

# Survey of Accounting, 9e

Carl S. Warren and  
Amanda G. Farmer



Warren, Survey of Accounting, Ninth Edition. © 2021 Cengage. All Rights Reserved. May not be scanned, copied or duplicated, or posted to a publicly accessible website, in whole or in part.

 CENGAGE

SURVEY OF <sup>9E</sup>  
**ACCOUNTING**  
WITH WARREN'S METRIC ANALYSIS

CARL S. WARREN  
AMANDA G. FARMER

# Chapter 5

## Internal Control and Cash

 CENGAGE

Warren, Survey of Accounting, Ninth Edition. © 2021 Cengage. All Rights Reserved. May not be scanned, copied or duplicated, or posted to a publicly accessible website, in whole or in part.

# Learning Objectives

- Describe the Sarbanes-Oxley Act and its impact on internal controls and financial reporting
- Describe and illustrate the objectives and elements of internal control
- Describe and illustrate the application of internal controls to cash
- Describe the nature of a bank account and its use in controlling cash
- Describe and illustrate the use of a bank reconciliation in controlling cash
- Describe the accounting for special-purpose cash funds

## Learning Objectives (continued)

- Describe and illustrate the reporting of cash and cash equivalents in the financial statements
- Describe and illustrate the ratio of cash to net monthly operating cash flows in assessing the ability of a company to continue operating

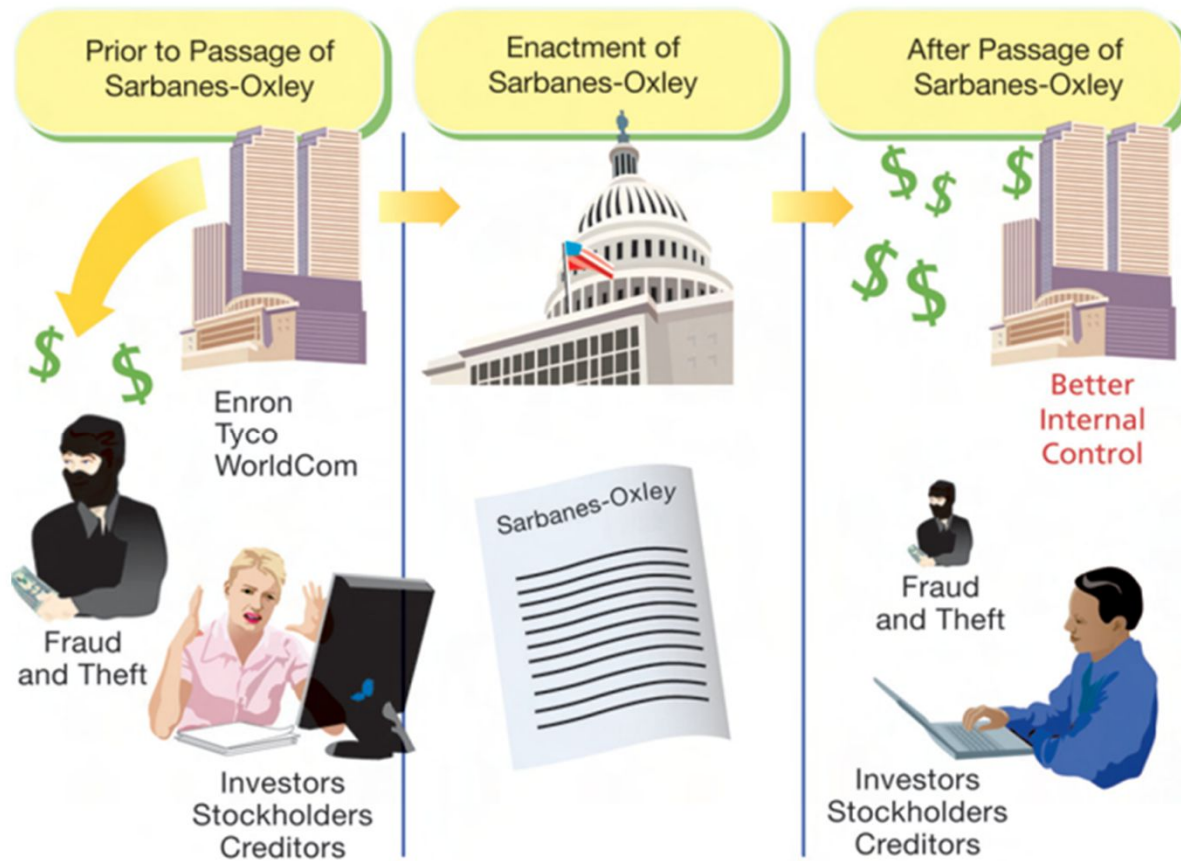
# Learning Objective 1

Describe the Sarbanes-Oxley Act and its impact on internal controls and financial reporting

# Sarbanes-Oxley Act

- Passed by the U.S. Congress to reduce the likelihood and mitigate the impact of financial fraud
- Emphasizes the importance of effective internal control
  - **Internal control:** Procedures and processes used by a company to:
    - Safeguard its assets
    - Process information accurately
    - Ensure compliance with laws and regulations

# Exhibit 1: Effect of Sarbanes-Oxley

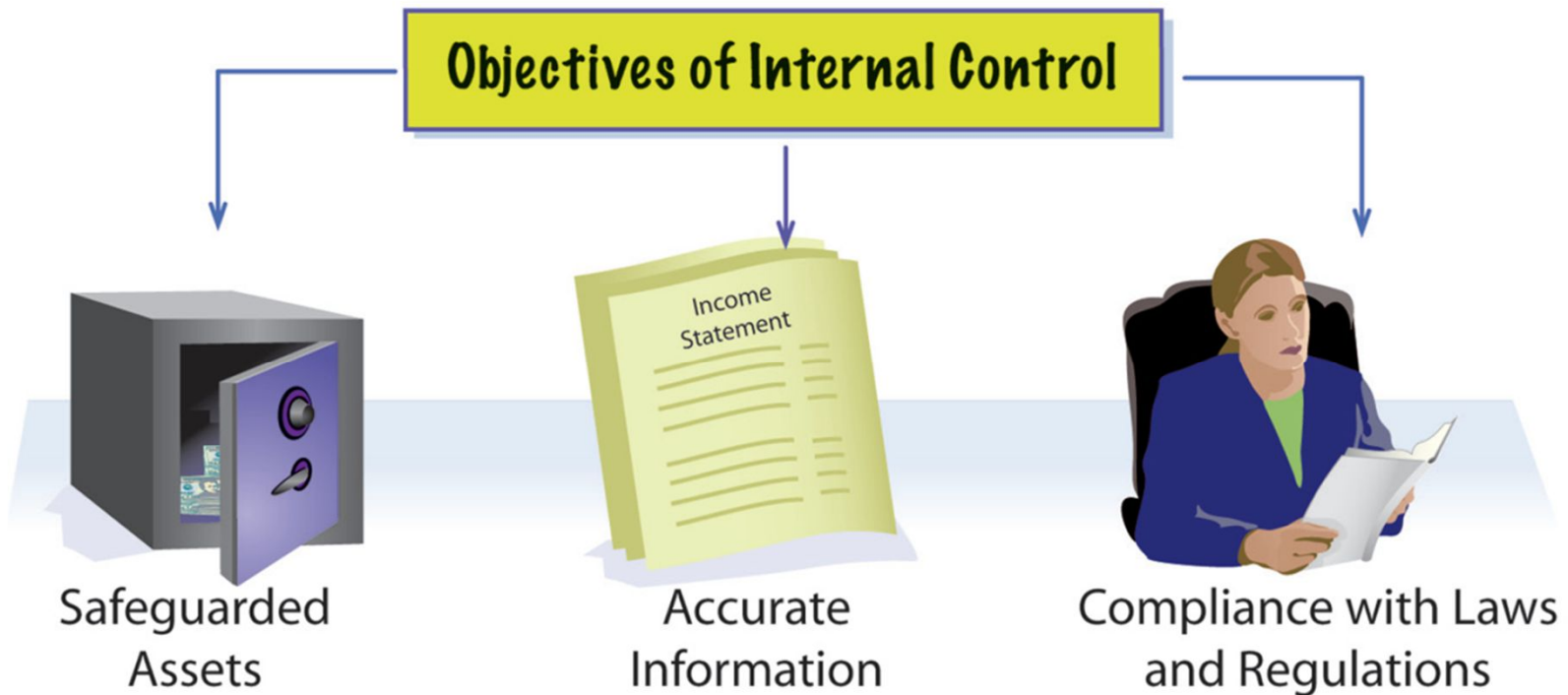


## Learning Objective 2

Describe and illustrate the objectives and elements of internal control



# Exhibit 3: Objectives of Internal Control



# Exhibit 4: Elements of Internal Control



# Control Environment

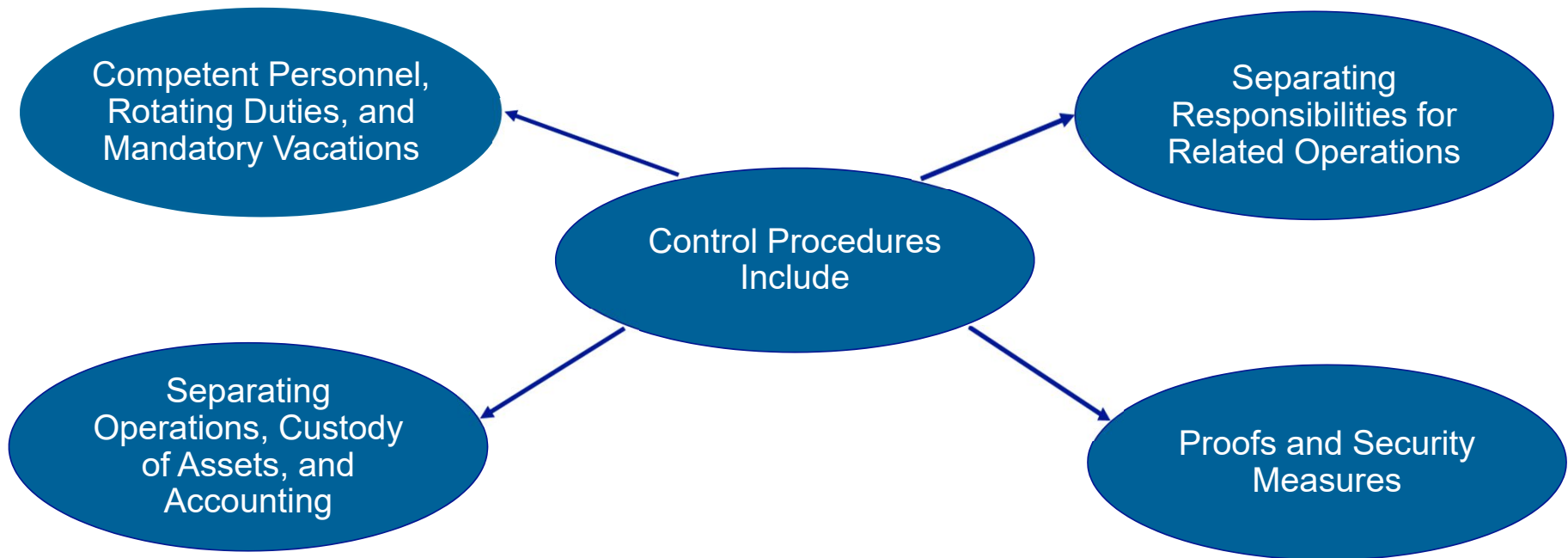
- Overall attitude of management and employees about the importance of controls
- Factors that influence a company's control environment
  - Management's philosophy and operating style
  - Company's organizational structure
  - Company's personnel policies

# Risk Assessment

- Management should:
  - Identify risks and analyze their significance
  - Assess the likelihood of the occurrence of risks
  - Take necessary actions to minimize risks

# Control Procedures

- Provide reasonable assurance that business goals will be achieved



# Exhibit 5: Warning Signs of Internal Control Problems

## Warning signs with regard to people

1. Abrupt change in lifestyle (without winning the lottery).
2. Close social relationships with suppliers.
3. Refusing to take a vacation.
4. Frequent borrowing from other employees.
5. Excessive use of alcohol or drugs.

## Warning signs from the accounting system

1. Missing documents or gaps in transaction numbers (could mean documents are being used for fraudulent transactions).
2. An unusual increase in customer refunds (refunds may be phony).
3. Difference between daily cash receipts and bank deposits (could mean receipts are being pocketed before being deposited).
4. Sudden increase in slow payments (employee may be pocketing the payments).
5. Backlog in recording transactions (possibly an attempt to delay detection of frauds).

# Information and Communication

- Information about the control environment, risk assessment, control procedures, and monitoring is used by management for:
  - Guiding operations
  - Ensuring compliance with reporting, legal, and regulatory requirements
- Management uses external information to assess events and conditions that impact decision making and external reporting

# Limitations of Internal Controls

## Human element of controls

- Fatigue, carelessness, confusion, or misjudgment can cause human errors

## Cost-benefit considerations

- Costs of internal controls should not exceed their benefits



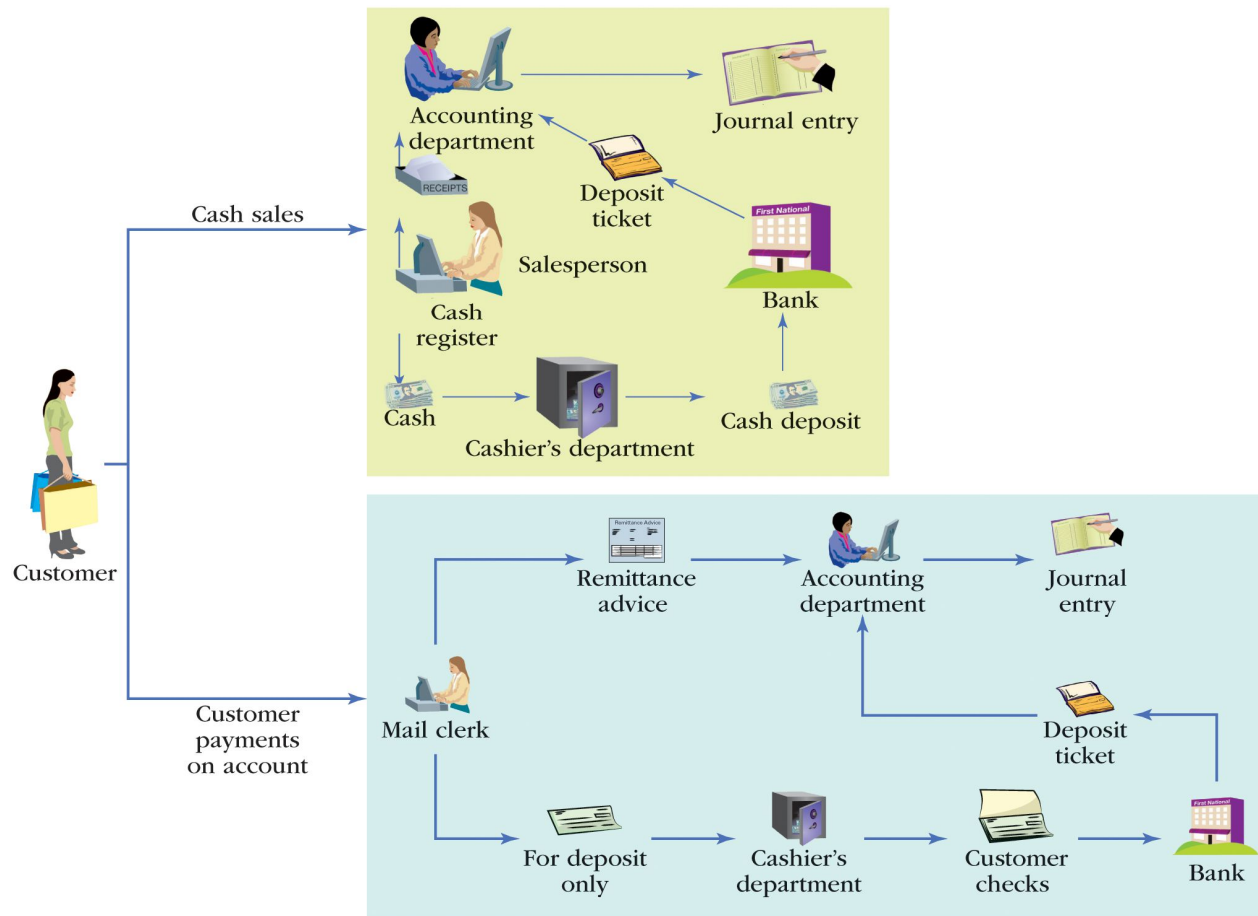
# Learning Objective 3

Describe and illustrate the application of internal controls to cash

# Cash

- Anything that a bank would accept for deposit in one's account
- Businesses should carefully control cash and cash transactions
  - Cash can be stolen or used improperly
- Sources
  - Customers purchasing products or services
  - Customers making payments on accounts

# Exhibit 6: Cash Received from Customers



# Cash Received from Cash Sales

- Cash register
  - An important control to protect cash received in over-the-counter sales
- Cash short and over
  - Difference in amount of cash on hand and cash sales
  - A cash overage is recorded as a positive amount
  - Reporting the balance at the end of the period
    - Negative balance reported as an Other operating expense
    - Positive balance reported as Other revenue

# Cash Received in the Mail

- Cash is in the form of checks and money orders
- Controlled using remittance advices
  - Remittance advice: Portion of the invoice returned by customers with their payment

# Cash Received by Electronic Funds Transfer (EFT)

- Companies encourage EFT for the following reasons:
  - Costs less than receiving cash payments through the mail
  - Cash is received directly by the bank
    - Enhances internal control
  - Reduces late payments from customers
  - Speeds up the processing of cash receipts

# Control of Cash Payments

- Should provide reasonable assurance that:
  - Payments are made for only authorized transactions
  - Cash is used effectively and efficiently
- Managing activities in a large business requires coordination to ensure payments are made to creditors

# Voucher System

- Set of procedures for authorizing and recording liabilities and cash payments
- **Voucher:** Any document that serves as a proof of authority to pay cash or issue an electronic funds transfer (EFT)
  - System of preparation can be manual or computerized
  - Companies use EFT to pay their employees, suppliers, and other vendors



## Learning Objective 4

Describe the nature of a bank account and its use in controlling cash

# Bank Accounts: Advantages

- Reduce the amount of cash on hand
- Provide an independent recording of cash transactions
- Help facilitate the transfer of funds using EFT systems

# Exhibit 7: Bank Statement

MEMBER FDIC		PAGE 1					
<b>Mariner National Bank</b> 5000 NE 75th Street Bellevue, WA 98005		ACCOUNT NUMBER	1627042				
Colter Inc. 200 West Main Street Bozeman, MT 59715		FROM	6/30/20Y7 TO 7/31/20Y7				
		BALANCE	4,218.60				
		22 DEPOSITS	13,749.75				
		52 WITHDRAWALS	14,698.57				
		3 OTHER DEBITS AND CREDITS	90.00CR				
		NEW BALANCE	3,359.78				
* -- CHECKS AND OTHER DEBITS ----- * ----- DEPOSITS -- DATE * BALANCE *							
No. 850	819.40	No. 852	122.54	585.75	07/01	3,862.41	
No. 854	369.50	No. 853	20.15	421.53	07/02	3,894.29	
No. 851	600.00	No. 856	190.70	No. 857	52.50	781.30	07/03 3,832.39
No. 855	25.93	No. 858	160.00	662.50	07/05	4,308.96	
No. 860	921.20	NSF	300.00	503.18	07/07	3,590.94	
No. 880	32.26	No. 877	535.09	ACH 932.00	07/29	4,136.66	
No. 881	21.10	No. 879	732.26	No. 882	126.20	705.21	07/30 3,962.31
		SC	18.00	MS 408.00	07/30	4,352.31	
No. 874	26.12	ACH	1,615.13	648.72	07/31	3,359.78	
EC — ERROR CORRECTION		ACH — AUTOMATED CLEARING HOUSE					
MS — MISCELLANEOUS		SC — SERVICE CHARGE					
NSF — NOT SUFFICIENT FUNDS							
***		***		***			
THE RECONCILEMENT OF THIS STATEMENT WITH YOUR RECORDS IS ESSENTIAL. ANY ERROR OR EXCEPTION SHOULD BE REPORTED IMMEDIATELY.							

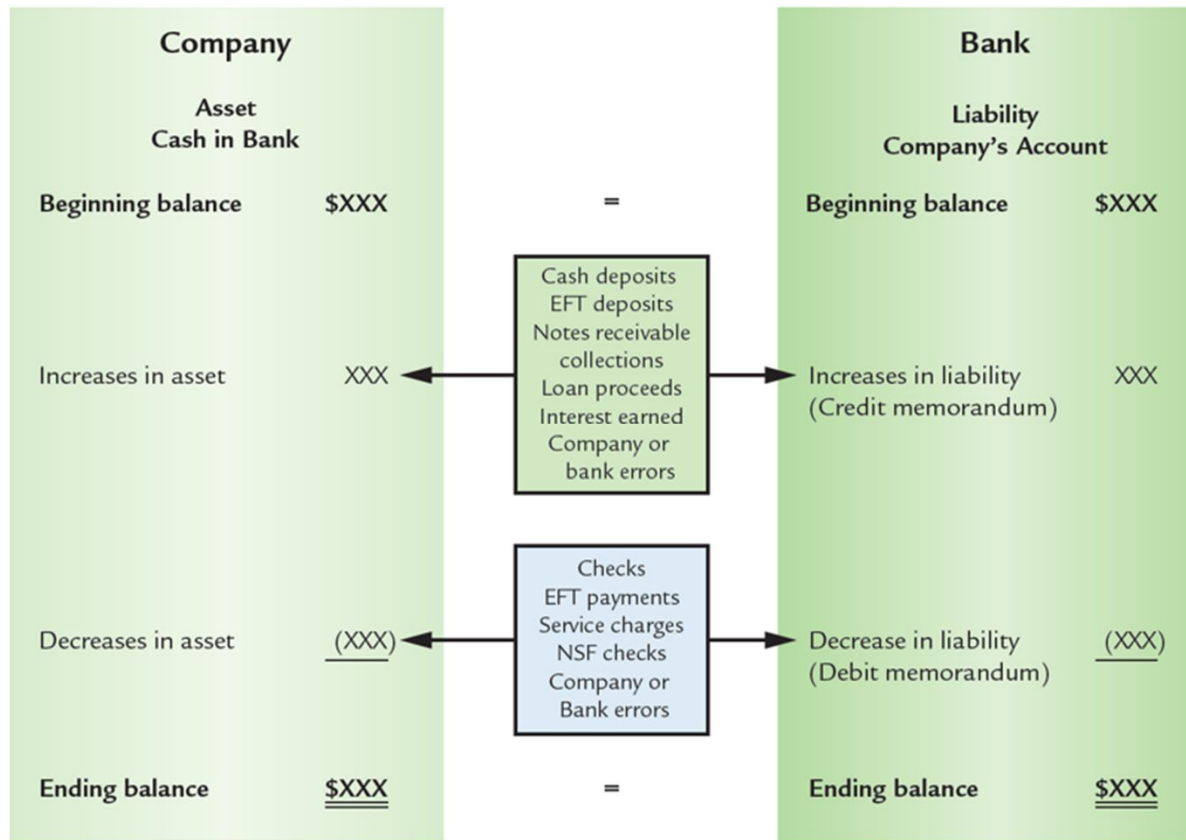


Warren, Survey of Accounting, Ninth Edition. © 2021 Cengage. All Rights Reserved. May not be scanned, copied or duplicated, or posted to a publicly accessible website, in whole or in part.

# Credit and Debit Memo Entries on the Bank Statement

- Credit memo entry
  - Indicates an increase in the depositor's account
- Debit memo entry
  - Indicates a decrease in the depositor's account
- Reasons for entry are indicated in the bank statement

# Exhibit 8: Relationship between Bank and Company



# Exhibit 9: Colter Inc.'s Records and Bank Statement

Bank Statement		
Beginning balance		\$ 4,218.60
Additions:		
Deposits	\$13,749.75	
Miscellaneous	<u>408.00</u>	14,157.75
Deductions:		
Checks	\$14,698.57	
NSF check	300.00	
Service charge	<u>18.00</u>	(15,016.57)
Ending balance		<u>\$ 3,359.78</u>

Colter Inc.'s Records	
Beginning balance	\$ 4,227.60
Deposits	14,565.95
Checks	(16,243.56)
Ending balance	<u>\$ 2,549.99</u>

Colter Inc. should determine the reason for the difference in these two amounts.

# Learning Objective 5

Describe and illustrate the use of a bank reconciliation in controlling cash

# Bank Reconciliation

- Analysis of the items and amounts that result in the cash balance reported in the bank statement differing from the balance of the cash account in the ledger
  - Adjusted cash balance determined in the bank reconciliation is reported on the balance sheet
- Should be prepared by an employee who does not take part in or record cash transactions to avoid mistakes



# Exhibit 10: Bank Reconciliation Format

Cash balance according to bank		\$XXX	
Add: Increases to cash not on bank statement (deposits in transit, etc.)	\$XXX		
Deduct: Decreases to cash not on bank statement (outstanding checks, etc.)	(XXX)	<u>XXX</u>	
Adjusted balance		<u><u>\$XXX</u></u>	
←			
Cash balance according to company		\$XXX	
Add: Unrecorded bank increases to cash (credit memos) (notes collected by bank, etc.)	\$XXX		
Deduct: Unrecorded decreases to cash (debit memos) (NSF checks, service charges, etc.)	(XXX)	<u>XXX</u>	
Adjusted balance		<u><u>\$XXX</u></u>	
←			

Must  
be  
equal

# Exhibit 11: Bank Reconciliation Steps

## Bank Section of Reconciliation

- Step 1.** Enter the *Cash balance according to bank* from the ending cash balance according to the bank statement.
- Step 2.** *Add deposits not recorded by the bank.* Identify deposits not recorded by the bank by comparing each deposit listed on the bank statement with unrecorded deposits appearing in the preceding period's reconciliation and with the current period's deposits. Example: Deposits in transit at the end of the period.
- Step 3.** *Deduct outstanding checks that have not been paid by the bank.* Identify outstanding checks by comparing paid checks with outstanding checks appearing on the preceding period's reconciliation and with recorded checks. Example: Outstanding checks at the end of the period.
- Step 4.** Determine the *Adjusted balance* by adding Step 2 and deducting Step 3.

## Exhibit 11: Bank Reconciliation Steps (continued)

### Company Section of Reconciliation

- Step 5.** Enter the *Cash balance according to company* from the ending cash balance in the ledger.
- Step 6.** *Add increases to cash (credit memos) that have not been recorded.* Identify the bank credit memos that have not been recorded by comparing the bank statement credit memos to entries in the journal. Examples: A note receivable and interest collected by the bank for the company.
- Step 7.** *Deduct decreases to cash (debit memos) that have not been recorded.* Identify the bank debit memos that have not been recorded by comparing the bank statement debit memos to entries in the journal. Examples: Customers' not sufficient funds (NSF) checks and bank service charges.
- Step 8.** Determine the *Adjusted balance* by adding Step 6 and deducting Step 7.

### Verify that Adjusted Balances Are Equal

- Step 9.** Verify that the Adjusted balances determined in Steps 4 and 8 are equal.

## Colter Inc.: Reconciling Items

- Deposit not recorded on bank statement: \$816.20
- Total outstanding checks: \$1,544.99
- Note receivable and interest revenue are not recorded by the company as indicated by a credit memo of \$408
- Check from a customer for \$300 was returned by the bank because of not sufficient funds
  - Bank service charges of \$18 not recorded by the company as indicated by a debit memo of \$18.00
- Check for \$732.26 to Taylor Co., on account, was recorded by the company as \$723.26

# Exhibit 12: Bank Reconciliation for Colter Inc.

		Colter Inc. Bank Reconciliation July 31, 20Y7	
Step 1	→	Cash balance according to bank statement.....	\$3,359.78
Step 2	→	Add deposit of July 31, not recorded by bank.....	<u>816.20</u>
			\$4,175.98
Step 3	→	Deduct outstanding checks:	
		No. 812.....	\$1,061.00
		No. 878.....	435.39
		No. 883.....	<u>48.60</u>
			<u>(1,544.99)</u>
Step 4	→	Adjusted balance.....	<u>\$2,630.99</u>
Step 5	→	Cash balance according to Colter Inc. ....	\$2,549.99
Step 6	→	Add note and interest collected by bank .....	<u>408.00</u>
			\$2,957.99
Step 7	→	Deduct: Check returned because of insufficient funds.....	\$ 300.00
		Bank service charge.....	18.00
		Error in recording Check No. 879 .....	<u>9.00</u>
			<u>(327.00)</u>
Step 8	→	Adjusted balance.....	<u>\$2,630.99</u>



## Effects of the Adjustments on the Accounts and Financial Statements of Colter Inc.

- Note receivable of \$400 plus interest of \$8 collected by bank, but not recorded by the company as indicated by a credit memo of \$408

### Increases to Cash

<b>Financial Statement Effects</b>					
<b>BALANCE SHEET</b>					
<b>Assets</b>		=	<b>Liabilities</b>	+	<b>Stockholders' Equity</b>
<b>Cash</b>	+	<b>Notes Receivable</b>	=	<b>Retained Earnings</b>	
<i>July 31.</i>	408	+	(400)	=	8

<b>STATEMENT OF CASH FLOWS</b>	
<i>July 31. Operating</i>	408

<b>INCOME STATEMENT</b>	
<i>July 31. Interest revenue</i>	8

## Effects of the Adjustments on the Accounts and Financial Statements of Colter Inc. (continued)

- Customer's NSF check for \$300 returned by the bank, bank service charges worth \$18 and error of \$9 not recorded

### Decreases to Cash

#### Financial Statement Effects

	BALANCE SHEET				
	Assets		=	Liabilities	+ Stockholders' Equity
	Cash	+ Accounts Receivable	=	Accounts Payable	+ Retained Earnings
<i>July 31.</i>	(327)	+ 300	=	(9)	+ (18)

#### STATEMENT OF CASH FLOWS

<i>July 31. Operating</i>	(327)
---------------------------	-------

#### INCOME STATEMENT

<i>July 31. Misc. expense</i>	(18)
-------------------------------	------

# Learning Objective 6

Describe the accounting for special-purpose cash funds



# Petty Cash Fund

- Special cash fund used to pay off small expenses such as postage, office supplies, or minor repairs
  - Established by estimating the amount of payments needed from the fund during a period
- Replenished at periodic intervals, when it is depleted, or reaches a minimum amount

# Petty Cash Fund Entries

- A petty cash fund of \$500 is established on August 1

<b>BALANCE SHEET</b>						
<b>Assets</b>			<b>=</b>	<b>Liabilities</b>	<b>+</b>	<b>Stockholders' Equity</b>
<b>Cash</b>	<b>+</b>	<b>Petty Cash</b>	<b>=</b>			
<i>Aug. 1.</i>		(500)		500		

<b>STATEMENT OF CASH FLOWS</b>	<b>INCOME STATEMENT</b>
_____	_____
_____	_____

## Petty Cash Fund Entries (continued)

- To pay off expenses, \$467 was used from the petty cash fund
- The petty cash fund was replenished on August 31

<b>BALANCE SHEET</b>									
<b>Assets</b>				<b>= Liabilities +</b>	<b>Stockholders' Equity</b>				
<b>Cash</b>	<b>+</b>	<b>Office Supplies</b>	<b>+</b>	<b>Store Supplies</b>	<b>=</b>	<b>Retained Earnings</b>			
<i>Aug. 31.</i>		(467)		402		35	=		(30)

<b>STATEMENT OF CASH FLOWS</b>	
<i>Aug. 31.</i>	Operating (467)

<b>INCOME STATEMENT</b>	
<i>Aug. 31.</i>	Misc. admin. expense (30)

# Learning Objective 7

Describe and illustrate the reporting of cash and cash equivalents in the financial statements

# Financial Statement Reporting of Cash

- Cash is normally listed as the first asset in the Current Assets section of a balance sheet
- Most companies combine all their bank and cash fund accounts into a single account and record it in the balance sheet
  - Includes **cash equivalents**
- Banks require companies to maintain a **compensating balance**
  - Compensating balance requirements are disclosed in notes to the financial statements

## Learning Objective 8

Describe and illustrate the ratio of cash to monthly cash expenses in assessing the ability of a company to continue operating

# Ratio of Cash to Monthly Cash Expenses

- Assesses the ability of a company to continue operations when it reports negative net cash flows from operations

$$\text{Ratio of Cash to Monthly Cash Expenses} = \frac{\text{Cash and Cash Equivalents}}{\text{Monthly Cash Expenses}}$$

$$\text{Monthly Cash Expenses} = \frac{\text{Net Cash Flows Used in Operations}}{12}$$

# Ratio of Cash to Monthly Cash Expenses: Data for Ztech Inc.

	Year 2	Year 1
Net cash flows used in operating activities.....	\$(3,420,000)	\$(3,600,000)
Cash and cash equivalents at end of year .....	1,824,000	2,550,000

	Year 2	Year 1
Monthly cash expenses:		
$\$3,420,000 \div 12$	\$285,000	
$\$3,600,000 \div 12$		\$300,000
Ratio of cash to monthly cash expenses:		
$\$1,824,000 \div \$285,000$	6.4 months	
$\$2,550,000 \div \$300,000$		8.5 months



# End of Chapter 5