

## CHAPTER 7: FRAUD, INTERNAL CONTROL, AND CASH



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## LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- [1 Define fraud and internal control.](#)
- [2 Identify the principles of internal control activities.](#)
- [3 Explain the applications of internal control principles to cash receipts.](#)
- [4 Explain the applications of internal control principles to cash disbursements.](#)
- [5 Prepare a bank reconciliation.](#)
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### Feature Story: MINDING THE MONEY IN MOOSE JAW

If you're ever looking for a cappuccino in Moose Jaw, Saskatchewan, stop by **Stephanie's Gourmet Coffee and More**, located on Main Street. Staff there serve, on average, 650 cups of coffee a day, including both regular and specialty coffees, not to mention soups, Italian sandwiches, and a wide assortment of gourmet cheesecakes.

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

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

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

There is only one cash register. "Up to three of us might operate it on any given shift, including myself," says Ms. Mintenko.

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

Ms. Mintenko sends all the cash tapes and float totals to a bookkeeper, who double-checks everything and provides regular reports. “We try to keep the accounting simple, so we can concentrate on making great coffee and food.”



## INSIDE CHAPTER 7...

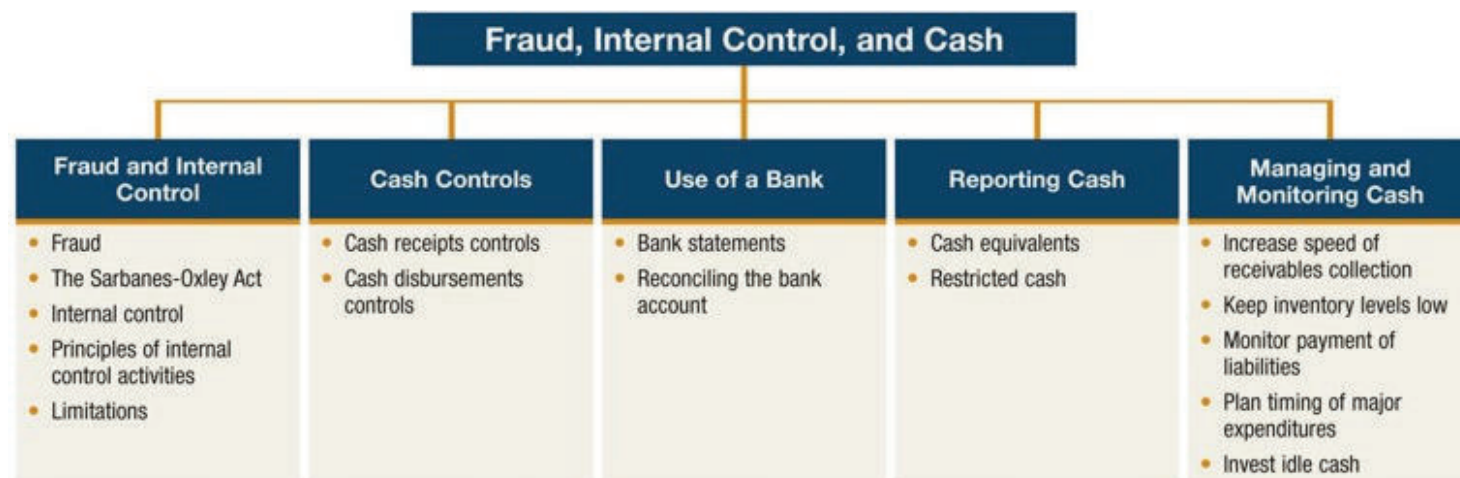
- **And the Controls Are ...** ([p. 338](#))
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## PREVIEW OF CHAPTER 7

As the story about recording cash sales at Stephanie’s Gourmet Coffee and More indicates, control of cash is important to ensure that fraud does not occur. Companies also need controls to safeguard other types of assets. For example, Stephanie’s undoubtedly has controls to prevent the theft of food and supplies, and controls to prevent the theft of tableware and dishes from its kitchen.

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

The content and organization of Chapter 7 are as follows.



## Fraud and Internal Control

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

### LEARNING OBJECTIVE 1

Define fraud and internal control.

## FRAUD

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

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

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

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

### Illustration 7-1: Fraud triangle





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

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

## THE SARBANES-OXLEY ACT

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

One poll found that 60% of investors believe that SOX helps safeguard their stock investments. Many say they would be unlikely to invest in a company that fails to follow SOX requirements. Although some corporate executives have criticized the time and expense involved in following the SOX requirements, SOX appears to be working well. For example, the chief accounting officer of **Eli Lilly** noted that SOX triggered a comprehensive review of how the company documents controls. This review uncovered redundancies and pointed out controls that needed to be added. In short, it added up to time and money well spent. And the finance chief at **General Electric** noted, “We have seen value in SOX. It helps build investors’ trust and gives them more confidence.”<sup>1</sup>

## INTERNAL CONTROL

[Internal control](#) consists of all the related methods and measures adopted within an organization to safeguard assets, enhance the reliability of accounting records, increase efficiency of operations, and ensure compliance with laws and regulations. Internal control systems have five primary components as listed below.<sup>2</sup>

- **A control environment.** It is the responsibility of top management to make it clear that the organization values integrity and that unethical activity will not be tolerated. This component is often referred to as the “tone at the top.”
- **Risk assessment.** Companies must identify and analyze the various factors that create risk for the business and must determine how to manage these risks.
- **Control activities.** To reduce the occurrence of fraud, management must design policies and procedures to address the specific risks faced by the company.
- **Information and communication.** The internal control system must capture and communicate all pertinent information both down and up the organization, as well as communicate information to appropriate external parties.
- **Monitoring.** Internal control systems must be monitored periodically for their adequacy. Significant deficiencies need to be reported to top management and/or the board of directors.



## **PEOPLE, PLANET, AND PROFIT INSIGHT: And the Controls Are ...**

Internal controls are important for an effective financial reporting system. The same is true for sustainability reporting. An effective system of internal controls for sustainability reporting will help in the following ways: (1) prevent the unauthorized use of data; (2) provide reasonable assurance that the information is accurate, valid, and complete; and (3) report information that is consistent with overall sustainability accounting policies. With these types of controls, users will have the confidence that they can use the sustainability information effectively.



**PRINTED BY: jromero0950@email.phoenix.edu. Printing is for personal, private use only. No part of this book may be reproduced or transmitted without publisher's prior permission. Violators will be prosecuted.** Some regulators are calling for even more assurance through audits of this information. Companies that potentially can cause environmental damage through greenhouse gases are subject to reporting requirements as well as companies in the mining and extractive industries. And, as demand for more information in the sustainability area expands, the need for audits of this information will grow.



Why is sustainability information important to investors? (See [page 393](#).)

## PRINCIPLES OF INTERNAL CONTROL ACTIVITIES

### LEARNING OBJECTIVE 2

Identify the principles of internal control activities.

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

The six principles of control activities are as follows.

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

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

### Establishment of Responsibility

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

To illustrate, assume that the cash on hand at the end of the day in a **Safeway** supermarket is \$10 short of the cash entered in the cash register. If only one person has operated the register, the shift manager can quickly determine responsibility for the shortage. What happens, though, if two or more individuals work the register? For example, in the Feature Story, the principle of establishing responsibility does not appear to be strictly applied by **Stephanie's Gourmet Coffee and More** since three people operate the cash register on any given shift. Many retailers solve this problem by having registers with multiple drawers. This makes it possible for more than one person to operate a register but still allows identification of a particular employee with a specific drawer. Only the signed-in cashier has access to his or her drawer.



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

## ANATOMY OF A FRAUD

Maureen Frugali was a training supervisor for claims processing at Colossal Healthcare. As a standard part of the claims-processing training program, Maureen created fictitious claims for use by trainees. These fictitious claims were then sent to the accounts payable department. After the training claims had been processed, she was to notify Accounts Payable of all fictitious claims, so that they would not be paid. However, she did not inform Accounts Payable about every fictitious claim. She created some fictitious claims for entities that she controlled (that is, she would receive the payment), and she let Accounts Payable pay her.

**Total take: \$11 million**

## THE MISSING CONTROL

*Establishment of responsibility.* The health-care company did not adequately restrict the responsibility for authorizing and approving claims transactions. The training supervisor should not have been authorized to create claims in the company's "live" system.



## Segregation of Duties

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

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

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

## SEGREGATION OF RELATED ACTIVITIES.

**Making one individual responsible for related activities increases the potential for errors and irregularities.**

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

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

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

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

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

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

## ANATOMY OF A FRAUD

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

**Total take: \$475,000**

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

*Source:* Adapted from Wells, *Fraud Casebook* (2007), pp. 3-15.

## SEGREGATION OF RECORD-KEEPING FROM PHYSICAL CUSTODY.

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



### **Accounting employee A**

Maintains cash  
balances per books



**Segregation of duties**  
(Accountability for assets)



### **Assistant cashier B**

Maintains custody  
of cash on hand

## **ANATOMY OF A FRAUD**

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

**Total take: \$570,000**

## **THE MISSING CONTROL**

*Segregation of duties.* Aggasiz Construction Company did not properly segregate record-keeping from physical custody. Angela had physical custody of the blank checks, which essentially was control of the cash. She also had

record-keeping responsibility because she prepared the bank reconciliation.  
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Source: Adapted from Wells, *Fraud Casebook* (2007), pp. 100-107.

## Documentation Procedures

Documents provide evidence that transactions and events have occurred. At Stephanie's Gourmet Coffee and More, the cash register tape is the restaurant's documentation for the sale and the amount of cash received. More sophisticated registers, called point-of-sale terminals, do not rely on tapes. Rather, they are networked with the company's computing and accounting records, which results in direct documentation. Similarly, a shipping document indicates that the goods have been shipped, and a sales invoice indicates that the company has billed the customer for the goods. By requiring signatures (or initials) on the documents, the company can identify the individual(s) responsible for the transaction or event. Companies should document transactions when the transaction occurs.

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|---------------|----------------------------------------------|-----------------|---------------------|----------|-------|
| Catalogue No. | Description                                  | Quantity        | Price               | Amount   |       |
| A8049240      | Production Model<br>Greuthe<br>(Cooperative) | 1               | 800                 | \$800    |       |

**Prenumbered invoices**

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

## ANATOMY OF A FRAUD

To support their reimbursement requests for travel costs incurred, employees at Mod Fashions Corporation's design center were required to submit receipts. The receipts could include the detailed bill provided for a meal, or the credit



card receipt provided when the credit card payment is made, or a copy of the employee's monthly credit card bill that listed the item. A number of the designers who frequently traveled together came up with a fraud scheme. They submitted claims for the same expenses. For example, if they had a meal together that cost \$200, one person submitted the detailed meal bill, another submitted the credit card receipt, and a third submitted a monthly credit card bill showing the meal as a line item. Thus, all three received a \$200 reimbursement.

**Total take: \$75,000**

## THE MISSING CONTROL

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

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

## Physical Controls

Use of physical controls is essential. **Physical controls** relate to the safeguarding of assets and enhance the accuracy and reliability of the accounting records. [Illustration 7-2](#) shows examples of these controls.

## ANATOMY OF A FRAUD

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

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

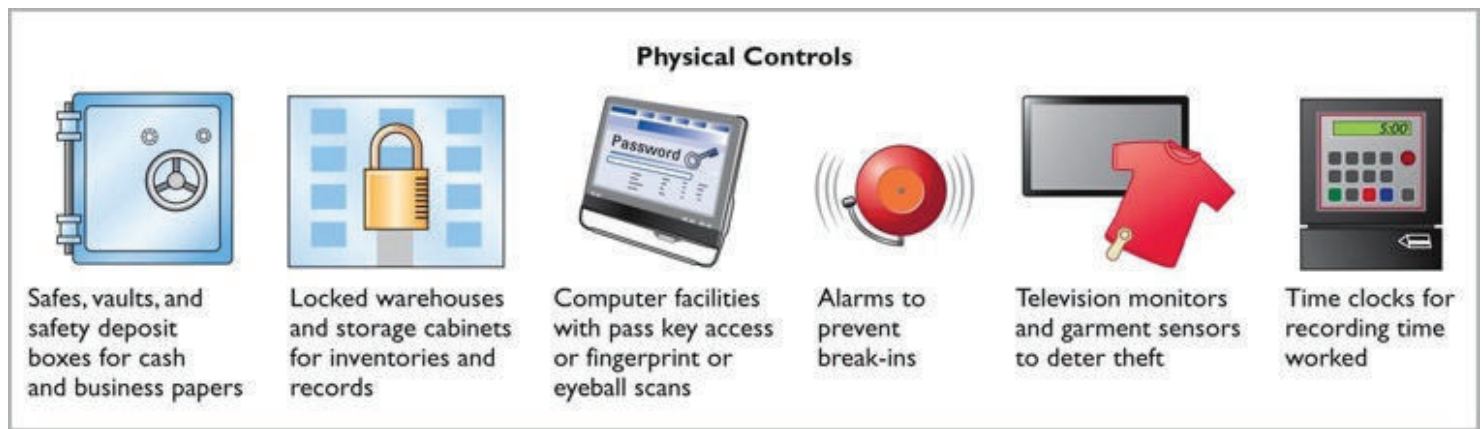
**Total take: \$240,000**

## THE MISSING CONTROL

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

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

## Illustration 7-2: Physical controls



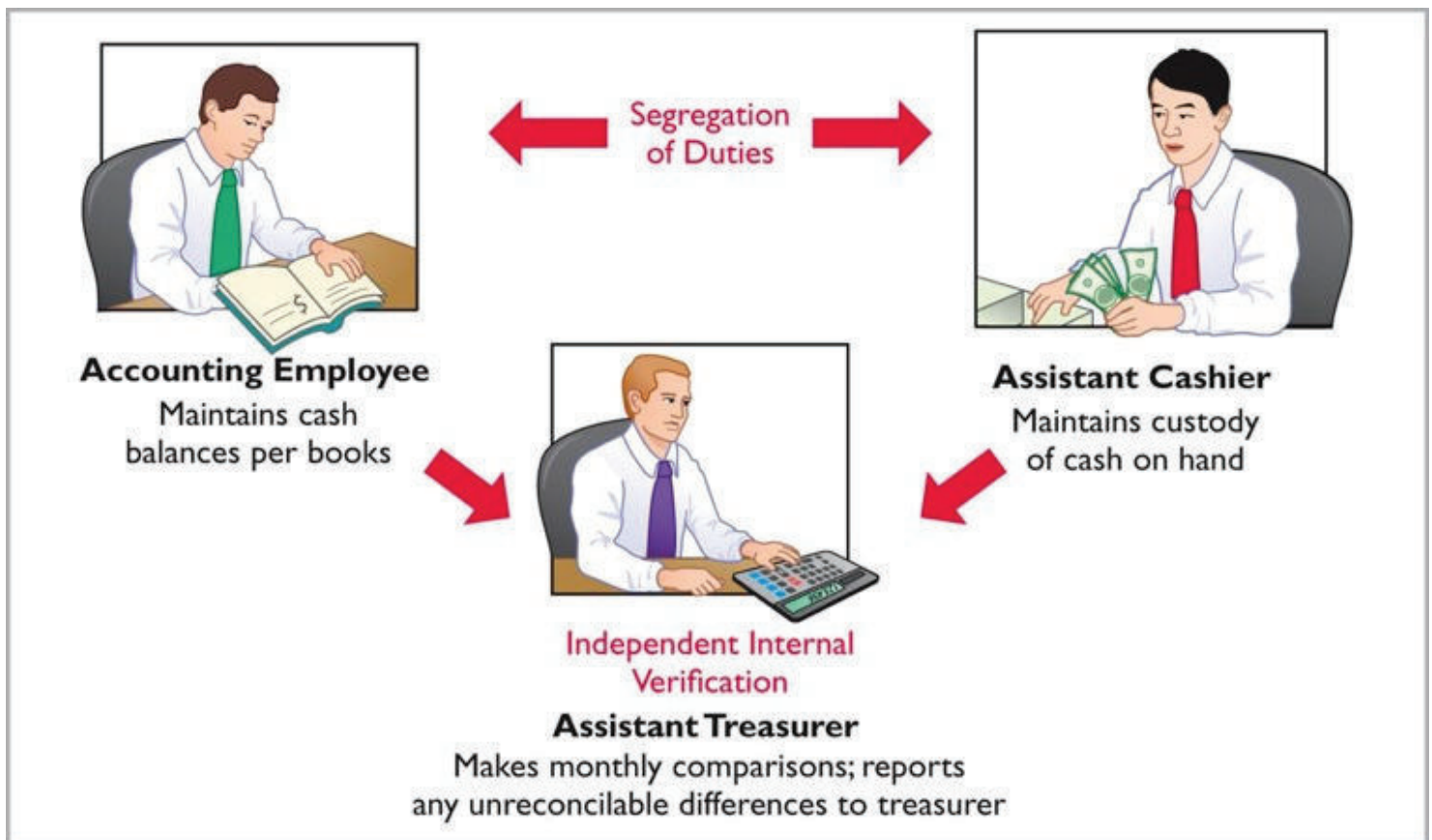
## Independent Internal Verification

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

- 1. Companies should verify records periodically or on a surprise basis.
- 2. An employee who is independent of the personnel responsible for the information should make the verification.
- 3. Discrepancies and exceptions should be reported to a management level that can take appropriate corrective action.

Independent internal verification is especially useful in comparing recorded transactions with existing assets. The reconciliation of the cash register tape with the cash in the register at **Stephanie's Gourmet Coffee and More** is an example of this internal control principle. Another common example is the reconciliation of a company's cash balance per books with the cash balance per bank and the verification of the perpetual inventory records through a count of physical inventory. [Illustration 7-3](#) shows the relationship between this principle and the segregation of duties principle.

### Illustration 7-3: Comparison of segregation of duties principle with independent internal verification principle



Large companies often assign independent internal verification to internal auditors. [Internal auditors](#) are company employees who continuously evaluate the effectiveness of the company's internal control systems. They review the activities of departments and individuals to determine whether prescribed internal controls are being followed. They also recommend improvements when needed. In fact, most fraud is discovered by the company through internal mechanisms such as existing internal controls and internal audits. For example, **WorldCom** was at one time the second largest U.S. telecommunications company. The fraud that caused its bankruptcy (the largest ever when it occurred) involved billions of dollars. It was uncovered by an internal auditor.

## ANATOMY OF A FRAUD

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

**Total take: \$275,000**

## THE MISSING CONTROL

*Independent internal verification.* Bobbi Jean's boss should have verified her expense reports. When asked what he thought her expenses for a year were, the boss said about \$10,000. At \$115,000 per year, her actual expenses were more than 10 times what would have been expected. However, because he was "too busy" to verify her expense reports or to review the budget, he never noticed.

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

Human resource control activities include the following.

- 1. **Bond employees who handle cash.** **Bonding** involves obtaining insurance protection against theft by employees. It contributes to the safeguarding of cash in two ways. First, the insurance company carefully screens all individuals before adding them to the policy and may reject risky applicants. Second, bonded employees know that the insurance company will vigorously prosecute all offenders.
- 2. **Rotate employees' duties and require employees to take vacations.** These measures deter employees from attempting thefts since they will not be able to permanently conceal their improper actions. Many banks, for example, have discovered employee thefts when the employee was on vacation or assigned to a new position.
- 3. **Conduct thorough background checks.** Many believe that the most important and inexpensive measure any business can take to reduce employee theft and fraud is for the human resources department to conduct thorough background checks. Two tips: (1) Check to see whether job applicants actually graduated from the schools they list. (2) Never use telephone numbers for previous employers provided by the applicant; always look them up yourself.



## ANATOMY OF A FRAUD

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



## THE MISSING CONTROL

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

*Source:* Adapted from Wells, *Fraud Casebook* (2007), pp. 145-155.

## LIMITATIONS OF INTERNAL CONTROL

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

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

### Helpful Hint

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



## Accounting Across the Organization: SOX Boosts the Role of Human Resources





Stockbyte/Getty Images, Inc.

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



Why would unsupervised employees or employees who report to each other represent potential internal control threats? (See [page 393](#).)

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

The **size of the business** also may impose limitations on internal control. Small companies often find it difficult to segregate duties or to provide for independent internal verification. A study by the Association of Certified Fraud Examiners (*2012 Report to the Nation on Occupational Fraud and Abuse*) indicates that businesses with fewer than 100 employees are most at risk for employee theft. In fact, 31.8% of frauds occurred at companies with fewer than



## DECISION TOOLKIT

| DECISION CHECKPOINTS                                                   | INFO NEEDED FOR DECISION                                                     | TOOL TO USE FOR DECISION                                                                                                                                                                                                                       | HOW TO EVALUATE RESULTS                                                                                |
|------------------------------------------------------------------------|------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------|
| Are the company's financial statements supported by internal controls? | Auditor's report, management discussion and analysis, and internal controls. | The principles of internal control activities are (1) establishment of responsibility, (2) segregation of duties, (3) documentation procedures, (4) physical controls, (5) independent internal verification, and (6) human resource controls. | If any indication is given that these or other controls are lacking, use the information with caution. |

## **Do it!** CONTROL ACTIVITIES

Identify which control activity is violated in each of the following situations, and explain how the situation creates an opportunity for a fraud.

- 1. The person with primary responsibility for reconciling the bank account and making all bank deposits is also the company's accountant.
- 2. Wellstone Company's treasurer received an award for distinguished service because he had not taken a vacation in 30 years.

## Action Plan

- Familiarize yourself with each of the control activities listed on [page 338](#).
- Understand the nature of the frauds that each control activity is intended to address.



### Solution

- 1. Violates the control activity of segregation of duties. Record-keeping should be separate from physical custody. As a consequence, the employee could embezzle cash and make journal entries to hide the theft.
- 2. Violates the control activity of human resource controls. Key employees, such as a treasurer, should be required to take vacations. The treasurer, who manages the company's cash, might embezzle cash and use his position to conceal the theft.
- 3. Violates the control activity of documentation procedures. If prenumbered documents are not used, then it is virtually impossible to account for the documents. As a consequence, an employee could write up a dinner sale, receive the cash from the customer, and then throw away the order slip and keep the cash.

Related exercise material: [BE7-1](#), [BE7-2](#), [BE7-3](#),  [7-1](#), [E7-1](#), and [E7-2](#).

## Cash Controls

### LEARNING OBJECTIVE 3

Explain the applications of internal control principles to cash receipts.

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

## CASH RECEIPTS CONTROLS

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

### Illustration 7-4: Application of internal control principles to cash receipts

## Cash Receipts Controls



### Establishment of Responsibility

Only designated personnel are authorized to handle cash receipts (cashiers)



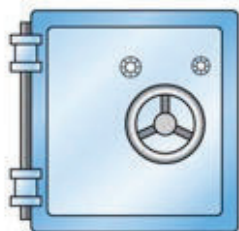
### Segregation of Duties

Different individuals receive cash, record cash receipts, and hold the cash



### Documentation Procedures

Use remittance advice (mail receipts), cash register tapes or computer records, and deposit slips



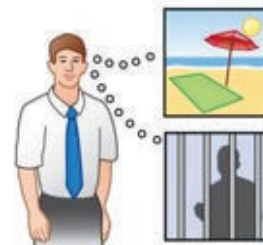
### Physical Controls

Store cash in safes and bank vaults; limit access to storage areas; use cash registers



### Independent Internal Verification

Supervisors count cash receipts daily; assistant treasurer compares total receipts to bank deposits daily



### Human Resource Controls

Bond personnel who handle cash; require employees to take vacations; conduct background checks

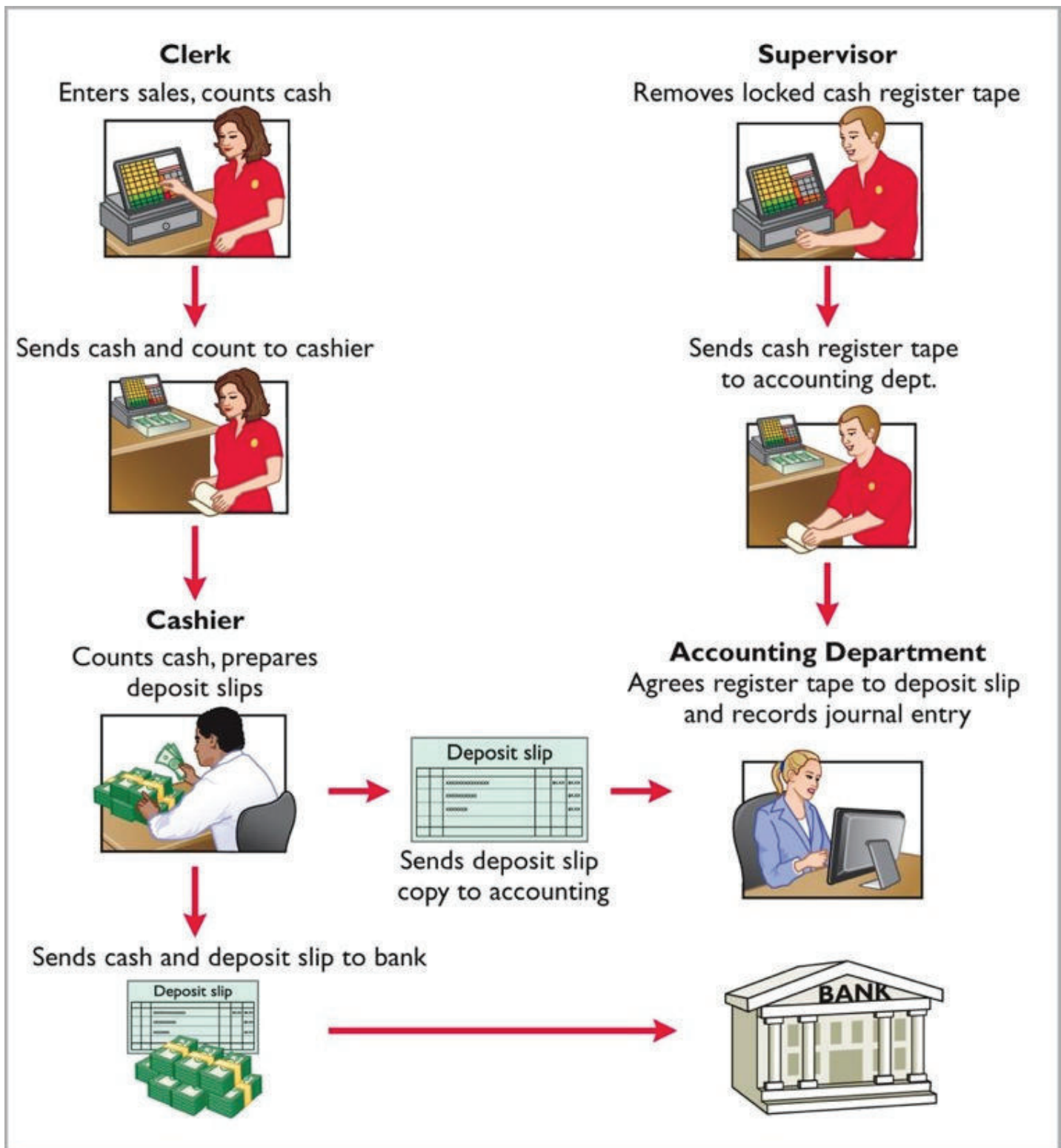
## Over-the-Counter Receipts

In retail businesses, control of over-the-counter receipts centers on cash registers that are visible to customers. A cash sale is entered in a cash register with the amount clearly visible to the customer. This activity prevents the cashier from entering a lower amount and pocketing the difference. The customer receives an itemized cash register receipt slip and is expected to count the change received. (One weakness at **Stephanie's Gourmet Coffee and More** in the Feature Story is that customers were only given a receipt if they requested it.) The cash register's tape is locked in the register until a supervisor removes it. This tape accumulates the daily transactions and totals. Alternatively, cash registers called point-of-sale terminals are often networked with the company's computers for direct recording in its records.

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

## Illustration 7-5: Control of over-the-counter receipts





## Helpful Hint

Flowcharts such as this one enhance the understanding of the flow of documents, the processing steps, and the internal control procedures.

This system for handling cash receipts uses an important internal control principle—segregation of record-keeping from physical custody. The supervisor has access to the cash register tape, but **not** to the cash. The clerk and the cashier have access to the cash, but **not** to the register tape. In addition, the cash register tape provides documentation and enables independent internal verification with the deposit slip. Use of these three principles of internal control (segregation of record-keeping from physical custody, documentation, and independent internal verification) provides



In some instances, the amount deposited at the bank will not agree with the cash recorded in the accounting records based on the cash register tape. These differences often result because the clerk hands incorrect change back to the retail customer. In this case, the difference between the actual cash and the amount reported on the cash register tape is reported in a Cash Over and Short account. For example, suppose that the cash register tape indicated sales of \$6,956.20 but the amount of cash was only \$6,946.10. A cash shortfall of \$10.10 exists. To account for this cash shortfall and related cash, the company makes the following entry.

|                     |          |
|---------------------|----------|
| Cash                | 6,946.10 |
| Cash Over and Short | 10.10    |
| Sales Revenue       | 6,956.20 |

(To record cash shortfall)

|                   |   |          |   |           |
|-------------------|---|----------|---|-----------|
| <b>A</b>          | = | <b>L</b> | + | <b>SE</b> |
| +6,946.10         |   |          |   |           |
|                   |   |          |   | -10.10    |
|                   |   |          |   | +6,956.20 |
| <b>Cash Flows</b> |   |          |   |           |
| +6,946.10         |   |          |   |           |



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

## Mail Receipts

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

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

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

## CONTROL OVER CASH RECEIPTS

L. R. Cortez is concerned about the control over cash receipts in his fast-food restaurant, Big Cheese. The restaurant has two cash registers. At no time do more than two employees take customer orders and enter sales. Work shifts for employees range from 4 to 8 hours. Cortez asks your help in installing a good system of internal control over cash receipts.

### Action Plan

- Differentiate among the internal control principles of (1) establishment of responsibility, (2) physical controls, and (3) independent internal verification.
- Design an effective system of internal control over cash receipts.



### Solution

Cortez should assign a separate cash register drawer to each employee at the start of each work shift, with register totals set at zero. Each employee should have access to only the assigned register drawer to enter all sales. Each customer should be given a receipt. At the end of the shift, the employee should do a cash count. A separate employee should compare the cash count with the register tape to be sure they agree. In addition, Cortez should install an automated system that would enable the company to compare orders entered in the register to orders processed by the kitchen.

Related exercise material: [BE7-4](#), [BE7-5](#),  [7-2](#), and [E7-3](#).

## CASH DISBURSEMENTS CONTROLS

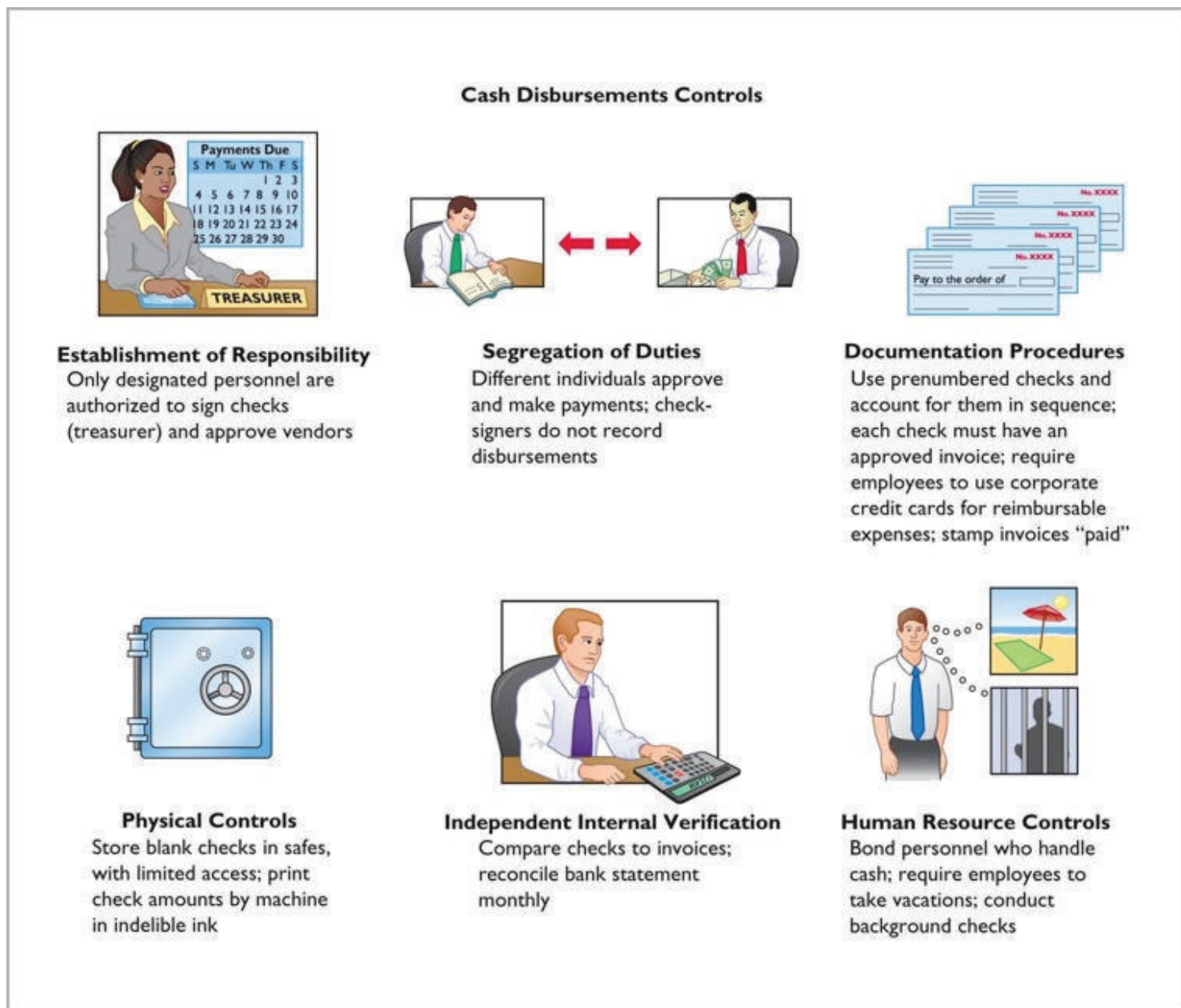
### LEARNING OBJECTIVE 4

Explain the applications of internal control principles to cash disbursements.

Companies disburse cash for a variety of reasons, such as to pay expenses and liabilities or to purchase assets. **Generally, internal control over cash disbursements is more effective when companies pay by check or electronic funds transfer (EFT) rather than by cash. One exception is payments for incidental amounts that are paid out of petty cash.**<sup>3</sup>

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

## Illustration: 7-6: Application of internal control principles to cash disbursements



## Voucher System Controls

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

The system begins with the authorization to incur a cost or expense. It ends with the issuance of a check for the liability incurred. A [voucher](#) is an authorization form prepared for each expenditure in a voucher system. Companies require vouchers for all types of cash disbursements except those from petty cash.

The starting point in preparing a voucher is to fill in the appropriate information about the liability on the face of the voucher. The vendor's invoice provides most of the needed information. Then, an employee in accounts payable records the voucher (in a journal called a **voucher register**) and files it according to the date on which it is to be paid. The company issues and sends a check on that date, and stamps the voucher "paid." The paid voucher is sent to the

accounting department for recording (in a journal called the **check register**). A voucher system involves two journal entries, one to record the liability when the voucher is issued and a second to pay the liability that relates to the voucher.

The use of a voucher system, whether done manually or electronically, improves internal control over cash disbursements. First, the authorization process inherent in a voucher system establishes responsibility. Each individual has responsibility to review the underlying documentation to ensure that it is correct. In addition, the voucher system keeps track of the documents that back up each transaction. By keeping these documents in one place, a supervisor can independently verify the authenticity of each transaction. Consider, for example, the case of Aesop University presented on [page 340](#). Aesop did not use a voucher system for transactions under \$2,500. As a consequence, there was no independent verification of the documents, which enabled the employee to submit fake invoices to hide his unauthorized purchases.

## Ethics Note

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

## Petty Cash Fund

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



### Ethics Insight: How Employees Steal

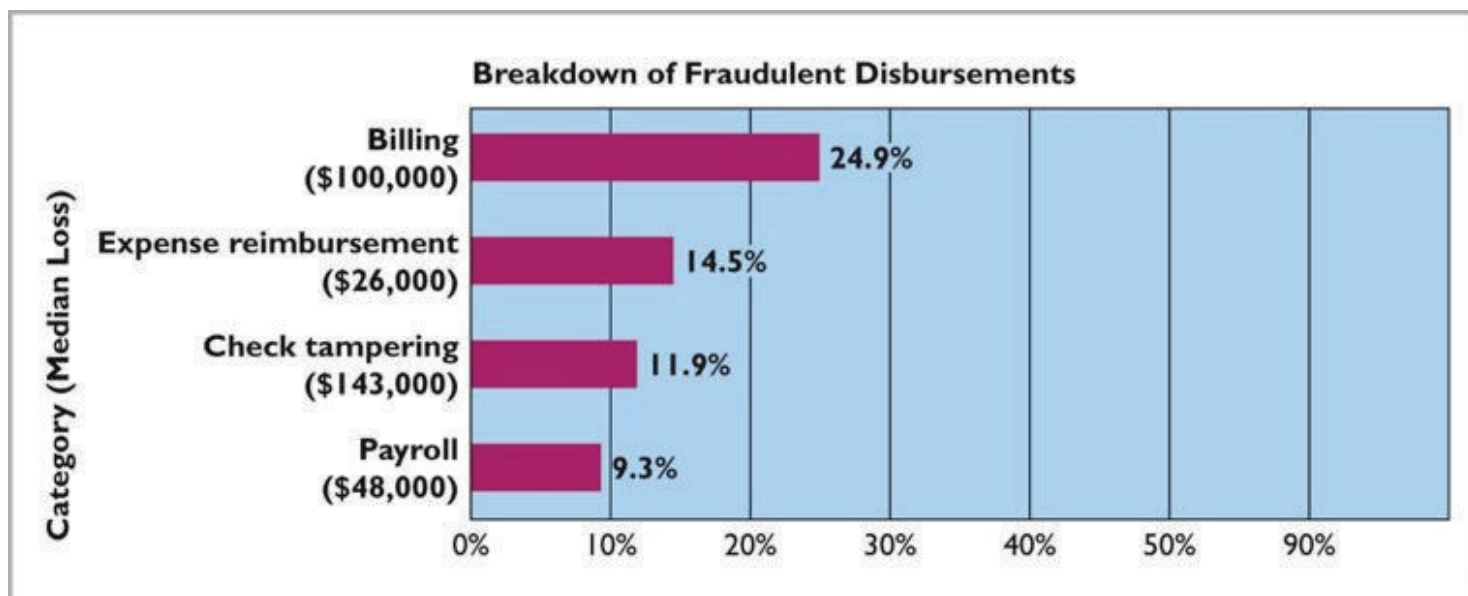
A recent study by the Association of Certified Fraud Examiners found that two-thirds of all employee thefts involved a fraudulent disbursement by an employee. The most common form (24.9% of cases) was fraudulent billing schemes. In these, the employee causes the company to issue a payment to the employee by submitting a bill for nonexistent goods or services, purchases of personal goods by the employee, or inflated invoices. The graph below shows various types of fraudulent disbursements and the median loss from each.



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Chris Fernig/iStockphoto



Source: 2012 Report to the Nation on Occupational Fraud and Abuse, Association of Certified Fraud Examiners, [www.acfe.com/uploadedfiles/ACFE\\_website/content/rtn/2012-report-to-nations.pdf](http://www.acfe.com/uploadedfiles/ACFE_website/content/rtn/2012-report-to-nations.pdf), p. 12.



How can companies reduce the likelihood of fraudulent disbursements? (See [page 393](#).)

## Control Features: Use of a Bank

### LEARNING OBJECTIVE 5

Prepare a bank reconciliation.

**The use of a bank contributes significantly to good internal control over cash.** A company can safeguard its cash by using a bank as a depository and clearinghouse for checks received and checks written. The use of a bank checking account minimizes the amount of currency that must be kept on hand. It also facilitates control of cash because a double record is maintained of all bank transactions—one by the business and the other by the bank. The asset account Cash maintained by the company is the “flip-side” of the bank’s liability account for that company. A [bank reconciliation](#) is the process of comparing the bank’s balance with the company’s balance, and explaining the differences to make them agree.

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

## BANK STATEMENTS

Each month, the company receives from the bank a [bank statement](#) showing its bank transactions and balances.<sup>4</sup> For example, the statement for Laird Company in [Illustration 7-7](#) shows the following: (1) checks paid and other debits (such as debit card transactions or direct withdrawals for bill payments) that reduce the balance in the depositor’s account, (2) deposits and other credits that increase the balance in the depositor’s account, and (3) the account balance after each day’s transactions.

Remember that bank statements are prepared from the *bank's* perspective. For example, every deposit the bank receives is an increase in the bank's liabilities (an account payable to the depositor). Therefore, in [Illustration 7-7](#), National Bank and Trust **credits** to Laird Company every deposit it received from Laird. The reverse occurs when the bank "pays" a check issued by Laird Company on its checking account balance: Payment reduces the bank's liability and is therefore **debited** to Laird's account with the bank.

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

A check that is not paid by a bank because of insufficient funds in a bank account is called an **NSF check** (not sufficient funds). The bank uses a debit memorandum when a previously deposited customer's check "bounces" because of insufficient funds. In such a case, the customer's bank marks the check NSF (not sufficient funds) and returns it to the depositor's bank. The bank then debits (decreases) the depositor's account, as shown by the symbol NSF in [Illustration 7-7](#), and sends the NSF check and debit memorandum to the depositor as notification of the charge. The NSF check creates an account receivable for the depositor and reduces cash in the bank account.

## Helpful Hint

Essentially, the bank statement is a copy of the bank's records sent to the customer or made available online for review.

## Illustration 7-7: Bank statement



# National Bank & Trust

Midland, Michigan 48654 Member FDIC

## ACCOUNT STATEMENT

LAIRD COMPANY  
77 WEST CENTRAL AVENUE  
MIDLAND, MICHIGAN 48654

Statement Date/Credit  
Line Closing Date

April 30, 2014

457923

ACCOUNT NUMBER

| Balance<br>Last Statement                                                                                                                                                                                   | Deposits and Credits |              | Checks and Debits    |              | Balance<br>This Statement |           |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------|--------------|----------------------|--------------|---------------------------|-----------|
|                                                                                                                                                                                                             | No.                  | Total Amount | No.                  | Total Amount |                           |           |
| 13,256.90                                                                                                                                                                                                   | 20                   | 34,805.10    | 26                   | 32,154.55    | 15,907.45                 |           |
| CHECKS AND DEBITS                                                                                                                                                                                           |                      |              | DEPOSITS AND CREDITS |              | DAILY BALANCE             |           |
| Date                                                                                                                                                                                                        | No.                  | Amount       | Date                 | Amount       | Date                      | Amount    |
| 4-2                                                                                                                                                                                                         | 435                  | 644.95       | 4-2                  | 4,276.85     | 4-2                       | 16,888.80 |
| 4-5                                                                                                                                                                                                         | 436                  | 3,260.00     | 4-3                  | 2,137.50     | 4-3                       | 18,249.65 |
| 4-4                                                                                                                                                                                                         | 437                  | 1,185.79     | 4-5                  | 1,350.47     | 4-4                       | 17,063.86 |
| 4-3                                                                                                                                                                                                         | 438                  | 776.65       | 4-7                  | 982.46       | 4-5                       | 15,154.33 |
| 4-8                                                                                                                                                                                                         | 439                  | 1,781.70     | 4-8                  | 1,320.28     | 4-7                       | 14,648.89 |
| 4-7                                                                                                                                                                                                         | 440                  | 1,487.90     | 4-9 CM               | 1,035.00     | 4-8                       | 11,767.47 |
| 4-8                                                                                                                                                                                                         | 441                  | 2,420.00     | 4-11                 | 2,720.00     | 4-9                       | 12,802.47 |
| 4-11                                                                                                                                                                                                        | 442                  | 1,585.60     | 4-12                 | 757.41       | 4-11                      | 13,936.87 |
| 4-12                                                                                                                                                                                                        | 443                  | 1,226.00     | 4-13                 | 1,218.56     | 4-12                      | 13,468.28 |
|                                                                                                                                                                                                             |                      |              |                      |              |                           |           |
| 4-29                                                                                                                                                                                                        | NSF                  | 425.60       | 4-27                 | 1,545.57     | 4-27                      | 13,005.45 |
| 4-29                                                                                                                                                                                                        | 459                  | 1,080.30     | 4-29                 | 2,929.45     | 4-29                      | 14,429.00 |
| 4-30                                                                                                                                                                                                        | DM                   | 30.00        | 4-30                 | 2,128.60     | 4-30                      | 15,907.45 |
| 4-30                                                                                                                                                                                                        | 461                  | 620.15       |                      |              |                           |           |
| Symbols: <b>CM</b> Credit Memo <b>EC</b> Error Correction <b>NSF</b> Not Sufficient Funds    Reconcile Your<br><b>DM</b> Debit Memo <b>INT</b> Interest Earned <b>SC</b> Service Charge    Account Promptly |                      |              |                      |              |                           |           |

## RECONCILING THE BANK ACCOUNT

Because the bank and the company maintain independent records of the company's checking account, you might assume that the respective balances will always agree. In fact, the two balances are seldom the same at any given time, and both balances differ from the "correct or true" balance. Therefore, it is necessary to make the balance per books and the balance per bank agree with the correct or true amount—a process called **reconciling the bank account**. The need for reconciliation has two causes:

- 1. **Time lags** that prevent one of the parties from recording the transaction in the same period.
- 2. **Errors** by either party in recording transactions.



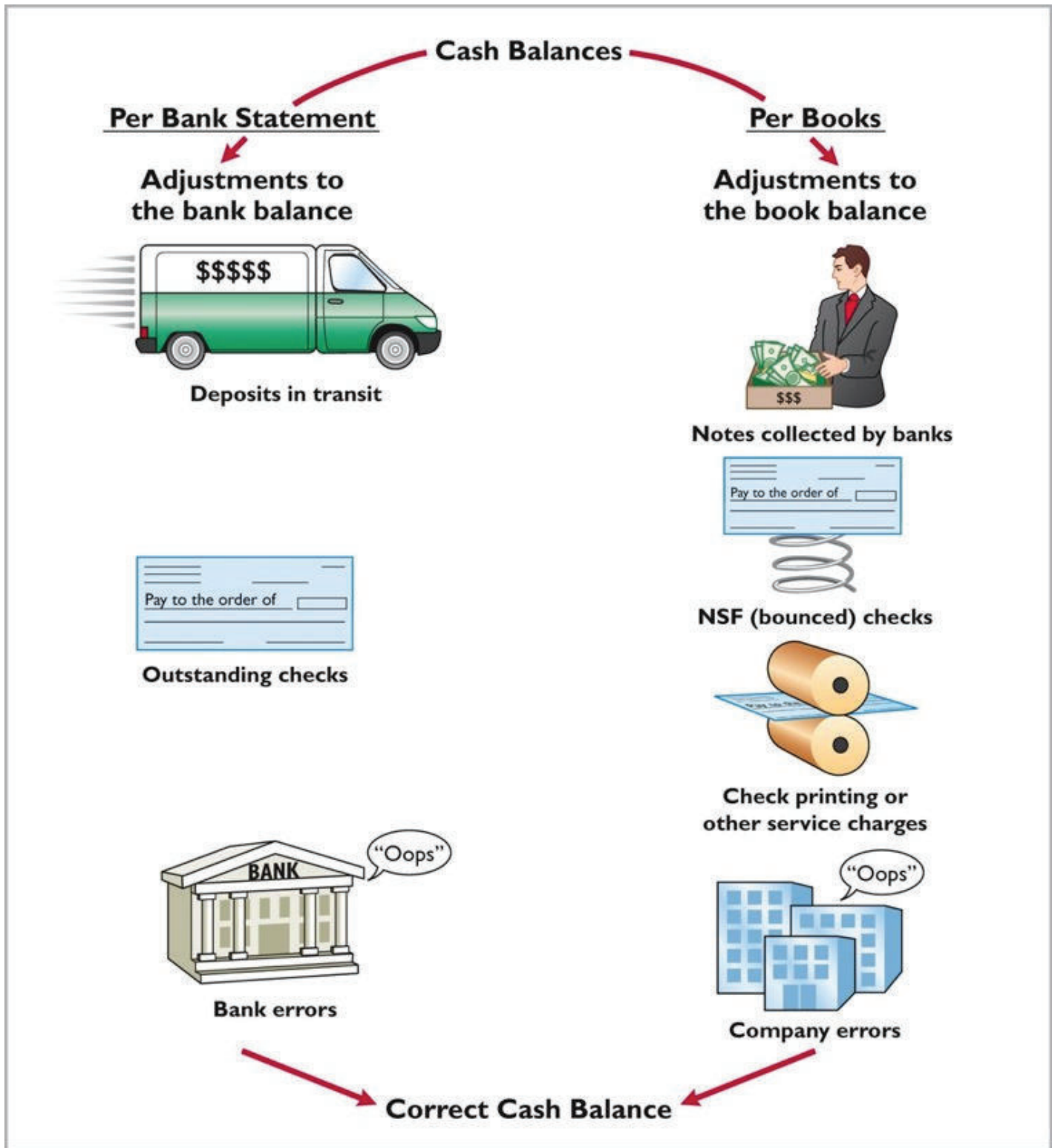
Time lags occur frequently. For example, several days may elapse between the time a company pays by check and the date the bank pays the check. Similarly, when a company uses the bank's night depository to make its deposits, there will be a difference of one day between the time the company records the receipts and the time the bank does so. A time lag also occurs whenever the bank mails a debit or credit memorandum to the company.

You might think that if a company never writes checks (for example, if a small company uses only a debit card or electronic bill payment), it does not need to reconcile its account. However, **the possibility of errors or fraud still necessitates periodic reconciliation.** The incidence of errors or fraud depends on the effectiveness of the internal controls maintained by the company and the bank. Bank errors are infrequent. However, either party could accidentally record a \$450 check as \$45 or \$540. In addition, the bank might mistakenly charge a check drawn by C. D. Berg to the account of C. D. Burg.

## Reconciliation Procedure

In reconciling the bank account, it is customary to reconcile the balance per books and balance per bank to their adjusted (correct or true) cash balances. **To obtain maximum benefit from a bank reconciliation, an employee who has no other responsibilities related to cash should prepare the reconciliation.** When companies do not follow the internal control principle of independent internal verification in preparing the reconciliation, cash embezzlements may escape unnoticed. For example, in the Anatomy of a Fraud box on [page 341](#), a bank reconciliation by someone other than Angela Bauer might have exposed her embezzlement.

## Illustration 7-8: Bank reconciliation adjustments



## Helpful Hint

Deposits in transit and outstanding checks are reconciling items because of time lags.

[Illustration 7-8](#) shows the reconciliation process. The starting point in preparing the reconciliation is to enter the balance per bank statement and balance per books on a schedule. The following steps should reveal all the reconciling items that cause the difference between the two balances.

- **Step 1. Deposits in transit.** Compare the individual deposits on the bank statement with the deposits in transit from the preceding bank reconciliation and with the deposits per company records or copies of duplicate deposit

- slips. Deposits recorded by the depositor that have not been recorded by the bank represent **deposits in transit**. Add these deposits to the balance per bank.
- **Step 2. Outstanding checks.** Compare the paid checks shown on the bank statement or the paid checks returned with the bank statement with (a) checks outstanding from the preceding bank reconciliation, and (b) checks issued by the company as recorded in the cash payments journal. Issued checks recorded by the company that have not been paid by the bank represent **outstanding checks**. Deduct outstanding checks from the balance per the bank.
  - **Step 3. Errors.** Note any errors discovered in the previous steps and list them in the appropriate section of the reconciliation schedule. For example, if the company mistakenly recorded as \$159 a paid check correctly written for \$195, the company would deduct the error of \$36 from the balance per books. All errors made by the depositor are reconciling items in determining the adjusted cash balance per books. In contrast, all errors made by the bank are reconciling items in determining the adjusted cash balance per the bank.
  - **Step 4. Bank memoranda.** Trace bank memoranda to the depositor's records. The company lists in the appropriate section of the reconciliation schedule any unrecorded memoranda. For example, the company would deduct from the balance per books a \$5 debit memorandum for bank service charges. Similarly, it would add to the balance per books a \$32 credit memorandum for interest earned.

## Bank Reconciliation Illustrated

Illustration 7-7 presented the bank statement for Laird Company which the company accessed online. It shows a balance per bank of \$15,907.45 on April 30, 2014. On this date the balance of cash per books is \$11,589.45. From the foregoing steps, Laird determines the following reconciling items.

|         |                                                                                                                                                                 |            |
|---------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------|------------|
| Step 1. | <b>Deposits in transit:</b> April 30 deposit (received by bank on May 1).                                                                                       | \$2,201.40 |
| Step 2. | <b>Outstanding checks:</b> No. 453, \$3,000.00; No. 457, \$1,401.30; No. 460, \$1,502.70.                                                                       | 5,904.00   |
| Step 3. | <b>Errors:</b> Check No. 443 was correctly written by Laird for \$1,226.00 and was correctly paid by the bank. However, Laird recorded the check as \$1,262.00. | 36.00      |
| Step 4. | <b>Bank memoranda:</b>                                                                                                                                          |            |
|         | (a) Debit—NSF check from J. R. Baron for \$425.60                                                                                                               | 425.60     |
|         | (b) Debit—Printing company checks charge, \$30                                                                                                                  | 30.00      |
|         | (c) Credit—Collection of note receivable for \$1,000 plus interest earned \$50, less bank collection fee \$15                                                   | 1,035.00   |

## Helpful Hint

Note in the bank statement that the bank has paid checks No. 459 and 461, but check No. 460 is not listed. Thus, this check is outstanding. If a complete bank statement were provided, checks No. 453 and 457 also would not be listed.

## Illustration 7-9: Bank reconciliation

| LAIRD COMPANY<br>Bank Reconciliation<br>April 30, 2014 |                 |           |                                  |
|--------------------------------------------------------|-----------------|-----------|----------------------------------|
| Cash balance per bank statement                        |                 |           | \$ 15,907.45                     |
| Add: Deposits in transit                               |                 |           | <u>2,201.40</u>                  |
|                                                        |                 |           | 18,108.85                        |
| Less: Outstanding checks                               |                 |           |                                  |
| No. 453                                                | \$3,000.00      |           |                                  |
| No. 457                                                | 1,401.30        |           |                                  |
| No. 460                                                | <u>1,502.70</u> | 5,904.00  |                                  |
| <b>Adjusted cash balance per bank</b>                  |                 |           | <b><u><u>\$12,204.85</u></u></b> |
| Cash balance per books                                 |                 |           | \$ 11,589.45                     |
| Add: Collection of note receivable for                 |                 |           |                                  |
| \$1,000 plus interest earned                           |                 |           |                                  |
| \$50, less collection fee \$15                         | \$1,035.00      |           |                                  |
| Error in recording check No. 443                       | <u>36.00</u>    | 1,071.00  |                                  |
|                                                        |                 | 12,660.45 |                                  |
| Less: NSF check                                        | 425.60          |           |                                  |
| Bank service charge                                    | <u>30.00</u>    | 455.60    |                                  |
| <b>Adjusted cash balance per books</b>                 |                 |           | <b><u><u>\$12,204.85</u></u></b> |

## Alternative Terminology

The terms *adjusted cash balance*, *true cash balance*, and *correct cash balance* are used interchangeably.

## Entries from Bank Reconciliation

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

## Helpful Hint

These entries are adjusting entries. In prior chapters, we considered Cash an account that did not require adjustment because we had not yet explained a bank reconciliation.

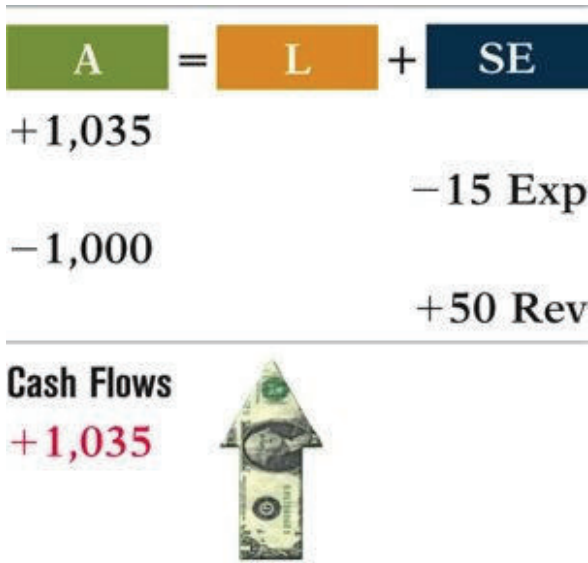


**COLLECTION OF NOTE RECEIVABLE**

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

|         |                       |       |
|---------|-----------------------|-------|
| Apr. 30 | Cash                  | 1,035 |
|         | Miscellaneous Expense | 15    |
|         | Notes Receivable      | 1,000 |
|         | Interest Revenue      | 50    |

(To record collection of note receivable by bank)



**BOOK ERROR.**

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

|         |                                 |    |
|---------|---------------------------------|----|
| Apr. 30 | Cash                            | 36 |
|         | Accounts Payable—Andrea Company | 36 |

(To correct error in recording check No. 443)

|                   |   |                                                                                   |   |           |
|-------------------|---|-----------------------------------------------------------------------------------|---|-----------|
| <b>A</b>          | = | <b>L</b>                                                                          | + | <b>SE</b> |
| +36               |   |                                                                                   |   |           |
|                   |   | +36                                                                               |   |           |
| <hr/>             |   |                                                                                   |   |           |
| <b>Cash Flows</b> |   |                                                                                   |   |           |
| +36               |   |                                                                                   |   |           |
|                   |   |  |   |           |

## NSF CHECK.

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

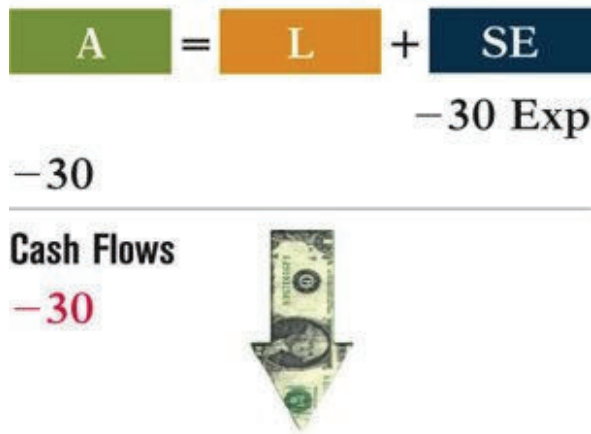
|                       |                                 |        |        |
|-----------------------|---------------------------------|--------|--------|
| Apr. 30               | Accounts Receivable—J. R. Baron | 425.60 |        |
|                       | Cash                            |        | 425.60 |
| (To record NSF check) |                                 |        |        |

|                   |   |                                                                                     |   |           |
|-------------------|---|-------------------------------------------------------------------------------------|---|-----------|
| <b>A</b>          | = | <b>L</b>                                                                            | + | <b>SE</b> |
| +425.60           |   |                                                                                     |   |           |
| -425.60           |   |                                                                                     |   |           |
| <hr/>             |   |                                                                                     |   |           |
| <b>Cash Flows</b> |   |                                                                                     |   |           |
| -425.60           |   |                                                                                     |   |           |
|                   |   |  |   |           |

## BANK SERVICE CHARGES.

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

|                                                |                       |    |    |
|------------------------------------------------|-----------------------|----|----|
| Apr. 30                                        | Miscellaneous Expense | 30 |    |
|                                                | Cash                  |    | 30 |
| (To record charge for printing company checks) |                       |    |    |



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

After Laird posts the entries, the Cash account will appear as in [Illustration 7-10](#). The adjusted cash balance in the ledger should agree with the adjusted cash balance per books in the bank reconciliation in [Illustration 7-9](#) (page 356).

## Illustration 7-10: Adjusted balance in Cash account

### Cash

Apr. 30 Bal. 11,589.45    Apr. 30 425.60

30      1,035.00      30 30.00

30      36.00

---

Apr. 30 Bal. **12,204.85**

What entries does the bank make? If the company discovers any bank errors in preparing the reconciliation, it should notify the bank so the bank can make the necessary corrections on its records. The bank does not make any entries for deposits in transit or outstanding checks. Only when these items reach the bank will the bank record these items.

## Electronic Funds Transfer (EFT) System

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

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



## Investor Insight: Madoff's Ponzi Scheme

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



Mary Altaffer/©AP/Wide World Photos





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How was Madoff able to conceal such a giant fraud? (See [page 393](#).)

## BANK RECONCILIATION

Sally Kist owns Linen Kist Fabrics. Sally asks you to explain how she should treat the following reconciling items when reconciling the company's bank account: (1) a debit memorandum for an NSF check, (2) a credit memorandum for a note collected by the bank, (3) outstanding checks, and (4) a deposit in transit.

### Action Plan

- Understand the purpose of a bank reconciliation.
- Identify time lags and explain how they cause reconciling items.



### Solution

Sally should treat the reconciling items as follows.

- (1) NSF check: Deduct from balance per books.
- (2) Collection of note: Add to balance per books.
- (3) Outstanding checks: Deduct from balance per bank.
- (4) Deposit in transit: Add to balance per bank.

Related exercise material: [BE7-8](#), [BE7-9](#), [BE7-10](#), [BE7-11](#),  [7-3](#), [E7-6](#), [E7-7](#), [E7-8](#), [E7-9](#), [E7-10](#), and [E7-11](#).

## Reporting Cash

### LEARNING OBJECTIVE 6

Explain the reporting of cash.

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

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

## CASH EQUIVALENTS

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

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

### Illustration 7-11: Balance sheet presentation of cash



#### DELTA AIR LINES, INC.

#### Balance Sheet (partial)

December 31, 2011

(in millions)

#### Assets

#### Current assets

|                                    |                |
|------------------------------------|----------------|
| <b>Cash and cash equivalents</b>   | <b>\$2,657</b> |
| Short-term investments             | 958            |
| <b>Restricted cash</b>             | <b>305</b>     |
| Accounts receivable and other, net | 1,563          |
| Parts inventories                  | 367            |
| Prepaid expenses and other         | <u>1,879</u>   |
| Total current assets               | \$ 7,729       |

Examples of cash equivalents are Treasury bills, commercial paper (short-term corporate notes), and money market funds. All typically are purchased with cash that is in excess of immediate needs.

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

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Recently, some companies were forced to restate their financial statements because they had too broadly interpreted which types of investments could be treated as cash equivalents. By reporting these items as cash equivalents, the companies made themselves look more liquid.

## RESTRICTED CASH

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

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

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



## DECISION TOOLKIT

| DECISION CHECKPOINTS | INFO NEEDED FOR DECISION | TOOL TO USE FOR DECISION | HOW TO EVALUATE RESULTS |
|----------------------|--------------------------|--------------------------|-------------------------|
|----------------------|--------------------------|--------------------------|-------------------------|

Is all of the company's cash available for general use?

Balance sheet and notes to financial statements

Does the company report any cash as being restricted?

A restriction on the use of cash limits management's ability to use those resources for general obligations. This might be considered when assessing liquidity.

## Managing and Monitoring Cash

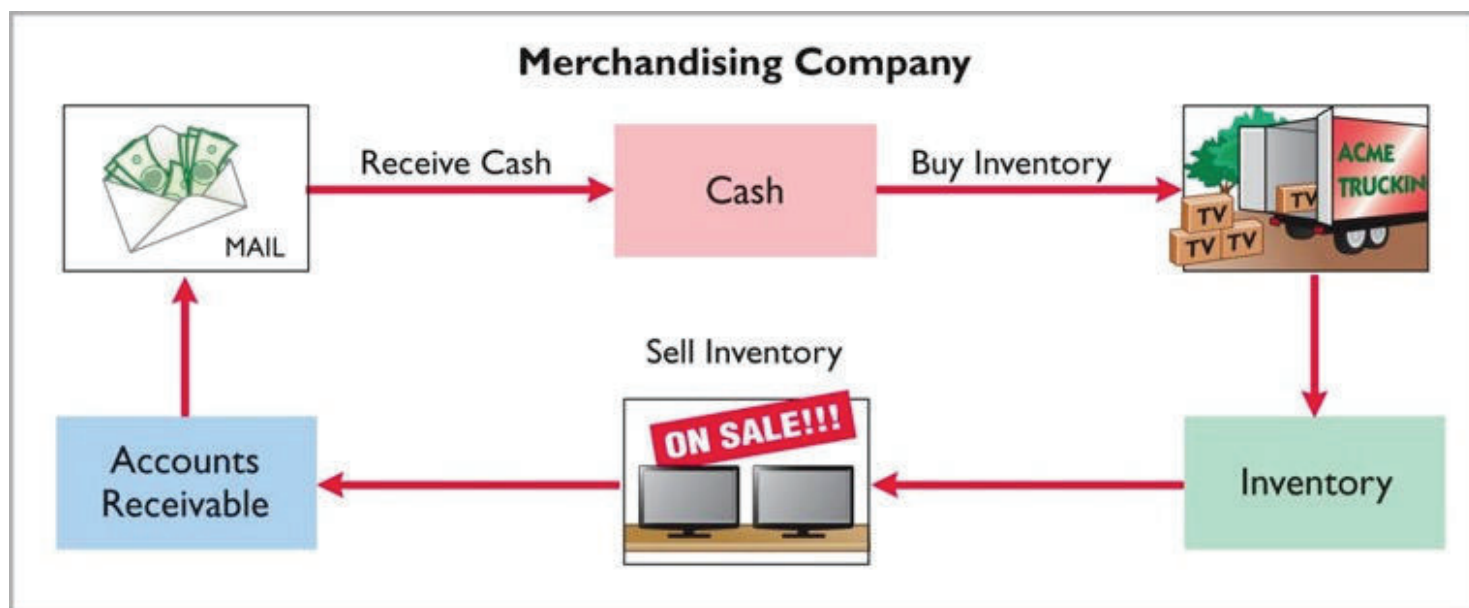
### LEARNING OBJECTIVE 7

Discuss the basic principles of cash management.

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

A merchandising company's operating cycle is generally shorter than that of a manufacturing company. [Illustration 7-12](#) shows the cash to cash operating cycle of a merchandising operation.

### Illustration 7-12: Operating cycle of a merchandising company



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

## BASIC PRINCIPLES OF CASH MANAGEMENT

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

- **1. Increase the speed of receivables collection.** Money owed Sharon McCollick by her customers is money that she can't use. The more quickly customers pay her, the more quickly she can use those funds. Thus, rather than have an average collection period of 30 days, she may want an average collection period of 15 days. However, she must carefully weigh any attempt to force her customers to pay earlier against the possibility that she may anger or alienate customers. Perhaps her competitors are willing to provide a 30-day grace period. As noted in [Chapter 5](#), one common way to encourage customers to pay more quickly is to offer cash discounts for early payment under such terms as 2/10, n/30.
- **2. Keep inventory levels low.** Maintaining a large inventory of cloth and finished clothing is costly. It ties up large amounts of cash, as well as warehouse space. Increasingly, companies are using techniques to reduce the inventory on hand, thus conserving their cash. Of course, if Sharon McCollick has inadequate inventory, she will lose sales. The proper level of inventory is an important decision.
- **3. Monitor payment of liabilities.** Sharon McCollick should monitor when her bills are due, so she avoids paying bills too early. Let's say her supplier allows 30 days for payment. If she pays in 10 days, she has lost the use of that cash for 20 days. Therefore, she should use the full payment period. But, she should not pay late. This could damage her credit rating (and future borrowing ability). Also, late payments to suppliers can damage important supplier relationships and may even threaten a supplier's viability. Sharon McCollick's company also should conserve cash by taking cash discounts offered by suppliers, when possible.
- **4. Plan the timing of major expenditures.** To maintain operations or to grow, all companies must make major expenditures. These often require some form of outside financing. To increase the likelihood of obtaining outside financing, McCollick should carefully consider the timing of major expenditures in light of her company's operating cycle. If at all possible, she should make any major expenditure when the company normally has excess cash—usually during the off-season.
- **5. Invest idle cash.** Cash on hand earns nothing. An important part of the treasurer's job is to ensure that the company invests any excess cash, even if it is only overnight. Many businesses, such as Sharon McCollick's clothing company, are seasonal. During her slow season, when she has excess cash, she should invest it. To avoid a cash crisis, however, it is very important that investments of idle cash be highly liquid and risk-free. A **liquid investment** is one with a market in which someone is always willing to buy or sell the investment. A **risk-free investment** means there is no concern that the party will default on its promise to pay its principal and interest. For example, using excess cash to purchase stock in a small company because you heard that it was probably going to increase in value in the near term is totally inappropriate. First, the stock of small companies is often illiquid. Second, if the stock suddenly decreases in value, you might be forced to sell the stock at a loss in order to pay your bills as they come due. The most common form of liquid investments is interest-paying U.S. government securities.

### International Note

International sales complicate cash management. For example, if **Nike** must repay a Japanese supplier 30 days from today in Japanese yen, Nike will be concerned about how the exchange rate of U.S. dollars for yen might change during those 30 days. Often, corporate treasurers make investments known as *hedges* to lock in an exchange rate to reduce the company's exposure to exchange-rate fluctuation.

[Illustration 7-13](#) summarizes these five principles of cash management.

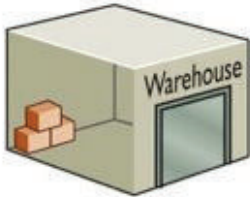
### Illustration 7-13: Five principles of sound cash management



**1. Increase the speed of receivables collection**



**2. Keep inventory low**

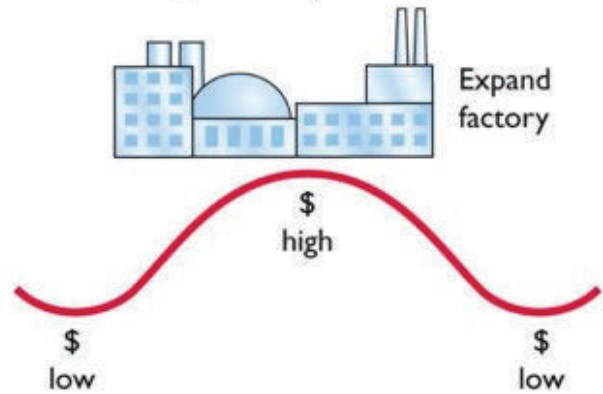


**3. Monitor payment of liabilities**

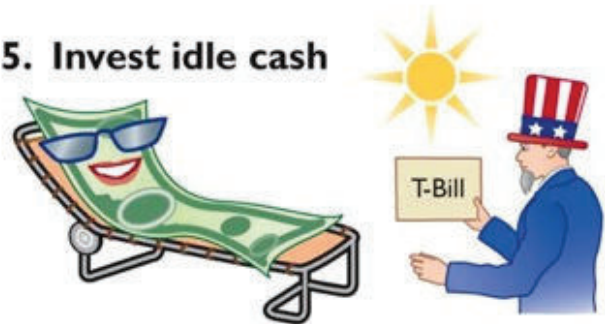


Payments  
due

**4. Plan timing of major expenditures**



**5. Invest idle cash**



## KEEPING AN EYE ON CASH

Because cash is so vital to a company, **planning the company's cash needs** is a key business activity. It enables the company to plan ahead to cover possible cash shortfalls and to make investments of idle funds. The [cash budget](#) shows anticipated cash flows, usually over a one- to two-year period. In this section, we introduce the basics of cash budgeting. More advanced discussion of cash budgets and budgets in general is provided in managerial accounting texts.

## LEARNING OBJECTIVE 8

Identify the primary elements of a cash budget.

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

### ANY COMPANY

#### Cash Budget

|                                      |              |
|--------------------------------------|--------------|
| Beginning cash balance               | \$X,XXX      |
| Add: <b>Cash receipts</b> (itemized) | <u>X,XXX</u> |
| Total available cash                 | X,XXX        |

**ANY COMPANY**

**Cash Budget**

Less: **Cash disbursements** (itemized) X,XXX

Excess (deficiency) of available cash over cash disbursements X,XXX

**Financing**

Add: Borrowings X,XXX

Less: Repayments X,XXX

Ending cash balance \$X,XXX

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

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

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

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

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

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

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

## HAYES COMPANY

### Cash Budget

For the Year Ending December 31, 2014

|                                                              | Quarter        |                |                |                |
|--------------------------------------------------------------|----------------|----------------|----------------|----------------|
|                                                              | <u>1</u>       | <u>2</u>       | <u>3</u>       | <u>4</u>       |
| Beginning cash balance                                       | \$ 38,000      | \$ 25,500      | \$ 15,000      | \$ 19,400      |
| Add: <b>Cash receipts</b>                                    |                |                |                |                |
| Collections from customers                                   | 168,000        | 198,000        | 228,000        | 258,000        |
| Sale of securities                                           | <u>2,000</u>   | <u>0</u>       | <u>0</u>       | <u>0</u>       |
| Total receipts                                               | <u>170,000</u> | <u>198,000</u> | <u>228,000</u> | <u>258,000</u> |
| Total available cash                                         | <u>208,000</u> | <u>223,500</u> | <u>243,000</u> | <u>277,400</u> |
| Less: <b>Cash disbursements</b>                              |                |                |                |                |
| Inventory                                                    | 23,200         | 27,200         | 31,200         | 35,200         |
| Salaries                                                     | 62,000         | 72,000         | 82,000         | 92,000         |
| Selling and administrative expenses (excluding depreciation) | 94,300         | 99,300         | 104,300        | 109,300        |
| Purchase of truck                                            | 0              | 10,000         | 0              | 0              |
| Income tax expense                                           | <u>3,000</u>   | <u>3,000</u>   | <u>3,000</u>   | <u>3,000</u>   |
| Total disbursements                                          | <u>182,500</u> | <u>211,500</u> | <u>220,500</u> | <u>239,500</u> |

HAYES COMPANY

Cash Budget

For the Year Ending December 31, 2014

|                                                          |        |        |        |        |
|----------------------------------------------------------|--------|--------|--------|--------|
| Excess (deficiency) of available cash over disbursements | 25,500 | 12,000 | 22,500 | 37,900 |
|----------------------------------------------------------|--------|--------|--------|--------|

Financing

|                 |   |       |   |   |
|-----------------|---|-------|---|---|
| Add: Borrowings | 0 | 3,000 | 0 | 0 |
|-----------------|---|-------|---|---|

|                                      |          |          |              |          |
|--------------------------------------|----------|----------|--------------|----------|
| Less: Repayments—plus \$100 interest | <u>0</u> | <u>0</u> | <u>3,100</u> | <u>0</u> |
|--------------------------------------|----------|----------|--------------|----------|

|                     |           |           |           |           |
|---------------------|-----------|-----------|-----------|-----------|
| Ending cash balance | \$ 25,500 | \$ 15,000 | \$ 19,400 | \$ 37,900 |
|---------------------|-----------|-----------|-----------|-----------|



DECISION TOOLKIT

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



## CASH BUDGET

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

### Action Plan

- Add the beginning cash balance to receipts to determine total available cash.
- Subtract disbursements to determine excess or deficiency.
- Compare excess or deficiency with desired minimum cash to determine borrowing needs.



### Solution

|                                                  |                |
|--------------------------------------------------|----------------|
| Beginning cash balance                           | \$16,500       |
| Add: Cash receipts for March                     | <u>210,000</u> |
| Total available cash                             | 226,500        |
| Less: Cash disbursements for March               | <u>220,000</u> |
| Excess of available cash over cash disbursements | 6,500          |
| Financing                                        |                |



Ending cash balance \$ 15,000

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

Related exercise material: [BE7-13](#), **Do it!** [7-4](#), and [E7-14](#).



## THE DECISION TOOLKIT USING

Presented below is hypothetical financial information for **Mattel Corporation**. Included in this information is financial statement data from the year ended December 31, 2013, which should be used to evaluate Mattel's cash position.

### Selected Financial Information

Year Ended December 31, 2013

(in millions)

|                                           |       |
|-------------------------------------------|-------|
| Net cash provided by operating activities | \$325 |
| Capital expenditures                      | 162   |
| Dividends paid                            | 80    |

**Selected Financial Information**

**Year Ended December 31, 2013**

**(in millions)**

|                      |     |
|----------------------|-----|
| Total expenses       | 680 |
| Depreciation expense | 40  |
| Cash balance         | 206 |

Also provided on the next page are projected data which are management's best estimate of its sources and uses of cash during the year ended December 31, 2014. This information should be used to prepare a cash budget for 2014.

**Projected Sources and Uses of Cash**

**(in millions)**

|                                                    |       |
|----------------------------------------------------|-------|
| Beginning cash balance                             | \$206 |
| Cash receipts from sales of product                | 355   |
| Cash receipts from sale of short-term investments  | 20    |
| Cash payments for inventory                        | 357   |
| Cash payments for selling and administrative costs | 201   |
| Cash payments for property, plant, and equipment   | 45    |
| Cash payments for taxes                            | 17    |

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

**Instructions**

- (a) Using the hypothetical projected sources and uses of cash information presented above, prepare a cash budget for 2014 for Mattel Corporation.

**Solution**

- (a)

**MATTEL CORPORATION**

**Cash Budget**

**For the Year Ending December 31, 2014**

**(in millions)**

|                        |       |
|------------------------|-------|
| Beginning cash balance | \$206 |
|------------------------|-------|

Add: Cash receipts

|                       |       |
|-----------------------|-------|
| From sales of product | \$355 |
|-----------------------|-------|

|                                     |           |            |
|-------------------------------------|-----------|------------|
| From sale of short-term investments | <u>20</u> | <u>375</u> |
|-------------------------------------|-----------|------------|

|                      |     |
|----------------------|-----|
| Total available cash | 581 |
|----------------------|-----|

Less: Cash disbursements

|                        |     |
|------------------------|-----|
| Payments for inventory | 357 |
|------------------------|-----|

|                                               |     |
|-----------------------------------------------|-----|
| Payments for selling and administrative costs | 201 |
|-----------------------------------------------|-----|

|                                             |    |
|---------------------------------------------|----|
| Payments for property, plant, and equipment | 45 |
|---------------------------------------------|----|

|                    |           |
|--------------------|-----------|
| Payments for taxes | <u>17</u> |
|--------------------|-----------|

|                     |            |
|---------------------|------------|
| Total disbursements | <u>620</u> |
|---------------------|------------|

|                                                          |      |
|----------------------------------------------------------|------|
| Excess (deficiency) of available cash over disbursements | (39) |
|----------------------------------------------------------|------|

Financing

## MATTEL CORPORATION

### Cash Budget

For the Year Ending December 31, 2014

(in millions)

Add: **Borrowings**

239

Ending cash balance

\$200

- (b) Using these hypothetical data, Mattel's cash position appears adequate. For 2014, Mattel is projecting a cash shortfall. This is not necessarily of concern, but it should be investigated. Its primary line of business is toys. Most toys are sold during December. We would expect Mattel's cash position to vary significantly during the course of the year. After the holiday season, once its customers have paid Mattel, it probably has a lot of excess cash. However, when it is making and selling its product but has not yet been paid, it may need to borrow to meet any temporary cash shortfalls. If Mattel's management is concerned with its cash position, it could take the following steps: (1) Offer its customers cash discounts for early payment, such as 2/10, n/30. (2) Implement inventory management techniques to reduce the need for large inventories of such things as the plastics used to make its toys. (3) Carefully time payments to suppliers by keeping track of when payments are due, so as not to pay too early. (4) If it has plans for major expenditures, time those expenditures to coincide with its seasonal period of excess cash.



## Summary of Learning Objectives

- **1 Define fraud and internal control.** A fraud is a dishonest act by an employee that results in personal benefit to the employee at a cost to the employer. The fraud triangle refers to the three factors that contribute to fraudulent activity by employees: opportunity, financial pressure, and rationalization. Internal control consists of all the related methods and measures adopted within an organization to safeguard assets, enhance the reliability of accounting records, increase efficiency of operations, and ensure compliance with laws and regulations.
- **2 Identify the principles of internal control activities.** The principles of internal control are establishment of responsibility; segregation of duties; documentation procedures; physical controls; independent internal verification; and human resource controls.
- **3 Explain the applications of internal control principles to cash receipts.** Internal controls over cash receipts include: (a) designating only personnel such as cashiers to handle cash; (b) assigning the duties of receiving cash, recording cash, and having custody of cash to different individuals; (c) obtaining remittance advices for mail receipts, cash register tapes or computer records for over-the-counter receipts, and deposit slips for bank deposits; (d) using company safes and bank vaults to store cash with access limited to authorized personnel, and using cash registers in executing over-the-counter receipts; (e) making independent daily counts of register receipts and daily comparisons of total receipts with total deposits; and (f) conducting background checks and bonding personnel who handle cash, as well as requiring them to take vacations.

- **4 Explain the applications of internal control principles to cash disbursements.** Internal controls over cash disbursements include: (a) having only specified individuals such as the treasurer authorized to sign checks; (b) assigning the duties of approving items for payment, paying the items, and recording the payment to different individuals; (c) using prenumbered checks and accounting for all checks, with each check supported by an approved invoice; after payment, stamping each approved invoice “paid”; (d) storing blank checks in a safe or vault with access restricted to authorized personnel, and using a machine with indelible ink to imprint amounts on checks; (e) comparing each check with the approved invoice before issuing the check, and making monthly reconciliations of bank and book balances; and (f) bonding personnel who handle cash, requiring employees to take vacations, and conducting background checks.
- **5 Prepare a bank reconciliation.** In reconciling the bank account, it is customary to reconcile the balance per books and the balance per bank to their adjusted balance. The steps reconciling the Cash account are to determine deposits in transit, outstanding checks, errors by the depositor or the bank, and unrecorded bank memoranda.
- **6 Explain the reporting of cash.** Cash is listed first in the current assets section of the balance sheet. Companies often report cash together with cash equivalents. Cash restricted for a special purpose is reported separately as a current asset or as a noncurrent asset, depending on when the company expects to use the cash.
- **7 Discuss the basic principles of cash management.** The basic principles of cash management include: (a) increase the speed of receivables collection, (b) keep inventory levels low, (c) monitor the timing of payment of liabilities, (d) plan timing of major expenditures, and (e) invest idle cash.
- **8 Identify the primary elements of a cash budget.** The three main elements of a cash budget are the cash receipts section, cash disbursements section, and financing section.





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

## Appendix 7A: Operation of the Petty Cash Fund

### LEARNING OBJECTIVE 9

Explain the operation of a petty cash fund.

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

### ESTABLISHING THE PETTY CASH FUND

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

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