

Financial Accounting



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Sixth Edition



Chapter 06

Reporting and Analyzing Cash and Internal Controls

[Conceptual Learning Objectives]

- C1:** Define internal control and identify its purpose and principles.
- C2:** Define cash and cash equivalents and explain how to report them.

Analytical Learning Objectives

A1: Compute the days' sales uncollected ratio and use it to assess liquidity.

Procedural Learning Objectives

- P1: Apply internal control to cash receipts and disbursements.
- P2: Explain and record petty cash fund transactions.
- P3: Prepare a bank reconciliation.
- P4: **Appendix 6A** – Describe the use of documentation and verification to control cash disbursements (see text for details).
- P5: **Appendix 6B** – Apply the net method to control purchase discounts (see text for details).

Purpose of Internal Control

Managers use policies and procedures to:

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



The Sarbanes-Oxley Act

The Sarbanes-Oxley Act, also known as SOX, requires management and auditors of publicly held companies to adhere to or perform specific requirements, such as:

1. Evaluation of internal controls.
2. Oversight of the Auditor's work by the Public Company Accounting Oversight Board (PCAOB).
3. Restriction on consulting services performed by auditors.
4. Term limits on person leading the audit.
5. Harsh penalties for violators, including prison time with severe fines.

Principles of Internal Control

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

Technology and Internal Control

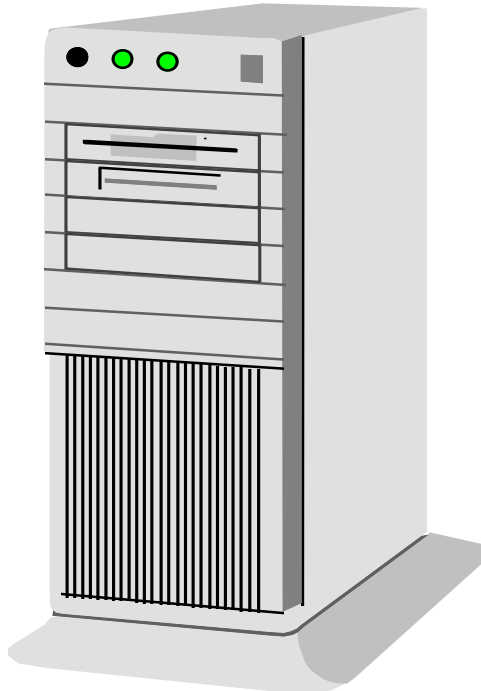
C1

**Reduced
Processing
Errors**

**More
Extensive Testing
of Records**

**Limited
Evidence of
Processing**

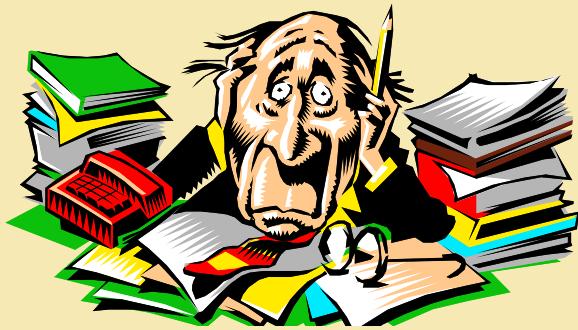
**Crucial
Separation of
Duties**



**Increased
E-commerce**

Limitations of Internal Control

Human Error



Negligence
Fatigue
Misjudgment
Confusion

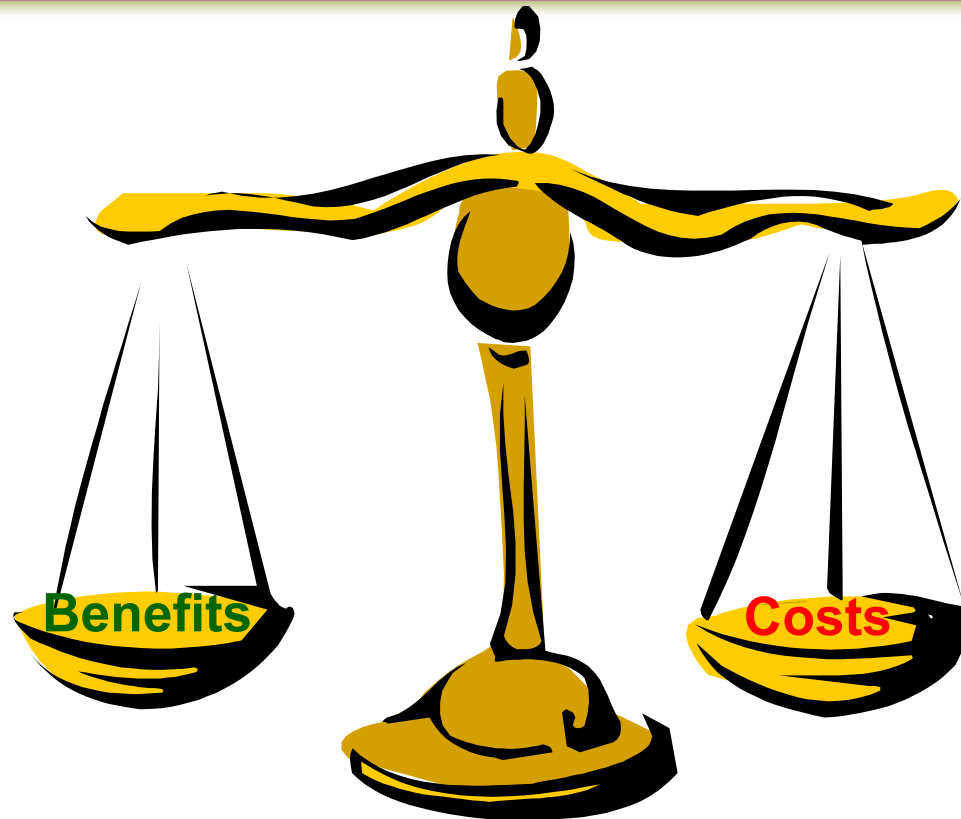
Human Fraud

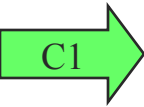


Intent to
defeat internal
controls for
personal gain

Limitations of Internal Control

The costs of internal controls must not exceed their benefits.





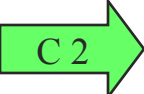
Control of Cash

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

Handling cash is separate from recordkeeping of cash.

Cash receipts are promptly deposited in a bank.

Cash disbursements are made by check.



Cash, Cash Equivalents, and Liquidity

Cash

Currency, coins, and amounts on deposit in bank accounts, checking accounts, and many savings accounts. Also includes items such as customer checks, cashier checks, certified checks, and money orders.

Cash Equivalents

Short-term, highly liquid investments that are:

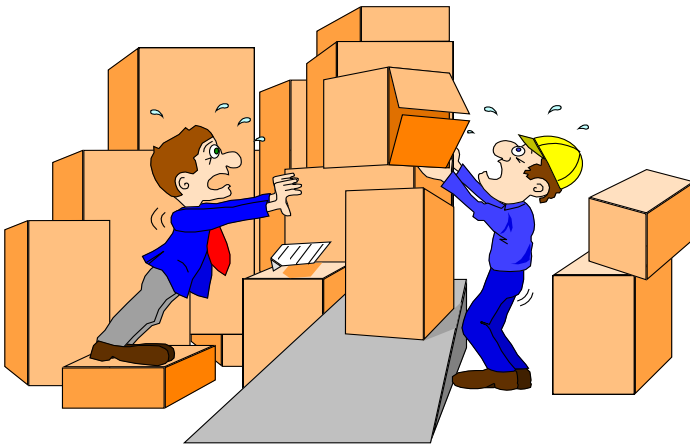
1. Readily convertible to a known cash amount.
2. Close to maturity date and not sensitive to interest rate changes.

Cash, Cash Equivalents, and Liquidity

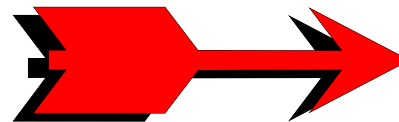
C2

Liquidity

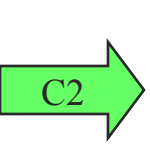
How easily an asset can be converted into cash to be used to pay for services or obligations.



Inventory



Cash



Cash Management Principles

When companies fail, one of the most common causes is their inability to manage cash. The goals of cash management are twofold:

- Plan cash receipts to meet cash payments when due.
- Keep the minimum level of cash necessary to operate.



Control of Cash Receipts

Over-the-Counter Cash Receipts

- *Cash register with locked-in record of transactions.*
- *Compare cash register record with cash reported.*

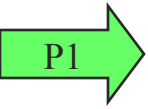
Cash Receipts By Mail

- *Two people open the mail.*
 - ✓ *Money to cashier's office.*
 - ✓ *List to accounting dept.*
 - ✓ *Copy of list filed.*

Control of Cash Disbursements

- All expenditures should be made by check. The only exception is for small payments from petty cash.
- Separate authorization for check signing and recordkeeping duties.
- Use a voucher system.

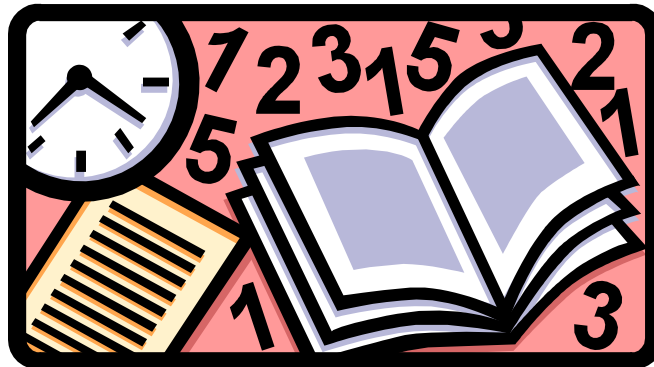




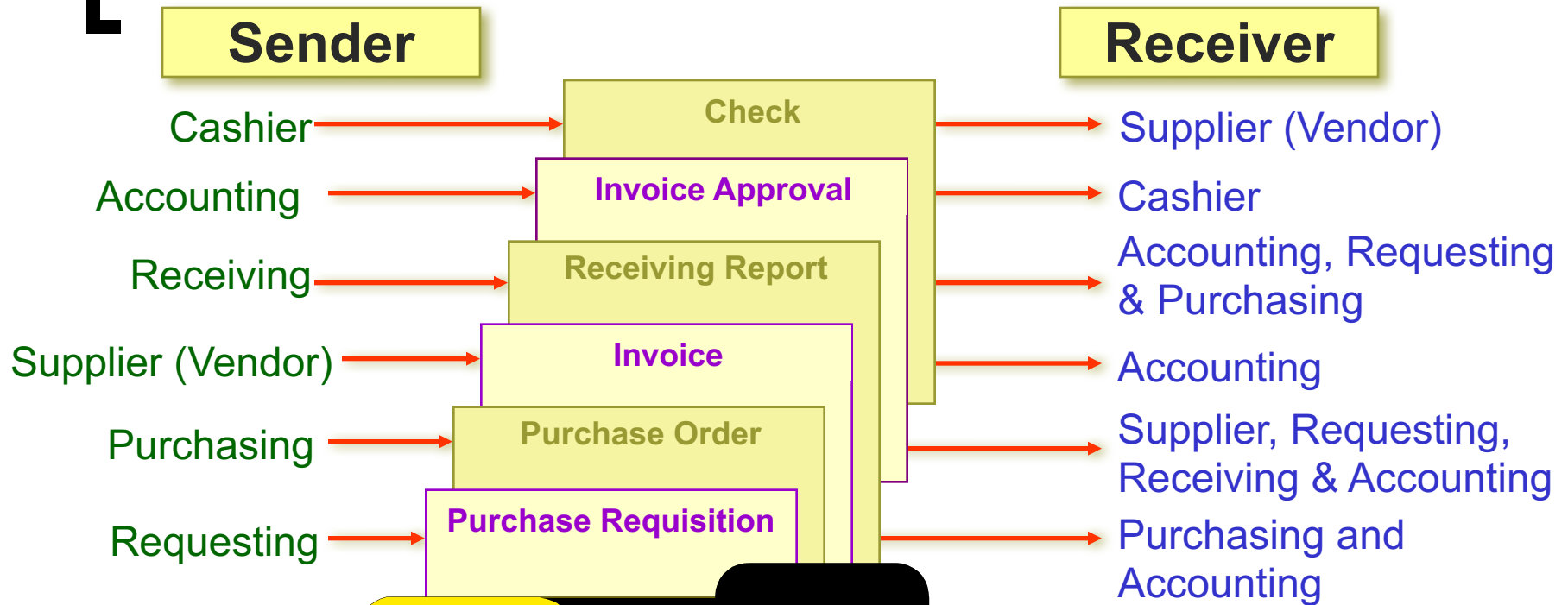
Voucher System of Control

A voucher system establishes procedures for:

- Verifying, approving, and recording obligations for eventual cash disbursements.
- Issuing checks for payment of verified, approved, and recorded obligations.

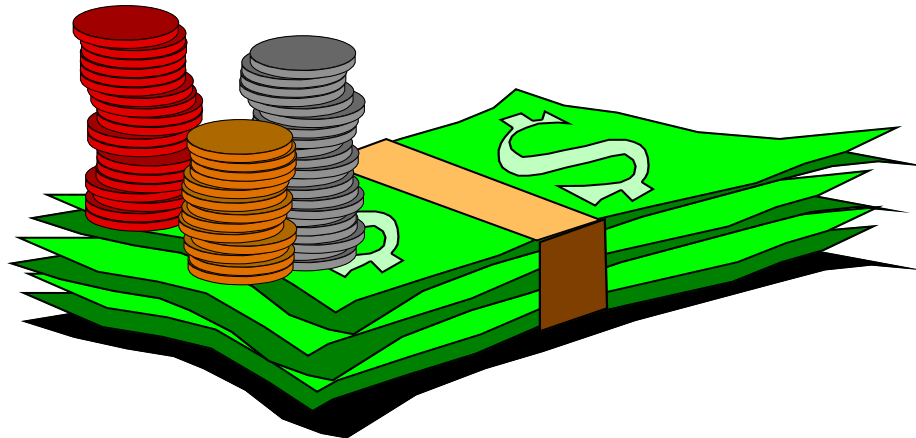


Voucher System of Control



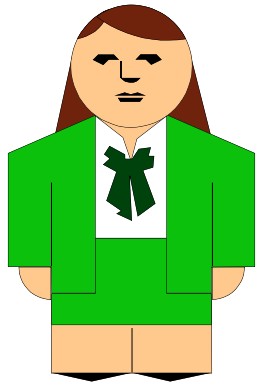
Petty Cash System of Control

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

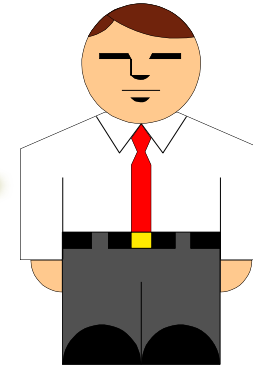


Operating a Petty Cash Fund

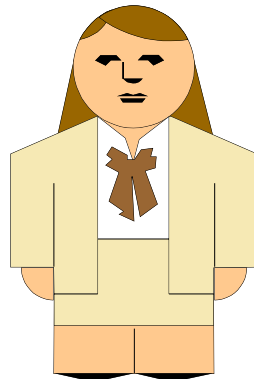
P2



**Company
Cashier**



**Petty
Cashier**

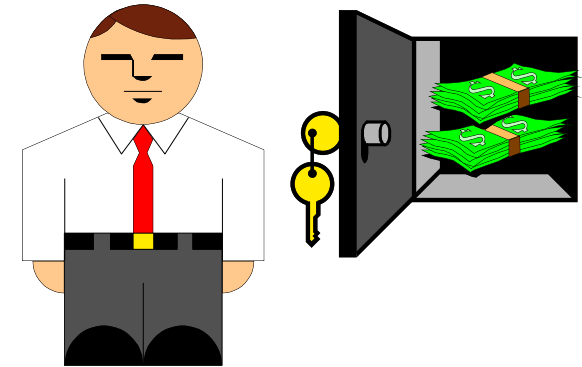


Accountant

May 1	Petty cash	400	
	Cash		400

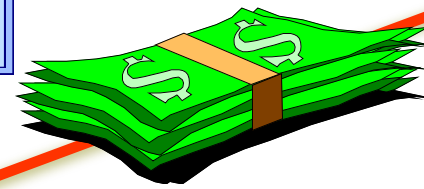
Operating a Petty Cash Fund

P2



Petty Cashier

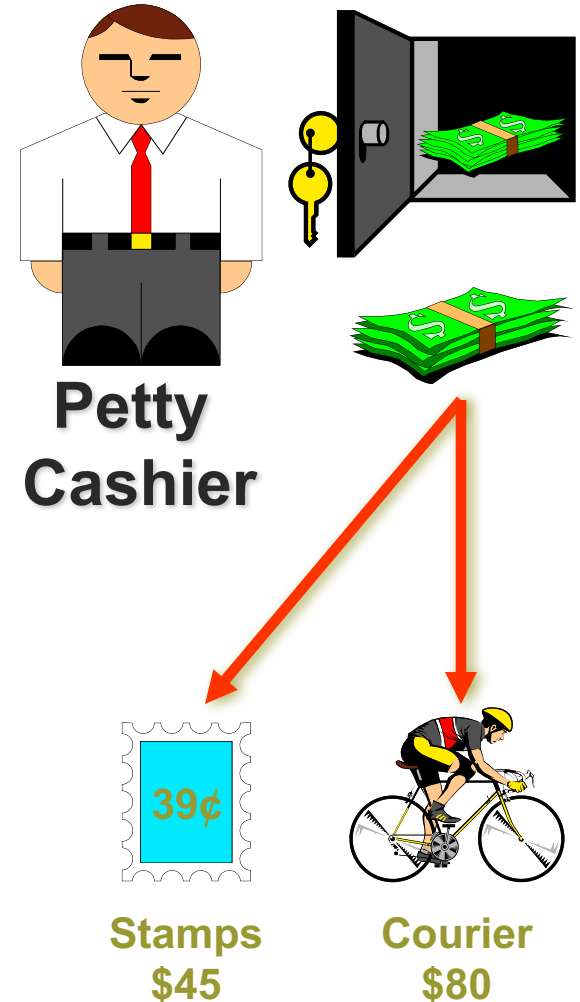
BOB JONES	DATE _____	2048
PAY TO THE ORDER OF Petty Cash	\$ _____	DOLLARS
FIRST NATIONAL BANK		
⑆00 2100 66⑆ 770⑆ 964076⑆ 212⑆		



Operating a Petty Cash Fund

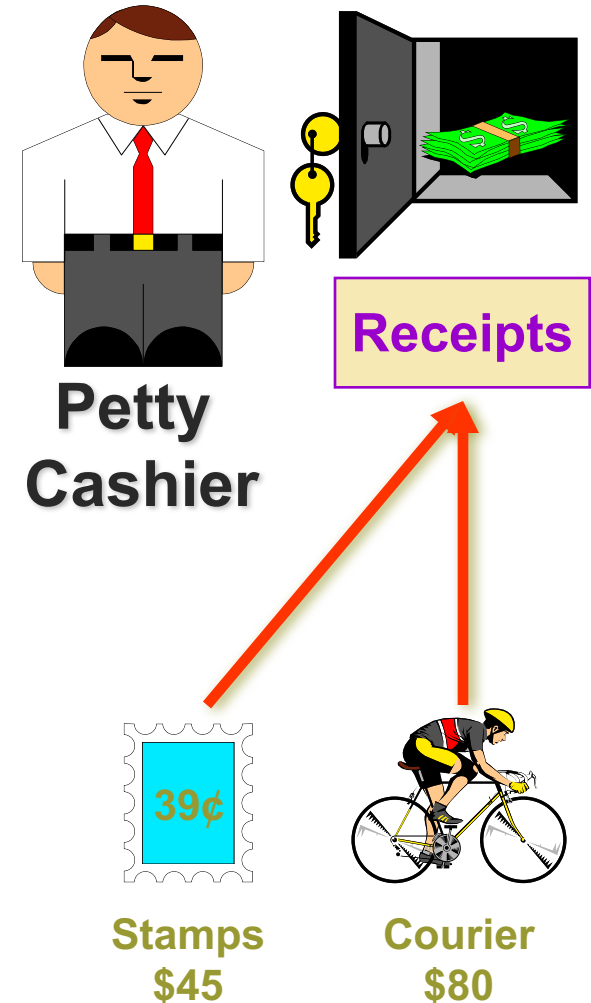
P2

A petty cash fund is used only for business expenses.



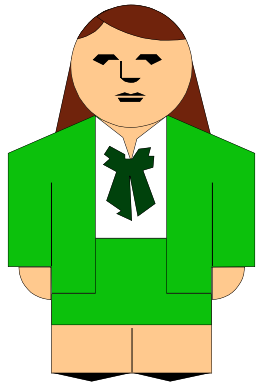
Operating a Petty Cash Fund

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



Operating a Petty Cash Fund

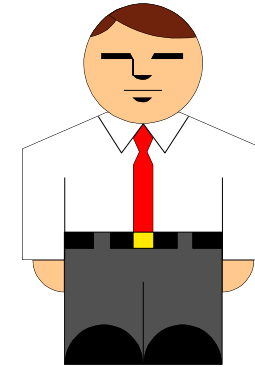
P2



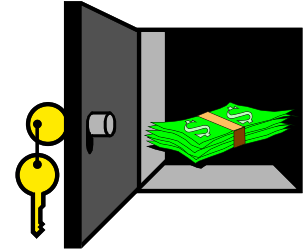
Company Cashier



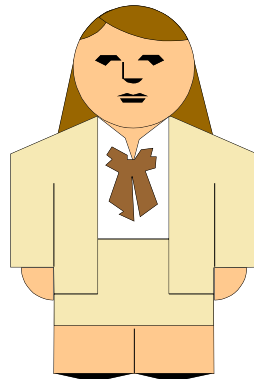
To reimburse
petty cash fund



Petty Cashier



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



Accountant

May 31	Postage expense	45	
	Delivery expense	80	
	Cash		125

Petty Cash Example

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

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

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



Petty Cash Example

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

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

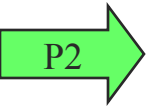
Petty Cash Example

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

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

Desired balance	\$400.00
Actual balance	137.80
Amount needed	<u>\$262.20</u>

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



Petty Cash Example

Journal entry to replenish petty cash fund

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

P1

Banking Activities as Controls

Bank Accounts

Signature Cards

Deposit Tickets



Checks

Electronic
Funds
Transfer

Bank
Statements

Bank Reconciliation

A bank reconciliation is prepared periodically to explain the difference between cash reported on the bank statement and the cash balance on company's books.

Bank Statement

First National Bank
Nashville, TN 37459

May 31, 2011

Clothes Mart
Nashville, TN

Acct No 278609

Previous Balance	Total Checks	Total Deposits	Current Balance
1488.79	1,367.09	2,604.22	2,725.92
5/1	107	55.00	
5/2			1,251.88
5/4	108	279.50	
5/7	109	44.75	
5/9	110	21.81	
5/12	111	37.55	
5/15			825.04
5/18	112	175.98	
5/21	113	288.31	
5/27	114	12.54	
5/30			527.30
5/31	115	451.65	

Why are the balances different?

GENERAL LEDGER

Account: **Cash**

Acct. No.

102

					Balance	
Date		Item	PR	Debit	Credit	DR (CR)
May	31	Balance				2,481.18

Reconciling Items

P3

Bank Statement Balance

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

Book Balance

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

Bank Reconciliation

Two sections:

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

The adjusted balances should be equal.



Bank Reconciliation Example

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

- The July 31 bank statement indicated a balance of \$9,610.
- The cash general ledger account on that date shows a balance of \$7,430.

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

Bank Reconciliation Example

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

Bank Reconciliation Example

Simmons Company Bank Reconciliation July 31, 2011

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

Adjusting Entries from a Bank Reconciliation

P3

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

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

Adjusting Entries from a Bank Reconciliation

P3

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

GENERAL LEDGER

Account: **Cash**

Acct. No.

101

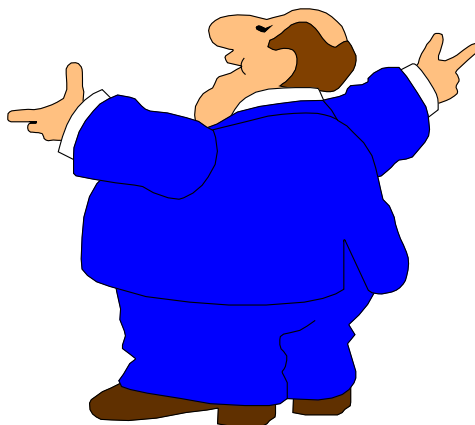
					Balance
Date	Item	PR	Debit	Credit	DR (CR)
July 31	Balance				7,430
31	Adjusting entry		30		7,460
31	Adjusting entry			253	7,207

Adjusted balance on July 31.

Days' Sales Uncollected

How much time is likely to pass before we receive cash receipts from credit sales?

$$\text{Days' sales uncollected} = \frac{\text{Accounts receivable}}{\text{Net sales}} \times 365$$



End of Chapter 06

