

7

Internal Control and Cash



Where Did the Cash Go?

Andrew Goard, chief financial officer of a sports-themed restaurant located in Brentwood, California, stared at the bank statement on his desk. The business recently experienced record-breaking revenue due to increased customer traffic and expanded menu and drink offerings. Andrew knew that the expenses of the business had also increased, but he had expected the cash in the business's checking account to increase, not decrease, as the bank statement was showing.

Andrew wondered if it was possible that one of his employees was stealing money from the cash register. He really liked all of his employees and didn't think that any of them would steal



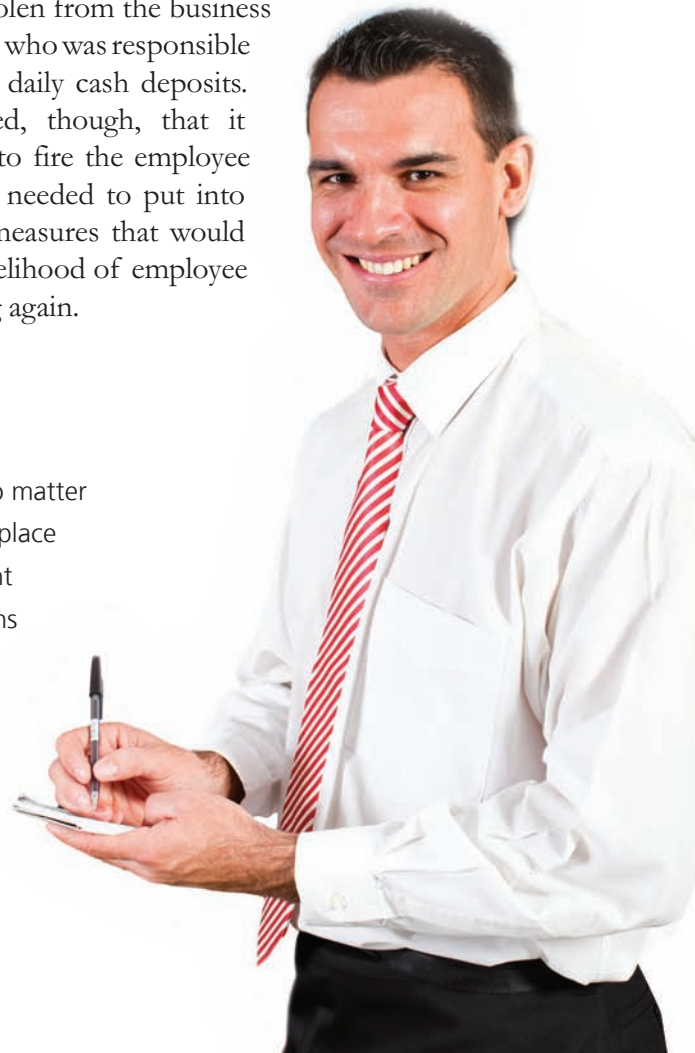
from the business. But the deposits on the bank statement from customer sales just didn't make sense. Given the

increased sales, the cash deposits should have been much higher.

Andrew knew that it was his responsibility to ensure that procedures were put into place to be sure the cash and other assets of the business remained secure. He had thought that completing employee background checks was enough to prevent the theft of the business's assets, but he now suspected that further controls needed to be put into place. Andrew began by reviewing the bank statement and comparing it to the cash records on hand. In doing this, he identified that cash was indeed being stolen from the business by the employee who was responsible for making the daily cash deposits. Andrew realized, though, that it wasn't enough to fire the employee responsible; he needed to put into place security measures that would decrease the likelihood of employee theft happening again.

What Are Internal Controls?

Safeguarding and securing assets should be a concern of all businesses—no matter how small or large the business is. The procedures that businesses put into place to protect their assets are called *internal controls* and are a key management responsibility. For example, **Buffalo Wild Wings, Inc.**, a company that owns and operates Buffalo Wild Wings, R Taco, and PizzaRev restaurants, must assure its investors that proper controls have been put into place to protect its assets, promote operational efficiency, and ensure accurate and reliable accounting records. In this chapter, we look at the policies and procedures that companies such as Buffalo Wild Wings use to fulfill this responsibility.





Chapter 7 Learning Objectives



- | | |
|--|--|
| <ol style="list-style-type: none"> 1 Define internal control and describe the components of internal control and control procedures 2 Apply internal controls to cash receipts 3 Apply internal controls to cash payments 4 Explain and journalize petty cash transactions | <ol style="list-style-type: none"> 5 Explain and journalize credit card sales 6 Demonstrate the use of a bank account as a control device and prepare a bank reconciliation and related journal entries 7 Use the cash ratio to evaluate business performance |
|--|--|

WHAT IS INTERNAL CONTROL, AND HOW CAN IT BE USED TO PROTECT A COMPANY'S ASSETS?

A key responsibility of a business manager is to control operations. Owners set goals, hire managers to lead the way, and hire employees to carry out the business plan. **Internal control** is the organizational plan and all the related measures designed to accomplish the following:

1. **Safeguard assets.** A company must protect its assets; otherwise it is throwing away resources. If you fail to safeguard cash, the most liquid of assets, it will quickly slip away.
2. **Encourage employees to follow company policies.** Everyone in an organization needs to work toward the same goals. It is important for a business to identify policies to help meet the company's goals. These policies are also important for the company to ensure that all customers are treated similarly and that results can be measured effectively.
3. **Promote operational efficiency.** Businesses cannot afford to waste resources. Businesses work hard to make sales and do not want to waste any of the benefits. Promoting operational efficiency reduces expenses and increases business profits.
4. **Ensure accurate, reliable accounting records.** Accurate, reliable accounting records are essential. Without reliable records, managers cannot tell which part of the business is profitable and which part needs improvement. A business could be losing money on every product sold and not realize it—unless it keeps accurate and reliable records.

Internal Control and the Sarbanes-Oxley Act

Internal controls are critical for all companies. Several organizations and laws have helped shape the way companies carry out internal controls. The **Committee of Sponsoring Organizations (COSO)**, for example, provides thought leadership related to enterprise risk management, internal control, and fraud deterrence. COSO's mission is to develop frameworks and guidance to help companies improve their internal controls and reduce fraud in organizations. **Public companies**—one that sells its stock to the general public—are required by the U. S. Congress to maintain a system of internal controls.

The Enron Corporation and WorldCom accounting scandals rocked the United States in the early years of this millennium. Enron overstated profits and went out of business almost overnight. WorldCom reported expenses as assets and overstated both profits and assets. The same accounting firm, Arthur Andersen LLP, had audited both companies' financial statements. Arthur Andersen voluntarily closed its doors in 2002 after nearly 90 years in public accounting.

Learning Objective 1

Define internal control and describe the components of internal control and control procedures

Internal Control

The organizational plan and all the related measures adopted by an entity to safeguard assets, encourage employees to follow company policies, promote operational efficiency, and ensure accurate and reliable accounting records.

Committee of Sponsoring Organizations (COSO)

A committee that provides thought leadership related to enterprise risk management, internal control, and fraud deterrence.

Public Company

A company that sells its stock to the general public.



Sarbanes-Oxley Act (SOX)

Requires companies to review internal control and take responsibility for the accuracy and completeness of their financial reports.

Internal Control Report

A report by management describing its responsibility for and the adequacy of internal controls over financial reporting.



To be IFRS compliant, foreign companies are not required to have their internal controls audited by outside auditors. While all companies have internal controls, foreign companies do not have the added expense of an audit of their internal controls. On the other hand, readers of the financial reports of foreign companies have no assurance that the controls are effective.

As the scandals unfolded, many people asked, “How could this happen? Where were the auditors?” To address public concern, Congress passed the **Sarbanes-Oxley Act**, abbreviated as **SOX**. This act requires companies to review internal control and take responsibility for the accuracy and completeness of their financial reports. SOX revamped corporate governance in the United States and affected the accounting profession. Here are some of the SOX provisions:

1. Public companies must issue an **internal control report**, which is a report by management describing its responsibility for and the adequacy of internal controls over financial reporting. Additionally, an outside auditor must evaluate the client’s internal controls and report on the internal controls as part of the audit report.
2. A new body, the Public Company Accounting Oversight Board (PCAOB), oversees the work of auditors of public companies.
3. Accounting firms are not allowed to audit a public company and also provide certain consulting services for the same client.
4. Stiff penalties await violators—25 years in prison for securities fraud and 20 years for an executive making false sworn statements.

The Sarbanes-Oxley Act changed the rules for auditors, limiting what services they can perform in addition to the audit and requiring a report on the internal controls of each public company audited. How does a business achieve good internal control? The next section identifies the components of internal control.

The Components of Internal Control

A business can achieve its internal control objectives by addressing the five components listed below:

- Control procedures
- Risk assessment
- Information system
- Monitoring of controls
- Environment

You can remember the five components of internal control by using the acronym CRIME.

Control Procedures

Control procedures are designed to ensure that the business’s goals are achieved. The next section, “Internal Control Procedures,” discusses the procedures in greater detail.

Risk Assessment

A company must identify its risks. For example, food manufacturers face the risk that their food products may harm people; airplane carrier businesses face the possibility that planes may crash; music companies face copyright infringement risks; and all companies face the risk of bankruptcy. Companies facing difficulties might be tempted to falsify their financial statements to make themselves look better than they really are. As part of the internal control system, the company’s business risk, as well as the risk concerning individual accounts, must be assessed. The higher the risk, the more controls a company must put in place to safeguard its assets and accounting records.

Information System

As we have seen, the information system is critical. Controls must be in place within the information system to ensure that only authorized users have access to various parts of the accounting information system. Additionally, controls must be in place to ensure adequate



approvals for recorded transactions are required. The decision makers need accurate information to keep track of assets and measure profits and losses.

Monitoring of Controls

Companies hire auditors to monitor their controls. An **internal auditor** is an employee of the business who ensures that the company's employees are following company policies and that operations are running efficiently. Internal auditors also determine whether the company is following legal requirements for internal controls to safeguard assets. An **external auditor** is an outside accountant who is completely independent of the business. External auditors evaluate the controls to ensure that the financial statements are presented fairly, in accordance with Generally Accepted Accounting Principles (GAAP).

Environment

The environment is the “tone at the top” or the culture of the business. It starts with the CFO or CEO and the top managers. They must behave honorably to set a good example for company employees. Each must demonstrate the importance of internal controls if he or she expects the employees to take the controls seriously.

Internal Control Procedures

Whether the business is a small business that generates less than \$10,000 in annual sales or a large business generating \$10 billion in annual sales, all companies need the following internal control procedures:

Competent, Reliable, and Ethical Personnel

Employees should be competent, reliable, and ethical. Paying good salaries will attract high-quality employees. Employees should also be trained to do the job, and their work should be adequately supervised.

Assignment of Responsibilities

In a business with good internal controls, no duty is overlooked. Each employee has certain, carefully defined responsibilities. For example, in a large company, the person in charge of signing checks is called the *treasurer*. The chief accounting officer is called the *controller*. Even an entry-level bookkeeper, whose job includes recording accounting transactions accurately, has clear responsibilities. This assignment of responsibilities creates job accountability, thus ensuring all important tasks get done.

Separation of Duties

Smart management policies divide responsibilities between two or more people. **Separation of duties** limits fraud and promotes the accuracy of the accounting records. Separation of duties can be divided into two parts:

1. **Separating operations from accounting.** Accounting should be completely separate from the operating departments, such as production and sales. What would happen if sales personnel recorded the company's revenue? Sales figures could be inflated, and then top managers would not know how much the company actually sold.
2. **Separating the custody of assets from accounting.** Accountants must not handle cash, and cashiers must not have access to the accounting records. If one employee has both duties, that employee could steal cash and conceal the theft in the accounting records. The treasurer of a company handles cash, and the controller accounts for the cash. Neither person has both responsibilities. This control applies to all assets, not just cash.

Internal Auditor

An employee of the business who ensures the company's employees are following company policies, that the company meets all legal requirements, and that operations are running efficiently.

External Auditor

An outside accountant, completely independent of the business, who evaluates the controls to ensure that the financial statements are presented fairly in accordance with GAAP.

Separation of Duties

Dividing responsibilities between two or more people to limit fraud and promote accuracy of accounting records.



Audits

To assess the adequacy and accuracy of their accounting records, most companies perform both internal and external audits. Remember that an audit is an examination of a company's financial statements and accounting system by a trained accounting professional called an *auditor*. Internal audits are performed by employees of the company. External audits are performed by independent auditors who are not employees of the company.

To evaluate the accounting system, auditors must examine the internal controls and test them to ensure the controls are working properly. For example, a control might require authorization by a manager for payments more than \$50. An auditor would check a sample of payments greater than \$50 to determine whether all payments were properly authorized by a manager.

Documents

Documents provide the details of business transactions and include invoices and orders, which may be paper or electronic. Documents should be prenumbered to prevent theft and inefficiency. A gap in the numbered sequence draws attention.

For example, for Smart Touch Learning, a key document is the sales invoice. The manager can compare the total cash sales on the invoices with the amount of cash received and deposited into the bank account.

Electronic Devices

Accounting systems are relying less on paper documents and more on electronic documents and digital storage devices. For example, retailers control inventory by attaching an electronic sensor to merchandise. The cashier removes the sensor after a sale is made. If a customer tries to leave the store with the sensor attached, an alarm sounds. Devices such as these can significantly reduce theft.

E-Commerce

E-commerce creates its own unique types of risks. Hackers may gain access to confidential information, such as account numbers and passwords, or introduce computer viruses, Trojans, or phishing expeditions. To address the risks posed by e-commerce, companies have devised a number of security measures. One technique for protecting customer data is encryption.

Encryption rearranges plain-text messages by a mathematical process. The encrypted message cannot be read by those who do not know the code. An accounting encryption example uses check-sum digits for account numbers. Each account number has its last digit equal to the sum of the previous digits. For example, consider customer number 2237, where $2 + 2 + 3 = 7$. Any account number failing this test triggers an error message.

Another technique for protecting data is firewalls. **Firewalls** limit access into a local network. Members can access the network, but nonmembers cannot. Usually several firewalls are built into the system. At the point of entry, additional security measures, such as passwords, PINs (personal identification numbers), and signatures are used. For additional security, more sophisticated firewalls are used deeper in the network to protect more sensitive data.

Encryption

Rearranging plain-text messages by a mathematical process—the primary method of achieving security in e-commerce.

Firewall

A device that enables members of a local network to access the network, while keeping nonmembers out of the network.



DECISIONS

What e-commerce internal controls should be put into place?

Jason Kane works as an information technology auditor for Netproducts, a retailer that sells merchandise over the Internet. Jason has been assigned the responsibility of reviewing the existing procedures and suggesting internal controls that could best protect the company. Netproducts sells all its merchandise over the Internet and accepts only credit card payments. Netproducts tracks trend information about its sales and maintains all customer, product, and pricing information on the company's intranet. In addition, Netproducts keeps employee information such as annual leave, payroll deposits, and Social Security numbers on its intranet. What e-commerce controls should Jason suggest?

Solution

Jason should suggest that specific controls be put into place, such as using encryption technology and firewalls, to protect customer and employee information. He should recommend that customers be required to create an online account with a password for the site and that the company only use secured Internet networks. In addition, Netproducts should ensure that the customer and employee data are physically secured and that access to the data can be obtained only by authorized individuals.

Other Controls

The types of other controls are as endless as the types of businesses that employ them. Some examples of other common controls include the following:

- Fireproof vaults to store important documents
- Burglar alarms, fire alarms, and security cameras
- Loss-prevention specialists who train company employees to spot suspicious activity
- Fidelity bonds to reimburse the company for any losses due to employee theft
- Mandatory vacations and job rotation

The Limitations of Internal Control—Costs and Benefits

Unfortunately, most internal controls can be overcome. **Collusion**—two or more people working together—can beat internal controls. For example, consider the following scenario with Galaxy Theater. Ralph and Lana, employees of Galaxy Theater, can design a scheme in which Ralph, the ticket seller, sells tickets and pockets the cash from 10 customers. Lana, the ticket taker, admits 10 customers to the theater without taking their tickets. Ralph and Lana split the cash. Ralph and Lana have colluded to circumvent controls, resulting in Galaxy Theater losing revenues. To prevent this situation, the manager must take additional steps, such as matching the number of people in the theater against the number of ticket stubs retained, which takes time away from the manager's other duties. It is difficult and costly to plan controls that can prevent collusion.

The stricter the internal control system, the more it costs. A complex system of internal control can strangle the business with red tape. How tight should the controls be? Internal controls must always be judged in light of their costs versus their benefits. Following is an example of a positive cost–benefit relationship: A security guard at a retail store costs about \$28,000 a year. On average, each guard prevents about \$50,000 of theft each year. The net savings to the retail store is \$22,000. An example of a negative cost–benefit relationship would be paying the same security guard \$28,000 a year to guard a \$1,000 cash drawer. The cost exceeds the benefit by \$27,000.

So far we have discussed what internal control is and how it can be used to protect a company's assets. We will now spend the remainder of the chapter concentrating on cash because it is the asset most likely to be stolen. However, it is important to remember that internal controls should be applied to all assets, not just cash.

Collusion

Two or more people working together to circumvent internal controls and defraud a company.



Try It!

Match the accounting terminology to the definitions.

- | | |
|-------------------------|--|
| 1. Sarbanes-Oxley Act | a. Organizational plan and all the related measures adopted by an entity to safeguard assets, encourage employees to follow company policies, promote operational efficiency, and ensure accurate and reliable accounting records. |
| 2. Internal control | b. Employees of the business who ensure that the company's employees are following company policies and meeting legal requirements and that operations are running efficiently. |
| 3. Encryption | c. Rearranging plain-text messages by a mathematical process—the primary method of achieving security in e-commerce. |
| 4. Separation of duties | d. Requires companies to review internal control and take responsibility for the accuracy and completeness of their financial reports. |
| 5. Internal auditors | e. Dividing responsibilities between two or more people. |

Check your answers online in MyAccountingLab or at <http://www.pearsonhighered.com/Horngren>.

For more practice, see Short Exercise 57-1. [MyAccountingLab](#)

WHAT ARE THE INTERNAL CONTROL PROCEDURES WITH RESPECT TO CASH RECEIPTS?

Learning Objective 2

Apply internal controls to cash receipts

Cash receipts occur primarily when a business sells merchandise or services. All cash receipts should be deposited in the bank for safekeeping shortly after the cash is received. Companies receive cash either over the counter, through the mail, or by electronic funds transfer. Each source of cash has its own security measures. We have already discussed internal control procedures for e-commerce, so this section focuses on over-the-counter and mailed cash receipts.

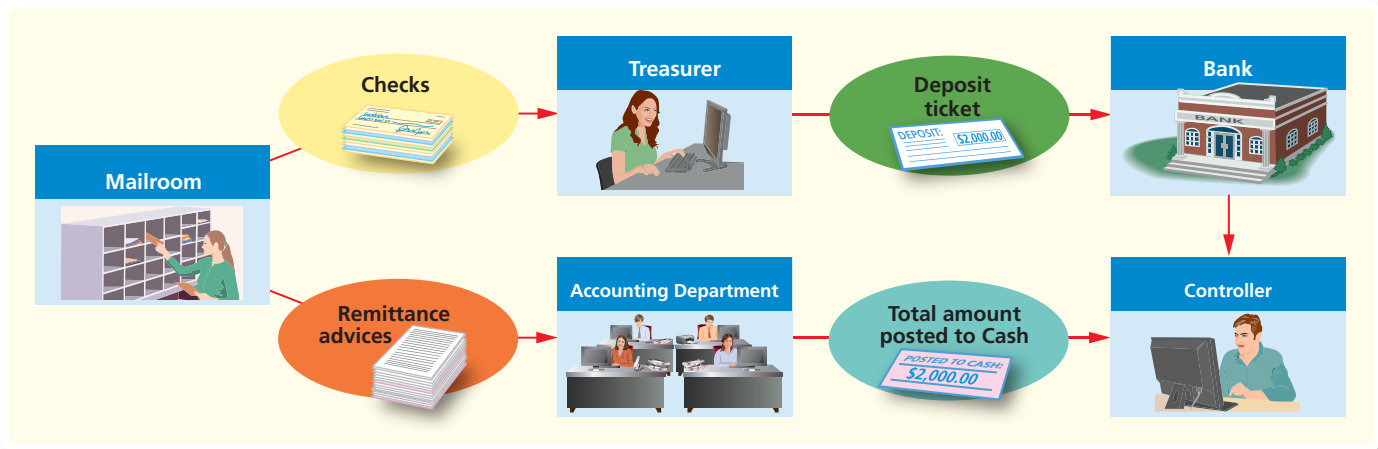
Cash Receipts Over the Counter

A cash receipt over the counter in a store involves a point-of-sale terminal (cash register) that provides control over the cash receipts. Consider a retail store. For each transaction, the retail store issues a receipt to ensure that each sale is recorded. The cash drawer opens after the clerk enters a transaction, and the machine (cash register) records it. At the end of the day, a manager proves the cash by comparing the cash in the drawer against the machine's record of cash sales. This step helps prevent theft by the clerk.

At the end of the day—or several times a day if business is brisk—the manager deposits the cash in the bank. The machine tape then goes to the accounting department to record the journal entry for cash receipts and sales revenue. These measures, coupled with oversight by a manager, discourage theft.

Cash Receipts by Mail

Many companies receive checks by mail for payments of services or merchandise. Checks sent via mail are considered to be cash receipts. Exhibit 7-1 shows how companies control cash received by mail.


Exhibit 7-1 | Cash Receipts by Mail


The process works like this:

Step 1: All incoming mail is opened by a mailroom employee. The mailroom then sends all customer checks to the treasurer and all remittance advices to the accounting department. A **remittance advice** is an optional attachment to a check that tells the business the reason for the payment.

Step 2: The treasurer has the cashier deposit the checks in the bank. The cashier receives a deposit receipt.

Step 3: The accounting department (or bookkeeper) uses the remittance advices to record the journal entries to Cash and customer accounts.

Step 4: As a final control, the controller compares the following records for the day:

- Bank deposit amount from the treasurer
- Debit to Cash from the accounting department

The debit to Cash should equal the amount deposited in the bank. If it does, all cash receipts are safe in the bank, and the company's books are up to date.

Many companies use a **lock-box system** as an alternative to accepting cash or checks via the mail or over the counter. In a lock-box system, customers send their checks directly to a post office box that belongs to a bank. A bank employee empties the box daily and records the deposits into the company's bank account. Internal control is tight because company personnel never touch incoming cash. The lock-box system puts a business's cash into the company's bank account quickly.

Remittance Advice

An optional attachment to a check that tells the business the reason for the payment.

Lock-Box System

A system in which customers send their checks to a post office box that belongs to a bank. A bank employee empties the box daily and records the deposits into the company's bank account.

Try It!

6. Fill in the missing information concerning how companies control cash received by mail.
 - a. The _____ opens the mail and sends customer checks to the treasurer.
 - b. The _____ deposits the customer checks in the bank.
 - c. The _____ uses the remittance advices to record the journal entries for cash receipts.
 - d. The _____ compares the bank deposit to the journal entry for cash receipts.

Check your answers online in MyAccountingLab or at <http://www.pearsonhighered.com/Horngren>.



Learning Objective 3

Apply internal controls to cash payments

WHAT ARE THE INTERNAL CONTROL PROCEDURES WITH RESPECT TO CASH PAYMENTS?

Companies make many payments by check. They also pay small amounts from a petty cash fund, which is discussed later in the chapter. Let's begin by discussing cash payments by check.

Controls Over Payment by Check

Companies need a good separation of duties between the operations of the business and writing checks for cash payments. Payment by check is an important internal control for the following reasons:

- The check provides a record of the payment.
- The check must be signed by an authorized official.
- Before signing the check, the official reviews the invoice or other evidence supporting the payment.

Controls Over Purchases and Payments

To illustrate the internal control over cash payments by check, suppose Smart Touch Learning buys its tablets from an electronics manufacturer. The purchasing and payment process follows these steps, as shown in Exhibit 7-2.

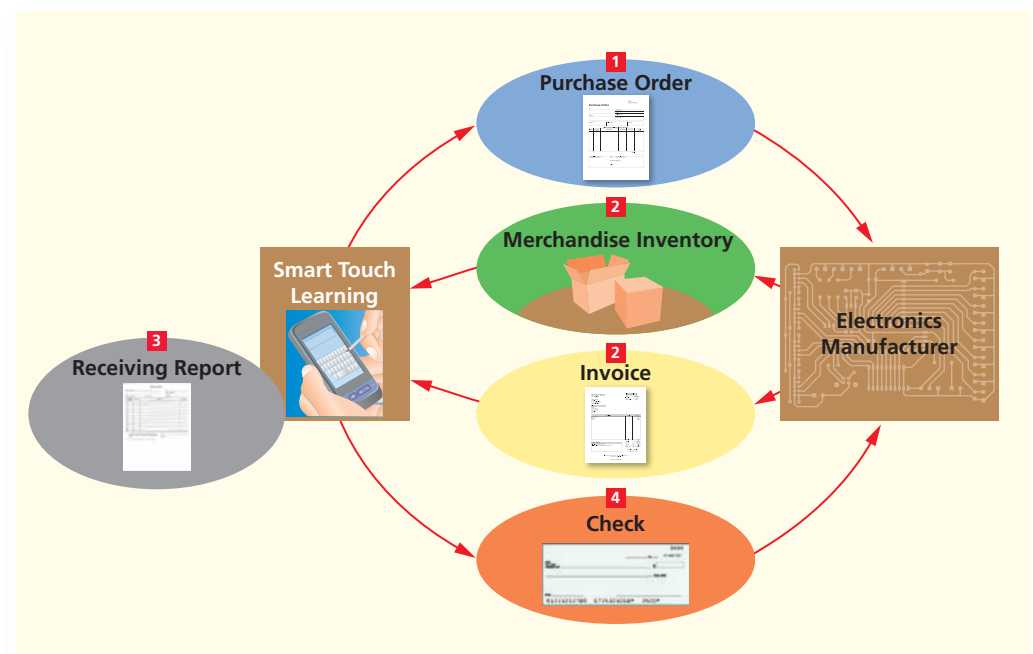
Step 1: Smart Touch Learning sends a purchase order to the electronics manufacturer that contains the quantity and type of goods needed.

Step 2: The electronics manufacturer ships the inventory and sends an invoice back to Smart Touch Learning.

Step 3: Smart Touch Learning receives the inventory and prepares a receiving report.

Step 4: After approving all documents, Smart Touch Learning sends a check to the electronics manufacturer.

Exhibit 7-2 | Cash Payments by Check



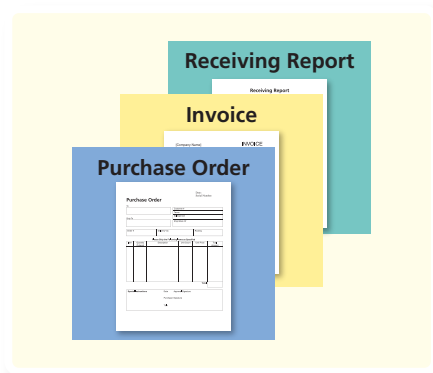


For good internal control, the purchasing agent (the employee who prepares the purchase order) should neither receive the goods nor approve the payment. If these duties are not separated, a purchasing agent could buy goods and have them shipped to his or her home. Or a purchasing agent could overpay for purchases, approve the payment, and split the excess with the supplier.

Exhibit 7-3 shows Smart Touch Learning's payment packet of documents, which may be in either electronic or paper format. Before signing the check for payment of goods, the controller or the treasurer should examine the packet to prove that all the documents agree. Only then does the company know the following:

1. It received the goods ordered.
2. It is paying only for the goods received and authorized.
3. It is paying the correct amount.

Exhibit 7-3 | Payment Packet



After payment, the payment packet is marked as paid to prevent the bill from being paid twice. Electronically paid invoices are automatically marked “paid” by most accounting systems.

Streamlined Procedures

Technology is streamlining payment procedures. **Evaluated receipts settlement (ERS)** compresses the payment approval process into a single step by comparing the receiving report to the purchase order. If those documents match, then Smart Touch Learning got the tablets it ordered and payment is made to the vendor.

An even more streamlined process bypasses paper documents altogether. In **electronic data interchange (EDI)**, a retailer's computers communicate directly with the computers of suppliers. When the retailer's inventory reaches a low level, the computer creates and sends an electronic purchase order to the supplier. The supplier then ships the inventory and electronically sends an invoice to the retailer. A manager approves the invoice, and then an electronic fund transfer (EFT) sends the retailer's payment to the supplier. These streamlined EDI procedures are used for both cash payments and cash receipts in many companies.

Evaluated Receipts Settlement (ERS)

A procedure that compresses the payment approval process into a single step by comparing the receiving report to the purchase order.

Electronic Data Interchange (EDI)

A streamlined process that bypasses paper documents altogether. Computers of customers communicate directly with the computers of suppliers to automate routine business transactions.



Try It!

7. Fill in the missing information.

- The vendor ships the inventory and sends a(n) _____ back to the purchaser.
- After approving all documents, the purchaser sends a(n) _____ to the vendor.
- When ordering merchandise inventory, the purchaser sends a(n) _____ to the vendor.
- The purchaser receives the inventory and prepares a(n) _____.

Check your answers online in MyAccountingLab or at <http://www.pearsonhighered.com/Horngren>.

For more practice, see Short Exercise S7-4. [MyAccountingLab](#)

Learning Objective 4

Explain and journalize petty cash transactions

Petty Cash

A fund containing a small amount of cash that is used to pay for minor expenditures.

HOW CAN A PETTY CASH FUND BE USED FOR INTERNAL CONTROL PURPOSES?

It is not cost effective for a business to write a check for a taxi fare or the delivery of a package across town. To meet these needs and to streamline record keeping for small cash transactions, companies keep cash on hand to pay small amounts. This fund is called **petty cash**.

We have already established that cash is the most liquid of assets. Petty cash is more liquid than cash in the bank because none of the bank controls are in place. Therefore, petty cash needs controls such as the following:

- Designate a custodian of the petty cash fund. The custodian is the individual assigned responsibility for the petty cash fund.
- Designate a specific amount of cash to be kept in the petty cash fund.
- Support all petty cash fund payments with a petty cash ticket. These tickets are sequentially numbered. The petty cash ticket serves as an authorization voucher and explanation.

Setting Up the Petty Cash Fund

The petty cash fund is opened when the company writes a check for the designated amount. The company makes the check payable to Petty Cash. Suppose on August 1, Smart Touch Learning creates a petty cash fund of \$200. The custodian cashes the \$200 check and places the currency in the fund box. The journal entry is as follows:

$$\begin{array}{c} \text{A} \updownarrow \\ \text{Petty Cash} \uparrow \\ \text{Cash} \downarrow \end{array} \left. \vphantom{\begin{array}{c} \text{A} \updownarrow \\ \text{Petty Cash} \uparrow \\ \text{Cash} \downarrow \end{array}} \right\} = \left\{ \begin{array}{c} \text{L} \\ + \\ \text{E} \end{array} \right.$$

Date	Accounts and Explanation	Debit	Credit
Aug. 1	Petty Cash	200	
	Cash		200
	<i>To open the petty cash fund.</i>		

For each petty cash payment, the custodian prepares a petty cash ticket like the one in Exhibit 7-4.


Exhibit 7-4 | Petty Cash Ticket

PETTY CASH TICKET		#101
Date	Aug 25, 2019	
Amount	\$60	
For	Letterhead invoices	
Debit	Office Supplies	
Received by	Lewis Wright	Fund Custodian MAR

Signatures (or initials) identify the recipient of the cash and the fund custodian. The custodian keeps the petty cash tickets in the fund box. The sum of the cash plus the total of the petty cash tickets should equal the fund balance, \$200, at all times.

Maintaining the Petty Cash account at its designated balance is the nature of an **imprest system**. The imprest system requires that, at any point in time, the petty cash box contain cash and petty cash tickets that total the amount of the imprest balance. This clearly identifies the amount of cash for which the custodian is responsible, and it is the system's main internal control feature.

Replenishing the Petty Cash Fund

Payments decrease the fund, so periodically the fund must be replenished. Suppose that on August 31, the petty cash fund holds \$118 in cash and \$80 in petty cash tickets (ticket no. 101 for \$60 for office supplies and ticket no. 102 for \$20 for a delivery).

You can see \$2 is missing:

Fund balance		\$ 200
Cash on hand	\$ 118	
Petty cash tickets	<u>80</u>	
Total accounted for		<u>198</u>
Amount of cash missing		<u>\$ 2</u>

To replenish the petty cash fund, you need to bring the cash on hand up to \$200. The company writes a check, payable to Petty Cash, for \$82 (\$200 imprest balance – \$118 cash on hand). The fund custodian cashes this check and puts \$82 back in the fund box. Now the fund box holds \$200 cash as it should.

The petty cash tickets tell you what to debit and the check amount tells you what to credit, as shown in this entry to replenish the fund:

Date	Accounts and Explanation	Debit	Credit
Aug. 31	Office Supplies	60	
	Delivery Expense	20	
	Cash Short & Over	2	
	Cash		82
	<i>To replenish the petty cash fund.</i>		

$$\begin{array}{l}
 \text{A} \downarrow \\
 \text{Office} \\
 \text{Supplies} \uparrow \\
 \text{Cash} \downarrow
 \end{array}
 \left. \vphantom{\begin{array}{l} \text{A} \downarrow \\ \text{Office} \\ \text{Supplies} \uparrow \\ \text{Cash} \downarrow \end{array}} \right\} = \left\{ \begin{array}{l} \text{L} + \\ \text{E} \downarrow \\ \text{Delivery} \\ \text{Expense} \uparrow \\ \text{Cash Short} \\ \text{\& Over} \uparrow \end{array} \right.$$



Why wasn't
Petty Cash debited
when the fund
was replenished?



Missing petty cash funds are debited to a new account, Cash Short & Over. In this case, \$2 was missing, so we debit Cash Short & Over for the missing petty cash. Another way to look at this is that we needed another \$2 debit to make the journal entry balance.

The Petty Cash account keeps its \$200 balance at all times. **The Petty Cash account is used in a journal entry only when the fund is started (see the August 1 entry) or when its amount is increased or decreased.** If the business increases the fund amount from \$200 to \$250, this would require a check to be cashed for \$50 and the debit would be to Petty Cash. **When replenishing the fund, the company debits either the associated expense incurred or the asset purchased with the funds.**

At times the sum of cash in the petty cash fund plus the tickets may exceed the fund balance. Consider the previous example. Assume the petty cash ticket no. 102 for delivery was for \$30 instead of \$20. Because we know the amount of the petty cash tickets and the amount of cash on hand, we can find out the amount of cash shortage or overage.

Fund balance		\$ 200
Cash on hand	\$ 118	
Petty cash tickets	<u>90</u>	
Total accounted for		<u>208</u>
Amount of cash overage		<u>\$ 8</u>

In this case, the cash on hand plus petty cash tickets (\$208) is more than the fund balance (\$200). A cash overage exists. The journal entry to replenish the fund would be:

$$\left. \begin{array}{l} \text{A} \downarrow \\ \text{Office} \\ \text{Supplies} \uparrow \\ \text{Cash} \downarrow \end{array} \right\} = \left\{ \begin{array}{l} \text{L} + \\ \text{E} \downarrow \\ \text{Delivery} \\ \text{Expense} \uparrow \\ \text{Cash Short} \\ \text{\& Over} \downarrow \end{array} \right.$$

Date	Accounts and Explanation	Debit	Credit
Aug. 31	Office Supplies	60	
	Delivery Expense	30	
	Cash Short & Over		8
	Cash		82
	<i>To replenish the petty cash fund.</i>		

We know the total debits are \$90 (\$60 + \$30). We know the check to replenish the fund was still \$82 (credit to Cash) because the fund balance should total \$200 and there was \$118 in the petty cash box. For this situation, we need an \$8 credit to make the journal entry balance, a gain, which is credited to Cash Short & Over.



Changing the Amount of the Petty Cash Fund

Suppose that on September 1, Smart Touch Learning decides to increase the amount of the petty cash fund from \$200 to \$300. In order to increase the fund, Smart Touch Learning must write a check for the additional \$100, cash the check, and place the additional currency in the petty cash box. Because the amount of the fund has changed, the company must record the following journal entry showing this change:

Date	Accounts and Explanation	Debit	Credit
Sep. 1	Petty Cash	100	
	Cash		100
	<i>To increase the petty cash fund.</i>		

$$\begin{array}{l} \frac{A \uparrow \downarrow}{\text{Petty Cash} \uparrow} \\ \text{Cash} \downarrow \end{array} \left. \vphantom{\begin{array}{l} \frac{A \uparrow \downarrow}{\text{Petty Cash} \uparrow} \\ \text{Cash} \downarrow \end{array}} \right\} = \left\{ \frac{L}{\quad} + \frac{E}{\quad} \right.$$

Had the Petty Cash fund been decreased, the debit would've been to Cash and the credit to the Petty Cash account. Remember that the only time the Petty Cash account is used in the journal entry is when the account is established, increased, or decreased.

Try It!

8. The following petty cash transactions of Green Golf Equipment occurred in May:

May 1 Established a petty cash fund with a \$200 balance.

31 The petty cash fund has \$18 in cash and \$180 in petty cash tickets that were issued to pay for Office Supplies (\$81), Delivery Expense (\$36), Postage Expense (\$54), and Miscellaneous Expense (\$9). The petty cash custodian replenished the fund and recorded the expenses.

Prepare the journal entries.

Check your answers online in MyAccountingLab or at <http://www.pearsonhighered.com/Horngren>.

For more practice, see Short Exercise S7-5. [MyAccountingLab](#)

HOW ARE CREDIT CARD SALES RECORDED?

In addition to receiving cash receipts from customers over the counter, most companies also accept credit cards and debit cards. By accepting credit cards and debit cards, such as Visa, MasterCard, and American Express, businesses are able to attract more customers. Credit cards offer the customer the convenience of buying something without having to pay cash immediately. Debit cards, on the other hand, reduce the customer's bank account immediately but allow the customer to pay electronically instead of with currency or by writing a check.

Learning Objective 5

Explain and journalize credit card sales



Companies hire a third-party processor to process credit and debit card transactions. Transactions are usually entered into an electronic terminal (card scanner) that the company either purchases or rents from the processor. The fees the card processor charges the company for its processing services vary depending on the type of card and the specific agreement the company has with the card processor. The processor agreement specifies how fees are paid to the processor. The following are two common methods of handling the proceeds and processing fees:

- **Net**—The total sale less the processing fee assessed equals the net amount of cash deposited by the processor, usually within a few days of the sale date.
- **Gross**—The total sale is deposited daily within a few days of the actual sale date. The processing fees for all transactions processed for the month are deducted from the company's bank account by the processor, often on the last day of the month.

Proceeds from credit and debit card transactions are usually deposited within a few business days after the sale. Therefore, credit and debit card sales are journalized similar to cash sales. For example, Smart Touch Learning sells merchandise inventory (ignore Cost of Goods Sold) to a customer for \$3,000 on August 15. The customer pays with a third-party credit card. Smart Touch Learning would record the entry, assuming the card processor assesses a 4% fee and deposits the net amount, as follows:

$$\left. \begin{array}{l} \text{A}\uparrow \\ \text{Cash}\uparrow \end{array} \right\} = \left\{ \begin{array}{l} \text{L} + \text{E}\uparrow \\ \text{Sales Revenue}\uparrow \\ \text{Credit Card Expense}\uparrow \end{array} \right.$$

Date	Accounts and Explanation	Debit	Credit
Aug. 15	Cash	2,880	
	Credit Card Expense (\$3,000 × 0.04)	120	
	Sales Revenue		3,000
	<i>Recorded credit card sales, net of fee.</i>		

The same entry, assuming the processor uses the gross method, on the sale date would be as follows:

$$\left. \begin{array}{l} \text{A}\uparrow \\ \text{Cash}\uparrow \end{array} \right\} = \left\{ \begin{array}{l} \text{L} + \text{E}\uparrow \\ \text{Sales Revenue}\uparrow \end{array} \right.$$

Date	Accounts and Explanation	Debit	Credit
Aug. 15	Cash	3,000	
	Sales Revenue		3,000
	<i>Recorded credit card sales.</i>		

At the end of August, the processor would collect the fees assessed for the month. (*Note:* We assume only the one credit card sale for this month.)

$$\left. \begin{array}{l} \text{A}\downarrow \\ \text{Cash}\downarrow \end{array} \right\} = \left\{ \begin{array}{l} \text{L} + \text{E}\downarrow \\ \text{Credit Card Expense}\uparrow \end{array} \right.$$

Date	Accounts and Explanation	Debit	Credit
Aug. 31	Credit Card Expense	120	
	Cash		120
	<i>Paid fees assessed by credit card processor.</i>		



TYING IT ALL TOGETHER

Buffalo Wild Wings, Inc. owns and operates more than 550 Buffalo Wild Wings, R Taco, and PizzaRev restaurants. The restaurant Buffalo Wild Wings features a variety of boldly-flavored, crave-able menu items including Buffalo, New York-style chicken wings in 16 signature sauces and 5 signature seasonings. R Taco is a fast casual taco concept that offers a variety of tacos at an affordable price. Lastly, PizzaRev empowers guests to craft their own custom personal pizza, using fresh ingredients and homemade pizza dough. (You can find Buffalo Wild Wings, Inc.'s annual report at <https://www.sec.gov/Archives/edgar/data/1062449/000106244916000052/bwld2015122710-k.htm>)

How does Buffalo Wild Wings, Inc. ensure the security of its credit and debit card payments?

In the notes to the financial statements, Buffalo Wild Wings, Inc. states the company maintains the highest level of Payment Card Industry (PCI) Data Security Standard compliance at its restaurants.

These standards require the company to build and maintain a secure network, protect cardholder data, use and regularly update antivirus software, implement strong access controls, regularly monitor and test networks, and maintain policies that address information security for employees.

Who is responsible for the internal controls and what could happen if the internal controls fail?

According to the notes in the financial statements, the management of Buffalo Wild Wings is responsible for establishing and maintaining effective internal control. Internal controls are meant to provide reasonable assurance regarding the reliability of financial reporting. Failure to maintain internal controls could limit the ability of the company to report accurate financial results and detect and prevent fraud. If significant enough, a failure of internal controls could cause a loss of investor confidence and a decline in market price of the company's stock.

Try It!

Phoenix Restaurants accepts credit and debit cards as forms of payment. Assume Phoenix had \$12,000 of credit and debit card sales on June 30, 2017.

9. Suppose Phoenix's processor charges a 2% fee and deposits sales net of the fee. Journalize the sale transaction for the restaurant.
10. Suppose Phoenix's processor charges a 2% fee and deposits sales using the gross method. Journalize the sale transaction for the restaurant.

Check your answers online in MyAccountingLab or at <http://www.pearsonhighered.com/Horngren>.

For more practice, see Short Exercise 57-6. [MyAccountingLab](#)

HOW CAN THE BANK ACCOUNT BE USED AS A CONTROL DEVICE?

Cash is the most liquid asset reported on the balance sheet because it is the medium of exchange. Because cash is easy to conceal and relatively easy to steal, businesses keep their cash in a bank account. The bank has established practices for safeguarding the business's money. This section identifies the most common controls applied to a bank account.

Learning Objective 6

Demonstrate the use of a bank account as a control device and prepare a bank reconciliation and related journal entries



Signature Card

A card that shows each authorized person's signature for a bank account.

Deposit Ticket

A bank form that is completed by the customer and shows the amount of each deposit.

Check

A document that instructs a bank to pay the designated person or business a specified amount of money.

Maker

The party who issues the check.

Payee

The individual or business to whom the check is paid.

Signature Card

Banks require each person authorized to sign on an account to provide a **signature card**. This helps protect against forgery because the signature card should be checked frequently by bank personnel to authenticate written checks or deposits made by the business.

Deposit Ticket

Banks supply standard forms such as a deposit ticket. Completed by the customer, the **deposit ticket** shows the amount of each deposit. As proof of the transaction, the customer receives a deposit receipt from the bank.

Check

To pay cash, the depositor writes a **check**, which is a prenumbered document that tells the bank to pay the designated party a specified amount. Exhibit 7-5 shows a check drawn by Smart Touch Learning. There are three parties to a check: the maker, payee, and bank. The **maker** is the issuer of the check, in this case, Smart Touch Learning. The **payee** (California Office Products) is the individual or business to whom the check is paid.

Exhibit 7-5 | Check with Remittance Advice

Smart Touch Learning		
Date	Description	Amount
4/21/19	paid on account	300.00

Remittance Advice

Maker: SMART TOUCH LEARNING
227 Lake Street
Pompton Plains, IL 07444

Payee: California Office Products

Amount: Three hundred and no/100 DOLLARS

Bank: VALPARAISO STATE BANK
John Sims Parkway
Pompton Plains, IL 07444

Routing Number: 071000013

Account Number: 136213733

Check Serial Number: 203

Signature: John Kolen, Treasurer
Sheena Bright, President

An easy way to remember the difference between the maker and the payee is the maker is the party who is **making** the promise that the cash is available in the bank to settle the check.

Routing Number

On a check, the 9-digit number that identifies the bank upon which the payment is drawn.

Account Number

On a check, the number that identifies the account upon which the payment is drawn.

This check has two parts, the check itself and the remittance advice. In addition, the check includes the routing number and account number. The **routing number** is a 9-digit number that identifies the bank upon which the payment is drawn. The **account number** identifies the account upon which the payment is drawn.



Bank Statement

Banks send monthly statements to customers either electronically or in the mail. A **bank statement** reports the activity in the customer's account. The statement shows the account's beginning and ending balances, cash receipts, and cash payments. Included with the statement sometimes are physical or scanned copies of the maker's **canceled checks**, the checks written by the maker that have been cashed (paid) by the bank. Exhibit 7-6 is the April 30, 2019, bank statement of Smart Touch Learning.

Bank Statement

A document from the bank that reports the activity in the customer's account. It shows the bank account's beginning and ending balances and lists the month's cash transactions conducted through the bank account.

Canceled Checks

Physical or scanned copies of the maker's cashed (paid) checks.

Exhibit 7-6 | Bank Statement

BEGINNING BALANCE		TOTAL DEPOSITS		TOTAL WITHDRAWALS		SERVICE CHARGES		ENDING BALANCE	
\$12,470		27,080		26,810		20		\$12,720	

TRANSACTIONS					
DEPOSITS			DATE		AMOUNT
Deposit			04/01		19,450
Deposit			04/10		5,500
Deposit			04/22		2,000
EFT—Collection from customer			04/27		100
Interest			04/30		30

CHARGES			DATE		AMOUNT
Service Charge			04/30		20

CHECKS					
Number	Amount	Number	Amount	Number	Amount
202	3,200	203	300		
201	20,000	205	150		
200	1,920				

OTHER DEDUCTIONS			DATE		AMOUNT
EFT—Water Works			04/20		40
NSF			04/25		1,200

Electronic Funds Transfers

Electronic funds transfer (EFT) moves cash by electronic communication. Many bills and other payments, such as salaries, rent, utilities, and insurance, are now paid by EFT. It is much cheaper to pay these items by EFT without having to mail a check. Debit card transactions and direct deposits are also considered EFTs.

Electronic Funds Transfer (EFT)

A system that transfers cash by electronic communication rather than by paper documents.



Bank Reconciliation

A document explaining the reasons for the difference between a depositor's cash records and the depositor's cash balance in its bank account.

Bank Reconciliation

The **bank reconciliation** compares and explains the differences between cash on the company's books and cash according to the bank's records on a specific date. There are two records of a business's cash:

1. The Cash account in the company's general ledger. April's Cash T-account for Smart Touch Learning is shown below.

Cash			
Beg. Bal.	10,550	20,000	Apr. 2
Apr. 1	19,450	3,200	Apr. 15
Apr. 8	5,500	300	Apr. 21
Apr. 22	2,000	2,000	Apr. 30
Apr. 30	9,000	150	Apr. 30
End. Bal.	20,850		

2. The bank statement, which shows the cash receipts and payments transacted through the bank. In Exhibit 7-6, however, the bank shows an ending balance of \$12,720 for Smart Touch Learning.

The books and the bank statement usually show different cash balances. Differences may arise because of a time lag in recording transactions, called **timing differences**. Three examples of timing differences follow:

- When a business writes a check, it immediately deducts the amount in its checkbook and Cash account. The bank, however, does not subtract the check from the company's account until the bank pays the check a few days later.
- When a company deposits cash in its account, it immediately adds the cash receipt to the checkbook and Cash account. The bank, however, may take a day or two to add deposits to the company's balance.
- EFT cash payments and EFT cash receipts are often recorded by the bank before a company learns of them.

To obtain accurate cash records, a company must update its Cash account after the company receives its bank statement. A bank reconciliation is used to carry out the updating process. The bank reconciliation explains all differences between the company's cash records and the bank's records of the company's balance. The person who prepares the bank reconciliation should have no other cash duties. This means the reconciler should not be a person who has access to cash or duties that require journalizing cash transactions. Otherwise, he or she could steal cash and manipulate the reconciliation to conceal the theft.

Preparing the Bank Side of the Bank Reconciliation

Here are the items that appear on the bank side of the bank reconciliation. They all cause differences between the bank balance and the book balance.

The bank side contains items not yet recorded by the bank but recorded by the company, or errors made by the bank. These items include the following:

Deposits in Transit (Outstanding Deposits) A **deposit in transit** has been recorded and has already been added to the company's book balance, but the bank has not yet recorded it. These are shown as "Add: Deposits in transit" on the bank side because when the bank does record these deposits, it will increase the bank balance.

Outstanding Checks An **outstanding check** is a check that has been recorded and has already been deducted from the company's book balance, but the bank has not yet paid

Deposit in Transit

A deposit recorded by the company but not yet by its bank.

Outstanding Check

A check issued by a company and recorded on its books but not yet paid by its bank.

Timing Difference

Difference that arises between the balance on the bank statement and the balance on the company's books because of a time lag in recording transactions.



(deducted) it. Such checks are shown as “Less: Outstanding checks” on the bank side because when the bank does make payment for the checks, it will decrease the bank balance.

Bank Errors Bank errors are posting errors made by the bank that either incorrectly increase or decrease the bank balance. All bank errors are corrected on the bank side of the reconciliation by reversing the effect of the errors.

Errors are always recorded on the side of the reconciliation of the party that made the error. If the bank made the error, it is recorded on the bank side. If the business made the error, it is recorded on the book side.

Preparing the Book Side of the Bank Reconciliation

The book side contains items not yet recorded by the company on its books but that have been recorded by the bank, or errors made by the company. Items to show on the book side include the following:

Bank Collections Bank collections are cash receipts the bank has received and recorded for a company’s account but that the company has not recorded yet on its books. An example of a bank collection would occur when a business has its customers use a lock-box system. Another example is a bank collecting on a note receivable for a business. A bank collection is often referred to as a credit memorandum. A **credit memorandum** indicates that the customer’s account has been increased. A bank collection (which increases the bank balance) that appears on the bank statement will show as “Add: Bank collections” on the book side of the reconciliation because it represents cash receipts not yet recorded by the company.

Credit Memorandum

An increase in a bank account.

Electronic Funds Transfers The bank may receive or pay cash on a company’s behalf. An EFT may be a cash receipt or a cash payment. These will either show up on the book side of the reconciliation as “Add: EFT” for receipts not yet added to the company’s books or “Less: EFT” for payments not yet deducted on the company’s books.

Service Charge This cash payment is the bank’s fee for processing a company’s transactions. Service charges can also include the cost of printed checks and other bank fees such as ATM fees. Service charges could also include the fees charged by the bank for processing credit and debit card transactions if the company used the gross method for recording credit card sales. A service charge is often referred to as a **debit memorandum** and represents a decrease in the bank account. This will show as “Less: Service charges” on the book side of the reconciliation because it represents a cash payment not yet subtracted from the company’s cash balance.

Debit Memorandum

A decrease in a bank account.

Interest Revenue on a Checking Account A business will sometimes earn interest if it keeps enough cash in its account. The bank statement tells the company of this cash receipt. This will show as “Add: Interest revenue” on the book side of the reconciliation because it represents cash receipts not yet added in the company’s cash balance.

Nonsufficient Funds (NSF) Checks **Nonsufficient funds (NSF) checks** represent checks received from customers for payment of services rendered or merchandise sold that have turned out to be worthless. NSF checks (sometimes called *hot checks* or *bad checks*) are treated as subtractions on a company’s bank reconciliation. NSF checks are customer checks the company has received and deposited for which the customer doesn’t have enough money in his or her bank account to cover. NSF checks will show as “Less: NSF checks” on the book side of the reconciliation, as the company previously recorded this receipt as an increase in cash, which now has to be deducted as the funds were not actually received.

Nonsufficient Funds (NSF) Check

A check for which the maker’s bank account has insufficient money to pay the check.



Book Errors Book errors are errors made on the books of the company that either incorrectly increase or decrease the cash balance in the company's general ledger. All book errors are corrected on the book side of the reconciliation by reversing the effect of the errors.

Completing the Bank Reconciliation

The bank statement in Exhibit 7-6 shows that the April 30 bank balance of Smart Touch Learning is \$12,720 (upper-right corner). However, the company's Cash account has a balance of \$20,850. This situation calls for a bank reconciliation to explain the difference. In completing the bank reconciliation, Smart Touch Learning will review the bank statement and the business's Cash account to determine the timing differences. Exhibit 7-7, Panel A, lists the reconciling items for your easy reference, and Panel B shows the completed reconciliation.

Exhibit 7-7 | Bank Reconciliation

PANEL A—Reconciling Items

Bank side:

1. Deposit in transit, Apr. 30, \$9,000.
2. Outstanding check no. 204, \$2,000.

Book side:

3. EFT receipt from customer, \$100.
4. Interest revenue earned on bank balance, \$30.
5. Bank service charge, \$20.
6. EFT payment of water bill, \$40.
7. NSF check, \$1,200.

PANEL B—Bank Reconciliation

SMART TOUCH LEARNING Bank Reconciliation April 30, 2019			
BANK		BOOK	
Balance, April 30, 2019	\$ 12,720	Balance, April 30, 2019	\$ 20,850
ADD:		ADD:	
1. Deposit in transit	9,000	3. EFT receipt from customer	\$ 100
	21,720	4. Interest revenue earned on bank balance	30
			130
			20,980
LESS:		LESS:	
2. Outstanding checks		5. Service charge	20
No. 204	2,000	6. EFT payment of water bill	40
		7. NSF check	1,200
			1,260
Adjusted bank balance, April 30, 2019	<u>\$ 19,720</u>	Adjusted book balance, April 30, 2019	<u>\$ 19,720</u>

These amounts must agree.

SUMMARY OF THE VARIOUS RECONCILING ITEMS:

BANK BALANCE—ALWAYS

- Add deposits in transit.
- Subtract outstanding checks.
- Add or subtract corrections of bank errors.

BOOK BALANCE—ALWAYS

- Add bank collections, interest revenue, and EFT receipts.
- Subtract service charges, NSF checks, and EFT payments.
- Add or subtract corrections of book errors.



Examining a Bank Reconciliation

Let's go through each side of the bank reconciliation for Smart Touch Learning.

Bank Side of the Reconciliation

Smart Touch Learning begins by recording the bank balance as of April 30, 2019, which is taken from the bank statement, \$12,720. The business then identifies any additions or subtractions affecting the bank balance:

- 1. Deposit in transit.** Smart Touch Learning reviews the bank statement and the Cash account to determine whether any cash deposits made by the business have not yet been recorded by the bank. Smart Touch Learning identifies that the deposit made on April 30 for \$9,000 has not yet been recorded by the bank. This amount is added to the bank balance.
- 2. Outstanding check.** The business reviews the canceled checks included with the statement to determine whether any checks written by the business have not yet cleared the bank. Smart Touch Learning identifies check number 204 for \$2,000 as outstanding. This amount is subtracted from the bank balance.

After all items affecting the bank side have been identified, the adjusted bank balance is determined.

Book Side of the Reconciliation

The book side of the reconciliation begins by Smart Touch Learning listing the Cash account balance as of April 30, 2019. This amount—\$20,850—is found in the general ledger. Next, Smart Touch Learning reviews the Cash account and bank statement for items that affect the company's Cash account balance but are not recorded by the company:

- 3. Electronic funds transfer (EFT).** In reviewing the bank statement, Smart Touch Learning identifies an EFT receipt from a customer in the amount of \$100. The company has not recorded this receipt in the Cash account; therefore, it will need to be added to the book balance.
- 4. Interest revenue.** Smart Touch Learning identifies a \$30 deposit on the bank statement for interest earned that has not yet been recorded in the Cash account. This deposit will be added to the book balance.
- 5. Service charge.** The bank statement shows a \$20 service charge. Smart Touch Learning has not recorded this charge in the company's Cash account and will, therefore, need to subtract this amount from the book balance.
- 6. Electronic funds transfer (EFT).** Listed in the other deductions section on the bank statement, Smart Touch Learning identifies an EFT payment to Water Works for \$40. This payment has not been recorded in the company's Cash account. Smart Touch Learning will subtract this amount from the book balance.
- 7. Nonsufficient funds (NSF) check.** Smart Touch Learning identifies an NSF check from a customer on the bank statement. The company had recorded the receipt of this check as an increase to cash originally. The bank has now communicated that the customer's check did not clear and that the customer's payment was never deposited into the business's account. Smart Touch Learning must subtract this amount from the book balance.

After recording all of the items that affect the book balance, Smart Touch Learning determines the adjusted book balance and verifies that it equals the adjusted bank balance. This amount represents the correct cash balance as of April 30, 2019.



Journalizing Transactions from the Bank Reconciliation

The bank reconciliation is an accountant's tool separate from the journals and ledgers. It does *not* account for transactions in the journal. To get the transactions into the accounts, we must make journal entries and post to the ledger. All items on the book side of the bank reconciliation require journal entries. We make no journal entries from the items on the bank side because we have already recorded these items in the business's Cash account.

The bank reconciliation in Exhibit 7-7 requires Smart Touch Learning to make journal entries to bring the Cash account up to date. Numbers in the journal entries correspond to the reconciling items listed in Exhibit 7-7, Panel A, and to the book side of the reconciliation in Panel B. Note that we chose to list each item in a separate journal entry here, but one compound entry could be made instead of the five separate entries illustrated.

$\frac{A \uparrow \downarrow}{\text{Cash} \uparrow \text{Accounts Receivable} \downarrow} \left. \vphantom{\frac{A \uparrow \downarrow}{\text{Cash} \uparrow \text{Accounts Receivable} \downarrow}} \right\} = \left\{ \begin{array}{l} \text{L} \\ \text{E} \end{array} \right. + \left. \vphantom{\frac{A \uparrow \downarrow}{\text{Cash} \uparrow \text{Accounts Receivable} \downarrow}} \right\}$	<table border="1"> <thead> <tr> <th>Date</th> <th>Accounts and Explanation</th> <th>Debit</th> <th>Credit</th> </tr> </thead> <tbody> <tr> <td>3: Apr. 30</td> <td>Cash</td> <td style="text-align: right;">100</td> <td></td> </tr> <tr> <td></td> <td> Accounts Receivable</td> <td></td> <td style="text-align: right;">100</td> </tr> <tr> <td></td> <td colspan="3"><i>To record account receivable collected by bank.</i></td> </tr> <tr> <td>4: 30</td> <td>Cash</td> <td style="text-align: right;">30</td> <td></td> </tr> <tr> <td></td> <td> Interest Revenue</td> <td></td> <td style="text-align: right;">30</td> </tr> <tr> <td></td> <td colspan="3"><i>To record interest earned on bank balance.</i></td> </tr> <tr> <td>5: 30</td> <td>Bank Expense</td> <td style="text-align: right;">20</td> <td></td> </tr> <tr> <td></td> <td> Cash</td> <td></td> <td style="text-align: right;">20</td> </tr> <tr> <td></td> <td colspan="3"><i>To record bank service charges incurred.</i></td> </tr> <tr> <td>6: 30</td> <td>Utilities Expense</td> <td style="text-align: right;">40</td> <td></td> </tr> <tr> <td></td> <td> Cash</td> <td></td> <td style="text-align: right;">40</td> </tr> <tr> <td></td> <td colspan="3"><i>To record payment of water bill by EFT.</i></td> </tr> <tr> <td>7: 30</td> <td>Accounts Receivable</td> <td style="text-align: right;">1,200</td> <td></td> </tr> <tr> <td></td> <td> Cash</td> <td></td> <td style="text-align: right;">1,200</td> </tr> <tr> <td></td> <td colspan="3"><i>To record NSF check returned by bank.</i></td> </tr> </tbody> </table>	Date	Accounts and Explanation	Debit	Credit	3: Apr. 30	Cash	100			Accounts Receivable		100		<i>To record account receivable collected by bank.</i>			4: 30	Cash	30			Interest Revenue		30		<i>To record interest earned on bank balance.</i>			5: 30	Bank Expense	20			Cash		20		<i>To record bank service charges incurred.</i>			6: 30	Utilities Expense	40			Cash		40		<i>To record payment of water bill by EFT.</i>			7: 30	Accounts Receivable	1,200			Cash		1,200		<i>To record NSF check returned by bank.</i>		
Date	Accounts and Explanation	Debit	Credit																																																														
3: Apr. 30	Cash	100																																																															
	Accounts Receivable		100																																																														
	<i>To record account receivable collected by bank.</i>																																																																
4: 30	Cash	30																																																															
	Interest Revenue		30																																																														
	<i>To record interest earned on bank balance.</i>																																																																
5: 30	Bank Expense	20																																																															
	Cash		20																																																														
	<i>To record bank service charges incurred.</i>																																																																
6: 30	Utilities Expense	40																																																															
	Cash		40																																																														
	<i>To record payment of water bill by EFT.</i>																																																																
7: 30	Accounts Receivable	1,200																																																															
	Cash		1,200																																																														
	<i>To record NSF check returned by bank.</i>																																																																
$\frac{A \uparrow}{\text{Cash} \uparrow} \left. \vphantom{\frac{A \uparrow}{\text{Cash} \uparrow}} \right\} = \left\{ \begin{array}{l} \text{L} \\ \text{E} \uparrow \end{array} \right. + \left. \vphantom{\frac{A \uparrow}{\text{Cash} \uparrow}} \right\} \frac{\text{Interest Revenue} \uparrow}{\text{Interest Revenue} \uparrow}$																																																																	
$\frac{A \downarrow}{\text{Cash} \downarrow} \left. \vphantom{\frac{A \downarrow}{\text{Cash} \downarrow}} \right\} = \left\{ \begin{array}{l} \text{L} \\ \text{E} \downarrow \end{array} \right. + \left. \vphantom{\frac{A \downarrow}{\text{Cash} \downarrow}} \right\} \frac{\text{Bank Expense} \uparrow}{\text{Bank Expense} \uparrow}$																																																																	
$\frac{A \downarrow}{\text{Cash} \downarrow} \left. \vphantom{\frac{A \downarrow}{\text{Cash} \downarrow}} \right\} = \left\{ \begin{array}{l} \text{L} \\ \text{E} \downarrow \end{array} \right. + \left. \vphantom{\frac{A \downarrow}{\text{Cash} \downarrow}} \right\} \frac{\text{Utilities Expense} \uparrow}{\text{Utilities Expense} \uparrow}$																																																																	
$\frac{A \uparrow \downarrow}{\text{Accounts Receivable} \uparrow \text{Cash} \downarrow} \left. \vphantom{\frac{A \uparrow \downarrow}{\text{Accounts Receivable} \uparrow \text{Cash} \downarrow}} \right\} = \left\{ \begin{array}{l} \text{L} \\ \text{E} \end{array} \right. + \left. \vphantom{\frac{A \uparrow \downarrow}{\text{Accounts Receivable} \uparrow \text{Cash} \downarrow}} \right\}$																																																																	

The above journal entries are posted to the Cash T-account to update the balance as shown below:

Cash			
Beg. Bal.	10,550	20,000	Apr. 2
Apr. 1	19,450	3,200	Apr. 15
Apr. 8	5,500	300	Apr. 21
Apr. 22	2,000	2,000	Apr. 30
Apr. 30	9,000	150	Apr. 30
Bal.	20,850		
Apr. 30	100	20	Apr. 30
Apr. 30	30	40	Apr. 30
		1,200	Apr. 30
End. Bal.	19,720		



Notice that the ending balance in the Cash T-account equals the adjusted book balance and the adjusted bank balance on the bank reconciliation at April 30, 2019.

Try It!

For each of the following items, determine whether the item would be:

- | | |
|-------------------------------------|-----------------------|
| a. added to the bank balance | |
| b. subtracted from the bank balance | |
| c. added to the book balance | |
| d. subtracted from the book balance | |
| 11. Interest revenue earned | 14. Service charge |
| 12. NSF check | 15. Outstanding check |
| 13. Deposit in transit | |

Check your answers online in MyAccountingLab or at <http://www.pearsonhighered.com/Horngren>.

For more practice, see Short Exercises S7-7 through S7-10. [MyAccountingLab](#)

HOW CAN THE CASH RATIO BE USED TO EVALUATE BUSINESS PERFORMANCE?

Cash is an important part of every business. Without an adequate supply of available cash, businesses cannot continue to operate. Businesses, therefore, monitor cash very carefully. One measure that can be used to measure a company's liquidity is the cash ratio. The **cash ratio** helps to determine a company's ability to meet its short-term obligations. It is calculated as follows:

$$\text{Cash ratio} = (\text{Cash} + \text{Cash equivalents}) / \text{Total current liabilities}$$

Notice that the cash ratio includes cash and cash equivalents. **Cash equivalents** are highly liquid investments that can be converted into cash in three months or less. Examples of cash equivalents are money-market accounts and investments in U.S. government securities.

Returning to **Kohl's Corporation**, let's evaluate the company's liquidity using the cash ratio. Kohl's cash and cash equivalents and total current liabilities can be found on the balance sheet (visit <http://www.pearsonhighered.com/Horngren> to view a link to Kohl's Corporation's annual report) and are presented below (shown in millions):

	January 30, 2016	January 31, 2015
Cash and cash equivalents	\$ 707	\$ 1,407
Total current liabilities	2,714	2,859

Kohl's cash ratio as of January 30, 2016, follows:

$$\text{Cash ratio} = \$707 / \$2,714 = 0.26$$

In comparison, the cash ratio as of January 31, 2015, was:

$$\text{Cash ratio} = \$1,407 / \$2,859 = 0.49$$

Learning Objective 7

Use the cash ratio to evaluate business performance

Cash Ratio

A measure of a company's ability to pay current liabilities from cash and cash equivalents: $(\text{Cash} + \text{Cash equivalents}) / \text{Total current liabilities}$.

Cash Equivalent

A highly liquid investment that can be converted into cash in three months or less.



The cash ratio has dropped significantly from 2015 to 2016 due to a decrease in available cash and cash equivalents. This ratio is the most conservative valuation of liquidity because it looks at only cash and cash equivalents, leaving out other current assets such as merchandise inventory and accounts receivable. Notice that for both years the cash ratio was below 1.0. Having a cash ratio below 1.0 is a good thing. A cash ratio above 1.0 might signify that the company has an unnecessarily large amount of cash supply. This cash could be used to generate higher profits or be paid out for dividends. However, a very low ratio doesn't send a strong message to investors and creditors that the company has the ability to repay its short-term debt.

Try It!

16. The Scott Sun & Shade Company had the following financial data at December 31, 2018:

Cash and cash equivalents	\$ 60,000
Total current liabilities	75,000

What is the cash ratio as of December 31, 2018, for Scott Sun & Shade?

Check your answer online in MyAccountingLab or at <http://www.pearsonhighered.com/Horngren>.

For more practice, see Short Exercise S7-11. [MyAccountingLab](#)

REVIEW

> Things You Should Know

1. What is internal control, and how can it be used to protect a company's assets?

- Internal control is the organizational plan and all the related measures designed to safeguard assets, encourage employees to follow company policies, promote operational efficiency, and ensure accurate and reliable accounting records.
- The Sarbanes-Oxley Act was passed by Congress to revamp corporate governance in the United States.
- Internal control includes five components: control procedures, risk assessment, information system, monitoring of controls, and environment.

2. What are the internal control procedures with respect to cash receipts?

- A point-of-sale terminal provides control over cash receipts over the counter.
- Companies control cash by mail by ensuring appropriate separation of duties when handling cash and recording the transaction.

3. What are the internal control procedures with respect to cash payments?

- Good separation of duties between operations of the business and writing checks for cash payments should exist.
- Many companies use technology to make secure payments.

4. How can a petty cash fund be used for internal control purposes?

- A petty cash fund allows a business to keep cash on hand to pay for small miscellaneous items such as postage, office supplies, and taxi fares.
- When the petty cash fund is established, the company records a debit to Petty Cash and a credit to Cash.
- The petty cash fund is replenished by debiting the associated asset and expense accounts and crediting Cash.
- Discrepancies in petty cash funds are either debited or credited to the Cash Short & Over account.

5. How are credit card sales recorded?

- Sales by credit cards and debit cards are treated as cash sales and typically include a fee (Credit Card Expense) that is paid by the business to the credit card processor.
- Sales can be either recorded using the net or gross method. The net method records the amount of the sale less the processing fee at the time of sale. The gross method records the gross amount of the sale at the time of sale and the credit card fees are recorded at a later time.

6. How can the bank account be used as a control device?

- Bank accounts provide established practices that safeguard a business's money. These controls include use of signature cards, deposit tickets, checks, bank statements, and electronic funds transfers.
- A bank reconciliation can also be used as a form of internal control. The bank reconciliation compares and explains the difference between cash on the company's books and cash according to the bank's records on a specific date.
- After the bank reconciliation has been prepared, journal entries must be completed for all items on the book side of the bank reconciliation.

7. How can the cash ratio be used to evaluate business performance?

- The cash ratio measures a company's ability to pay its current liabilities from cash and cash equivalents.
- $\text{Cash ratio} = (\text{Cash} + \text{Cash equivalents}) / \text{Total current liabilities}$.

> Check Your Understanding 7-1

Check your understanding of the chapter by completing this problem and then looking at the solution. Use this practice to help identify which sections of the chapter you need to study more.

Misler Corporation established a \$300 petty cash fund on January 12, 2018. Karen Misler (KM) is the fund custodian. At the end of the month, the petty cash fund contains the following:

- Cash: \$163
- Petty cash tickets, as follows:

No.	Amount	Issued to	Signed by	Account Debited
44	\$ 14	B. Jarvis	B. Jarvis and KM	Office Supplies
45	39	S. Bell	S. Bell	Delivery Expense
47	43	R. Tate	R. Tate and KM	—
48	33	L. Blair	L. Blair and KM	Travel Expense

Requirements

1. Identify three internal control weaknesses revealed in the given data. (See Learning Objectives 1, 4)
2. Journalize the following transactions (See Learning Objective 4):
 - a. Establishment of the petty cash fund on January 12, 2018.
 - b. Replenishment of the fund on January 31, 2018. Assume petty cash ticket no. 47 was issued for the purchase of office supplies.
3. What is the balance in the Petty Cash account immediately before replenishment? Immediately after replenishment? (See Learning Objective 4)

> Solution

Requirement 1

The three internal control weaknesses are as follows:

1. Petty cash ticket no. 46 is missing. There is no indication of what happened to this ticket. The company should investigate.
2. The petty cash custodian (KM) did not sign petty cash ticket no. 45. This omission may have been an oversight on her part. However, it raises the question of whether she authorized the payment. Both the fund custodian and the recipient of the cash should sign the petty cash ticket.
3. Petty cash ticket no. 47 does not indicate which account to debit on the actual ticket. If Tate or Karen Mislser do not remember where the \$43 went, then the accountant will not know what account should be debited.

Requirement 2

Petty cash journal entries:

- a. Entry to establish the petty cash fund:

Date	Accounts and Explanation	Debit	Credit
Jan. 12	Petty Cash	300	
	Cash		300
	<i>To open the petty cash fund.</i>		

- b. Entry to replenish the fund:

Date	Accounts and Explanation	Debit	Credit
Jan. 31	Office Supplies	57	
	Delivery Expense	39	
	Travel Expense	33	
	Cash Short & Over	8	
	Cash		137
	<i>To replenish the petty cash fund.</i>		

Requirement 3

The balance in the Petty Cash account is *always* its imprest balance, in this case \$300.

> Check Your Understanding 7-2

Check your understanding of the chapter by completing this problem and then looking at the solution. Use this practice to help identify which sections of the chapter you need to study more.

The Cash account of Baylor Associates at February 28, 2019, follows:

Cash			
Beg. Bal.	3,995	400	Feb. 3
Feb. 6	800	3,100	Feb. 12
Feb. 15	1,800	1,100	Feb. 19
Feb. 23	1,100	500	Feb. 25
Feb. 28	2,400	900	Feb. 27
End. Bal.	4,095		

Baylor Associates received the following bank statement on February 28, 2019:

BEGINNING BALANCE		TOTAL DEPOSITS	TOTAL WITHDRAWALS	SERVICE CHARGES	ENDING BALANCE
\$3,995		4,715	5,630	10	\$3,070

TRANSACTIONS					
DEPOSITS				DATE	AMOUNT
Deposit				02/07	800
Deposit				02/15	1,800
EFT—Collection of note				02/17	1,000
Deposit				02/24	1,100
Interest				02/28	15
CHARGES				DATE	AMOUNT
Service Charge				02/28	10
CHECKS					
Number	Amount	Number	Amount	Number	Amount
102	400	103	1,100		
101	3,100				
OTHER DEDUCTIONS				DATE	AMOUNT
EFT—EZ Rent				02/01	330
NSF Check				02/13	700

Additional data:

Baylor deposits all cash receipts in the bank and makes all payments by check.

Requirements

1. Prepare the bank reconciliation of Baylor Associates at February 28, 2019. (See Learning Objective 6)
2. Journalize the entries based on the bank reconciliation. (See Learning Objective 6)

> Solution

Requirement 1

BAYLOR ASSOCIATES Bank Reconciliation February 28, 2019		
Bank:		
Balance, February 28, 2019		\$ 3,070
Add: Deposit of February 28 in transit		2,400
		<u>5,470</u>
Less: Outstanding checks issued on February 25		
(\$500) and February 27 (\$900)		1,400
Adjusted bank balance, February 28, 2019		<u><u>\$ 4,070</u></u>
Books:		
Balance, February 28, 2019		\$ 4,095
Add: Bank collection of note receivable	\$ 1,000	
Interest revenue earned on bank balance	15	1,015
		<u>5,110</u>
Less: Service charge	10	
NSF check	700	
EFT—Rent expense	330	1,040
Adjusted book balance, February 28, 2019		<u><u>\$ 4,070</u></u>

Must be equal.

Requirement 2

Date	Accounts and Explanation	Debit	Credit
Feb. 28	Cash	1,000	
	Notes Receivable		1,000
	<i>Note receivable collected by bank.</i>		
28	Cash	15	
	Interest Revenue		15
	<i>Interest earned on bank balance.</i>		
28	Bank Expense	10	
	Cash		10
	<i>Bank service charge.</i>		
28	Accounts Receivable	700	
	Cash		700
	<i>NSF check returned by bank.</i>		
28	Rent Expense	330	
	Cash		330
	<i>Monthly rent expense.</i>		

> Key Terms

Account Number (p. 396)
 Bank Reconciliation (p. 398)
 Bank Statement (p. 397)
 Canceled Checks (p. 397)
 Cash Equivalent (p. 403)
 Cash Ratio (p. 403)
 Check (p. 396)
 Collusion (p. 385)
 Committee of Sponsoring Organizations (COSO) (p. 381)
 Credit Memorandum (p. 399)
 Debit Memorandum (p. 399)
 Deposit in Transit (p. 398)
 Deposit Ticket (p. 396)

Electronic Data Interchange (EDI) (p. 389)
 Electronic Funds Transfer (EFT) (p. 397)
 Encryption (p. 384)
 Evaluated Receipts Settlement (ERS) (p. 389)
 External Auditor (p. 383)
 Firewall (p. 384)
 Imprest System (p. 391)
 Internal Auditor (p. 383)
 Internal Control (p. 381)
 Internal Control Report (p. 382)
 Lock-Box System (p. 387)

Maker (p. 396)
 Nonsufficient Funds (NSF) Check (p. 399)
 Outstanding Check (p. 398)
 Payee (p. 396)
 Petty Cash (p. 390)
 Public Company (p. 381)
 Remittance Advice (p. 387)
 Routing Number (p. 396)
 Sarbanes-Oxley Act (SOX) (p. 382)
 Separation of Duties (p. 383)
 Signature Card (p. 396)
 Timing Difference (p. 398)

> Quick Check**Learning Objective 1**

1. Which of the following is *not* part of the definition of internal control?
 - a. Separation of duties
 - b. Safeguard assets
 - c. Encourage employees to follow company policies
 - d. Promote operational efficiency

Learning Objective 1

2. The Sarbanes-Oxley Act
 - a. created the Private Company Accounting Board.
 - b. allows accountants to audit and to perform any type of consulting work for a public company.
 - c. stipulates that violators of the act may serve 20 years in prison for securities fraud.
 - d. requires that an outside auditor must evaluate a public company's internal controls.

Learning Objective 1

3. Encryption
 - a. avoids the need for separation of duties.
 - b. creates firewalls to protect data.
 - c. cannot be broken by hackers.
 - d. rearranges messages by a special process.

Learning Objective 1

4. Separation of duties is important for internal control of

a. cash receipts.	c. Neither of the above
b. cash payments.	d. Both a and b

Learning Objective 2

5. Michelle Darby receives cash from customers. Her other assigned job is to post the collections to customer accounts receivable. Her company has weak

a. assignment of responsibilities.	c. computer controls.
b. ethics.	d. separation of duties.

Learning Objective 3

6. Payment by check is an important internal control over cash payments because
 - a. the check must be signed by an authorized official.
 - b. before signing the check, the official reviews the invoice supporting the payment.
 - c. Both a and b
 - d. None of the above

Learning Objective 4

7. The petty cash fund had an initial imprest balance of \$100. It currently has \$20 and petty cash tickets totaling \$75 for office supplies. The entry to replenish the fund would contain

a. a credit to Cash Short & Over for \$5.	c. a debit to Cash Short & Over for \$5.
b. a credit to Petty Cash for \$80.	d. a debit to Petty Cash for \$80.

Learning Objective 5

8. When recording credit card or debit card sales using the net method,
 - a. cash received equals sales.
 - b. cash received equals sales minus the fee assessed by the card processing company.
 - c. cash received equals sales plus the fee assessed by the card processing company.
 - d. cash isn't received by the seller until the customer pays his or her credit card statement.

15. What is a bank reconciliation?
16. List some examples of timing differences, and for each difference, determine if it would affect the book side of the reconciliation or the bank side of the reconciliation.
17. Why is it necessary to record journal entries after the bank reconciliation has been prepared? Which side of the bank reconciliation requires journal entries?
18. What does the cash ratio help determine, and how is it calculated?

> Short Exercises

Learning Objective 1

S7-1 Defining internal control

Internal controls are designed to safeguard assets, encourage employees to follow company policies, promote operational efficiency, and ensure accurate accounting records.

Requirements

1. Which objective do you think is most important?
2. Which objective do you think the internal controls must accomplish for the business to survive? Give your reason.

Learning Objective 2

S7-2 Applying internal control over cash receipts

Sandra Kristof sells furniture for McKinney Furniture Company. Kristof is having financial problems and takes \$650 that she received from a customer. She rang up the sale through the cash register. What will alert Megan McKinney, the controller, that something is wrong?

Learning Objective 2

S7-3 Applying internal control over cash receipts by mail

Review the internal controls over cash receipts by mail presented in the chapter. Exactly what is accomplished by the final step in the process, performed by the controller?

Learning Objective 3

S7-4 Applying internal control over cash payments by check

A purchasing agent for Franklin Office Supplies receives the goods that he purchases and also approves payment for the goods.

Requirements

1. How could this purchasing agent cheat his company?
2. How could Franklin avoid this internal control weakness?

Learning Objective 4

S7-5 Journalizing petty cash

Prepare the journal entries for the following petty cash transactions of Everly Gaming Supplies:

Mar. 1	Established a petty cash fund with a \$250 balance.
31	The petty cash fund has \$24 in cash and \$235 in petty cash tickets that were issued to pay for Office Supplies (\$35) and Entertainment Expense (\$200). Replenished the fund and recorded the expenditures.
Apr. 15	Increased the balance of the petty cash fund to \$300.

S7-6 Recording credit card and debit card sales

Restaurants do a large volume of business by credit and debit cards. Suppose Summer, Sand, and Castles Resort restaurant had these transactions on January 28, 2018:

National Express credit card sales	\$ 10,800
ValueCard debit card sales	10,000

Requirements

1. Suppose Summer, Sand, and Castles Resort's processor charges a 2% fee and deposits sales net of the fee. Journalize these sales transactions for the restaurant.
2. Suppose Summer, Sand, and Castles Resort's processor charges a 2% fee and deposits sales using the gross method. Journalize these sales transactions for the restaurant.

S7-7 Understanding bank account controls

Answer the following questions about the controls in bank accounts:

Requirements

1. Which bank control protects against forgery?
2. Which bank control reports the activity in the customer's account each period?
3. Which bank control confirms the amount of money put into the bank account?

S7-8 Identifying timing differences related to a bank reconciliation

For each timing difference listed, identify whether the difference would be reported on the book side of the reconciliation or the bank side of the reconciliation. In addition, identify whether the difference would be an addition or subtraction.

- | | |
|--|--|
| a. Deposit in transit | g. Service charges |
| b. Bank collection | h. Interest revenue |
| c. Debit memorandum from bank | i. \$2,500 cash payment for rent expense erroneously recorded by the business as \$250 |
| d. EFT cash receipt | j. Credit memorandum from bank |
| e. Outstanding checks | |
| f. \$1,000 deposit erroneously recorded by the bank as \$100 | |

S7-9 Preparing a bank reconciliation

The Cash account of Guard Dog Security Systems reported a balance of \$2,540 at December 31, 2018. There were outstanding checks totaling \$400 and a December 31 deposit in transit of \$100. The bank statement, which came from Park Cities Bank, listed the December 31 balance of \$3,340. Included in the bank balance was a collection of \$510 on account from Brendan Ballou, a Guard Dog customer who pays the bank directly. The bank statement also shows a \$30 service charge and \$20 of interest revenue that Guard Dog earned on its bank balance. Prepare Guard Dog's bank reconciliation at December 31.

Learning Objective 5**Learning Objective 6****Learning Objective 6****Learning Objective 6**

Note: Short Exercise S7-9 must be completed before attempting Short Exercise S7-10.

.....
Learning Objective 6

S7-10 Recording transactions from a bank reconciliation

Review your results from preparing Guard Dog Security Systems's bank reconciliation in Short Exercise S7-9. Journalize the company's transactions that arise from the bank reconciliation. Include an explanation with each entry.

.....
Learning Objective 7

S7-11 Computing the cash ratio

Smythe Banners reported the following figures in its financial statements:

Cash	\$ 26,500
Cash Equivalents	5,000
Total Current Liabilities	30,000

Compute the cash ratio for Smythe Banners.

> **Exercises**

.....
Learning Objective 1

E7-12 Understanding the Sarbanes-Oxley Act and identifying internal control strengths and weaknesses

The following situations suggest a strength or a weakness in internal control.

- a. Top managers delegate all internal control procedures to the accounting department.
- b. Accounting department staff (or the bookkeeper) orders merchandise and approves invoices for payment.
- c. Cash received over the counter is controlled by the sales clerk, who rings up the sale and places the cash in the register. The sales clerk matches the total recorded by the register to each day's cash sales.
- d. The employee who signs checks need not examine the payment packet because he is confident the amounts are correct.

Requirements

1. Define *internal control*.
2. The system of internal control must be tested by external auditors. What law or rule requires this testing?
3. Identify each item in the list above as either a strength or a weakness in internal control, and give your reason for each answer.

.....
Learning Objective 1

E7-13 Identifying internal controls

Consider each situation separately. Identify the missing internal control procedure from these characteristics:

- Assignment of responsibilities
- Separation of duties
- Audits
- Electronic devices
- Other controls (specify)

- a. While reviewing the records of Quality Pharmacy, you find that the same employee orders merchandise and approves invoices for payment.
- b. Business is slow at Amazing Amusement Park on Tuesday, Wednesday, and Thursday nights. To reduce expenses, the business decides not to use a ticket taker on those nights. The ticket seller (cashier) is told to keep the tickets as a record of the number sold.
- c. The same trusted employee has served as cashier for 12 years.
- d. When business is brisk, Fast Mart deposits cash in the bank several times during the day. The manager at one store wants to reduce the time employees spend delivering cash to the bank, so he starts a new policy. Cash will build up over weekends, and the total will be deposited on Monday.
- e. Grocery stores such as Convenience Market and Natural Foods purchase most merchandise from a few suppliers. At another grocery store, the manager decides to reduce paperwork. He eliminates the requirement that the receiving department prepare a receiving report listing the goods actually received from the supplier.

E7-14 Evaluating internal control over cash receipts

Dogtopia sells pet supplies and food and handles all sales with a cash register. The cash register displays the amount of the sale. It also shows the cash received and any change returned to the customer. The register also produces a customer receipt but keeps no internal record of the transactions. At the end of the day, the clerk counts the cash in the register and gives it to the cashier for deposit in the company bank account.

Requirements

1. Identify the internal control weakness over cash receipts.
2. What could you do to correct the weakness?

E7-15 Evaluating internal control over cash payments

Gary's Great Cars purchases high-performance auto parts from a Nebraska vendor. Dave Simon, the accountant for Gary's, verifies receipt of merchandise and then prepares, signs, and mails the check to the vendor.

Requirements

1. Identify the internal control weakness over cash payments.
2. What could the business do to correct the weakness?

Learning Objective 2

Learning Objective 3

Learning Objectives 1, 2, 3

E7-16 Understanding internal control, components, procedures, and laws

Match the following terms with their definitions.

1. Internal control	a. Two or more people working together to overcome internal controls.
2. Control procedures	b. Part of internal control that ensures resources are not wasted.
3. Firewalls	c. Requires companies to review internal control and take responsibility for the accuracy and completeness of their financial reports.
4. Encryption	d. Should be prenumbered to prevent theft and inefficiency.
5. Environment	e. Limits access to a local network.
6. Information system	f. Example: The person who opens the bank statement should not also be the person who is reconciling cash.
7. Separation of duties	g. Identification of uncertainties that may arise due to a company's products, services, or operations.
8. Collusion	h. Examination of a company's financial statements and accounting system by a trained accounting professional.
9. Documents	i. Without a sufficient one of these, information cannot properly be gathered and summarized.
10. Audits	j. The organizational plan and all the related measures that safeguard assets, encourage employees to follow company policies, promote operational efficiency, and ensure accurate and reliable accounting data.
11. Operational efficiency	k. Component of internal control that helps ensure business goals are achieved.
12. Risk assessment	l. Rearranges data by a mathematical process.
13. Sarbanes-Oxley Act	m. To establish an effective one, a company's CEO and top managers must behave honorably to set a good example for employees.

Learning Objective 4

2. Cash Short & Over \$15

E7-17 Accounting for petty cash

Jackie's Dance Studio created a \$220 imprest petty cash fund. During the month, the fund custodian authorized and signed petty cash tickets as follows:

Petty Cash			
Ticket No.	Item	Account Debited	Amount
1	Delivery of programs to customers	Delivery Expense	\$ 20
2	Mail package	Postage Expense	10
3	Newsletter	Printing Expense	25
4	Key to closet	Miscellaneous Expense	40
5	Copier paper	Office Supplies	70

Requirements

1. Make the general journal entry to create the petty cash fund. Include an explanation.
2. Make the general journal entry to record the petty cash fund replenishment. Cash in the fund totals \$40. Include an explanation.
3. Assume that Jackie's Dance Studio decides to decrease the petty cash fund to \$120. Make the general journal entry to record this decrease.

E7-18 Controlling petty cash

Just Hangin' Night Club maintains an imprest petty cash fund of \$150, which is under the control of Sandra Morgan. At March 31, the fund holds \$14 cash and petty cash tickets for office supplies, \$128, and delivery expense, \$15.

Requirements

1. Explain how an imprest petty cash system works.
2. Journalize the establishment of the petty cash fund on March 1 and the replenishing of the fund on March 31.
3. Prepare a T-account for Petty Cash and post to the account. What is the balance of the Petty Cash account at all times?

E7-19 Journalizing credit card sales

Marathon Running Shoes reports the following:

2018

-
- | | |
|--------|---|
| Sep. 1 | Recorded National Express credit card sales for of \$96,000, net of processor fee of 1%. Ignore Cost of Goods Sold. |
| 15 | Recorded ValueMax credit card sales of \$80,000. Processor charges a 1.5% fee. ValueMax charges the fee at the end of the month, therefore Marathon uses the gross method for these credit card sales. Ignore Cost of Goods Sold. |
| 30 | ValueMax collected the fees for the month of September. Assume the September 15 transaction is the only ValueMax credit card sale. |
-

Journalize all entries required for Marathon Running Shoes.

E7-20 Classifying bank reconciliation items

The following items could appear on a bank reconciliation:

- a. Outstanding checks, \$670.
- b. Deposits in transit, \$1,500.
- c. NSF check from customer, no. 548, for \$175.
- d. Bank collection of note receivable of \$800, and interest of \$80.
- e. Interest earned on bank balance, \$20.
- f. Service charge, \$10.
- g. The business credited Cash for \$200. The correct amount was \$2,000.
- h. The bank incorrectly decreased the business's account by \$350 for a check written by another business.

Classify each item as (1) an addition to the book balance, (2) a subtraction from the book balance, (3) an addition to the bank balance, or (4) a subtraction from the bank balance.

Learning Objective 4

2. March 31, Cash CR \$136

Learning Objective 5**Learning Objective 6**

Learning Objective 6

- Adjusted Balance \$1,137

E7-21 Preparing a bank reconciliation

Hardy Photography's checkbook lists the following:

Date	Check No.	Item	Check	Deposit	Balance
Nov. 1					\$ 500
4	622	Quick Mailing	\$ 45		455
9		Service Revenue		\$ 135	590
13	623	Photo Supplies	85		505
14	624	Utilities	45		460
18	625	Cash	50		410
26	626	Office Supplies	110		300
28	627	Upstate Realty Co.	290		10
30		Service Revenue		1,235	1,245

Hardy's November bank statement shows the following:

Balance			\$ 500	
Deposits			135	
Checks:	No.	Amount		
	622	\$ 45		
	623	85		
	624	105*		
	625	50	(285)	
Other charges:				
Printed checks		23		
Service charge		25	(48)	
Balance				\$ 302

*This is the correct amount for check number 624.

Requirements

- Prepare Hardy Photography's bank reconciliation at November 30, 2018.
- How much cash does Hardy actually have on November 30, 2018?
- Journalize any transactions required from the bank reconciliation.

Learning Objective 6

- Book Deductions \$314

E7-22 Preparing a bank reconciliation

Jim Root Corporation operates four bowling alleys. The business just received the October 31, 2018, bank statement from City National Bank, and the statement shows an ending balance of \$910. Listed on the statement are an EFT rent collection of \$440, a service charge of \$7, NSF checks totaling \$50, and a \$23 charge for printed checks. In reviewing the cash records, the business identified outstanding checks totaling \$440 and a deposit in transit of \$1,800. During October, the business recorded a \$260 check by debiting Salaries Expense and crediting Cash for \$26. The business's Cash account shows an October 31 balance of \$2,144.

Requirements

- Prepare the bank reconciliation at October 31.
- Journalize any transactions required from the bank reconciliation.

> Problems Group A

P7-23A Identifying internal control weakness in cash receipts

Seawind Productions makes all sales on credit. Cash receipts arrive by mail. Justin Broadway, the mailroom clerk, opens envelopes and separates the checks from the accompanying remittance advices. Broadway forwards the checks to another employee, who makes the daily bank deposit but has no access to the accounting records. Broadway sends the remittance advices, which show cash received, to the accounting department for entry in the accounts. Broadway's only other duty is to grant sales allowances to customers. (A *sales allowance* decreases the customer's account receivable.) When Broadway receives a customer check for \$600 less a \$30 allowance, he records the sales allowance and forwards the document to the accounting department.

Requirements

1. Identify the internal control weakness in this situation.
2. Who should record sales allowances?
3. What is the amount that should be shown in the ledger for cash receipts?

P7-24A Correcting internal control weaknesses

Each of the following situations has an internal control weakness.

- a. Upside-Down Applications develops custom programs to customer's specifications. Recently, development of a new program stopped while the programmers redesigned Upside-Down's accounting system. Upside-Down's accountants could have performed this task.
- b. Norma Rottler has been your trusted employee for 24 years. She performs all cash-handling and accounting duties. Norma just purchased a new luxury car and a new home in an expensive suburb. As owner of the company, you wonder how she can afford these luxuries because you pay her only \$30,000 a year and she has no source of outside income.
- c. Izzie Hardwoods, a private company, falsified sales and inventory figures in order to get an important loan. The loan went through, but Izzie later went bankrupt and could not repay the bank.
- d. The office supply company where Pet Grooming Goods purchases sales receipts recently notified Pet Grooming Goods that its documents were not prenumbered. Howard Mustro, the owner, replied that he never uses receipt numbers.
- e. Discount stores such as Cusco make most of their sales in cash, with the remainder in credit card sales. To reduce expenses, one store manager ceases purchasing fidelity bonds on the cashiers.
- f. Cornelius's Corndogs keeps all cash receipts in an empty box for a week because the owner likes to go to the bank on Tuesdays when Joann is working.

Requirements

1. Identify the missing internal control characteristics in each situation.
2. Identify the possible problem caused by each control weakness.
3. Propose a solution to each internal control problem.

Learning Objective 2

Learning Objectives 1, 2, 3

Learning Objective 4

3. June 30, Cash CR \$210

P7-25A Accounting for petty cash transactions

On June 1, Fab Salad Dressings creates a petty cash fund with an imprest balance of \$300. During June, Al Franklin, the fund custodian, signs the following petty cash tickets:

Petty Cash		
Ticket Number	Item	Amount
101	Office supplies	\$ 30
102	Cab fare for executive	20
103	Delivery of package across town	50
104	Business dinner	40
105	Merchandise inventory	90

On June 30, prior to replenishment, the fund contains these tickets plus cash of \$90. The accounts affected by petty cash payments are Office Supplies, Travel Expense, Delivery Expense, Entertainment Expense, and Merchandise Inventory.

Requirements

1. Explain the characteristics and the internal control features of an imprest fund.
2. On June 30, how much cash should the petty cash fund hold before it is replenished?
3. Journalize all required entries to create the fund and replenish it. Include explanations.
4. Make the July 1 entry to increase the fund balance to \$375. Include an explanation and briefly describe what the custodian does.

Learning Objective 4

2. June 30, Cash CR \$160

P7-26A Accounting for petty cash transactions

Suppose that on June 1, Rockin' Gyration, a disc jockey service, creates a petty cash fund with an imprest balance of \$300. During June, Michael Martell, fund custodian, signs the following petty cash tickets:

Petty Cash		
Ticket Number	Item	Amount
1	Postage for package received	\$ 30
2	Office party	25
3	Two boxes of stationery	20
4	Printer cartridges	15
5	Business dinner	65

On June 30, prior to replenishment, the fund contains these tickets plus cash of \$140. The accounts affected by petty cash payments are Office Supplies, Entertainment Expense, and Postage Expense.

Requirements

1. On June 30, how much cash should this petty cash fund hold before it is replenished?
2. Journalize all required entries to (a) create the fund and (b) replenish it. Include explanations.
3. Make the entry on July 1 to increase the fund balance to \$325. Include an explanation.

P7-27A Preparing a bank reconciliation and journal entries

The December cash records of Davidson Insurance follow:

Cash Receipts		Cash Payments	
Date	Cash Debit	Check No.	Cash Credit
Dec. 4	\$ 4,240	1416	\$ 810
9	550	1417	180
14	600	1418	630
17	1,900	1419	1,390
31	1,860	1420	1,490
		1421	700
		1422	600

Davidson's Cash account shows a balance of \$17,450 at December 31. On December 31, Davidson Insurance received the following bank statement:

Bank Statement for December				
Beginning Balance				\$ 14,100
Deposits and other Credits:				
Dec.	1	EFT	\$ 350	
Dec.	5		4,240	
Dec.	10		550	
Dec.	15		600	
Dec.	18		1,900	
Dec.	22	BC	1,400	9,040
Checks and other Debits:				
Dec.	8	NSF	400	
Dec.	11 (check no. 1416)		810	
Dec.	19	EFT	225	
Dec.	22 (check no. 1417)		180	
Dec.	29 (check no. 1418)		630	
Dec.	31 (check no. 1419)		1,930	
Dec.	31	SC	10	(4,185)
Ending Balance				<u>\$ 18,955</u>

Explanations: BC—bank collection; EFT—electronic funds transfer; NSF—nonsufficient funds checks; SC—service charge

Additional data for the bank reconciliation follow:

- The EFT credit was a receipt of rent. The EFT debit was an insurance payment.
- The NSF check was received from a customer.
- The \$1,400 bank collection was for a note receivable.
- The correct amount of check no. 1419, for rent expense, is \$1,930. Davidson's controller mistakenly recorded the check for \$1,390.

Learning Objective 6

- Adjusted Balance \$18,025

Requirements

1. Prepare the bank reconciliation of Davidson Insurance at December 31, 2018.
2. Journalize any required entries from the bank reconciliation.

Learning Objective 6

1. Book Additions \$2,120

P7-28A Preparing a bank reconciliation and journal entries

The August 31 bank statement of Well Healthcare has just arrived from United Bank. To prepare the bank reconciliation, you gather the following data:

- a. The August 31 bank balance is \$4,540.
- b. The bank statement includes two charges for NSF checks from customers. One is for \$380 (#1), and the other is for \$180 (#2).
- c. The following Well Healthcare checks are outstanding at August 31:

Check No.	Amount
237	\$ 80
288	190
291	570
294	600
295	30
296	70

- d. Well collects from a few customers by EFT. The August bank statement lists a \$1,200 EFT deposit for a collection on account.
- e. The bank statement includes two special deposits that Well hasn't recorded yet: \$800 for dividend revenue, and \$120 for the interest revenue Well earned on its bank balance during August.
- f. The bank statement lists a \$50 subtraction for the bank service charge.
- g. On August 31, the Well treasurer deposited \$260, but this deposit does not appear on the bank statement.
- h. The bank statement includes a \$1,050 deduction for a check drawn by Multi-State Freight Company. Well notified the bank of this bank error.
- i. Well's Cash account shows a balance of \$2,800 on August 31.

Requirements

1. Prepare the bank reconciliation for Well Healthcare at August 31, 2018.
2. Journalize any required entries from the bank reconciliation. Include an explanation for each entry.

> Problems Group B**Learning Objective 2****P7-29B Identifying internal control weakness in cash receipts**

Pendley Productions makes all sales on credit. Cash receipts arrive by mail. Larry Chipello, the mailroom clerk, opens envelopes and separates the checks from the accompanying remittance advices. Chipello forwards the checks to another employee, who makes the daily bank deposit but has no access to the accounting records. Chipello sends the remittance advices, which show cash received, to the accounting department for entry in the accounts. Chipello's only other duty is to grant sales

allowances to customers. (A *sales allowance* decreases the customer's account receivable.) When Chipello receives a customer check for \$575 less a \$45 allowance, he records the sales allowance and forwards the document to the accounting department.

Requirements

1. Identify the internal control weakness in this situation.
2. Who should record sales allowances?
3. What is the amount that should be shown in the ledger for cash receipts?

P7-30B Correcting internal control weaknesses

Each of the following situations has an internal control weakness.

- a. Jade Applications has decided that one way to cut costs in the upcoming year is to fire the external auditor. The business believes that the internal auditor should be able to efficiently monitor the company's internal controls.
- b. In an effort to minimize the amount of paperwork, Ross Homes has decided that it will not keep copies of customer invoices related to sales revenue. Ross believes that this effort will minimize the amount of data storage the company will have to pay for.
- c. Elle Bee, a trusted employee for many years, has never taken a vacation. The owner believes that he's lucky that she is so committed to her job.
- d. The Medicine Chest Company keeps a small petty cash fund to handle small cash transactions. Because no one wants to volunteer to be the custodian, the business manager has decided that all employees should have access to the petty cash. She figures that as long as each employee fills out a petty cash ticket, then there are proper controls in place.
- e. Due to the cost of maintaining the security cameras, Wings and More has decided that it will remove the cameras that monitor the cash register.
- f. Bryan Miller, manager of Hardware Emporium, prides himself on hiring exceptionally skilled employees who need no training to do their jobs.

Requirements

1. Identify the missing internal control characteristics in each situation.
2. Identify the possible problem caused by each control weakness.
3. Propose a solution to each internal control problem.

P7-31B Accounting for petty cash transactions

On September 1, Party Salad Dressings creates a petty cash fund with an imprest balance of \$600. During September, Michael Martell, the fund custodian, signs the following petty cash tickets:

Petty Cash		
Ticket Number	Item	Amount
101	Office supplies	\$ 60
102	Cab fare for executive	25
103	Delivery of package across town	45
104	Business dinner	55
105	Merchandise inventory	75

Learning Objectives 1, 2, 3

Learning Objective 4

3. Cash Short & Over CR \$15

On September 30, prior to replenishment, the fund contains these tickets plus cash of \$355. The accounts affected by petty cash payments are Office Supplies, Travel Expense, Delivery Expense, Entertainment Expense, and Merchandise Inventory.

Requirements

1. Explain the characteristics and the internal control features of an imprest fund.
2. On September 30, how much cash should the petty cash fund hold before it is replenished?
3. Journalize all required entries to create the fund and replenish it. Include explanations.
4. Make the October 1 entry to increase the fund balance to \$800. Include an explanation and briefly describe what the custodian does.

Learning Objective 4

2. Sep. 30, Cash CR \$140

P7-32B Accounting for petty cash transactions

Suppose that on September 1, Cool Gyration, a disc jockey service, creates a petty cash fund with an imprest balance of \$350. During September, Ruth Mangan, fund custodian, signs the following petty cash tickets:

Petty Cash		
Ticket Number	Item	Amount
1	Postage for package received	\$ 25
2	Office party	10
3	Two boxes of stationery	20
4	Printer cartridges	15
5	Business dinner	65

On September 30, prior to replenishment, the fund contains these tickets plus cash of \$210. The accounts affected by petty cash payments are Office Supplies, Entertainment Expense, and Postage Expense.

Requirements

1. On September 30, how much cash should this petty cash fund hold before it is replenished?
2. Journalize all required entries to (a) create the fund and (b) replenish it. Include explanations.
3. Make the entry on October 1 to increase the fund balance to \$425. Include an explanation.

Learning Objective 6

1. Adjusted Balance \$17,580

P7-33B Preparing a bank reconciliation and journal entries

The May cash records of Donald Insurance follow:

Cash Receipts		Cash Payments	
Date	Cash Debit	Check No.	Cash Credit
May 4	\$ 4,230	1416	\$ 890
9	520	1417	120
14	530	1418	630
17	1,950	1419	1,090
31	1,840	1420	1,420
		1421	900
		1422	670

Donald's Cash account shows a balance of \$17,750 at May 31. On May 31, Donald Insurance received the following bank statement:

Bank Statement for May				
Beginning Balance				\$ 14,400
Deposits and other Credits:				
May	1	EFT	\$ 450	
May	5		4,230	
May	10		520	
May	15		530	
May	18		1,950	
May	22	BC	1,700	9,380
Checks and other Debits:				
May	8	NSF	1,100	
May	11 (check no. 1416)		890	
May	19	EFT	375	
May	22 (check no. 1417)		120	
May	29 (check no. 1418)		630	
May	31 (check no. 1419)		1,900	
May	31	SC	35	(5,050)
Ending Balance				<u>\$ 18,730</u>

Explanations: BC—bank collection; EFT—electronic funds transfer; NSF—nonsufficient funds checks; SC—service charge

Additional data for the bank reconciliation follow:

- The EFT credit was a receipt of rent. The EFT debit was an insurance payment.
- The NSF check was received from a customer.
- The \$1,700 bank collection was for a note receivable.
- The correct amount of check 1419, for rent expense, is \$1,900. Donald's controller mistakenly recorded the check for \$1,090.

Requirements

- Prepare the bank reconciliation of Donald Insurance at May 31, 2018.
- Journalize any required entries from the bank reconciliation.

P7-34B Preparing a bank reconciliation and journal entries

The October 31 bank statement of Wyndham's Healthcare has just arrived from State Bank. To prepare the bank reconciliation, you gather the following data:

- The October 31 bank balance is \$6,290.
- The bank statement includes two charges for NSF checks from customers. One is for \$370 (#1), and the other is for \$180 (#2).

Learning Objective 6

- Book Deductions \$630

- c. The following Wyndham's checks are outstanding at October 31:

Check No.	Amount
237	\$ 120
288	140
291	570
294	570
295	30
296	110

- d. Wyndham's collects from a few customers by EFT. The October bank statement lists a \$2,200 EFT deposit for a collection on account.
- e. The bank statement includes two special deposits that Wyndham's hasn't recorded yet: \$900 for dividend revenue and \$100 for the interest revenue Wyndham's earned on its bank balance during October.
- f. The bank statement lists a \$80 subtraction for the bank service charge.
- g. On October 31, the Wyndham's treasurer deposited \$270, but this deposit does not appear on the bank statement.
- h. The bank statement includes a \$750 deduction for a check drawn by Multi-State Freight Company. Wyndham's notified the bank of this bank error.
- i. Wyndham's Cash account shows a balance of \$3,200 on October 31.

Requirements

1. Prepare the bank reconciliation for Wyndham's Healthcare at October 31, 2018.
2. Journalize any required entries from the bank reconciliation. Include an explanation for each entry.

CRITICAL THINKING

> Using Excel

P7-35 Using Excel for a Bank Reconciliation

Download an Excel template for this problem online in MyAccountingLab or at <http://www.pearsonhighered.com/Horngren>.

Lori Anders of Wilderness Associates is getting ready to prepare the October bank reconciliation.

The cash balance on the books of Wilderness Associates on October 31 is \$3,546.

Lori reviews the bank statement, and notes the checking account balance at October 31 is \$2,445. The bank statement also reveals that the bank collected a note receivable on behalf of Wilderness Associates—the principal was \$1,500 and the interest was \$15. One customer's check for \$29 was returned by the bank for insufficient funds. Two additional items on the bank statement were the monthly EFT for the utilities, \$250, and the bank service fee of \$12. Lori notes that the cash deposit made on October 31 of \$3,300 does not appear on the statement, and that three checks totaling \$975 had not cleared the bank account when the bank statement was prepared.

Requirements

1. Prepare the bank reconciliation for Wilderness Associates at October 31, 2018. Format appropriate cells with dollar signs and double underlines. Use Excel formulas to calculate subtotals and totals.
2. Journalize the entries based on the bank reconciliation. For dollar amounts, use cell references on bank reconciliation.

> Continuing Problem

P7-36 Preparing a bank reconciliation and journal entries

This problem continues the Canyon Canoe Company situation from Chapter 6. Canyon Canoe Company has decided to open a new checking account at River Nations Bank during March 2019. Canyon Canoe Company's March Cash T-account for the new cash account from its general ledger is as follows:

Mar. 1	Balance	0			
2	Deposit	10,000	200	Mar. 2	Ck#101
13	Deposit	2,325	4,300	4	Ck#102
20	Deposit	2,750	750	9	Ck#103
27	Deposit	4,500	1,675	14	Ck#104
31	Deposit	3,490	1,500	21	Ck#105
			175	28	Ck#106
			300	30	Ck#107
	Balance	14,165			

Canyon Canoe Company's bank statement dated March 31, 2019, follows:

Beginning Balance, March 1, 2019		\$ 0
Deposits and other credits:		
Mar. 2	\$10,000	
14	2,325	
21	2,750	
28	4,500	
29 EFT Sport Shirts ⁽¹⁾	500	
31 Interest Revenue	45	20,120
Checks and other debits:		
Mar. 2 EFT to Bank Checks ⁽²⁾	55	
3 Ck#101	200	
6 Ck#102	4,300	
15 Ck#104	1,675	
16 Ck#103	750	
28 EFT to Rivers Energy ⁽³⁾	270	
29 Ck#106	175	
31 Bank service charge	70	(7,495)
Ending balance, March 31, 2019		<u>\$ 12,625</u>

⁽¹⁾ Sport Shirts is a customer making a payment on account.

⁽²⁾ Bank Checks is a company that prints business checks (considered a bank expense) for Canyon Canoe Company

⁽³⁾ Rivers Energy is a utility provider.

Requirements

1. Prepare the bank reconciliation at March 31, 2019.
2. Journalize any transactions required from the bank reconciliation.
3. Compute the adjusted account balance for the Cash T-account, and denote the balance as *End. Bal.* Does the adjusted balance of the Cash T-account match the adjusted book balance on the bank reconciliation?

> Practice Set

P7-37 Preparing a bank reconciliation and journal entries

This problem continues the Crystal Clear Cleaning problem begun in Chapter 2 and continued through Chapter 6.

In March 2019, Crystal Clear Cleaning opened a new checking account at First Regional Bank. The bank statement dated March 31, 2019, for Crystal Clear Cleaning follows:

Beginning Balance, March 1, 2019		\$	0
Deposits and other credits:			
Mar. 2	\$33,000		
10	900		
18	19,000		
20	50,000		
23 EFT Peg's Restaurant ⁽¹⁾	350		
31 Interest Revenue	50		
	<u>103,300</u>		
Checks and other debits:			
Mar. 2 EFT to Check Art ⁽²⁾	10		
5 Ck#235	2,400		
9 Ck#237	1,500		
9 Ck#236	2,900		
26 Ck#239	2,000		
28 EFT to Texas Energy ⁽³⁾	130		
29 Ck#240	300		
31 Bank service charge	25		
		<u>(9,265)</u>	
Ending balance, March 31, 2019		<u>\$</u>	<u>94,035</u>

⁽¹⁾ Peg's Restaurant is a customer making a payment on account.

⁽²⁾ Check Art is a company that prints business checks (considered a bank expense) for Crystal Clear Cleaning.

⁽³⁾ Texas Energy is a utility provider.

Crystal Clear Cleaning's Cash account in the general ledger shows the following transactions for March:

Balance		0			
Mar. 2	Deposit	33,000	2,400	Mar. 2	Ck#235
10	Deposit	900	2,900	4	Ck#236
18	Deposit	19,000	1,500	5	Ck#237
20	Deposit	50,000	400	10	Ck#238
31	Deposit	1,770	2,000	21	Ck#239
			300	23	Ck#240
			300	29	Ck#241
Balance		94,870			

Requirements

1. Prepare the bank reconciliation at March 31, 2019.
2. Journalize any required entries from the bank reconciliation. Post to the Cash T-account to verify the balance of the account matches the adjusted book balance from the bank reconciliation.

> Tying It All Together Case 7-1

Before you begin this assignment, review the *Tying It All Together* feature in the chapter. It will also be helpful if you review *Buffalo Wild Wings, Inc.'s 2015 annual report* (<https://www.sec.gov/Archives/edgar/data/1062449/000106244916000052/bwld2015122710-k.htm>).

Buffalo Wild Wings, Inc. owns and operates more than 550 Buffalo Wild Wings, R Taco, and PizzaRev restaurants. Additionally, the corporation has franchised restaurants in both the United States and Canada. The corporation takes internal control responsibilities very seriously and in 2015 conducted an assessment of the effectiveness of its internal controls over financial reporting.

Requirements

1. Review Item 9a (Controls and Procedures) of the Notes to the Financial Statements. What was the material weakness in internal controls that Buffalo Wild Wings discovered when the company conducted its assessment?
2. Review the auditor's report over internal controls (p. 66 of the annual report). What did the auditor have to say about the company's internal controls?
3. What remedial measures does the company plan to take in order to correct the weaknesses in internal control?

> Decision Cases

Decision Case 7-1

Conduct an Internet search for information on internal control and the Sarbanes-Oxley Act. Write a report of your findings. In your report, discuss some of the advantages and disadvantages of the Sarbanes-Oxley Act. Present it to your class (if required by your instructor).

Decision Case 7-2

This case is based on an actual situation. Centennial Construction Company, headquartered in Dallas, Texas, built a Rodeway Motel 35 miles north of Dallas. The construction foreman, whose name was Slim Chance, hired the 40 workers needed to complete the project. Slim had the construction workers fill out the necessary tax forms, and he sent their documents to the home office.

Work on the motel began on April 1 and ended September 1. Each week, Slim filled out a time card of hours worked by each employee during the week. Slim faxed the time cards to the home office, which prepared the payroll checks on Friday morning. Slim drove to the home office on Friday, picked up the payroll checks, and returned to the construction site. At 5 p.m. on Friday, Slim distributed payroll checks to the workers.

Requirements

1. Describe in detail the main internal control weakness in this situation. Specify what negative result(s) could occur because of the internal control weakness.
2. Describe what you would do to correct the internal control weakness.

> Fraud Case 7-1

Levon Helm was a kind of one-man mortgage broker. He would drive around Tennessee looking for homes that had second mortgages, and if the criteria were favorable, he would offer to buy the second mortgage for “cash on the barrelhead.” Helm bought low and sold high, making sizable profits. Being a small operation, he employed one person, Cindy Patterson, who did all his bookkeeping. Patterson was an old family friend, and he trusted her so implicitly that he never checked up on the ledgers or the bank reconciliations. At some point, Patterson started “borrowing” from the business and concealing her transactions by booking phony expenses. She intended to pay it back someday, but she got used to the extra cash and couldn’t stop. By the time the scam was discovered, she had drained the company of funds that it owed to many of its creditors. The company went bankrupt, Patterson did some jail time, and Helm lost everything.

Requirements

1. What was the key control weakness in this case?
2. Many small businesses cannot afford to hire enough people for adequate separation of duties. What can they do to compensate for this?

> Financial Statement Case 7-1

Visit <http://www.pearsonhighered.com/Horngren> to view a link to **Target Corporation's** 2015 Fiscal Year Annual Report. Study the audit opinion (labeled Report of Independent Registered Public Accounting Firm) of Target Corporation and the Target Corporation financial statements. Answer the following questions about the company:

Requirements

1. What is the name of Target's outside auditing firm (independent registered public accounting firm)? What office of this firm signed the audit report?
2. Who bears primary responsibility for maintaining effective internal control over financial reporting? How can you tell?
3. Does it appear that Target's internal controls are adequate? How can you tell?
4. What standard of auditing did the outside auditors use in examining the Target financial statements?
5. By how much did Target's cash balance (including cash equivalents) change during year ended January 30, 2016? What were the beginning and ending cash balances?
6. Review the notes to the consolidated financial statements, specifically Note 11 dealing with Cash Equivalents. What type of instruments does Target consider to be cash equivalents?
7. Determine Target's cash ratio as of January 30, 2016, and January 31, 2015. How do Target's cash ratios compare with **Kohl's Corporation** as illustrated in the chapter? Explain.

> Communication Activity 7-1

In 100 words or fewer, explain why there may be a difference between the bank statement ending cash balance and the ending balance in the Cash account. Give at least two examples each of adjustments to the bank balance and to the book balance.

MyAccountingLab

For a wealth of online resources, including exercises, problems, media, and immediate tutorial help, please visit <http://www.myaccountinglab.com>.

> Quick Check Answers

1. a 2. d 3. d 4. d 5. d 6. c 7. c 8. b 9. d 10. c 11. b