

# Chapter 7

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## Internal Control, Managing Cash, and Making Ethical Judgments

### T Questions

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1. Safeguarding assets is the most fundamental internal control feature because the entity must safeguard its assets if it is to survive. Accurate and reliable accounting records, operational efficiency, and adherence to company policies are important, but they are not as critical as safeguarding assets.
2. Seven features of an effective system of internal control are (1) competent, reliable, and ethical personnel, (2) assignment of responsibilities, (3) proper authorization, (4) separation of duties, (5) internal and external audits, (6) documents and records, and (7) electronic devices and computer controls.
3. Four key elements of separation of duties are (1) separation of operations from accounting, (2) separation of the custody of assets from accounting, (3) separation of the authorization of transactions from the custody of related assets, and (4) separation of duties within the accounting function.
4. Internal control systems are not usually designed to be foolproof and perfect because of cost constraints. The benefits of the system should exceed its cost.
5. The *bank account* acts as a control device because banks have established practices for safeguarding cash. Also, banks provide depositors with detailed records of cash transactions. Banks use the *signature card* to verify signatures on documents and thus protect the bank and the depositor against forgery. The *deposit ticket* serves as a receipt for a deposit made in a bank account. The deposit ticket describes the details of the deposit. The *bank statement* provides a record of each transaction that affected the account during the period.
6. 

<u>a</u> Deposit in transit	<u>b</u> Outstanding check
<u>c</u> Bank collection	<u>d</u> NSF check
<u>d</u> Customer check returned because of unauthorized signature	<u>d</u> Bank service charge
<u>d</u> Book error that increased balance of Cash account	<u>a</u> Bank error that decreased bank balance
7. A bank reconciliation explains the difference between the book and bank balances of the depositor's cash in the bank account. It ensures that all cash transactions have been accounted for and that the bank and book records of cash are correct.
8. This company would likely report all the amounts as a single figure—Cash—because each amount is cash or liquid enough to be considered cash. An analogy is the reporting of one amount for Accounts Receivable even though the entity may have many individual customer accounts in its accounts receivable subsidiary ledger.
9. A cash register controls cash receipts. It is a security device because the machine records the amount of each transaction entered through it. Periodic comparisons of cash on hand against the record inside the machine discourage theft.

10. A mailroom employee should open incoming mail and compare the amount of cash to the accompanying remittance advice. If no remittance advice is enclosed, the employee should prepare one. The employee should also enter each cash receipt amount on a control tape and present the tape to a responsible official, such as the controller, for verification. Actual cash receipts should be given to the cashier, who combines them with the cash received over the counter and prepares the bank deposit.

The remittance advices are forwarded to the accounting department. Their information is entered in the cash receipts journal and posted to customers' accounts in the accounts receivable ledger. In the final step, the controller compares the three records of the day's cash receipts: (1) control tape total from the mailroom; (2) bank deposit amount from the cashier; and (3) debit to Cash from the accounting department.

11. The invoice, the receiving report, the purchase order, and the purchase request make up the payment packet. Three accounting department procedures use the payment packet to ensure that each payment is appropriate, as follows:
- The *invoice* is compared to a copy of the *purchase order* and *purchase request* to ensure that the business pays cash only for the goods ordered. A purchasing agent prepares the purchase order and mails it to the supplier as the first step in the purchase transaction.
  - The *invoice* is compared to the *receiving report* to ensure that cash is paid only for the goods actually received. The receiving department prepares the receiving report when the goods arrive.
  - The mathematical accuracy of the invoice is proved.

12. The Petty Cash account keeps its prescribed balance at all times. This balance does *not* always equal the amount of cash in the fund. The two amounts are equal immediately after the fund has been opened or replenished. At other times, when payments have been made from the fund, the balance in the account exceeds the amount of cash in the Petty Cash fund.
13. A budget helps a company manage its cash by providing a plan for the receipt and payment of cash during a future period. During the period covered by the budget, owners and managers compare actual figures to budgeted amounts. Differences between actual and budget amounts lead managers to take needed action.
14. Accountants should generally adhere to a higher standard of ethical conduct than other members of society because accountants agree to abide by a code of professional conduct. The work of professionals is difficult to judge, so the American Institute of Certified Public Accountants and the Institute of Management Accountants require a high standard of conduct as a condition of membership.

## T Daily Exercises

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(5-10 min.) **DE 7-4**

(5 min.) **DE 7-1**

Treasurer – chief finance officer  
responsible for cash management

Controller – chief accounting officer  
responsible for all aspects of accounting

Separating the controller's duties (accounting) from the treasurer's duties (cash management) keeps either person from stealing cash and making accounting entries to cover the theft.

The internal auditors examine various segments of the business to ensure that employees follow company policies. Internal auditors report to the company's audit committee.

The internal auditors do not report to the treasurer because the treasurer is responsible for cash management. If the treasurer is not managing cash effectively, then higher-level personnel, such as the audit committee, need to know about it. If the internal auditors were to report directly to the treasurer, the treasurer may not correct his or her behavior or improve performance.

*Note:* Student responses may vary.

(5 min.) **DE 7-2**

Safeguarding assets is most important because all organizations need assets to survive.

(5 min.) **DE 7-5**

### Differences:

1. External auditors are entirely independent of the business.  
Internal auditors are employees of the business.
2. External audits are designed to determine whether the company's financial statements are prepared in accordance with generally accepted accounting principles.  
Internal audits are designed to ensure that employees follow company policies and that operations run efficiently.

### Similarities:

1. Both types of auditors are independent of the operations they examine.
2. Both types of auditors suggest improvements that help the business run more efficiently.

Separation of duties is essential for safeguarding assets. The person who has custody of an asset should *not* also account for the asset. With both duties, the person can steal the asset and hide the theft by making a false entry in the accounting records.

*Note:* Student responses may vary.

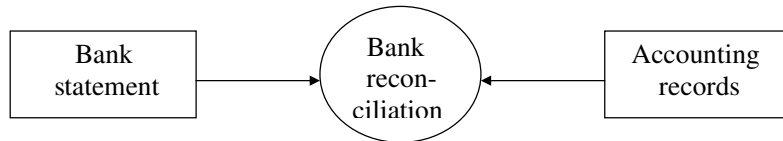
(5 min.) **DE 7-6**

Merrill Lynch could have:

1. Kept all accounting duties away from the cashier. This would have kept the cashier from covering her theft with entries in the accounting records.
2. Required employees to take vacations and rotated employees from job to job. These measures would have placed another person in the cashier's job and probably would have brought the theft to light earlier.
3. Used an internal auditor. Darlyne Lopez would be less likely to steal and manipulate customer accounts if she knew her work would be audited.

*Note:* Only two measures are required.

(5 min.) **DE 7-7**



*Note:* Student responses may vary.

(5 min.) **DE 7-8**

1. A *bank statement* is the document the bank uses to report what it did with the depositor's cash. The statement shows the bank account's beginning and ending cash balances for the period and lists the month's cash transactions conducted through the bank.

A *bank reconciliation* is a document prepared by the company (not by the bank) to ensure that all cash transactions have been accounted for and that the bank and book records of cash are correct.

2. A bank reconciliation is neither a journal, a ledger, an account, nor a financial statement. Instead, it is an accountant's tool, separate from the company's books, that explains all differences between the firm's cash records and the bank statement figures.

3. The *Books* side

(10 min.) **DE 7-9**

1. Deposit in transit:

Date	Amount
Jan. 31	\$1,591.63

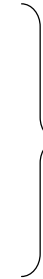


3. Bank side of reconciliation

Added on bank side of reconciliation

2. Outstanding checks:

Check No.	Amount
337	\$286.00
338	319.47
339	83.00
340	203.14
341	458.53



Subtracted on bank side of reconciliation

(10 min.) **DE 7-10**

Theraband Equipment			
Bank Reconciliation			
May 31, 20XX			
BANK		BOOKS	
Balance, May 31	\$3,270	Balance, May 31	\$2,280
Add:		Add:	
Deposit in transit	<u>200</u>	Bank collection	300
	3,470	Interest revenue	<u>10</u>
			2,590
Less:		Less:	
Outstanding checks	<u>(900)</u>	Service charge	<u>(20)</u>
Adjusted bank balance	<u>\$2,570</u>	Adjusted book balance	<u>\$2,570</u>



Amounts agree

(5 min.) **DE 7-11**

May 31	Cash .....	300	
	Accounts Receivable—Kelly Brooks .....		300
	Collection on account.		
31	Cash.....	10	
	Interest Revenue .....		10
	Interest earned on bank balance.		
31	Miscellaneous Expense .....	20	
	Cash.....		20
	Bank service charge.		

(5 min.) **DE 7-12**

Someone with only accounting duties should prepare the bank reconciliation. The preparer should *not* have cash-handling duties because that person could steal cash and cover the theft by manipulating the bank reconciliation.

(5 min.) **DE 7-13**

It appears that the employee has stolen \$980 (adjusted book balance, \$3,280 !adjusted bank balance, \$2,300). The adjusted bank balance is the company’s true cash balance, and the company books show more cash on hand, so the books must be wrong.

(5 min.) **DE 7-14**

A dishonest salesperson could steal cash from the cash register and alter the record of transactions.

Macy’s keeps this from happening by denying the salesperson access to the transaction record.

(5 min.) **DE 7-15**

Dupree will notice a gap in the sequence of sales receipts for the receipt Carter destroyed.

This knowledge will lead Dupree to investigate what happened to the missing sales receipt and what happened to the related cash.

The controller compares three records of the day's cash receipts, as follows:

- |   |   |   |
|---|---|---|
| 1. Control tape total from the mailroom         | } | This comparison establishes that cash receipts went into the bank.                    |
| 2. Bank deposit amount from the cashier         |   |   |
| 3. Debit to Cash from the accounting department | } | This comparison establishes that customers received proper credit for their payments. |

A lock-box system protects cash from theft by having customers send the amounts they owe directly to the bank, not to the company. This way company personnel never touch cash receipts from customers.

1. Two controls over cash resulting from payment by check:
  - Each check acts as a source document.
  - To be valid, the check must be signed by an authorized official, so each payment by check draws the attention of management.
2. A dishonest purchasing agent could:
  - Purchase goods and have them delivered to his home or other location that he controls, or otherwise take the goods for personal use.
  - Approve payment by the company for goods that he used for personal gain.

Companies avoid this internal control weakness by separating the following duties related to the purchase of, and payment for, goods:

- purchasing goods
- receiving goods
- approving and paying for goods

1. An *imprest* petty cash system maintains the Petty Cash account at the prescribed balance at all times. The account balance equals the sum of cash still in the fund plus petty cash tickets for payments that have been made from the fund.

The main control feature of an imprest system is that it clearly identifies the amount of cash for which the custodian is responsible.

2. Nov. 1 Petty Cash ..... 400  
           Cash in Bank ..... 400  
           To open the petty cash fund.
- 30 Travel Expense..... 80  
       Office Supplies..... 60  
       Delivery Expense ..... 40  
       Cash in Bank ..... 180  
       To replenish the petty cash fund.

- 3.
- |                                       |     |
|---------------------------------------|-----|
| <u>          Petty Cash          </u> |     |
| Nov. 1                                | 400 |
- Petty Cash balance at all times ..... \$400

1.

Gap, Inc.	
Cash Budget	
Year Ended January 31, 20X2	
	<i>Millions</i>
Cash balance, February 1, 20X1	\$ 203
Estimated cash receipts—total	<u>2,869</u>
	3,072
Estimated cash payments—total (\$3,386 ! \$349)	<u>(3,037)</u>
Cash available (needed) before new financing	35
Budgeted cash balance, January 31, 20X2	(200)
Cash available for additional investments, or (New financing needed)	<u><u>\$ (165)</u></u>

2.

Gap, Inc.	
Cash Budget	
Year Ended January 31, 20X2	
	<i>Millions</i>
Cash balance, February 1, 20X1	\$ 203
Estimated cash receipts—total	<u>2,869</u>
	3,072
Estimated cash payments—total (\$3,386 ! \$206 ! \$349)	<u>(2,831)</u>
Cash available (needed) before new financing	241
Budgeted cash balance, January 31, 20X2	(200)
Cash available for additional investments	<u><u>\$ 41</u></u>

(5-10 min.) **DE 7-20**

Florida Progreso Growers	
Cash Budget	
Year Ended January 31, 2002	
	<i>Millions</i>
Cash balance, December 31, 2001	\$ 6
Estimated cash receipts—total	147
	153
Estimated cash payments—total	(158)
Cash available (needed) before new financing	(5)
Budgeted cash balance, December 31, 2002	(5)
Cash available for additional investments, or (New financing needed)	\$ (10)

(5 min.) **DE 7-21**

Larson should report the errors to Kwan because Kwan is Larson's supervisor, and Kwan is responsible for the errors. If Kwan fails to take action, then Larson should report the errors to the owner of the company. In any event, outsiders who are relying on BSI's financial statements must be made aware of the need to correct the reported net income figure.

## T Exercises

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(10 min.) **E 7-1**

Toshima's internal control weakness was a lack of separation of duties. The article states that "Takeda admitted to concealing the losses by falsifying Toshima's books and records." Obviously Mr. Takeda, a copper trader, also had access to the accounting records for his own trades.

Toshima could have avoided the losses by denying Takeda access to the accounting records. This would have prevented him from falsifying the records and probably would have brought the losses to light earlier. Also, Toshima could have kept the losses from growing so large by having a supervisor review Takeda's work and trace his trades to the related accounting records to ensure that the records agreed with details of Takeda's trades.

(10 min.) **E 7-2**

Cash Receipts:

- a. Weak internal control. The accountant both handles cash and accounts for cash.
- b. Strong internal control. There is a good separation of duties. Different people handle cash and account for cash.

Equipment Purchases:

- a. Strong internal control. There is a good separation of duties. Supervisors request equipment, and the home office purchases the equipment.
- b. Weak internal control. Supervisors request, purchase, and pay for equipment, with little oversight by the home office.

(10 min.) **E 7-3**

- a. *Weakness.* The sales clerk should not have access to the control tape because he or she could steal cash and delete a cash receipt from the tape.
- b. *Weakness.* The vice-president should examine the payment packet to ensure that the payment is valid and for the correct amount. *Note:* He or she may have to do this on a sample basis if there is a large number of checks to sign.
- c. *Weakness.* The control environment will not be as effective as it would be if top management led in establishing internal controls.
- d. *Weakness.* The accounting department should not be allowed to order merchandise. An accountant could have goods sent to a location he or she controls, then approve payment for the goods.
- e. *Strength.* The computer operator cannot steal cash because he or she does not handle the cash of the business.

(10 min.) **E 7-4**

The missing internal control characteristic in each situation is:

- a. Other controls (not depositing cash frequently enough for adequate security).
- b. Separation of duties (same person ordering merchandise and approving payment).
- c. Separation of duties (same person selling tickets and taking tickets).
- d. Other controls (not pricing at odd amounts to require that change be made and force the sale to be entered on the cash register's tape).
- e. Documents and records (no receiving report).

(20 min.) **E 7-5**

a. Managers are more concerned about safeguarding assets because most businesses cannot operate without assets. At a minimum, the business needs cash to purchase goods for resale and to pay employee salaries and other bills. Managers must safeguard the company's assets, or it will go out of business.

Auditors are more concerned about the quality of the accounting records for two reasons. The final product of the records is the set of financial statements on which the auditors express an opinion. To arrive at the opinion, the auditors must rely on accounting records. If the records are reliable, auditors do not have to examine every transaction and can thus reduce the cost of the audit.

b. Separation of duties is important because it limits the chances for fraud (loss of assets) and also promotes the accuracy of accounting records. This allows managers to rely on the accounting records to produce information useful for operating the business.

c. Cash is important because of its effect on a business. All transactions ultimately affect cash. Businesses purchase assets and must pay cash. They make sales and collect cash. All expenses ultimately require cash. Also, cash is susceptible to theft because it is the medium of exchange. Financial distress is usually accompanied by a shortage of cash. These factors combine to give cash more importance than its account balance would suggest.

d. Having a check signer cancel supporting documents reduces the opportunity for fraud. Without this control procedure, a dishonest employee could resubmit the documents for payment a second time. The employee could change the payee's address and have the check sent to an address that the employee controls. Or the employee could arrange to have the second payee split the second payment with the employee. Canceling the documents immediately upon payment makes it difficult to get approval for duplicate payment.

(5 min.) **E 7-6**

- a. 1
- b. 4
- c. 3
- d. 2
- e. 3
- f. 2
- g. 1

(10-20 min.) **E 7-7**

Bill Westphal		
Bank Reconciliation		
September 30, 20XX		
<b>BANK:</b>		
Balance, September 30		\$ 441
Add: Deposit in transit		1,800
Less: Outstanding checks:		
Check No.		
626	\$ (75)	
627	(275)	(350)
Adjusted bank balance		<u>\$1,891</u>
<b>BOOKS:</b>		
Balance, September 30		\$1,921
Less:		
Correction of book error—		
Recorded \$68 check as \$58	\$ (10)	
Cost of checks	(8)	
Service charge	(12)	(30)
Adjusted book balance		<u>\$1,891</u>

(10-15 min.) **E 7-8**

Mario Bocelli		
Bank Reconciliation		
October 31, 20XX		
<b>BANK:</b>		
Balance, October 31		\$2,750
Add: Deposit in transit		<u>1,788</u>
		4,538
Less: Outstanding checks:		<u>(467)</u>
Adjusted bank balance		<u><u>\$4,071</u></u>
<b>BOOKS:</b>		
Balance, October 31		\$4,027
Add: EFT collection—rent		<u>400</u>
		4,427
Less:		
Service charge	\$ (12)	
NSF checks	(74)	
Charge for printed checks	(9)	
Correction of book error—		
Recorded \$290 check as \$29	(261)	<u>(356)</u>
Adjusted book balance		<u><u>\$4,071</u></u>



(10 min.) **E 7-9**

Journal					
DATE		ACCOUNTS AND EXPLANATIONS	POST. REF.	DEBIT	CREDIT
Oct.	31	Cash		400	
		Rent Revenue			400
		EFT collection of rent.			
	31	Miscellaneous Expense (\$12 + \$9)		21	
		Cash			21
		Bank service charge and charge for printed checks.			
	31	Accounts Receivable		74	
		Cash			74
		NSF checks returned by bank.			
	31	Salary Expense (\$290 ! \$29)		261	
		Cash			261
		Correction of book error.			

(5-15 min.) **E 7-10**

The most likely way a person would manipulate a bank reconciliation to cover a theft is by understating the dollar amount of the outstanding checks. These are the most numerous items on the bank reconciliation and thus the place where a manipulation would be hardest to detect.

Example:

Reconciliation

	Honest	Manipulated
Bal. per bank	\$500	\$500
Less: Outstanding checks	(200)	(100) <i>Understated</i>
Adjusted bal. per bank	<u>\$300</u>	<u>\$400</u>
Adjusted bal. per books	<u>\$400</u>	<u>\$400</u>

← Amounts disagree
← Amounts agree

This theft could have been avoided by having someone besides the restaurant manager perform the bank reconciliation.

*Note:* Student responses probably will not include this numerical example.

(10 min.) **E 7-11**

TO: Store Manager

There is a weakness in internal control over cash receipts from customers. The cash registers do not keep an internal record of sales. With no record of sales locked in the cash register, there is no way to determine how much cash should be in the cash drawer. This omission makes it easy for the cashier to steal cash and not get caught. To improve internal control over cash, the company should use cash registers that lock a record of each sale and a record of the total cash receipts for the day into the machine. The manager can prove the amount of cash in the cash drawer against this recorded amount.

(10 min.) **E 7-12**

<b>Journal</b>					
DATE		ACCOUNTS AND EXPLANATIONS	POST. REF.	DEBIT	CREDIT
Apr.	1	Petty Cash		300	
		Cash			300
	2	Cash		2,873	
		Sales Revenue			2,869
		Cash Short and Over			4
	10	Office Supplies		111	
		Delivery Expense		13	
		Entertainment Expense		37	
		Cash Short and Over		20	
		Cash			181

Req. 1

<b>Journal</b>				
DATE	ACCOUNTS AND EXPLANATIONS	POST. REF.	DEBIT	CREDIT
	Petty Cash		500.00	
	Cash in Bank			500.00
	To set up the petty cash fund.			
	Delivery Expense		22.19	
	Supplies Expense (\$34.14 + \$85.37)		119.51	
	Miscellaneous Expense (\$2.85 + \$13.78)		16.63	
	Postage Expense		52.80	
	Cash in Bank			211.13
	To replenish the petty cash fund.			

Req. 2

Prior to replenishment:

Currency and coins totaling .....	\$288.87
Petty cash tickets totaling .....	<u>211.13</u>
Imprest total .....	<u>\$500.00</u>

Req. 3

After replenishment:

Currency and coins totaling .....	<u>\$500.00</u>
-----------------------------------	-----------------

Sprint Corporation		
Cash Budget		
Year Ended December 31, 20X4		
	<i>Millions</i>	
Cash balance, December 31, 20X3		\$ 135
Estimated cash receipts:		
Collections from customers		11,813
Sale of assets		<u>116</u>
		12,064
Estimated cash payments:		
Payments for cost of services and products	\$(6,166)	
Payments of operating expenses	(2,744)	
Investment in equipment	(1,826)	
Investment in cellular division	(275)	
Payment of debt	(597)	
Payments to owners	<u>(338)</u>	<u>(11,946)</u>
Cash available (needed) before financing		118
Budgeted cash balance, December 31, 20X4		<u>(137)</u>
(New financing needed)		<u>\$ (19)</u>

Sprint expects to need an additional \$19 million to carry out its plans during 20X4.

(15-20 min.) **E 7-15**

1. *Determine the facts.* Given in the text description.
2. *Identify the ethical issues.* You must decide whether it is ethical—good or bad, moral or immoral—for a member of the Congress to write these NSF checks on a regular basis.
3. *Specify the alternatives.* Deliberately write the NSF checks or not.
4. *Identify the people involved.* You, other House members, and the public at large can be affected. The public is affected mostly by the example set by deliberately writing NSF checks. The money used to pay the checks belongs to the other members of the U.S. House of Representatives.
5. *Assess the possible consequences.* If you write the NSF checks, you may anger your constituents back home because they may not enjoy this privilege and view the practice as dishonest. They may vote you out of office (this actually occurred). You may also be encouraging the public to be lax in their own thrift and money management. The effect on people's spending and saving behavior could be negative and widespread. Finally, you would be borrowing from your colleagues with no interest or service charges.
6. *Make the decision.* It would be ethical and wise to avoid the practice. The high road is always best. Was it unethical for the legislators to write the NSF checks? Each person must decide for himself or herself. The class discussion should be lively.

It is interesting to contrast the House bank situation with private citizens' writing NSF checks by prior arrangement with their bank and paying interest and other charges on the borrowed money. Because of the prior arrangement with the bank, this is simply another way to borrow money.

## Challenge Exercise

(30-40 min.) **E 7-16**

*Req. 1*

Continental Paper Company		
Cash Budget		
Year Ended December 31, 20X5		
	Millions	
Cash balance, December 31, 20X4		\$ 340
Estimated cash receipts:		
Collections from customers	\$ 19,467	
Investments by owners	516	
Other cash receipts	<u>111</u>	<u>20,094</u>
		20,434
Estimated cash payments:		
Purchases of inventory	\$(14,345)	
Payments of operating expenses	(2,349)	
Purchase of property and equipment	(1,518)	
Acquisition of other companies	(1,168)	
Payment of long-term and short-term debt	(950)	
Payments to owners	<u>(237)</u>	<u>20,567</u>
Cash available (shortage) before financing		(133)
Budgeted cash balance, December 31, 20X5		<u>(300)</u>
Cash available for additional investments, or (New financing needed)		<u>\$ (433)</u>

*Req. 2*

Before Borrowing:

$$\text{Current ratio} = \frac{\text{Total current assets}}{\text{Total current liabilities}} = \frac{\$5,873}{\$4,863} = 1.21$$

$$\text{Debt ratio} = \frac{\text{Total liabilities}}{\text{Total assets}} = \frac{\$16,180}{\$23,977} = 0.67$$

After Borrowing:

$$\text{Current ratio} = \frac{\$5,873 + \$433}{\$4,863} = 1.30$$

$$\text{Debt ratio} = \frac{\$16,180 + \$433}{\$23,977 + \$433} = 0.68$$

I would lend \$433 million to Continental Paper because the loan would improve the current ratio and have virtually no effect on the debt ratio.

The budgeted amount of borrowing (\$433 million) is low relative to Continental Paper's current liabilities and total liabilities, so the company should have no trouble paying off the long-term debt.