to segregate duties or to provide for independent internal verification.

ACCOUNTING ACROSS THE ORGANIZATION

SOX Boosts the Role of Human Resources

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

Why would unsupervised employees or employees who report to each other represent potential internal control threats? (See page 392.)

HELPFUL HINT

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

ETHICS INSIGHT

Big Theft at Small Companies

A study by the Association of Certified Fraud Examiners indicates that businesses with fewer than 100 employees are most at risk for employee theft. In fact, 38% of frauds occurred at companies with fewer than 100 employees. The median loss at small companies was $200,000, which was higher than the median fraud at companies with more than 10,000 employees ($147,000). A $200,000 loss can threaten the very existence of a small company.


Why are small companies more susceptible to employee theft? (See page 392.)
Cash Controls

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

CASH RECEIPTS CONTROLS

Illustration 7-4 shows how the internal control principles explained earlier apply to cash receipts transactions. As you might expect, companies vary considerably in how they apply these principles. To illustrate internal control over...
cash receipts, we will examine control activities for a retail store with both over-the-counter and mail receipts.

**Over-the-Counter Receipts**

In retail businesses, control of over-the-counter receipts centers on cash registers that are visible to customers. A cash sale is rung-up on a cash register with the amount clearly visible to the customer. This activity prevents the cashier from ringing up a lower amount and pocketing the difference. The customer receives an itemized cash register receipt slip and is expected to count the change received. The cash register's tape is locked in the register until a supervisor removes it. This tape accumulates the daily transactions and totals.

At the end of the clerk's shift, the clerk counts the cash and sends the cash and the count to the cashier. The cashier counts the cash, prepares a deposit slip, and deposits the cash at the bank. The cashier also sends a duplicate of the deposit slip to the accounting department to indicate cash received. The supervisor removes the cash register tape and sends it to the accounting department as the basis for a journal entry to record the cash received. The tape is compared to the deposit slip for any discrepancies. Illustration 7-5 (page 348) summarizes this process.

This system for handling cash receipts uses an important internal control principle—segregation of record-keeping from physical custody. The supervisor has access to the cash register tape, but **not** to the cash. The clerk and the cashier have access to the cash, but **not** to the register tape. In addition, the cash register tape provides documentation and enables independent internal verification with the deposit slip. Use of these three principles of internal control (segregation of record-keeping from physical custody, documentation, and independent internal verification) provides an effective system of internal control. Any attempt at fraudulent activity should be detected unless there is collusion among the employees.
In some instances, the amount deposited at the bank will not agree with the cash recorded in the accounting records based on the cash register tape. These differences often result because the clerk hands incorrect change back to the retail customer. In this case, the difference between the actual cash and the amount reported on the cash register tape is reported in a Cash Over and Short account. For example, suppose that the cash register tape indicated sales of $6,956.20 but the amount of cash was only $6,946.10. A cash shortfall of $10.10 exists. To account for this cash shortfall and related cash, the company makes the following entry.

\[
\begin{align*}
\text{Cash} & \quad 6,946.10 \\
\text{Cash Over and Short} & \quad 10.10 \\
\text{Sales Revenue} & \quad 6,956.20
\end{align*}
\]

(To record cash shortfall)

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

**Mail Receipts**

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

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

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

**CASH DISBURSEMENTS CONTROLS**

Companies disburse cash for a variety of reasons, such as to pay expenses and liabilities or to purchase assets. Generally, internal control over cash disbursements is more effective when companies pay by check, rather than by cash. One exception is for incidental amounts that are paid out of petty cash.3

Companies generally issue checks only after following specified control procedures. Illustration 7-6 (page 350) shows how principles of internal control apply to cash disbursements.

**Voucher System Controls**

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

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3We explain the operation of a petty cash fund in the appendix to this chapter on pages 366–368.
The system begins with the authorization to incur a cost or expense. It ends with the issuance of a check for the liability incurred. A voucher is an authorization form prepared for each expenditure in a voucher system. Companies require vouchers for all types of cash disbursements except those from petty cash.

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

The use of a voucher system improves internal control over cash disbursements. First, the authorization process inherent in a voucher system establishes responsibility. Each individual has responsibility to review the underlying documentation to ensure that it is correct. In addition, the voucher system keeps track of the documents that back up each transaction. By keeping these documents in one place, a supervisor can independently verify the authenticity of the documentation.

**Illustration 7-6**
Application of internal control principles to cash disbursements
each transaction. Consider, for example, the case of Aesop University presented on page 340. Aesop did not use a voucher system for transactions under $2,500. As a consequence, there was no independent verification of the documents, which enabled the employee to submit fake invoices to hide his unauthorized purchases.

**Petty Cash Fund**

As you learned earlier in the chapter, better internal control over cash disbursements is possible when companies make payments by check. However, using checks to pay such small amounts as those for postage due, employee working lunches, and taxi fares is both impractical and a nuisance. A common way of handling such payments, while maintaining satisfactory control, is to use a petty cash fund. A **petty cash fund** is a cash fund used to pay relatively small amounts. We explain the operation of a petty cash fund in the appendix at the end of this chapter.

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

**How Employees Steal**

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

**Control Features: Use of a Bank**

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 clearinghouse for checks received and checks written. The use of a bank checking account minimizes the amount of currency that must be kept on hand. It also facilitates control of cash because a double record is maintained of all bank transactions—one by the business and the other by the bank. The asset account
Cash maintained by the company is the “flip-side” of the bank’s liability account for that company. A bank reconciliation is the process of comparing the bank’s balance with the company’s balance, and explaining the differences to make them agree.

Many companies have more than one bank account. For efficiency of operations and better control, national retailers like Wal-Mart and Target often have regional bank accounts. Similarly, a company such as ExxonMobil with more than 100,000 employees may have a payroll bank account as well as one or more general bank accounts. In addition, a company may maintain several bank accounts in order to have more than one source for short-term loans.

**BANK STATEMENTS**

Each month, the company receives from the bank a bank statement showing its bank transactions and balances. For example, the statement for Laird Company in Illustration 7-7 shows the following: (1) checks paid and other debits that reduce the balance in the depositor’s account, (2) deposits and other credits that increase the balance in the depositor’s account, and (3) the account balance after each day’s transactions.

Illustration 7-7 Bank statement

---

<table>
<thead>
<tr>
<th>Date</th>
<th>No.</th>
<th>Amount</th>
<th>Date</th>
<th>Amount</th>
<th>Date</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>4-2</td>
<td>435</td>
<td>644.95</td>
<td>4-2</td>
<td>4,276.85</td>
<td>4-3</td>
<td>18,849.65</td>
</tr>
<tr>
<td>4-3</td>
<td>436</td>
<td>3,260.00</td>
<td>4-3</td>
<td>2,137.50</td>
<td>4-4</td>
<td>17,083.65</td>
</tr>
<tr>
<td>4-4</td>
<td>437</td>
<td>1,185.79</td>
<td>4-4</td>
<td>1,350.47</td>
<td>4-5</td>
<td>16,154.33</td>
</tr>
<tr>
<td>4-5</td>
<td>438</td>
<td>776.65</td>
<td>4-5</td>
<td>962.46</td>
<td>4-6</td>
<td>14,648.89</td>
</tr>
<tr>
<td>4-6</td>
<td>439</td>
<td>1,781.70</td>
<td>4-6</td>
<td>1,350.28</td>
<td>4-7</td>
<td>11,767.47</td>
</tr>
<tr>
<td>4-7</td>
<td>440</td>
<td>1,487.90</td>
<td>4-7</td>
<td>1,035.00</td>
<td>4-8</td>
<td>12,806.47</td>
</tr>
<tr>
<td>4-8</td>
<td>441</td>
<td>2,430.00</td>
<td>4-8</td>
<td>2,795.00</td>
<td>4-9</td>
<td>13,936.87</td>
</tr>
<tr>
<td>4-9</td>
<td>442</td>
<td>1,588.60</td>
<td>4-9</td>
<td>797.41</td>
<td>4-10</td>
<td>15,907.45</td>
</tr>
<tr>
<td>4-10</td>
<td>443</td>
<td>1,508.00</td>
<td>4-10</td>
<td>1,218.60</td>
<td>4-11</td>
<td>12,968.28</td>
</tr>
<tr>
<td>4-11</td>
<td>444</td>
<td>425.60</td>
<td>4-11</td>
<td>754.57</td>
<td>4-12</td>
<td>14,005.45</td>
</tr>
<tr>
<td>4-12</td>
<td>445</td>
<td>30.00</td>
<td>4-12</td>
<td>2,128.60</td>
<td>4-13</td>
<td>14,122.45</td>
</tr>
<tr>
<td>4-13</td>
<td>446</td>
<td>620.15</td>
<td>4-13</td>
<td>1,080.30</td>
<td>4-14</td>
<td>15,148.65</td>
</tr>
</tbody>
</table>

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

---

Our presentation assumes that a company makes all adjustments at the end of the month. In practice, a company may also make journal entries during the month as it receives information from the bank regarding its account.
Remember that bank statements are prepared from the bank's perspective. For example, every deposit the bank receives is an increase in the bank's liabilities (an account payable to the depositor). Therefore, in Illustration 7-7, National Bank and Trust credits to Laird Company every deposit it received from Laird. The reverse occurs when the bank “pays” a check issued by Laird Company on its checking account balance: Payment reduces the bank’s liability and is therefore debited to Laird's account with the bank.

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

A check that is not paid by a bank because of insufficient funds in a bank account is called an NSF check (not sufficient funds). The bank uses a debit memorandum when a previously deposited customer’s check “bounces” because of insufficient funds. In such a case, the customer’s bank marks the check NSF (not sufficient funds) and returns it to the depositor’s bank. The bank then debits (decreases) the depositor’s account, as shown by the symbol NSF in Illustration 7-7, and 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.

**RECONCILING THE BANK ACCOUNT**

Because the bank and the company maintain independent records of the company’s 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, and both balances differ from the “correct or true” balance. Therefore, it is necessary to make the balance per books and the balance per bank agree with the correct or true amount—a process called reconciling the bank account.

The need for reconciliation has two causes:

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 company pays by check and the date the bank pays the check. Similarly, when a company uses the bank’s night depository to make its deposits, there will be a difference of one day between the time the company records the receipts and the time the bank does so. A time lag also occurs whenever the bank mails a debit or credit memorandum to the company.

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

**Reconciliation Procedure**

In reconciling the bank account, it is customary to reconcile the balance per books and balance per bank to their adjusted (correct or true) cash balances. **To obtain maximum benefit from a bank reconciliation, an employee who has no other responsibilities related to cash should prepare the reconciliation.** When companies do not follow the internal control principle of independent internal verification in preparing the reconciliation, cash embezzlements may escape unnoticed. For example, in the Anatomy of a Fraud box at the bottom of page 340, a bank reconciliation by someone other than Angela Bauer might have exposed her embezzlement.
Illustration 7-8 shows the reconciliation process. The starting point in preparing the reconciliation is to enter the balance per bank statement and balance per books on a schedule. The following steps should reveal all the reconciling items that cause the difference between the two balances.

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

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

**Step 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**. Deduct outstanding checks from the balance per the bank.

**Step 3. Errors.** Note any errors discovered in the previous steps and list them in the appropriate section of the reconciliation schedule. For example,
if the company mistakenly recorded as $159 a paid check correctly written for $195, the company would deduct the error of $36 from the balance per books. All errors made by the depositor are reconciling items in determining the adjusted cash balance per books. In contrast, all errors made by the bank are reconciling items in determining the adjusted cash balance per the bank.

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

**Bank Reconciliation Illustrated**

Illustration 7-7 presented the bank statement for Laird Company. It shows a balance per bank of $15,907.45 on April 30, 2012. On this date the balance of cash per books is $11,589.45. From the foregoing steps, Laird determines the following reconciling items.

**Step 1.** Deposits in transit: April 30 deposit (received by bank on May 1). $2,201.40

**Step 2.** Outstanding checks: No. 453, $3,000.00; No. 457, $1,401.30; No. 460, $1,502.70. 5,904.00

**Step 3.** Errors: Check No. 443 was correctly written by Laird for $1,226.00 and was correctly paid by the bank. However, Laird recorded the check as $1,262.00. 36.00

**Step 4.** Bank memoranda: (a) Debit—NSF check from J. R. Baron for $425.60 425.60 (b) Debit—Printing company checks charge, $30 30.00 (c) Credit—Collection of note receivable for $1,000 plus interest earned $50, less bank collection fee $15 1,035.00

Illustration 7-9 shows Laird’s bank reconciliation.

<table>
<thead>
<tr>
<th>LAIRD COMPANY</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Bank Reconciliation</strong></td>
</tr>
<tr>
<td><strong>April 30, 2012</strong></td>
</tr>
</tbody>
</table>

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

**Alternative Terminology** The terms adjusted cash balance, true cash balance, and correct cash balance are used interchangeably.
The depositor (that is, the company) next must record each reconciling item used to determine the **adjusted cash balance per books**. If the company does not journalize and post these items, the Cash account will not show the correct balance. The adjusting entries for the Laird Company bank reconciliation on April 30 are as follows.

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

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

<table>
<thead>
<tr>
<th>Cash Flows</th>
<th>1,035</th>
</tr>
</thead>
<tbody>
<tr>
<td>+1,035</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Apr. 30</th>
<th>Cash</th>
<th>Notes Receivable</th>
<th>Interest Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1,035</td>
<td>1,000</td>
<td>50</td>
</tr>
<tr>
<td>(To record collection of note receivable by bank)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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

| A = L + SE |
| --- | --- | --- |
| +36 | -36 | 36 |

<table>
<thead>
<tr>
<th>Cash Flows</th>
<th>36</th>
</tr>
</thead>
<tbody>
<tr>
<td>+36</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Apr. 30</th>
<th>Cash</th>
<th>Accounts Payable—Andrea Company</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>36</td>
<td>36</td>
</tr>
<tr>
<td>(To correct error in recording check No. 443)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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

| A = L + SE |
| --- | --- | --- |
| +425.60 | -425.60 | 0 |

<table>
<thead>
<tr>
<th>Cash Flows</th>
<th>425.60</th>
</tr>
</thead>
<tbody>
<tr>
<td>-425.60</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Apr. 30</th>
<th>Accounts Receivable—J. R. Baron</th>
<th>Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>425.60</td>
<td>425.60</td>
</tr>
<tr>
<td>(To record NSF check)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**BANK SERVICE CHARGES.** Companies typically debit Miscellaneous Expense the check printing charges (DM) and other bank service charges (SC) because they are usually small in amount. Laird’s entry is:

| A = L + SE |
| --- | --- | --- |
| -30 Exp | -30 | 30 |

<table>
<thead>
<tr>
<th>Cash Flows</th>
<th>30</th>
</tr>
</thead>
<tbody>
<tr>
<td>-30</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Apr. 30</th>
<th>Miscellaneous Expense</th>
<th>Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>30</td>
<td>30</td>
</tr>
<tr>
<td>(To record charge for printing company checks)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The foregoing entries could also be combined into one compound entry.

After Laird posts the entries, the Cash account will appear as in Illustration 7-10. The adjusted cash balance in the ledger should agree with the adjusted cash balance per books in the bank reconciliation in Illustration 7-9 (page 355).
What entries does the bank make? If the company discovers any bank errors in preparing the reconciliation, it should notify the bank so the bank can make the necessary corrections on its records. The bank does not make any entries for deposits in transit or outstanding checks. Only when these items reach the bank will the bank record these items.

**Electronic Funds Transfer (EFT) System**

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

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

**Illustration 7-10**

Adjusted balance in Cash account

<table>
<thead>
<tr>
<th>Cash</th>
<th>Apr. 30 Bal.</th>
<th>Apr. 30</th>
<th>Apr. 30 Bal.</th>
</tr>
</thead>
<tbody>
<tr>
<td>11,589.45</td>
<td>1,035.00</td>
<td>30.00</td>
<td>12,204.85</td>
</tr>
<tr>
<td>36.00</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Investor Insight**

**Madoff’s Ponzi Scheme**

No recent fraud has generated more interest and rage than the one perpetrated by Bernard Madoff. Madoff was an elite New York investment fund manager who was highly regarded by securities regulators. Investors flocked to him because he delivered very steady returns of between 10% and 15%, no matter whether the market was going up or going down. However, for many years, Madoff did not actually invest the cash that people gave to him. Instead, he was running a Ponzi scheme: He paid returns to existing investors using cash received from new investors. As long as the size of his investment fund continued to grow from new investments at a rate that exceeded the amounts that he needed to pay out in returns, Madoff was able to operate his fraud smoothly. To conceal his misdeeds, he fabricated false investment statements that were provided to investors. In addition, Madoff hired an auditor that never verified the accuracy of the investment records but automatically issued unqualified opinions each year. Although a competing fund manager warned the SEC a number of times over a nearly 10-year period that he thought Madoff was engaged in fraud, the SEC never aggressively investigated the allegations. Investors, many of which were charitable organizations, lost more than $18 billion. Madoff was sentenced to a jail term of 150 years.

? How was Madoff able to conceal such a giant fraud? (See page 392.)
Reporting Cash

Cash consists of coins, currency (paper money), checks, money orders, and money on hand or on deposit in a bank or similar depository. Checks that are dated later than the current date (post-dated checks) are not included in cash. Companies report cash in two different statements: the balance sheet and the statement of cash flows. The balance sheet reports the amount of cash available at a given point in time. The statement of cash flows shows the sources and uses of cash during a period of time. The cash flow statement was introduced in Chapters 1 and 2 and will be discussed in much detail in Chapter 12. In this section, we discuss some important points regarding the presentation of cash in the balance sheet.

When presented in a balance sheet, cash on hand, cash in banks, and petty cash are often combined and reported simply as Cash. Because it is the most liquid asset owned by the company, cash is listed first in the current assets section of the balance sheet.

CASH EQUIVALENTS

Many companies use the designation “Cash and cash equivalents” in reporting cash. (See Illustration 7-11 for an example.) Cash equivalents are short-term, highly liquid investments that are both:

1. Readily convertible to known amounts of cash, and
2. So near their maturity that their market value is relatively insensitive to changes in interest rates.

### Illustration 7-11

Balance sheet presentation of cash

<table>
<thead>
<tr>
<th>Assets</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td></td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
<td>$4,607</td>
</tr>
<tr>
<td>Short-term investments</td>
<td>71</td>
</tr>
<tr>
<td>Restricted cash</td>
<td>423</td>
</tr>
<tr>
<td>Accounts receivable and other, net</td>
<td>1,360</td>
</tr>
<tr>
<td>Parts inventories</td>
<td>327</td>
</tr>
<tr>
<td>Prepaid expenses and other</td>
<td>953</td>
</tr>
<tr>
<td>Total current assets</td>
<td>$7,741</td>
</tr>
</tbody>
</table>
Examples of cash equivalents are Treasury bills, commercial paper (short-term corporate notes), and money market funds. All typically are purchased with cash that is in excess of immediate needs.

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

**RESTRICTED CASH**

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

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

Illustration 7-11 shows restricted cash reported in the financial statements of Delta Air Lines. The company is required to maintain restricted cash as collateral to support insurance obligations related to workers’ compensation claims. Delta does not have access to these funds for general use, and so it must report them separately, rather than as part of cash and cash equivalents.

**Managing and Monitoring Cash**

Many companies struggle, not because they fail to generate sales, but because they can’t manage their cash. A real-life example of this is a clothing manufacturing company owned by Sharon McCollick. McCollick gave up a stable, high-paying marketing job with Intel Corporation to start her own company. Soon she had more orders from stores such as JC Penney and Dayton Hudson (now Target) than she could fill. Yet she found herself on the brink of financial disaster, owing three mortgage payments on her house and $2,000 to the IRS. Her company could generate sales, but it was not collecting cash fast enough to support its operations. The bottom line is that a business must have cash.5

A merchandising company’s operating cycle is generally shorter than that of a manufacturing company. Illustration 7-12 (page 360) shows the cash to cash operating cycle of a merchandising operation.

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To understand cash management, consider the operating cycle of Sharon McCollick’s clothing manufacturing company. First, it purchases cloth. Let’s assume that it purchases the cloth on credit provided by the supplier, so the company owes its supplier money. Next, employees convert the cloth to clothing. Now the company also owes its employees money. Next, it sells the clothing to retailers, on credit. McCollick’s company will have no money to repay suppliers or employees until it receives payments from customers. In a manufacturing operation there may be a significant lag between the original purchase of raw materials and the ultimate receipt of cash from customers.

Managing the often-precarious balance created by the ebb and flow of cash during the operating cycle is one of a company’s greatest challenges. The objective is to ensure that a company has sufficient cash to meet payments as they come due, yet minimize the amount of non-revenue-generating cash on hand.

**BASIC PRINCIPLES OF CASH MANAGEMENT**

Management of cash is the responsibility of the company treasurer. Any company can improve its chances of having adequate cash by following five basic principles of cash management.

1. **Increase the speed of receivables collection.** Money owed Sharon McCollick by her customers is money that she can’t use. The more quickly customers pay her, the more quickly she can use those funds. Thus, rather than have an average collection period of 30 days, she may want an average collection period of 15 days. However, she must carefully weigh any attempt to force her customers to pay earlier against the possibility that she may anger or alienate customers. Perhaps her competitors are willing to provide a 30-day grace period. As noted in Chapter 5, one common way to encourage customers to pay more quickly is to offer cash discounts for early payment under such terms as 2/10, n/30.

2. **Keep inventory levels low.** Maintaining a large inventory of cloth and finished clothing is costly. It ties up large amounts of cash, as well as warehouse space. Increasingly, companies are using techniques to reduce the inventory on hand, thus conserving their cash. Of course, if Sharon McCollick has inadequate inventory, she will lose sales. The proper level of inventory is an important decision.

3. **Monitor payment of liabilities.** Sharon McCollick should monitor when her bills are due, so she avoids paying bills too early. Let’s say her supplier...
allows 30 days for payment. If she pays in 10 days, she has lost the use of that cash for 20 days. Therefore, she should use the full payment period. But, she should not pay late. This could damage her credit rating (and future borrowing ability). Also, late payments to suppliers can damage important supplier relationships and may even threaten a supplier’s viability. Sharon McCollick’s company also should conserve cash by taking cash discounts offered by suppliers, when possible.

4. **Plan the timing of major expenditures.** To maintain operations or to grow, all companies must make major expenditures. These often require some form of outside financing. In order to increase the likelihood of obtaining outside financing, McCollick should carefully consider the timing of major expenditures in light of her company's operating cycle. If at all possible, she should make any major expenditure when the company normally has excess cash—usually during the off-season.

5. **Invest idle cash.** Cash on hand earns nothing. An important part of the treasurer's job is to ensure that the company invests any excess cash, even if it is only overnight. Many businesses, such as Sharon McCollick's clothing company, are seasonal. During her slow season, when she has excess cash, she should invest it.

   To avoid a cash crisis, however, it is very important that investments of idle cash be highly liquid and risk-free. A *liquid investment* is one with a market in which someone is always willing to buy or sell the investment. A *risk-free investment* means there is no concern that the party will default on its promise to pay its principal and interest. For example, using excess cash to purchase stock in a small company because you heard that it was probably going to increase in value in the near term is totally inappropriate. First, the stock of small companies is often illiquid. Second, if the stock suddenly decreases in value, you might be forced to sell the stock at a loss in order to pay your bills as they come due. The most common form of liquid investments is interest-paying U.S. government securities.

Illustration 7-13 summarizes these five principles of cash management.
Because cash is so vital to a company, planning the company’s cash needs is a key business activity. It enables the company to plan ahead to cover possible cash shortfalls and to make investments of idle funds. The cash budget shows anticipated cash flows, usually over a one- to two-year period. In this section, we introduce the basics of cash budgeting. More advanced discussion of cash budgets and budgets in general is provided in managerial accounting texts.

As shown below, the cash budget contains three sections—cash receipts, cash disbursements, and financing—and the beginning and ending cash balances.

<table>
<thead>
<tr>
<th>ANY COMPANY</th>
<th>Cash Budget</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning cash balance</td>
<td>$X,XXX</td>
</tr>
<tr>
<td>Add: Cash receipts (itemized)</td>
<td>X,XXX</td>
</tr>
<tr>
<td>Total available cash</td>
<td>X,XXX</td>
</tr>
<tr>
<td>Less: Cash disbursements (itemized)</td>
<td>X,XXX</td>
</tr>
<tr>
<td>Excess (deficiency) of available cash over cash disbursements</td>
<td>X,XXX</td>
</tr>
<tr>
<td>Financing</td>
<td></td>
</tr>
<tr>
<td>Add: Borrowings</td>
<td>X,XXX</td>
</tr>
<tr>
<td>Less: Repayments</td>
<td>X,XXX</td>
</tr>
<tr>
<td>Ending cash balance</td>
<td>$X,XXX</td>
</tr>
</tbody>
</table>

The Cash receipts section includes expected receipts from the company’s principal source(s) of cash, such as cash sales and collections from customers on credit sales. This section also shows anticipated receipts of interest and dividends, and proceeds from planned sales of investments, plant assets, and the company’s capital stock.

The Cash disbursements section shows expected payments for inventory, labor, overhead, and selling and administrative expenses. It also includes projected payments for income taxes, dividends, investments, and plant assets. Note that it does not include depreciation since depreciation expense does not use cash.

The Financing section shows expected borrowings and repayments of borrowed funds plus interest. Financing is needed when there is a cash deficiency or when the cash balance is less than management’s minimum required balance.

Companies must prepare multi-period cash budgets in sequence because the ending cash balance of one period becomes the beginning cash balance for the next period. In practice, companies often prepare cash budgets for the next 12 months on a monthly basis.

To minimize detail, we will assume that Hayes Company prepares an annual cash budget by quarters. Preparing a cash budget requires making some assumptions. For example, Hayes makes assumptions regarding collection of accounts receivable, sales of securities, payments for materials and salaries, and purchases of property, plant, and equipment. The accuracy of the cash budget is very dependent on the accuracy of these assumptions.

On the next page, we present the cash budget for Hayes Company. The budget indicates that the company will need $3,000 of financing in the second quarter to maintain a minimum cash balance of $15,000. Since there is an excess of available cash over disbursements of $22,500 at the end of the third quarter, Hayes will repay the borrowing, plus $100 interest, in that quarter.

A cash budget contributes to more effective cash management. For example, it can show when a company will need additional financing, well before the actual need arises. Conversely, it can indicate when the company will have excess cash available for investments or other purposes.
## HAYES COMPANY

Cash Budget
For the Year Ending December 31, 2012

<table>
<thead>
<tr>
<th>Quarter</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning cash balance</td>
<td>$ 38,000</td>
<td>$ 25,500</td>
<td>$ 15,000</td>
<td>$ 19,400</td>
</tr>
<tr>
<td>Add: Cash receipts</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Collections from customers</td>
<td>168,000</td>
<td>198,000</td>
<td>228,000</td>
<td>258,000</td>
</tr>
<tr>
<td>Sale of securities</td>
<td>2,000</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total receipts</td>
<td>170,000</td>
<td>198,000</td>
<td>228,000</td>
<td>258,000</td>
</tr>
<tr>
<td>Total available cash</td>
<td>208,000</td>
<td>223,500</td>
<td>243,000</td>
<td>277,400</td>
</tr>
<tr>
<td>Less: Cash disbursements</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>23,200</td>
<td>27,200</td>
<td>31,200</td>
<td>35,200</td>
</tr>
<tr>
<td>Salaries</td>
<td>62,000</td>
<td>72,000</td>
<td>82,000</td>
<td>92,000</td>
</tr>
<tr>
<td>Selling and administrative expenses (excluding depreciation)</td>
<td>94,300</td>
<td>99,300</td>
<td>104,300</td>
<td>109,300</td>
</tr>
<tr>
<td>Purchase of truck</td>
<td>0</td>
<td>10,000</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>3,000</td>
<td>3,000</td>
<td>3,000</td>
<td>3,000</td>
</tr>
<tr>
<td>Total disbursements</td>
<td>182,500</td>
<td>211,500</td>
<td>220,500</td>
<td>239,500</td>
</tr>
<tr>
<td>Excess (deficiency) of available cash over disbursements</td>
<td>25,500</td>
<td>12,000</td>
<td>22,500</td>
<td>37,900</td>
</tr>
<tr>
<td>Financing</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Add: Borrowings</td>
<td>0</td>
<td>3,000</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Less: Repayments—plus $100 interest</td>
<td>0</td>
<td>0</td>
<td>3,100</td>
<td>0</td>
</tr>
<tr>
<td>Ending cash balance</td>
<td>$ 25,500</td>
<td>$ 15,000</td>
<td>$ 19,400</td>
<td>$ 37,900</td>
</tr>
</tbody>
</table>

## DECISION TOOLKIT

<table>
<thead>
<tr>
<th>DECISION CHECKPOINTS</th>
<th>INFO NEEDED FOR DECISION</th>
<th>TOOL TO USE FOR DECISION</th>
<th>HOW TO EVALUATE RESULTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Will the company be able to meet its projected cash needs?</td>
<td>Cash budget (typically available only to management)</td>
<td>The cash budget shows projected sources and uses of cash. If cash uses exceed internal cash sources, then the company must look for outside sources.</td>
<td>Two issues: (1) Are management’s projections reasonable? (2) If outside sources are needed, are they available?</td>
</tr>
</tbody>
</table>

## Do it!

Martian Company’s management wants to maintain a minimum monthly cash balance of $15,000. At the beginning of March, the cash balance is $16,500; expected cash receipts for March are $210,000; and cash disbursements are expected to be $220,000. How much cash, if any, must Martian borrow to maintain the desired minimum monthly balance?
### Solution

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning cash balance</td>
<td>$16,500</td>
</tr>
<tr>
<td>Add: Cash receipts for March</td>
<td>210,000</td>
</tr>
<tr>
<td>Total available cash</td>
<td>226,500</td>
</tr>
<tr>
<td>Less: Cash disbursements for March</td>
<td>220,000</td>
</tr>
<tr>
<td>Excess of available cash over cash disbursements</td>
<td>6,500</td>
</tr>
<tr>
<td>Financing</td>
<td></td>
</tr>
<tr>
<td>Add: <strong>Borrowings</strong></td>
<td>8,500</td>
</tr>
<tr>
<td>Ending cash balance</td>
<td>$15,000</td>
</tr>
</tbody>
</table>

To maintain the desired minimum cash balance of $15,000, Martian Company must borrow $8,500 of cash.

Related exercise material: BE7-13, *Do It!* 7-4, and E7-14.

## USING THE DECISION TOOLKIT

Presented below is hypothetical financial information for Mattel Corporation. Included in this information is financial statement data from the year ended December 31, 2011, which should be used to evaluate Mattel's cash position.

### Selected Financial Information

**Year Ended December 31, 2011**

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net cash provided by operations</td>
<td>$325</td>
</tr>
<tr>
<td>Capital expenditures</td>
<td>162</td>
</tr>
<tr>
<td>Dividends paid</td>
<td>80</td>
</tr>
<tr>
<td>Total expenses</td>
<td>680</td>
</tr>
<tr>
<td>Depreciation expense</td>
<td>40</td>
</tr>
<tr>
<td>Cash balance</td>
<td>206</td>
</tr>
</tbody>
</table>

Also provided are projected data which are management's best estimate of its sources and uses of cash during 2012. This information should be used to prepare a cash budget for 2012.

### Projected Sources and Uses of Cash

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning cash balance</td>
<td>$206</td>
</tr>
<tr>
<td>Cash receipts from sales of product</td>
<td>355</td>
</tr>
<tr>
<td>Cash receipts from sale of short-term investments</td>
<td>20</td>
</tr>
<tr>
<td>Cash payments for inventory</td>
<td>357</td>
</tr>
<tr>
<td>Cash payments for selling and administrative costs</td>
<td>201</td>
</tr>
<tr>
<td>Cash payments for property, plant, and equipment</td>
<td>45</td>
</tr>
<tr>
<td>Cash payments for taxes</td>
<td>17</td>
</tr>
</tbody>
</table>

Mattel Corporation's management believes it should maintain a balance of $200 million cash.

### Instructions

(a) Using the hypothetical projected sources and uses of cash information presented above, prepare a cash budget for 2012 for Mattel Corporation.

(b) Comment on the company's cash adequacy, and discuss steps that might be taken to improve its cash position.
Solution

(a) MATTEL CORPORATION
Cash Budget
For the Year 2012
(in millions)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning cash balance</td>
<td>$206</td>
</tr>
<tr>
<td>Add: Cash receipts</td>
<td></td>
</tr>
<tr>
<td>From sales of product</td>
<td>$355</td>
</tr>
<tr>
<td>From sale of short-term investments</td>
<td>20</td>
</tr>
<tr>
<td>Total available cash</td>
<td>581</td>
</tr>
<tr>
<td>Less: Cash disbursements</td>
<td></td>
</tr>
<tr>
<td>Payments for inventory</td>
<td>357</td>
</tr>
<tr>
<td>Payments for selling and administrative costs</td>
<td>201</td>
</tr>
<tr>
<td>Payments for property, plant, and equipment</td>
<td>45</td>
</tr>
<tr>
<td>Payments for taxes</td>
<td>17</td>
</tr>
<tr>
<td>Total disbursements</td>
<td>620</td>
</tr>
<tr>
<td>Excess (deficiency) of available cash over disbursements</td>
<td>(39)</td>
</tr>
</tbody>
</table>

Financing

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Add: Borrowings</td>
<td>239</td>
</tr>
</tbody>
</table>

Ending cash balance $200

(b) Using these hypothetical data, Mattel's cash position appears adequate. For 2012, Mattel is projecting a cash shortfall. This is not necessarily of concern, but it should be investigated. Given that its primary line of business is toys, and that most toys are sold during December, we would expect Mattel's cash position to vary significantly during the course of the year. After the holiday season, it probably has a lot of excess cash. Earlier in the year, when it is making and selling its product but has not yet been paid, it may need to borrow to meet any temporary cash shortfalls.

If Mattel's management is concerned with its cash position, it could take the following steps: (1) Offer its customers cash discounts for early payment, such as 2/10, n/30. (2) Implement inventory management techniques to reduce the need for large inventories of such things as the plastics used to make its toys. (3) Carefully time payments to suppliers by keeping track of when payments are due, so as not to pay too early. (4) If it has plans for major expenditures, time those expenditures to coincide with its seasonal period of excess cash.

Summary of Study Objectives

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

2 Identify the principles of internal control activities. The principles of internal control are: establishment of responsibility; segregation of duties; documentation procedures; physical controls; independent internal verification; and human resource 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 having 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) conducting background checks and bonding personnel who handle cash, as well as 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; after payment, stamping each approved invoice “paid”; (d) storing blank checks in a safe or vault with access restricted to authorized personnel, and using a machine with indelible ink to imprint amounts on checks; (e) comparing each check with the approved invoice before issuing the check, and making monthly reconciliations of bank and book balances; and (f) bonding personnel who handle cash, requiring employees to take vacations, and conducting background checks.

**5 Prepare a bank reconciliation.** In reconciling the bank account, it is customary to reconcile the balance per books and the balance per bank to their adjusted balance. The steps reconciling the Cash account are to determine deposits in transit, outstanding checks, errors by the depositor or the bank, and unrecorded bank memoranda.

**6 Explain the reporting of cash.** Cash is listed first in the current assets section of the balance sheet. Companies often report cash together with cash equivalents. Cash restricted for a special purpose is reported separately as a current asset or as a noncurrent asset, depending on when the company expects to use the cash.

**7 Discuss the basic principles of cash management.** The basic principles of cash management include: (a) increase the speed of receivables collection, (b) keep inventory levels low, (c) monitor the timing of payment of liabilities, (d) plan timing of major expenditures, and (e) invest idle cash.

**8 Identify the primary elements of a cash budget.** The three main elements of a cash budget are the cash receipts section, cash disbursements section, and financing section.

---

**DECISION TOOLKIT A SUMMARY**

| Are the company’s financial statements supported by adequate internal controls? | Auditor’s report, management discussion and analysis, articles in financial press | The principles of internal control activities are (1) establishment of responsibility, (2) segregation of duties, (3) documentation procedures, (4) physical controls, (5) independent internal verification, and (6) human resource controls. | If any indication is given that these or other controls are lacking, use the financial statements with caution. |
| Is all of the company’s cash available for general use? | Balance sheet and notes to financial statements | Does the company report any cash as being restricted? | A restriction on the use of cash limits management’s ability to use those resources for general obligations. This might be considered when assessing liquidity. |
| Will the company be able to meet its projected cash needs? | Cash budget (typically available only to management) | The cash budget shows projected sources and uses of cash. If cash uses exceed internal cash sources, then the company must look for outside sources. | Two issues: (1) Are management’s projections reasonable? (2) If outside sources are needed, are they available? |

---

**appendix 7A**

**Operation of the Petty Cash Fund**

The operation of a petty cash fund involves (1) establishing the fund, (2) making payments from the fund, and (3) replenishing the fund.
ESTABLISHING THE PETTY CASH FUND

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

When the company establishes the petty cash fund, it issues a check payable to the petty cash custodian for the stipulated amount. If Laird Company decides to establish a $100 fund on March 1, the entry in general journal form is:

<table>
<thead>
<tr>
<th>Mar. 1</th>
<th>Petty Cash</th>
<th>100</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Cash</td>
<td>100</td>
</tr>
<tr>
<td>(To establish a petty cash fund)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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

MAKING PAYMENTS FROM PETTY CASH

The custodian of the petty cash fund has the authority to make payments from the fund that conform to prescribed management policies. Usually, management limits the size of expenditures that come from petty cash and does not permit use of the fund for certain types of transactions (such as making short-term loans to employees).

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

The custodian keeps the receipts in the petty cash box until the fund is replenished. As a result, the sum of the petty cash receipts and money in the fund should equal the established total at all times. This means that management can make surprise counts at any time by an independent person, such as an internal auditor, to determine the correctness of the fund.

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

REPLENISHING THE PETTY CASH FUND

When the money in the petty cash fund reaches a minimum level, the company replenishes the fund. The petty cash custodian initiates a request for reimbursement. This individual prepares a schedule (or summary) of the payments that have been made and sends the schedule, supported by petty cash receipts and other documentation, to the treasurer’s office. The receipts and supporting documents are examined in the treasurer’s office to verify that they were proper payments from the fund. The treasurer then approves the request, and a check is prepared to restore the fund to its established amount. At the same time, all supporting documentation is stamped “paid” so that it cannot be submitted again for payment.

To illustrate, assume that on March 15 the petty cash custodian requests a check for $87. The fund contains $13 cash and petty cash receipts for postage.
$44, supplies $38, and miscellaneous expenses $5. The entry, in general journal form, to record the check is:

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mar. 15</td>
<td>Postage Expense</td>
<td>44 Exp</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Supplies</td>
<td>38 Sup</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Miscellaneous Expense</td>
<td>5 Misc</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td>87 Cash</td>
<td></td>
</tr>
</tbody>
</table>

(To replenish petty cash fund)

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

Occasionally, in replenishing a petty cash fund the company may need to recognize a cash shortage or overage. To illustrate, assume in the preceding example that the custodian had only $12 in cash in the fund plus the receipts as listed. The request for reimbursement would therefore be for $88, and the following entry would be made:

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mar. 15</td>
<td>Postage Expense</td>
<td>44 Exp</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Supplies</td>
<td>38 Sup</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Miscellaneous Expense</td>
<td>5 Misc</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash Over and Short</td>
<td>1 Exp</td>
<td>88 Cash</td>
</tr>
</tbody>
</table>

(To replenish petty cash fund)

Conversely, if the custodian had $14 in cash, the reimbursement request would be for $86, and Cash Over and Short would be credited for $1. A debit balance in Cash Over and Short is reported in the income statement as miscellaneous expense; a credit balance is reported as miscellaneous revenue. The company closes Cash Over and Short to Income Summary at the end of the year.

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

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

**Summary of Study Objective for Appendix 7A**

9 Explain the operation of a petty cash fund. In operating a petty cash fund, a company establishes the fund by appointing a custodian and determining the size of the fund. The custodian makes payments from the fund for documented expenditures. The company replenishes the fund as needed, and at the end of each accounting period. Accounting entries to record payments are made each time the fund is replenished.

**Glossary**

Bank reconciliation (p. 352) The process of comparing the bank’s account balance with the company’s balance, and explaining the differences to make them agree.

Bank statement (p. 352) A statement received monthly from the bank that shows the depositor’s bank transactions and balances.

Bonding (p. 344) Obtaining insurance protection against theft by employees.

Cash (p. 358) Resources that consist of coins, currency, checks, money orders, and money on hand or on deposit in a bank or similar depository.

Cash budget (p. 362) A projection of anticipated cash flows, usually over a one- to two-year period.

Cash equivalents (p. 358) Short-term, highly liquid investments that can be readily converted to a specific amount of cash.

Deposits in transit (p. 354) Deposits recorded by the depositor that have not been recorded by the bank.

Electronic funds transfer (EFT) (p. 357) A disbursement system that uses wire, telephone, or computer to transfer cash from one location to another.
**Fraud** (p. 336) A dishonest act by an employee that results in personal benefit to the employee at a cost to the employer.

**Fraud triangle** (p. 336) The three factors that contribute to fraudulent activity by employees: opportunity, financial pressure, and rationalization.

**Internal auditors** (p. 343) Company employees who continuously evaluate the effectiveness of the company’s internal control systems.

**Internal control** (p. 337) All the related methods and measures adopted within an organization to safeguard its assets and enhance the reliability of its accounting records, increase efficiency of operations, and ensure compliance with laws and regulations.

**NSF check** (p. 353) A check that is not paid by a bank because of insufficient funds in a bank account.

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**Comprehensive Do it!**

Trillo Company’s bank statement for May 2012 shows these data.

<table>
<thead>
<tr>
<th></th>
<th>Balance May 1</th>
<th>$12,650</th>
<th>Balance May 31</th>
<th>$14,280</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debit memorandum:</td>
<td></td>
<td></td>
<td>Credit memorandum:</td>
<td></td>
</tr>
<tr>
<td>NSF check</td>
<td>175</td>
<td></td>
<td>Collection of note receivable</td>
<td>505</td>
</tr>
</tbody>
</table>

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 Co., a customer.
2. The note collected by the bank was a $500, 3-month, 12% note. The bank charged a $10 collection fee. No interest has been previously accrued.
3. Outstanding checks at May 31 total $2,410.
4. Deposits in transit at May 31 total $1,752.
5. A Trillo Company 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 Comprehensive Do it!**

(a)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash balance per bank statement</td>
<td>$14,280</td>
</tr>
<tr>
<td>Add: Deposits in transit</td>
<td>1,752</td>
</tr>
<tr>
<td>Less: Outstanding checks</td>
<td>2,410</td>
</tr>
<tr>
<td>Adjusted cash balance per bank</td>
<td>$13,622</td>
</tr>
<tr>
<td>Cash balance per books</td>
<td>$13,319</td>
</tr>
<tr>
<td>Add: Collection of note receivable $500. plus $15 interest less collection fee $10</td>
<td>505</td>
</tr>
<tr>
<td>Less: NSF check</td>
<td>175</td>
</tr>
<tr>
<td>Error in recording check</td>
<td>27</td>
</tr>
<tr>
<td>Adjusted cash balance per books</td>
<td>$13,622</td>
</tr>
</tbody>
</table>

**Action Plan**

- Follow the four steps used in reconciling items (pp. 354–355).
- Work carefully to minimize mathematical errors in the reconciliation.
- Prepare entries based on reconciling items per books.
- Make sure the cash ledger balance after posting the reconciling entries agrees with the adjusted cash balance per books.
Self-Test Questions

Answers are on page 392.

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

2. Internal control is used in a business to enhance the accuracy and reliability of its accounting records and to: (SO 1)
   (a) safeguard its assets.
   (b) create fraud.
   (c) analyze financial statements.
   (d) determine employee bonuses.

3. The principles of internal control do not include: (SO 2)
   (a) establishment of responsibility.
   (b) documentation procedures.
   (c) financial performance measures.
   (d) independent internal verification.

4. Physical controls do not include: (SO 2)
   (a) safes and vaults to store cash.
   (b) independent bank reconciliations.
   (c) locked warehouses for inventories.
   (d) bank safety deposit boxes for important papers.

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

6. Permitting only designated personnel such as cashiers to handle cash receipts is an application of the principle of: (SO 3)
   (a) documentation procedures.
   (b) establishment of responsibility.
   (c) independent internal verification.
   (d) other controls.

7. The use of prenumbered checks in disbursing cash is an application of the principle of: (SO 4)
   (a) establishment of responsibility.
   (b) segregation of duties.
   (c) physical controls.
   (d) documentation procedures.

8. The control features of a bank account do not include: (SO 4)
   (a) having bank auditors verify the correctness of the bank balance per books.
   (b) minimizing the amount of cash that must be kept on hand.
   (c) providing a double record of all bank transactions.
   (d) safeguarding cash by using a bank as a depository.

9. Which of the following control activities is not relevant when a company uses a computerized (rather than manual) accounting system? (SO 2)
   (a) Establishment of responsibility.
   (b) Segregation of duties.
   (c) Independent internal verification.
   (d) All of these control activities are relevant to a computerized system.

10. In a bank reconciliation, deposits in transit are: (SO 5)
    (a) deducted from the book balance.
    (b) added to the book balance.
    (c) added to the bank balance.
    (d) deducted from the bank balance.
Questions 371

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

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

13. Which of the following would not be an example of good cash management?
   (a) Provide discounts to customers to encourage early payment.  
   (b) Invest temporary excess cash in stock of a small company.  
   (c) Carefully monitor payments so that payments are not made early.
   (d) Employ just-in-time inventory methods to keep inventory low.

14. Which of the following is not one of the sections of a cash budget?
   (a) Cash receipts section.  
   (b) Cash disbursements section.  
   (c) Financing section.  
   (d) Cash from operations section.

15. A check is written to replenish a $100 petty cash fund when the fund contains receipts of $94 and $2 in cash. In recording the check:
   (a) Cash Over and Short should be debited for $4.  
   (b) Petty Cash should be debited for $94.  
   (c) Cash should be credited for $94.  
   (d) Petty Cash should be credited for $4.

with the approved invoice. Identify the internal control principles that are present in these controls.

20. How do these principles apply to cash disbursements?
   (a) Physical controls.
   (b) Human resource controls.

21. What is the essential feature of an electronic funds transfer (EFT) procedure?

22. "The use of a bank contributes significantly to good internal control over cash." Is this true? Why?

23. Peter Dunn is confused about the lack of agreement between the cash balance per books and the balance per bank. Explain the causes for the lack of agreement to Peter and give an example of each cause.

24. Identify the basic principles of cash management.

25. Jennifer Earl asks your help concerning an NSF check. Explain to Jennifer (a) what an NSF check is, (b) how it is treated in a bank reconciliation, and (c) whether it will require an adjusting entry on the company's books.

26. (a) Describe cash equivalents and explain how they are reported.
    (b) How should restricted cash funds be reported on the balance sheet?

27. What was Tootsie Roll's balance in cash and cash equivalents at December 31, 2009? Did it report any restricted cash? How did Tootsie Roll define cash equivalents?

28. (a) Identify the three activities that pertain to a petty cash fund, and indicate an internal control principle that is applicable to each activity.
    (b) When are journal entries required in the operation of a petty cash fund?

**Brief Exercises**

**BE7-1**  Match each situation with the fraud triangle factor (opportunity, financial pressure, or rationalization) that best describes it.

(a) An employee's monthly credit card payments are nearly 75% of their monthly earnings.
   (b) An employee earns minimum wage at a firm that has reported record earnings for each of the last five years.
   (c) An employee has an expensive gambling habit.
   (d) An employee has check writing and signing responsibilities for a small company, and is also responsible for reconciling the bank account.

**BE7-2**  Gwyn Wallander is the new owner of Bennett Co. She has heard about internal control but is not clear about its importance for her business. Explain to Gwyn the four purposes of internal control, and give her one application of each purpose for Bennett Co.

**BE7-3**  The internal control procedures in Phillips Company make the following provisions. Identify the principles of internal control that are being followed in each case.

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

**BE7-4**  Aldstadt Company has the following internal control procedures over cash receipts. Identify the internal control principle that is applicable to each procedure.

(a) All over-the-counter receipts are registered on cash registers.
    (b) All cashiers are bonded.
    (c) Daily cash counts are made by cashier department supervisors.
    (d) The duties of receiving cash, recording cash, and having custody of cash are assigned to different individuals.
    (e) Only cashiers may operate cash registers.

**BE7-5**  While examining cash receipts information, the accounting department determined the following information: opening cash balance $150, cash on hand $1,125.74, and cash sales per register tape $988.62. Prepare the required journal entry based upon the cash count sheet.

**BE7-6**  Ndon Company has the following internal control procedures over cash disbursements. Identify the internal control principle that is applicable to each procedure.

(a) Company checks are prenumbered.
    (b) The bank statement is reconciled monthly by an internal auditor.
(c) Blank checks are stored in a safe in the treasurer's office.
(d) Only the treasurer or assistant treasurer may sign checks.
(e) Check signers are not allowed to record cash disbursement transactions.

**BE7-7** Jay Bauer is uncertain about the control features of a bank account. Explain the control benefits of (a) a checking account and (b) a bank statement.

**BE7-8** The following reconciling items are applicable to the bank reconciliation for Gratz Co. Indicate how each item should be shown on a bank reconciliation.
(a) Outstanding checks.
(b) Bank debit memorandum for service charge.
(c) Bank credit memorandum for collecting a note for the depositor.
(d) Deposit in transit.

**BE7-9** Using the data in BE7-8, indicate (a) the items that will result in an adjustment to the depositor's records and (b) why the other items do not require adjustment.

**BE7-10** At July 31, Cisler Company has this bank information: cash balance per bank $7,291; outstanding checks $762; deposits in transit $1,350; and a bank service charge $40. Determine the adjusted cash balance per bank at July 31.

**BE7-11** In the month of November, Hasbrook Company Inc. wrote checks in the amount of $9,750. In December, checks in the amount of $11,762 were written. In November, $8,800 of these checks were presented to the bank for payment, and $10,889 in December. What is the amount of outstanding checks at the end of November? At the end of December?

**BE7-12** Laib Company has these cash balances: cash in bank $12,742; payroll bank account $6,000; and plant expansion fund cash $25,000. Explain how each balance should be reported on the balance sheet.

**BE7-13** The following information is available for Eckman Company for the month of January: expected cash receipts $59,000; expected cash disbursements $67,000; and cash balance on January 1, $12,000. Management wishes to maintain a minimum cash balance of $9,000. Prepare a basic cash budget for the month of January.

**BE7-14** On March 20, Palasz’s petty cash fund of $100 is replenished when the fund contains $19 in cash and receipts for postage $40, supplies $26, and travel expense $15. Prepare the journal entry to record the replenishment of the petty cash fund.

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**Do it! Review**

**Do it! 7-1** Identify which control activity is violated in each of the following situations, and explain how the situation creates an opportunity for fraud or inappropriate accounting practices.
1. Once a month, the sales department sends sales invoices to the accounting department to be recorded.
2. Greg Mursky orders merchandise for Ross Company; he also receives merchandise and authorizes payment for merchandise.
3. Several clerks at Terando’s Groceries use the same cash register drawer.

**Do it! 7-2** Mark Graziano is concerned with control over mail receipts at Grazi’s Sporting Goods. All mail receipts are opened by Glen Schrag. Glen sends the checks to the accounting department, where they are stamped “For Deposit Only.” The accounting department records and deposits the mail receipts weekly. Mark asks your help in installing a good system of internal control over mail receipts.

**Do it! 7-3** Leon Holzner owns Leon Blankets. Leon asks you to explain how he should treat the following reconciling items when reconciling the company’s bank account.
1. Outstanding checks
2. A deposit in transit
3. The bank charged to our account a check written by another company
4. A debit memorandum for a bank service charge
Prepare a cash budget. (SO 8), AP

E7-1 Bank employees use a system known as the “maker-checker” system. An employee will record an entry in the appropriate journal, and then a supervisor will verify and approve the entry. These days, as all of a bank’s accounts are computerized, the employee first enters a batch of entries into the computer, and then the entries are posted automatically to the general ledger account after the supervisor approves them on the system.

Access to the computer system is password-protected and task-specific, which means that the computer system will not allow the employee to approve a transaction or the supervisor to record a transaction.

Instructions
Identify the principles of internal control inherent in the “maker-checker” procedure used by banks.

E7-2 Lisa’s Pizza operates 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.

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.)

E7-3 The following control procedures are used in Danner Company for over-the-counter cash receipts.

1. Cashiers are experienced; thus, they are not bonded.
2. All over-the-counter receipts are registered by three clerks who share a cash register with a single cash drawer.
3. 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.
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. The company accountant makes the bank deposit and then records the day’s receipts.

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 the procedure that will result in good internal control.

E7-4 The following control procedures are used in Katja’s Boutique Shoppe for cash disbursements.

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

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.

Do it! 7-4 Ross Corporation’s management wants to maintain a minimum monthly cash balance of $8,000. At the beginning of September, the cash balance is $12,270; expected cash receipts for September are $97,200; cash disbursements are expected to be $115,000. How much cash, if any, must Ross borrow to maintain the desired minimum monthly balance? Determine your answer by using the basic form of the cash budget.
E7-5 At Reyes Company, checks are not prenumbered because both the purchasing agent and the treasurer are authorized to issue checks. Each signor has access to unissued checks kept in an unlocked file cabinet. The purchasing agent pays all bills pertaining to goods purchased for resale. Prior to payment, the purchasing agent determines that the goods have been received and verifies the mathematical accuracy of the vendor’s invoice. After payment, the invoice is filed by vendor and the purchasing agent records the payment in the cash disbursements journal. The treasurer pays all other bills following approval by authorized employees. After payment, the treasurer stamps all bills “paid,” files them by payment date, and records the checks in the cash disbursements journal. Reyes Company maintains one checking account that is reconciled by the treasurer.

Instructions
(a) List the weaknesses in internal control over cash disbursements.
(b) Identify improvements for correcting these weaknesses.

E7-6 Tasha Orin is unable to reconcile the bank balance at January 31. Tasha’s reconciliation is shown here.

| Cash balance per bank $3,677.20 |
| Add: NSF check 450.00 |
| Less: Bank service charge 28.00 |
| Adjusted balance per bank $4,099.20 |

| Cash balance per books $3,975.20 |
| Less: Deposits in transit 590.00 |
| Add: Outstanding checks 770.00 |
| Adjusted balance per books $4,155.20 |

Instructions
(a) What is the proper adjusted cash balance per bank?
(b) What is the proper adjusted cash balance per books?
(c) Prepare the adjusting journal entries necessary to determine the adjusted cash balance per books.

E7-7 At April 30, the bank reconciliation of Silvestre Company shows three outstanding checks: No. 254 $650, No. 255 $700, and No. 257 $410. The May bank statement and the May cash payments journal are given here.

| Bank Statement Checks Paid |
| Date | Check No. | Amount |
| 5-4 | 254 | $650 |
| 5-2 | 257 | 410 |
| 5-17 | 258 | 159 |
| 5-12 | 259 | 275 |
| 5-20 | 260 | 925 |
| 5-29 | 263 | 480 |
| 5-30 | 262 | 750 |

| Cash Payments Journal Checks Issued |
| Date | Check No. | Amount |
| 5-2 | 258 | $159 |
| 5-5 | 259 | 275 |
| 5-10 | 260 | 925 |
| 5-15 | 261 | 500 |
| 5-22 | 262 | 750 |
| 5-24 | 263 | 480 |
| 5-29 | 264 | 360 |

Instructions
Using step 2 in the reconciliation procedure (see page 354), list the outstanding checks at May 31.

E7-8 The following information pertains to Ghose Company.
1. Cash balance per bank, July 31, $7,328.
2. July bank service charge not recorded by the depositor $38.
3. Cash balance per books, July 31, $7,364.
4. Deposits in transit, July 31, $2,700.
5. Note for $2,000 collected for Ghose in July by the bank, plus interest $36 less fee $20. The collection has not been recorded by Ghose, and no interest has been accrued.
6. Outstanding checks, July 31, $686.

Instructions
(a) Prepare a bank reconciliation at July 31, 2012.
(b) Journalize the adjusting entries at July 31 on the books of Ghose Company.
Prepare bank reconciliation and adjusting entries.

E7-9 This information relates to the Cash account in the ledger of Hawkins Company.

Balance September 1—$16,400; Cash deposited—$64,000
Balance September 30—$17,600; Checks written—$62,800

The September bank statement shows a balance of $16,500 at September 30 and the following memoranda.

<table>
<thead>
<tr>
<th>Credits</th>
<th>Debits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Collection of $1,800 note plus interest $30</td>
<td>NSF check: H. Juno $560</td>
</tr>
<tr>
<td>Interest earned on checking account 45</td>
<td>Safety deposit box rent 60</td>
</tr>
</tbody>
</table>

At September 30, deposits in transit were $4,738 and outstanding checks totaled $2,383.

Instructions

(a) Prepare the bank reconciliation at September 30, 2012.
(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.

E7-10 The cash records of Arora Company show the following.

For July:
1. The June 30 bank reconciliation indicated that deposits in transit total $580. During July, the general ledger account Cash shows deposits of $16,900, but the bank statement indicates that only $15,600 in deposits were received during the month.
2. The June 30 bank reconciliation also reported outstanding checks of $940. During the month of July, Arora Company books show that $17,500 of checks were issued, yet the bank statement showed that $16,400 of checks cleared the bank in July.

For September:
3. In September, deposits per bank statement totaled $25,900, deposits per books were $26,400, and deposits in transit at September 30 were $2,200.
4. In September, cash disbursements per books were $23,500, checks clearing the bank were $24,000, and outstanding checks at September 30 were $2,100.

There were no bank debit or credit memoranda, and no errors were made by either the bank or Arora Company.

Instructions

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

E7-11 Mazor Inc.’s bank statement from Hometown Bank at August 31, 2012, gives the following information.

| Cash Account Balance, August 1 | $18,400 |
| August deposits | 71,000 |
| Checks cleared in August | 68,678 |
| Bank debit memorandum: | |
| Interest earned | 45 |
| Bank credit memorandum: | Balance, August 31 |
| Safety deposit box fee | $25 |
| Service charge | 50 |
| A summary of the Cash account in the ledger for August shows the following: balance, August 1, $18,700; receipts $74,000; disbursements $73,570; and balance, August 31, $19,130. Analysis reveals that the only reconciling items on the July 31 bank reconciliation were a deposit in transit for $4,800 and outstanding checks of $4,500. In addition, you determine that there was an error involving a company check drawn in August: A check for $400 to a creditor on account that cleared the bank in August was journalized and posted for $40.

Instructions

(a) Determine deposits in transit.
(b) Determine outstanding checks. (Hint: You need to correct disbursements for the check error.)
(c) Prepare a bank reconciliation at August 31.
(d) Journalize the adjusting entry(ies) to be made by Mazor Inc. at August 31.

E7-12 A new accountant at Netzloff Inc. is trying to identify which of the amounts shown on page 377 should be reported as the current asset “Cash and cash equivalents” in the year-end balance sheet, as of April 30, 2012.
Exercises

1. $60 of currency and coin in a locked box used for incidental cash transactions.
3. $260 of April-dated checks that Netzloff has received from customers but not yet deposited.
4. An $85 check received from a customer in payment of its April account, but post-dated to May 1.
5. $2,500 in the company’s checking account.
6. $4,800 in its savings account.
7. $75 of prepaid postage in its postage meter.
8. A $25 IOU from the company receptionist.

Instructions
(a) What balance should Netzloff report as its “Cash and cash equivalents” balance at April 30, 2012?
(b) In what account(s) and in what financial statement(s) should the items not included in “Cash and cash equivalents” be reported?

E7-13 Amster, Lasca, and Vang, three law students who have joined together to open a law practice, are struggling to manage their cash flow. They haven’t yet built up sufficient clientele and revenues to support their legal practice’s ongoing costs. Initial costs, such as advertising, renovations to their premises, and the like, all result in outgoing cash flow at a time when little is coming in. Amster, Lasca, and Vang haven’t had time to establish a billing system since most of their clients’ cases haven’t yet reached the courts, and the lawyers didn’t think it would be right to bill them until “results were achieved.”

Unfortunately, Amster, Lasca, and Vang’s suppliers don’t feel the same way. Their suppliers expect them to pay their accounts payable within a few days of receiving their bills. So far, there hasn’t even been enough money to pay the three lawyers, and they are not sure how long they can keep practicing law without getting some money into their pockets.

Instructions
Can you provide any suggestions for Amster, Lasca, and Vang to improve their cash management practices?

E7-14 Merrick Company expects to have a cash balance of $46,000 on January 1, 2012. These are the relevant monthly budget data for the first two months of 2012.
1. Collections from customers: January $71,000, February $146,000
2. Payments to suppliers: January $40,000, February $75,000
3. Wages: January $30,000, February $40,000. Wages are paid in the month they are incurred.
4. Administrative expenses: January $21,000, February $24,000. These costs include depreciation of $1,000 per month. All other costs are paid as incurred.
5. Selling expenses: January $15,000, February $20,000. These costs are exclusive of depreciation. They are paid as incurred.
6. Sales of short-term investments in January are expected to realize $12,000 in cash. Merrick has a line of credit at a local bank that enables it to borrow up to $25,000. The company wants to maintain a minimum monthly cash balance of $20,000.

Instructions
Prepare a cash budget for January and February.

E7-15 During October, Central Light Company experiences the following transactions in establishing a petty cash fund.

Oct. 1 A petty cash fund is established with a check for $150 issued to the petty cash custodian.
31 A check was written to reimburse the fund and increase the fund to $200. A count of the petty cash fund disclosed the following items:
Currency $59.00
Coins 0.70
Expenditure receipts (vouchers):
Supplies $26.10
Telephone, Internet, and fax 16.40
Postage 39.70
Freight-out 6.80

Instructions
Prepare journal entries for a petty cash fund.
Journalize the entries in October that pertain to the petty cash fund.

*E7-16 Paik Company maintains a petty cash fund for small expenditures. These transactions occurred during the month of August.

Aug. 1 Established the petty cash fund by writing a check on Westown Bank for $200.

15 Replenished the petty cash fund by writing a check for $175. On this date, the fund consisted of $25 in cash and these petty cash receipts: freight-out $74.40, entertainment expense $36, postage expense $33.70 and miscellaneous expense $27.50.

16 Increased the amount of the petty cash fund to $400 by writing a check for $200.

31 Replenished the petty cash fund by writing a check for $283. On this date, the fund consisted of $117 in cash and these petty cash receipts: postage expense $145, entertainment expense $90.60, and freight-out $46.40.

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

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

Problems: Set A

P7-1A Classic Theater is in the Greenbelt Mall. A cashier’s booth is located near the entrance to the theater. Two cashiers are employed. One works from 1:00 to 5:00 P.M., the other from 5:00 to 9:00 P.M. Each cashier is bonded. The cashiers receive cash from customers and operate a machine that ejects serially numbered tickets. The rolls of tickets are inserted and locked into the machine by the theater manager at the beginning of each cashier’s shift.

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

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

Instructions
(a) Identify the internal control principles and their application to the cash receipts transactions of Classic Theater.
(b) If the doorperson and cashier decided to collaborate to misappropriate cash, what actions might they take?

P7-2A Nature Hill Middle School wants to raise money for a new sound system for its auditorium. The primary fund-raising event is a dance at which the famous disc jockey Jay Dee will play classic and not-so-classic dance tunes. Barry Cameron, the music and
Problems: Set A

theater instructor, has been given the responsibility for coordinating the fund-raising efforts. This is Barry's first experience with fund-raising. He decides to put the eighth-grade choir in charge of the event; he will be a relatively passive observer.

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

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

The day of the dance, Barry wrote a check from the account to pay Jay Dee. The DJ said, however, that he accepted only cash and did not give receipts. So Barry took $200 out of the cash box and gave it to Jay. At the dance, Barry had Amy Kuether working at the entrance to the gymnasium, collecting tickets from students and selling tickets to those who had not pre-purchased them. Barry estimated that 400 students attended the dance.

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

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

P7-3A On July 31, 2012, Fraiser Company had a cash balance per books of $6,140. The statement from Nashota State Bank on that date showed a balance of $7,690.80. A comparison of the bank statement with the Cash account revealed the following facts.

1. The bank service charge for July was $25.
2. The bank collected a note receivable of $1,500 for Fraiser Company on July 15, plus $30 of interest. The bank made a $10 charge for the collection. Fraiser has not accrued any interest on the note.
3. The July 31 receipts of $1,193.30 were not included in the bank deposits for July. These receipts were deposited by the company in a night deposit vault on July 31.
4. Company check No. 2480 issued to T. Crain, a creditor, for $384 that cleared the bank in July was incorrectly entered in the cash payments journal on July 10 for $348.
5. Checks outstanding on July 31 totaled $1,860.10.
6. On July 31, the bank statement showed an NSF charge of $575 for a check received by the company from K. Fonner, a customer, on account.

Instructions
(a) Prepare the bank reconciliation as of July 31.
(b) Prepare the necessary adjusting entries at July 31.

P7-4A The bank portion of the bank reconciliation for Horsman Company at October 31, 2012, is shown here and on the next page.

HORSMAN COMPANY
Bank Reconciliation
October 31, 2012

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash balance per bank</td>
<td>$12,367.90</td>
</tr>
<tr>
<td>Add: Deposits in transit</td>
<td>1,530.20</td>
</tr>
<tr>
<td></td>
<td>13,898.10</td>
</tr>
</tbody>
</table>
The adjusted cash balance per bank agreed with the cash balance per books at October 31. The November bank statement showed the following checks and deposits.

<table>
<thead>
<tr>
<th>Check Number</th>
<th>Check Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2451</td>
<td>$1,260.40</td>
</tr>
<tr>
<td>2470</td>
<td>684.20</td>
</tr>
<tr>
<td>2471</td>
<td>844.50</td>
</tr>
<tr>
<td>2472</td>
<td>426.80</td>
</tr>
<tr>
<td>2474</td>
<td>$4,265.90</td>
</tr>
</tbody>
</table>

Adjusted cash balance per bank $9,632.20

The cash records per books for November showed the following.

<table>
<thead>
<tr>
<th>Date</th>
<th>Number</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>11-1</td>
<td>2470</td>
<td>$684.20</td>
</tr>
<tr>
<td>11-2</td>
<td>2471</td>
<td>844.50</td>
</tr>
<tr>
<td>11-4</td>
<td>2474</td>
<td>1,050.00</td>
</tr>
<tr>
<td>11-8</td>
<td>2476</td>
<td>2,830.00</td>
</tr>
<tr>
<td>11-10</td>
<td>2477</td>
<td>600.00</td>
</tr>
<tr>
<td>11-15</td>
<td>2478</td>
<td>1,750.00</td>
</tr>
<tr>
<td>11-18</td>
<td>2480</td>
<td>1,330.00</td>
</tr>
<tr>
<td>11-27</td>
<td>2481</td>
<td>695.40</td>
</tr>
<tr>
<td>11-30</td>
<td>2483</td>
<td>575.50</td>
</tr>
<tr>
<td>11-29</td>
<td>2486</td>
<td>940.00</td>
</tr>
</tbody>
</table>

Total $12,940.30

The bank statement contained two bank memoranda:

1. A credit of $2,242 for the collection of a $2,100 note for Horsman Company plus interest of $157 and less a collection fee of $15. Horsman Company has not accrued any interest on the note.
2. A debit for the printing of additional company checks $85.
At November 30, the cash balance per books was $11,073.80 and the cash balance per bank statement was $17,712.50. The bank did not make any errors, but Horsman Company made two errors.

**Instructions**

(a) Using the four steps in the reconciliation procedure described on pages 354–355, prepare a bank reconciliation at November 30, 2012.

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

**P7-5A** Stromberg Company of Zwingle, Kansas, spreads herbicides and applies liquid fertilizer for local farmers. On May 31, 2012, the company's Cash account per its general ledger showed a balance of $6,738.90.

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

<table>
<thead>
<tr>
<th>Checks and Debits</th>
<th>Deposits and Credits</th>
<th>Daily Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>XXX</td>
<td>XXX</td>
<td>5-31 6,968.00</td>
</tr>
</tbody>
</table>

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

1. The statement included a debit memo of $40 for the printing of additional company checks.
2. Cash sales of $883.15 on May 12 were deposited in the bank. The cash receipts journal entry and the deposit slip were incorrectly made for $933.15. The bank credited Stromberg Company for the correct amount.
3. Outstanding checks at May 31 totaled $276.25, and deposits in transit were $1,880.15.
4. On May 18, the company issued check No. 1181 for $685 to M. Dornbos, on account. The check, which cleared the bank in May, was incorrectly journalized and posted by Stromberg Company for $658.
5. A $2,600 note receivable was collected by the bank for Stromberg Company on May 31 plus $110 interest. The bank charged a collection fee of $20. No interest has been accrued on the note.
6. Included with the cancelled checks was a check issued by Strongberg Company to P. Jordan for $360 that was incorrectly charged to Stromberg Company by the bank.
7. On May 31, the bank statement showed an NSF charge of $380 for a check issued by Bev Fountain, a customer, to Stromberg Company on account.

**Instructions**

(a) Prepare the bank reconciliation at May 31, 2012.

(b) Prepare the necessary adjusting entries for Stromberg Company at May 31, 2012.

**P7-6A** You are provided with the following information taken from Washburne Inc.'s March 31, 2012, balance sheet.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$11,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>20,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>36,000</td>
</tr>
<tr>
<td>Property, plant, and equipment, net of depreciation</td>
<td>120,000</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>22,400</td>
</tr>
<tr>
<td>Common stock</td>
<td>150,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>11,600</td>
</tr>
</tbody>
</table>

Additional information concerning Washburne Inc. is as follows.

1. Gross profit is 25% of sales.
2. Actual and budgeted sales data:

<table>
<thead>
<tr>
<th>Month</th>
<th>Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>March (actual)</td>
<td>$46,000</td>
</tr>
<tr>
<td>April (budgeted)</td>
<td>70,000</td>
</tr>
</tbody>
</table>
3. Sales are both cash and credit. Cash collections expected in April are:

<table>
<thead>
<tr>
<th>Month</th>
<th>Cash Collections ($)</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>March</td>
<td>18,400</td>
<td>40% of $46,000</td>
</tr>
<tr>
<td>April</td>
<td>42,000</td>
<td>60% of $70,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$60,400</strong></td>
<td></td>
</tr>
</tbody>
</table>

4. Half of a month's purchases are paid for in the month of purchase and half in the following month. Cash disbursements expected in April are:

<table>
<thead>
<tr>
<th>Month</th>
<th>Purchases ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>March</td>
<td>22,400</td>
</tr>
<tr>
<td>April</td>
<td>28,100</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$50,500</strong></td>
</tr>
</tbody>
</table>

5. Cash operating costs are anticipated to be $11,200 for the month of April.

6. Equipment costing $2,500 will be purchased for cash in April.

7. The company wishes to maintain a minimum cash balance of $9,000. An open line of credit is available at the bank. All borrowing is done at the beginning of the month, and all repayments are made at the end of the month. The interest rate is 12% per year, and interest expense is accrued at the end of the month and paid in the following month.

**Instructions**

Prepare a cash budget for the month of April. Determine how much cash Washburne Inc. must borrow, or can repay, in April.

---

### P7-7A

Austin Corporation prepares monthly cash budgets. Here are relevant data from operating budgets for 2012.

<table>
<thead>
<tr>
<th></th>
<th>January</th>
<th>February</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$360,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>120,000</td>
<td>130,000</td>
</tr>
<tr>
<td>Salaries</td>
<td>84,000</td>
<td>81,000</td>
</tr>
<tr>
<td>Administrative expenses</td>
<td>72,000</td>
<td>75,000</td>
</tr>
<tr>
<td>Selling expenses</td>
<td>79,000</td>
<td>88,000</td>
</tr>
</tbody>
</table>

All sales and purchases are on account. Budgeted collections and disbursement data are given below. All other expenses are paid in the month incurred except for administrative expenses, which include $1,000 of depreciation per month.

Other data.
1. Collections from customers: January $326,000; February $378,000.
2. Payments for purchases: January $110,000; February $135,000.
3. Other receipts: January: collection of December 31, 2011, notes receivable $15,000; February: proceeds from sale of securities $4,000.
4. Other disbursements: February $10,000 cash dividend.

The company's cash balance on January 1, 2012, is expected to be $46,000. The company wants to maintain a minimum cash balance of $40,000.

**Instructions**

Prepare a cash budget for January and February.

---

### P7-8A

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

The balance per the bank statement on October 31, 2012, was $18,380. Outstanding checks were: No. 62 for $140.75, No. 183 for $180, No. 284 for $253.25, No. 862 for $190.71, No. 863 for $226.80, and No. 864 for $165.28. Included with the statement was...
Problems: Set B

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a credit memorandum of $185 indicating the collection of a note receivable for Fetter Company by the bank on October 25. This memorandum has not been recorded by Fetter.

The company’s ledger showed one Cash account with a balance of $21,877.72. The balance included undeposited cash on hand. Because of the lack of internal controls, Allan took for personal use all of the undeposited receipts in excess of $3,795.51. He then prepared the following bank reconciliation in an effort to conceal his theft of cash.

| Cash balance per books, October 31 | $21,877.72 |
| Add: Outstanding checks | |
| No. 862 | $190.71 |
| No. 863 | 226.80 |
| No. 864 | 165.28 |
| **Total** | **482.79** |
| Less: Undeposited receipts | 3,795.51 |
| Unadjusted balance per bank, October 31 | 18,565.00 |
| Less: Bank credit memorandum | 185.00 |
| Cash balance per bank statement, October 31 | **$18,380.00** |

Instructions
(a) Prepare a correct bank reconciliation. (Hint: Deduct the amount of the theft from the adjusted balance per books.)
(b) Indicate the three ways that Allan attempted to conceal the theft and the dollar amount involved in each method.
(c) What principles of internal control were violated in this case?

Problems: Set B

P7-1B Erin Company recently changed its system of internal control over cash disbursements. The system includes the following features.

1. Instead of being unnumbered and manually prepared, all checks must now be prenumbered and written by using the new checkwriter purchased by the company.
2. Before a check can be issued, each invoice must have the approval of Karen Noonan, the purchasing agent, and Tom Fah, the receiving department supervisor.
3. Checks must be signed by either Carl Merfeld, the treasurer, or Bonnie Kurt, the assistant treasurer. Before signing a check, the signer is expected to compare the amounts of the check with the amounts on the invoice.
4. After signing a check, the signer stamps the invoice “paid” and inserts within the stamp, the date, check number, and amount of the check. The “paid” invoice is then sent to the accounting department for recording.
5. Blank checks are stored in a safe in the treasurer’s office. The combination to the safe is known by only the treasurer and assistant treasurer.
6. Each month the bank statement is reconciled with the bank balance per books by the assistant chief accountant.
7. All employees who handle or account for cash are bonded.

Instructions
Identify the internal control principles and their application to cash disbursements of Erin Company.

P7-2B The board of trustees of a local church is concerned about the internal accounting controls pertaining to the offering collections made at weekly services. They ask you to serve on a three-person audit team with the internal auditor of a local university and a CPA who has just joined the church. At a meeting of the audit team and the board of trustees, you learn the following.

1. The church’s board of trustees has delegated responsibility for the financial management and audit of the financial records to the finance committee. This group prepares
the annual budget and approves major disbursements but is not involved in collections or recordkeeping. No audit has been made in recent years because the same trusted employee has kept church records and served as financial secretary for 15 years. The church does not carry any fidelity insurance.

2. The collection at the weekly service is taken by a team of ushers who volunteer to serve for 1 month. The ushers take the collection plates to a basement office at the rear of the church. They hand their plates to the head usher and return to the church service. After all plates have been turned in, the head usher counts the cash received. The head usher then places the cash in the church safe along with a notation of the amount counted. The head usher volunteers to serve for 3 months.

3. The next morning, the financial secretary opens the safe and recounts the collection. The secretary withholds $150–$200 in cash, depending on the cash expenditures expected for the week, and deposits the remainder of the collections in the bank. To facilitate the deposit, church members who contribute by check are asked to make their checks payable to “Cash.”

4. Each month, the financial secretary reconciles the bank statement and submits a copy of the reconciliation to the board of trustees. The reconciliations have rarely contained any bank errors and have never shown any errors per books.

**Instructions**

(a) Indicate the weaknesses in internal accounting control in the handling of collections.

(b) List the improvements in internal control procedures that you plan to make at the next meeting of the audit team for (1) the ushers, (2) the head usher, (3) the financial secretary, and (4) the finance committee.

(c) What church policies should be changed to improve internal control?

**P7-3B** On May 31, 2012, Laban Company had a cash balance per books of $5,681.50. The bank statement from Citizens Bank on that date showed a balance of $7,964.60. A comparison of the statement with the Cash account revealed the following facts.

1. The statement included a debit memo of $70 for the printing of additional company checks.

2. Cash sales of $786.15 on May 12 were deposited in the bank. The cash receipts journal entry and the deposit slip were incorrectly made for $796.15. The bank credited Laban Company for the correct amount.

3. Outstanding checks at May 31 totaled $1,106.25, and deposits in transit were $799.15.

4. On May 18, the company issued check No. 1181 for $685 to A. Hawkins, on account. The check, which cleared the bank in May, was incorrectly journalized and posted by Laban Company for $658.

5. A $2,500 note receivable was collected by the bank for Laban Company on May 31 plus $80 interest. The bank charged a collection fee of $42. No interest has been accrued on the note.

6. Included with the cancelled checks was a check issued by Logan Company to D. Reyes for $290 that was incorrectly charged to Laban Company by the bank.

7. On May 31, the bank statement showed an NSF charge of $165 for a check issued by G. Verdier, a customer, to Laban Company on account.

**Instructions**

(a) Prepare the bank reconciliation as of May 31, 2012.

(b) Prepare the necessary adjusting entries at May 31, 2012.

**Prepare a bank reconciliation and adjusting entries.**

**P7-4B** The bank portion of the bank reconciliation for Carlin Company at November 30, 2012, is shown here and on the next page.

<table>
<thead>
<tr>
<th>CARLIN COMPANY</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Bank Reconciliation</strong></td>
</tr>
<tr>
<td><strong>November 30, 2012</strong></td>
</tr>
</tbody>
</table>

| Cash balance per bank | $14,367.90 |
| Add: Deposits in transit | 2,530.20 |
| **Total** | **16,898.10** |
Problems: Set B 385

Less: Outstanding checks

<table>
<thead>
<tr>
<th>Check Number</th>
<th>Check Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>3451</td>
<td>$2,260.40</td>
</tr>
<tr>
<td>3470</td>
<td>1,100.10</td>
</tr>
<tr>
<td>3471</td>
<td>844.50</td>
</tr>
<tr>
<td>3472</td>
<td>1,426.80</td>
</tr>
<tr>
<td>3474</td>
<td>1,050.00</td>
</tr>
</tbody>
</table>

Adjusted cash balance per bank $10,216.30

The adjusted cash balance per bank agreed with the cash balance per books at November 30. The December bank statement showed the following checks and deposits.

<table>
<thead>
<tr>
<th>Bank Statement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Checks</td>
</tr>
<tr>
<td>Date</td>
</tr>
<tr>
<td>------</td>
</tr>
<tr>
<td>12-1</td>
</tr>
<tr>
<td>12-2</td>
</tr>
<tr>
<td>12-7</td>
</tr>
<tr>
<td>12-4</td>
</tr>
<tr>
<td>12-8</td>
</tr>
<tr>
<td>12-15</td>
</tr>
<tr>
<td>12-27</td>
</tr>
<tr>
<td>12-30</td>
</tr>
<tr>
<td>12-29</td>
</tr>
<tr>
<td>12-31</td>
</tr>
</tbody>
</table>

Total $15,318.30

<table>
<thead>
<tr>
<th>Deposits</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Date</td>
<td>Amount</td>
</tr>
<tr>
<td>12-1</td>
<td>$2,530.20</td>
</tr>
<tr>
<td>12-4</td>
<td>1,211.60</td>
</tr>
<tr>
<td>12-8</td>
<td>2,365.10</td>
</tr>
<tr>
<td>12-16</td>
<td>2,632.70</td>
</tr>
<tr>
<td>12-21</td>
<td>2,945.00</td>
</tr>
<tr>
<td>12-26</td>
<td>2,567.30</td>
</tr>
<tr>
<td>12-29</td>
<td>2,836.00</td>
</tr>
<tr>
<td>12-30</td>
<td>1,025.00</td>
</tr>
<tr>
<td>Total</td>
<td>$18,112.90</td>
</tr>
</tbody>
</table>

The cash records per books for December showed the following.

<table>
<thead>
<tr>
<th>Cash Payments Journal</th>
</tr>
</thead>
<tbody>
<tr>
<td>Date</td>
</tr>
<tr>
<td>------</td>
</tr>
<tr>
<td>12-1</td>
</tr>
<tr>
<td>12-2</td>
</tr>
<tr>
<td>12-2</td>
</tr>
<tr>
<td>12-4</td>
</tr>
<tr>
<td>12-8</td>
</tr>
<tr>
<td>12-10</td>
</tr>
<tr>
<td>12-17</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cash Receipts Journal</th>
</tr>
</thead>
<tbody>
<tr>
<td>Date</td>
</tr>
<tr>
<td>------</td>
</tr>
<tr>
<td>12-3</td>
</tr>
<tr>
<td>12-7</td>
</tr>
<tr>
<td>12-15</td>
</tr>
<tr>
<td>12-20</td>
</tr>
<tr>
<td>12-25</td>
</tr>
<tr>
<td>12-28</td>
</tr>
<tr>
<td>12-30</td>
</tr>
<tr>
<td>12-31</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

The bank statement contained two memoranda.
1. A credit of $2,645 for the collection of a $2,500 note for Carlin Company plus interest of $160 and less a collection fee of $15. Carlin Company has not accrued any interest on the note.
2. A debit of $819.10 for an NSF check written by K. Webster, a customer. At December 31, the check had not been redeposited in the bank.
At December 31, the cash balance per books was $12,513.30, and the cash balance per bank statement was $18,988.40. The bank did not make any errors, but Carlin Company made two errors.

**Instructions**

(a) Using the four steps in the reconciliation procedure described on pages 354–355, prepare a bank reconciliation at December 31, 2012.

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

---

### P7-5B

Grossfeld Company of Omaha, Nebraska, provides liquid fertilizer and herbicides to regional farmers. On July 31, 2012, the company's Cash account per its general ledger showed a balance of $5,876.70.

The bank statement from Tri-State Bank on that date showed the following balance:

<table>
<thead>
<tr>
<th>TRI-STATE BANK</th>
<th>Checks and Debits</th>
<th>Deposits and Credits</th>
<th>Daily Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>XXX</td>
<td>XXX</td>
<td>7-31 7,043.80</td>
</tr>
</tbody>
</table>

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

1. The bank service charge for July was $32.
2. The bank collected a note receivable of $900 for Grossfeld Company on July 15, plus $48 of interest. The bank made an $18 charge for the collection. Grossfeld has not accrued any interest on the note.
3. The July 31 receipts of $1,339 were not included in the bank deposits for July. These receipts were deposited by the company in a night deposit vault on July 31.
4. Company check No. 2480 issued to S. Tully, a creditor, for $471 that cleared the bank in July was incorrectly entered in the cash payments journal on July 10 for $417.
5. Checks outstanding on July 31 totaled $2,480.10.
6. On July 31, the bank statement showed an NSF charge of $818 for a check received by the company from L. Weare, a customer, on account.

**Instructions**

(a) Prepare the bank reconciliation as of July 31, 2012.

(b) Prepare the necessary adjusting entries at July 31, 2012.

---

### P7-6B

Pincus Co. expects to have a cash balance of $26,000 on January 1, 2012. Relevant monthly budget data for the first two months of 2012 are as follows.

- Collections from customers: January $70,000; February $147,000
- Payments to suppliers: January $45,000; February $69,000
- Salaries: January $38,000; February $40,000. Salaries are paid in the month they are incurred.
- Selling and administrative expenses: January $27,000; February $32,000. These costs are exclusive of depreciation and are paid as incurred.
- Sales of short-term investments in January are expected to realize $7,000 in cash.

Pincus has a line of credit at a local bank that enables it to borrow up to $45,000. The company wants to maintain a minimum monthly cash balance of $25,000. Any excess cash above the $25,000 minimum is used to pay off the line of credit.

**Instructions**

(a) Prepare a cash budget for January and February.

(b) Explain how a cash budget contributes to effective management.

---

### P7-7B

Vaux Inc. prepares monthly cash budgets. Shown on page 387 are relevant data from operating budgets for 2012.
Problems: Set B

All sales and purchases are on account. Collections and disbursement data are given below. All other items above are paid in the month incurred. Depreciation has been excluded from selling and administrative expenses.

Other data.
1. Collections from customers: January $293,000; February $358,000.
2. Payments for purchases: January $98,000; February $118,000.
3. Other receipts: January: collection of December 31, 2011, interest receivable $2,000; February: proceeds from sale of short-term investments $5,000
4. Other disbursements: February payment of $20,000 for land

The company's cash balance on January 1, 2012, is expected to be $58,000. The company wants to maintain a minimum cash balance of $40,000.

Instructions
Prepare a cash budget for January and February.

---

**Jan. 31 cash bal. $43,000**

Prepare a comprehensive bank reconciliation with theft and internal control deficiencies. (SO 2, 3, 4, 5, E)

---

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

The balance per the bank statement on October 31, 2012, was $13,600. Outstanding checks were: No. 62 for $126.75, No. 183 for $190, No. 284 for $253.25, No. 862 for $190.71, No. 863 for $226.80, and No. 864 for $165.28. Included with the statement was a credit memorandum of $440 indicating the collection of a note receivable for Monti Company by the bank on October 25. This memorandum has not been recorded by Monti Company.

The company’s ledger showed one Cash account with a balance of $15,797.21. The balance included undeposited cash on hand. Because of the lack of internal controls, Stark took for personal use all of the undeposited receipts in excess of $2,240. He then prepared the following bank reconciliation in an effort to conceal his theft of cash.

<table>
<thead>
<tr>
<th></th>
<th>January</th>
<th>February</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$330,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>110,000</td>
<td>130,000</td>
</tr>
<tr>
<td>Salaries</td>
<td>80,000</td>
<td>95,000</td>
</tr>
<tr>
<td>Selling and administrative expenses</td>
<td>132,000</td>
<td>150,000</td>
</tr>
</tbody>
</table>

Instructions
(a) Prepare a correct bank reconciliation. (Hint: Deduct the amount of the theft from the adjusted balance per books.)
(b) Indicate the three ways that Stark attempted to conceal the theft and the dollar amount pertaining to each method.
(c) What principles of internal control were violated in this case?
Chapter 7: Fraud, Internal Control, and Cash

Problems: Set C

Visit the book’s companion website, at www.wiley.com/college/kimmel, and choose the Student Companion site to access Problem Set C.

Comprehensive Problem

On December 1, 2012, Bluemound Company had the following account balances.

<table>
<thead>
<tr>
<th>Debits</th>
<th>Credits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$18,200</td>
</tr>
<tr>
<td>Notes Receivable</td>
<td>$2,200</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>$7,500</td>
</tr>
<tr>
<td>Inventory</td>
<td>$16,000</td>
</tr>
<tr>
<td>Prepaid Insurance</td>
<td>$1,600</td>
</tr>
<tr>
<td>Equipment</td>
<td>$28,000</td>
</tr>
<tr>
<td>Accumulated Depreciation—Equipment</td>
<td>$3,000</td>
</tr>
<tr>
<td>Accounts Payable</td>
<td>$6,100</td>
</tr>
<tr>
<td>Common Stock</td>
<td>$20,000</td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>$44,400</td>
</tr>
<tr>
<td></td>
<td>$73,500</td>
</tr>
</tbody>
</table>

During December, the company completed the following transactions.

Dec.  7 Received $3,600 cash from customers in payment of account (no discount allowed).
   12 Purchased merchandise on account from Klump Co. $12,000, terms 1/10, n/30.
   17 Sold merchandise on account $15,000, terms 2/10, n/30. The cost of the merchandise sold was $10,000.
   19 Paid salaries $2,500.
   22 Paid Klump Co. in full, less discount.
   26 Received collections in full, less discounts, from customers billed on December 17.

Adjustment data:
1. Depreciation $200 per month.
2. Insurance expired $400.
3. Income tax expense was $425. It was unpaid at December 31.

Instructions
(a) Journalize the December transactions. (Assume a perpetual inventory system.)
(b) Enter the December 1 balances in the ledger T accounts and post the December transactions. Use Cost of Goods Sold, Depreciation Expense, Insurance Expense, Salaries and Wages Expense, Sales Revenue, Sales Discounts, Income Taxes Payable, and Income Tax Expense.
(c) The statement from Jackson County Bank on December 31 showed a balance of $21,994. A comparison of the bank statement with the Cash account revealed the following facts.
   1. The bank collected a note receivable of $2,200 for Bluemound Company on December 15.
   2. The December 31 receipts of $2,736 were not included in the bank deposits for December. The company deposited these receipts in a night deposit vault on December 31.
   3. Checks outstanding on December 31 totaled $1,210.
   4. On December 31, the bank statement showed a NSF charge of $800 for a check received by the company from L. Shur, a customer, on account.

Prepare a bank reconciliation as of December 31 based on the available information. (Hint: The cash balance per books is $22,120. This can be proven by finding the balance in the Cash account from parts (a) and (b).)

(d) Journalize the adjusting entries resulting from the bank reconciliation and adjustment data.
(e) Post the adjusting entries to the ledger T accounts.
(f) Prepare an adjusted trial balance.
(g) Prepare an income statement for December and a classified balance sheet at December 31.
Continuing Cookie Chronicle

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

**CCC7 Part 1** Natalie is struggling to keep up with the recording of her accounting transactions. She is spending a lot of time marketing and selling mixers and giving her cookie classes. Her friend John is an accounting student who runs his own accounting service. He has asked Natalie if she would like to have him do her accounting. John and Natalie meet and discuss her business.

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

Financial Reporting and Analysis

**FINANCIAL REPORTING PROBLEM: Tootsie Roll Industries Inc.**

**BYP7-1** The financial statements of Tootsie Roll are presented in Appendix A of this book, together with an auditor’s report—Report of Independent Auditors.

**Instructions**
Using the financial statements and reports, answer these questions about Tootsie Roll’s internal controls and cash.

(a) What comments, if any, are made about cash in the “Report of Independent Registered Public Accounting Firm”?

(b) What data about cash and cash equivalents are shown in the consolidated balance sheet (statement of financial position)?

(c) What activities are identified in the consolidated statement of cash flows as being responsible for the changes in cash during 2009?

(d) How are cash equivalents defined in the Notes to Consolidated Financial Statements?

(e) Read the section of the report titled “Management’s Report on Internal Control Over Financial Reporting.” Summarize the statements made in that section of the report.

**COMPARATIVE ANALYSIS PROBLEM: Tootsie Roll vs. Hershey**

**BYP7-2** The financial statements of The Hershey Company are presented in Appendix B, following the financial statements for Tootsie Roll in Appendix A.

**Instructions**
Answer the following questions for each company.

(a) What is the balance in cash and cash equivalents at December 31, 2009?

(b) What percentage of total assets does cash represent for each company over the last two years? Has it changed significantly for either company?

(c) How much cash was provided by operating activities during 2009?

(d) Comment on your findings in parts (a) through (c).

**RESEARCH CASE**

**BYP7-3** The website [www.cpa2biz.com](http://www.cpa2biz.com) has an article dated February 4, 2010, by Mary Schaeffer entitled “Emerging Issues: Demise of Paper Checks.”
Instructions
Go to the website and do a search on the article title. Read the article and answer the following questions.
(a) How many different forms of payment types does the article list? What are the payment types?
(b) What problems does the shift away from paper checks to alternative payment options present for companies?
(c) What five controls does the article suggest incorporating, to decrease problems associated with multiple payment options?

INTERPRETING FINANCIAL STATEMENTS

The international accounting firm Ernst and Young performed a global survey. The results of that survey are summarized in a report titled "Fraud Risk in Emerging Markets." You can find this report at: http://www.ey.com/Global/assets.nsf/International/FIDS_-_9th_Global_Fraud_Survey_2006/$file/EY_Fraud_Survey_June2006.pdf, or do an Internet search for "9th Global Fraud Survey—Fraud Risk in Emerging Markets."

Instructions
Read the Executive Summary section, and then skim the remainder of the report to answer the following questions.
(a) What did survey respondents consider to be the top three factors to prevent fraud?
(b) What type of fraud poses the greatest threat in developed markets? What type of fraud poses the greatest threat in emerging markets?
(c) In what three regions are anti-fraud measures most likely to be considered when deciding whether to begin doing business in that region?

FINANCIAL ANALYSIS ON THE WEB

The Financial Accounting Standards Board (FASB) is a private organization established to improve accounting standards and financial reporting. The FASB conducts extensive research before issuing a “Statement of Financial Accounting Standards,” which represents an authoritative expression of generally accepted accounting principles.

Steps
Choose About FASB.

Instructions
Answer the following questions.
(a) What is the mission of the FASB?
(b) How are topics added to the FASB technical agenda? (Hint: See Project Plans in Our Rules of Procedure.)
(c) What characteristics make the FASB’s procedures an “open” decision-making process? (Hint: See Due Process in Our Rules of Procedure.)

The Public Company Accounting Oversight Board (PCAOB) was created as a result of the Sarbanes-Oxley Act. It has oversight and enforcement responsibilities over accounting firms in the U.S.

Address: http://www.pcaobus.org/, or go to www.wiley.com/college/kimmel

Instructions
Answer the following questions.
(a) What is the mission of the PCAOB?
(b) Briefly summarize its responsibilities related to inspections.
(c) Briefly summarize its responsibilities related to enforcement.

Critical Thinking

DEcision making across the organization

Alternative Distributor Corp., a distributor of groceries and related products, is headquartered in Medford, Massachusetts.

During a recent audit, Alternative Distributor Corp. was advised that existing internal controls necessary for the company to develop reliable financial statements were inadequate. The audit
report stated that the current system of accounting for sales, receivables, and cash receipts constituted a material weakness. Among other items, the report focused on non timely deposit of cash receipts, exposing Alternative Distributor to potential loss or misappropriation, excessive past due accounts receivable due to lack of collection efforts, disregard of advantages offered by vendors for prompt payment of invoices, absence of appropriate segregation of duties by personnel consistent with appropriate control objectives, inadequate procedures for applying accounting principles, lack of qualified management personnel, lack of supervision by an outside board of directors, and overall poor recordkeeping.

Instructions
(a) Identify the principles of internal control violated by Alternative Distributor Corporation.
(b) Explain why managers of various functional areas in the company should be concerned about internal controls.

COMMUNICATION ACTIVITY
BYP7-8 As a new auditor for the CPA firm of Ticke and Tie, you have been assigned to review the internal controls over mail cash receipts of Perso Company. Your review reveals that checks are promptly endorsed “For Deposit Only,” but no list of the checks is prepared by the person opening the mail. The mail is opened either by the cashier or by the employee who maintains the accounts receivable records. Mail receipts are deposited in the bank weekly by the cashier.

Instructions
Write a letter to S. A. Davis, owner of the Perso Company, explaining the weaknesses in internal control and your recommendations for improving the system.

ETHICS CASES
BYP7-9 Banks charge fees for “bounced” checks—that is, checks that exceed the balance in the account. It has been estimated that processing bounced checks costs a bank roughly $1.50 per check. Thus, the profit margin on bounced checks is very high. Recognizing this, some banks have started to process checks from largest to smallest. By doing this, they maximize the number of checks that bounce if a customer overdraws an account. For example, NationsBank (now Bank of America) projected a $14 million increase in fee revenue as a result of processing largest checks first. In response to criticism, banks have responded that their customers prefer to have large checks processed first, because those tend to be the most important. At the other extreme, some banks will cover their customers’ bounced checks, effectively extending them an interest-free loan while their account is overdrawn.

Instructions
Answer each of the following questions.
(a) William Preston had a balance of $1,500 in his checking account at First National Bank on a day when the bank received the following five checks for processing against his account.

<table>
<thead>
<tr>
<th>Check Number</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>3150</td>
<td>$ 35</td>
</tr>
<tr>
<td>3162</td>
<td>400</td>
</tr>
<tr>
<td>3165</td>
<td>$ 550</td>
</tr>
<tr>
<td>3166</td>
<td>1,510</td>
</tr>
<tr>
<td>3169</td>
<td>180</td>
</tr>
</tbody>
</table>

Assuming a $30 fee assessed by the bank for each bounced check, how much fee revenue would the bank generate if it processed checks (1) from largest to smallest, (2) from smallest to largest, and (3) in order of check number?
(b) Do you think that processing checks from largest to smallest is an ethical business practice?
(c) In addition to ethical issues, what other issues must a bank consider in deciding whether to process checks from largest to smallest?
(d) If you were managing a bank, what policy would you adopt on bounced checks?

BYP7-10 The NFIC was originally established in 1992 by the National Consumers League, the oldest nonprofit consumer organization in the United States, to fight the growing menace of telemarketing fraud by improving prevention and enforcement. It maintains a website that provides many useful fraud related resources.
Address: www.fraud.org/scamsagainstbusinesses/bizscams.htm or go to www.wiley.com/college/kimmel

Instructions
Go to the site and find an item of interest to you. Write a short summary of your findings.

“ALL ABOUT YOU” ACTIVITY
BYP7-11 The print and electronic media are full of stories about potential security risks that can arise from your personal computer. It is important to keep in mind, however, that there are also many ways that your identity can be stolen other than from your computer. The federal government provides many resources to help protect you from identity thieves.

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

FASB CODIFICATION ACTIVITY
BYP7-12 If your school has a subscription to the FASB Codification, go to http://aaahq.org/ascLogin.cfm to log in and prepare responses to the following.
(a) How is cash defined in the Codification?
(b) How are cash equivalents defined in the Codification?
(c) What are the disclosure requirements related to cash and cash equivalents?

Answers to Insight and Accounting Across the Organization Questions
p. 345 SOX Boosts the Role of Human Resources Q: Why would unsupervised employees or employees who report to each other represent potential internal control threats? A: An unsupervised employee may have a fraudulent job (or may even be a fictitious person)—e.g., a person drawing a paycheck without working. Or, if two employees supervise each other, there is no real separation of duties, and they can conspire to defraud the company.

p. 345 Big Theft at Small Companies Q: Why are small companies more susceptible to employee theft? A: The high degree of trust often found in small companies makes them more vulnerable. Also, small companies tend to have less sophisticated systems of internal control, and they usually lack internal auditors. In addition, it is very hard to achieve some internal control features, such as segregation of duties, when you have very few employees.

p. 351 How Employees Steal Q: How can companies reduce the likelihood of fraudulent disbursements? A: To reduce the occurrence of fraudulent disbursements, a company should follow the procedures discussed in this chapter. These include having only designated personnel sign checks; having different personnel approve payments and make payments; ensuring that check signers do not record disbursements; using prenumbered checks and matching each check to an approved invoice; storing blank checks securely; reconciling the bank statement; and stamping invoices PAID.

p. 357 Madoff’s Ponzi Scheme Q: How was Madoff able to conceal such a giant fraud? A: Madoff fabricated false investment statements that were provided to investors. In addition, his auditor never verified these investment statements even though the auditor gave him an unqualified opinion each year.

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

**KEY POINTS**

- The fraud triangle discussed in this chapter is applicable to all international companies. Some of the major frauds on an international basis are Parmalat (Italy), Royal Ahold (the Netherlands), and Satyam Computer Services (India).
- Rising economic crime poses a growing threat to companies, with nearly half of all organizations worldwide being victims of fraud in a recent two-year period (*PricewaterhouseCoopers’ Global Economic Crime Survey*, 2005). Specifically, 44% of Romanian companies surveyed experienced fraud in the past two years.
- Globally, the number of companies reporting fraud increased from 37% to 45% since 2003, a 22% increase. The cost to companies was an average $1.7 million in losses from "tangible frauds," that is, those that result in an immediate and direct financial loss. These include asset misappropriation, false pretenses, and counterfeiting (*PricewaterhouseCoopers’ Global Economic Crime Survey*, 2005).
- Accounting scandals both in the United States and internationally have re-ignited the debate over the relative merits of GAAP, which takes a “rules-based” approach to accounting, versus IFRS, which takes a “principles-based” approach. The FASB announced that it intends to introduce more principles-based standards.
- On a lighter note, at one time the Ig Nobel Prize in Economics went to the CEOs of those companies involved in the corporate accounting scandals of that year for "adapting the mathematical concept of imaginary numbers for use in the business world." The Ig Nobel Prizes (read Ig noble, as not noble) are a parody of the Nobel Prizes and are given each year in early October for 10 achievements that “first make people laugh, and then make them think.” Organized by the scientific humor magazine *Annals of Improbable Research* (AIR), they are presented by a group that includes genuine Nobel laureates at a ceremony at Harvard University’s Sanders Theater. (See [en.wikipedia.org/wiki/Ig_Nobel_Prize](en.wikipedia.org/wiki/Ig_Nobel_Prize).)
- Internal controls are a system of checks and balances designed to prevent and detect fraud and errors. While most companies have these systems in place, many have never completely documented them, nor had an independent auditor attest to their effectiveness. Both of these actions are required under SOX.
- Companies find that internal control review is a costly process but badly needed. One study estimates the cost of SOX compliance for U.S. companies at over $35 billion, with audit fees doubling in the first year of compliance. At the same time, examination of internal controls indicates lingering problems in the way companies operate. One study of first compliance with the internal-control testing provisions documented material weaknesses for about 13% of companies reporting in a two-year period (*PricewaterhouseCoopers’ Global Economic Crime Survey*, 2005).
- The SOX internal control standards apply only to companies listed on U.S. exchanges. There is continuing debate over whether foreign issuers should have to comply with this extra layer of regulation.
- The accounting and internal control procedures related to cash are essentially the same under both IFRS and this textbook. In addition, the definition used for cash equivalents is the same.
- Most companies report cash and cash equivalents together under IFRS, as shown in this textbook. In addition, IFRS follows the same accounting policies related to the reporting of restricted cash.
- IFRS defines cash and cash equivalents as follows.
  - **Cash** is comprised of cash on hand and demand deposits.
  - **Cash equivalents** are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.
LOOKING TO THE FUTURE

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

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

Under proposed new standards for financial statements, companies would not be allowed to combine cash equivalents with cash.

IFRS Self-Test Questions

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

2. Which of the following is the correct accounting under IFRS for cash?
   (a) Cash cannot be combined with cash equivalents.
   (b) Restricted cash funds may be reported as a current or non-current asset depending on the circumstances.
   (c) Restricted cash funds cannot be reported as a current asset.
   (d) Cash on hand is not reported on the balance sheet as Cash.

3. The Sarbanes-Oxley Act of 2002 applies to:
   (a) all U.S. companies listed on U.S. exchanges.
   (b) all companies that list stock on any stock exchange in any country.
   (c) all European companies listed on European exchanges.
   (d) Both (a) and (c).

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

5. Cash equivalents under IFRS:
   (a) are significantly different than the cash equivalents discussed in the textbook.
   (b) are generally disclosed separately from cash.
   (c) may be required to be reported separately from cash in the future.
   (d) None of the above.

IFRS Concepts and Application

IFRS7–1 Some people argue that the internal control requirements of the Sarbanes-Oxley Act (SOX) put U.S. companies at a competitive disadvantage to companies outside the United States. Discuss the competitive implications (both pros and cons) of SOX.

IFRS7–2 State whether each of the following is true or false. For those that are false, explain why.
   (a) A proposed new financial accounting standard would not allow cash equivalents to be reported in combination with cash.
   (b) Perspectives on bribery and penalties for engaging in bribery are the same across all countries.
   (c) Cash equivalents are comprised of cash on hand and demand deposits.
   (d) SOX was created by the International Accounting Standards Board.
INTERNATIONAL FINANCIAL REPORTING PROBLEM: 

IFRS7–3  The financial statements of Zetar plc are presented in Appendix C. The company's complete annual report, including the notes to its financial statements, is available at www.zetarplc.com.

Instructions
(a) Which committee of the board of directors is responsible for considering management's reports on internal control?
(b) What are the company's key control procedures?
(c) Does the company have an internal audit department?
(d) In what section or sections does Zetar report its bank overdrafts?

Answers to IFRS Self-Test Questions
1. c  2. b  3. a  4. b  5. c