Chapter 6[1]

Internal Control & Accounting for Cash

Learning Objectives

- Define internal control and identify its purpose and principles.
- Provide some background information on the Sarbanes-Oxley Act (SOX).
- List some basic limitations of internal control.
- List which 3 basic duties should be segregated.
- Apply internal control to cash receipts and cash disbursements.
- Explain and illustrate your knowledge of how petty cash fund transactions are accounted for.
- Prepare the bank reconciliation.
- Define cash and cash equivalents and explain how these items are reported and to whom.
- Compute the days' sales uncollected ratio and explain how it is used to assess liquidity.
- Describe the documentation used to verify and control cash disbursements.
- Apply the net method to control purchase discounts.

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Professor Walt Cressler, a West Chester University Professor of Library Services, is the administrator of Digital Commons @ West Chester University, the digital platform where this extraordinary free accounting textbook has been published. Digital Commons @ West Chester University is an online showcase of research and creative works produced by the WCU community. It is one of Professor Cressler's more recent projects, having begun in the fall of 2013.

Walt first came to campus as a temporary instructor in the Geology & Astronomy Department in the fall of 1999. He managed to find a more permanent place in the West Chester University community in the fall of 2001, when he became the Science Librarian. He had successfully parlayed his background as a public middle school librarian along with his recent Ph.D. in Geology and experience teaching at WCU in securing the job.

It is the perfect niche for Professor Cressler. In addition to assisting students and faculty on their quests for knowledge on a day-to-day basis, he has done his own research in both paleo botany and on the history of the local watersheds. His interests are quite far-ranging, and working with Digital Commons @ West Chester University provides Walt an opportunity to collaborate, if even in a small way, with scholars in the full range of disciplines. He never expected to get mentioned in an introductory financial accounting textbook.

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U.S. Securities and Exchange Commission

SEC Charges Arizona-Based Software Company for Inadequate Internal Accounting Controls over Its Financial Reporting FOR IMMEDIATE RELEASE 2014-216 *Washington D.C., Sept. 25, 2014* —

The Securities and Exchange Commission today sanctioned a Scottsdale, Ariz.-based software company for having ***inadequate internal accounting controls*** (emphasis added) over its financial reporting, which resulted in misstated revenues in public filings.

An SEC investigation found that JDA Software Group Inc. failed to properly recognize and report revenue from certain software license agreements it sold to customers because its ***internal accounting controls failed*** (emphasis added) to consider information needed for determining a critical component of revenue recognition for software companies. If companies are unable to demonstrate this component – known as vendor specific objective evidence of fair value (VSOE) – when determining the fair value of certain services related to a software license agreement, then they cannot immediately recognize the entire revenue from that agreement. With proper internal controls that appropriately considered VSOE, JDA would have recognized revenue from certain sales ratably over the term of a services agreement.

JDA agreed to settle the SEC's charges by paying a $750,000 penalty.

"Companies must have ***adequate internal accounting controls*** (emphasis added) designed to comply with their financial reporting obligations to the public," said Michael Maloney, Chief Accountant of the SEC's Enforcement Division. "VSOE is a critically important component in determining the timing in which software companies recognize revenue, and JDA's internal accounting controls surrounding VSOE were inadequate in various ways."

According to the SEC's order instituting a settled administrative proceeding, JDA's ***internal accounting controls*** (emphasis added) surrounding VSOE were inadequate in several ways. For example, JDA lacked adequate revenue recognition policies and procedures and failed to identify all service-related contracts needed for VSOE testing to determine the fair value of certain services. Moreover, JDA ***did not have sufficient internal accounting controls*** (emphasis added) to determine whether a software license agreement and related services contract were linked to each other. As a result of these internal control failures, some of JDA's financial statements for 2008, 2009, 2010, and 2011 were materially misstated. JDA restated those financial statements in August 2012, reporting that it had overstated its revenue for fiscal year 2010 by 4 percent and overstated EBITDA by approximately 18 percent. In connection with the restatement, JDA identified ***control deficiencies that constituted a previously undisclosed material weakness in its internal control*** (emphasis) over financial reporting related to revenue recognition.

The SEC's order finds that JDA violated the reporting, books and records, and internal controls provisions of the federal securities laws, namely Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Securities Exchange Act of 1934 and Rules 12b-20, 13a-1, 13a-11, and 13a-13. In agreeing to settle the charges without admitting or denying the SEC's findings, JDA consented to the SEC's order imposing a $750,000 penalty and requiring the company to cease and desist from committing or causing any violations or any future violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11, and 13a-13.

The SEC's investigation was conducted by Noel Gittens and William Scarborough and supervised by Antonia Chion and Ricky Sachar.

Internal control and its fundamental principles are described in this section. The impact of technology and the limitations of internal control procedures are also discussed. Internal controls, their establishment and maintenance, like anything in a firm or organization comes from the top (i.e., the "tone at the top"). If executives and top management provide support for the strong internal controls, the organization's culture will place great emphasis on it.

Managers and owners may be in control of the entire organization: hiring and managing all employees, negotiating all contracts, and signing all checks. However, most companies cannot maintain this close personal attention and must, instead, delegate certain responsibilities. An internal control system is comprised of policies and procedures managers use to:

1. Protect assets
2. Ensure reliable accounting
3. Promote efficient operations
4. Urge compliance with company policies

A properly designed system of internal control will make it possible for managers and owners to prevent avoidable losses. There are no guarantees, but the firm's risk of loss through *error* (an unintentional mistake) or *irregularity* (fraud) can be minimized.

Sarbanes-Oxley Act (SOX)
The Sarbanes-Oxley Act (SOX) was passed into law in 2002, following the Enron and WorldCom audit or market failures.[2] It requires the managers and auditors of companies publicly traded on exchanges (NYSE, AMEX and NASDAQ) to document and certify systems of internal control. Some specific requirements follow:

- Auditors must evaluate and report on internal controls (ICs).
- Auditors are restricted with respect to consulting services they might provide to an audit client.
- Audit leadership must rotate, where an audit leader can serve no more than seven years without a two year break.
- Auditor work is overseen by the *Public Company Accounting Oversight Board* (*PCAOB*).
- Prison sentences of up to 25 years and severe fines are imposed for violations.

SOX increased compliance costs for publicly traded firms. Section 404 requires management documentation and assessment of IC effectiveness to the extent that these processes impact financial reporting. Auditors must provide an opinion on management's documentation and assessment.

[2] This raised the cost of audits and increased demand for auditors, so accountants, jokingly, referred to this as "the accountants full employment act."

Principles of Internal Control

Internal control principles and systems are designed to reduce the incidence of *errors* and *irregularities*. Errors are operationally defined as and result from honest mistakes. Irregularities are operationally defined as and result from intentional deceit or fraud. Internal control are designed to

1. Establish fixed responsibilities
2. Maintain adequate records
3. Insure and protect assets and bond key employees
4. Provide for the separation of recordkeeping and custody of assets functions
5. Provide for the division of responsibilities for related transactions
6. Apply technological controls
7. Provide for regular and independent reviews

1-Establish fixed responsibilities

Establishing fixed responsibilities to a single individual for a specific task provides for linkage between performance and responsibility. For example, if two individuals share the same cash register and there is a cash shortage, accountability would be difficult to identify or assign. You have probably observed retail organizations when changing shifts swap cash drawers. Errors and irregularities are isolated and fixed with respect to responsibility in this fashion.

2-Maintain adequate records

Maintenance of adequate records helps to protect assets and ensure employee performance with respect to prescribed procedures. Managers use the records and the information they are designed to produce to monitor activities and make decisions. Detailed records also reduce the potential for lost or stolen assets. Charts of accounts and preprinted, pre-numbered and controlled forms are part of a good system of internal control. For example, a missing, pre-numbered sales slip, issued to a specific employee, can be used to identify an error or irregularity.

3-Insure and protect assets and bond key employees

Asset protection is facilitated through bonding. A bond is an insurance policy, protecting the organization from losses caused by an employee. Bonding employees is thought to reduce the probability and incidence of loss, since bonded employees are advised that an independent insurer will be involved in the investigation of an irregularity.

4-Provide for the separation of recordkeeping and custody of assets functions

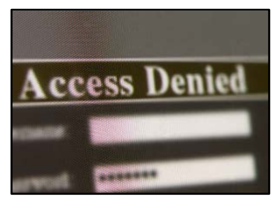
The separation of recordkeeping and custody of assets functions provides for and facilitates the timely identification of errors and produces an administrative environment that is more likely to require collusion to facilitate the ongoing failure to detect irregularities. Each employee is aware of the checks and balances in the system. This reduces the risk of both errors and irregularities.

5-Provide for the division of responsibilities for related transactions
The division of responsibilities for related transactions provides assurance that errors and irregularities will be detected in a timely fashion. This does not require a duplication of work effort, but separates duties and responsibilities. Examples include the separation of recordkeeping and authorization for purchase orders, the receipt of merchandise, and vendor payment. A single individual should not perform all of these tasks, as this increases the risk of errors and irregularities.

6-Apply technological controls
Cash registers, time clocks, passwords and personal identification codes represent examples of technological controls and innovations that identify and fix responsibility. Fixed responsibilities improve the isolation and early detection of errors and irregularities.

7-Provide for regular and independent reviews
Periodic and independent reviews of IC ensure that procedures are followed and updated, as personnel change and technological advances alter the sequence and composition of tasks being performed. If the firm maintains an internal audit staff, these reviews can be performed internally, and should evaluate both efficiency and effectiveness. External auditors may also be used to verify the work of the internal audit staff or perform these reviews.

Technology and Internal Control
Internal control (IC) is essential for both manual and automated accounting and administrative systems. Technology accelerates the pace of access to data and information, improving the managers' ability to monitor and control business activities and the decision-making process.



Reduced processing errors can be expected when using technologically advanced systems. If the software is functioning properly and the data is being entered correctly, errors of any type are nearly eliminated. Ongoing monitoring of all types of systems is important and necessary.

More extensive testing of records and transactions unlike manual systems, when all data is stored and easily and rapidly accessed, auditors are able to produce a variety of test of very large samples or even the entire population of data, prior transactions, and data resulting from the transactions.

Limited evidence of processing may be explained in cases where computer programs examine the data, to be led by those competent to establish such controls through access from passwords and alternative forms of identification. In such cases, internal controls are dependent more on the design and operation of information systems and less on the analysis of documents that might no longer need to be produced.

E-commerce creates at least 3 additional risks: theft of (1) credit card numbers, (2) computer files, and (3) impersonation or identity theft.

Limitations of internal control
Internal control policies and procedures have limitations. Frequently, even the strongest internal controls can be circumvented through collusion or the collaboration of 2 or more persons. Furthermore, the implementation of internal controls systems is costly, so cost-benefit decisions must be made. The cost of a system of internal controls should not exceed the benefit.

Internal controls fail when *errors* or *irregularities* occur. Errors are unintentional mistakes. The so-called triple threat of fraud includes (1) opportunity, (2) pressure, and (3) rationalization.

Controlling Cash
Firms must establish accounting and administrative systems of internal control to protect assets. Assets include cash, receivables, inventory and property, plant and equipment. Of course, the most liquid and vulnerable asset to be protected is cash.

To maintain appropriate internal controls over cash, the firm must provide for the separation (or segregation) of duties involving cash. Duties that should be conducted by different employees include:

1. Custody of cash (and other assets);
2. Record keeping involving cash (and other assets); and
3. Authorization of transactions involving cash (and other assets).

Furthermore, cash receipts should be deposited in a timely manner, to maximize cash flow for the firm.

Cash and Cash Equivalents
Cash based transactions are recorded in cash receipts and cash disbursement journals.

Cash and cash equivalents must be available to pay obligations and provide sufficient liquid assets for daily operations. Well-designed accounting and administrative systems, pro forma financial statements, cash budget forecasts, and strong internal controls systems assure the availability of sufficient cash for day-to-day operations. Cash equivalents include short-term investments in U.S. Treasury bills and money market funds.

Managing Cash
Effective cash management focuses on maximizing net cash inflows, by collecting and depositing cash inflows from receivables as quickly as possible, and delaying cash outflows required to pay liabilities until the due date. Inventories are costly to store and manage, so systems of *just-in-time* inventory are desirable to minimize inventory and

related storage and maintenance costs. Fixed asset utilization should be maximized and surplus or excess capacity should be sold or leased to others to generate revenues and cash inflows, or simply be avoided in the first place. Surplus cash should be invested in relatively liquid, interest- or dividend-bearing cash equivalent instruments, if needed in the near-term, or productive or cost-reducing assets, or applied to debt reduction, if not required for short-term operations.

Bank Overdrafts

Bank overdrafts suggests that a firm is "floating" or "kiting" checks (e.g., writing checks on a checking account with insufficient funds, and anticipating a delay in check clearing that will prevent a check from "bouncing" and an insufficient funds notification and "not sufficient funds" charge from the financial institution from which the account is drawn). While a balance sheet might, otherwise, net all cash and cash equivalents for presentation on the face of a firm's balance sheet, any bank overdrafts warrant "grossing up" and separate liability disclosure, if significant or material in dollar amount. The partial balance sheet below illustrates:

Assets	
Cash and cash equivalents	$xxx
Liabilities	
Bank overdraft	$xx

Cash Receipts and Cash Disbursements Journals

As indicated above, cash receipts and cash disbursements journals are the "original books of entry" for transactions involving cash. However, cash receipts and cash disbursement journals involve the use of spreadsheets with quite a few columns. This would consume quite a bit of pages in a textbook. For this reason, we teach you and test your knowledge of the "mechanics" of double-entry accounting using the less voluminous general journal format. The general journal format illustrates the final destination of the debits and the credits in the general ledger.

Examples of cash receipts and cash disbursements journals are provided in Appendix A and Appendix B, respectively.

Controlling cash receipts

Cash receipts must be recorded and deposited in a timely manner. Two important types of cash receipts requiring internal control include cash received from over-the-counter transactions and by mail.

Cash receipts: Over-the-Counter

Over-the-counter cash receipts must be recorded at the cash register at the time of sale. Customers should be able to read the amount registered, as this represents an additional internal control.

Custody of cash, an asset, must be separated from record-keeping. Those with access to cash should not have access to the cash register tape or record-keeping mechanisms.

At the end of each shift, the sales clerk should (1) count the cash, (2) generate a record of the amount received, and (3) turn in the cash and record over to the cashier. The cashier has access to the cash, but not records or cash register tapes. A third individual, a supervisor compares the cash amount reported to record the cash sale. The record represents the source document for the journal entry recording over-the-counter cash receipts. The sales clerk and the cashier have access to cash, but not record-keeping. The risk of error or irregularity is minimized, since the latter would require collusion.

Cash Over and Short

Honest errors occur, so transactions involving cash may be over or short. These overages and shortages are isolated to each clerk and their shift. The cash over and short account is an income statement account.

Assume, for example, that $500 should have been deposited, but $501 was the actual deposit. The following journal entry would be made to record the cash sales for the shift or day:

Cash	$501	
Cash Over and Short		$1
Sales		$500

Assume the reverse case. Sales were $500, but only $499 in cash was provided:

Cash	$499	
Cash Over and Short	$1	
Sales		$500

These cash shortages and overages should be immaterial and insignificant in dollar amount. They are often reported as a general and administrative expense.

Cash Receipts: Received by Mail

Cash received in the mail should be assigned to two persons. This reduces the risk of theft, which would require collusion.

Those opening the mail generate a list of money received. The list includes (1) sender's name, (2) amount, and (3) a reason for the receipt. A copy is sent to the cashier and a copy is sent to the record-keeper. One copy is retained. The cashier makes the deposit and the record-keeper records amounts into the accounting records.

Bank records represent external evidence of deposits, which should be matched to the internal documents described, above.

Controlling cash disbursements
Cash disbursements must be controlled to avoid errors or irregularities with respect to payments. All expenditures must be made by check. Relatively immaterial or insignificant amounts may be paid from petty cash. Voucher and petty cash systems produce relatively strong systems for internal control.

The Voucher System
A voucher system establishes procedures for (1) verifying, approving, and recording obligations for cash payment, and (2) issuing checks for verified, approved, and recorded obligations.

A voucher system permits only approved departments and individuals to incur legitimate obligations, where the type of obligation is matched to the appropriate department or individual. For example, only the purchasing department in a large retail store can authorize the purchase of merchandise inventory. Procedures and responsibilities for purchase requests, purchasing, receiving, and payment are separated (or segregated), and all related documents, representing an audit trail, are accumulated in a voucher (an internal document or file).

Appendix C elaborates on source documentation and internal controls.

Petty Cash

Many firms have a need to make very modest cash payments in their day-to-day operations. It might be inefficient for these firms to write checks to reimburse an employee for a few dollars or for gasoline or for occasional out-of-pocket purchases. To avoid writing checks for each and every one of these very small and intermittent expenses, a firm might establish a petty cash fund. These funds are usually insignificant or immaterial, relative to the firm's other cash accounts. The first step is to establish the fund and a custodian. The below journal entry illustrates how the petty cash fund for $100 might be established. A check for $100 is cashed, advancing cash, which is given to the fund custodian for very small, out-of-pocket expenses.

Petty Cash	$100	
Cash		$100
To establish petty cash fund.		

At any point in time, the cash or receipts in the custodian's care will equal $100.

For example, if an employee is sent to the store to pick up some supplies, the employee is (1) given $20, (2) signs a slip of paper acknowledging receipt of the $20, (3) returns with the receipt and change, and (4) the receipt and change replacing the slip of paper, representing the $20 advanced to the employee for the purchase. The slip of paper signed by the employee for the $20 is destroyed or may be attached to the actual receipt.

This process repeats until the cash in the fund reaches a point where the custodian or the firm's policy requires that the fund must be replenished. It is likely to always be replenished at the end of each month or accounting period, to achieve proper matching of the expense to the period. It is replenished with a check made out to cash, totaling all receipts in the custodians care. At that point in time, a brief summary of the receipts is generated and an additional check is written to restore the petty cash fund to $100 in cash.

The below general journal entry illustrates the restoration of a petty cash fund to the desired $100 cash balance where $5.00 was given to an employee for personal vehicle use and gasoline, $20.00 was spent on US postage stamps, $5.75 was spent on coffee for the office, $13.50 was spent for paper for the office copier, when paper supplies ran low between regular shipments, and $25.00 was spent on employees for pizza, when a few had to work late one evening:

Fuel	$5.00	
Office Supplies	$39.25	
Meals and Entertainment	$25.00	
Cash		$69.25
To replenish petty cash fund.		

The check for $69.25 would be cashed and the cash exchanged for the receipts and the summary sheet or worksheet. While the meals and entertainment expense might also be considered office supplies, the actual classifications used will depend on the firm's chart of accounts and internal policy. For example, some of these cash expenses might appropriately be classified as "miscellaneous" expenses.

If reimbursements are required frequently, the size of the petty cash fund might need to be increased (debit petty cash and credit cash). Alternatively, if the petty cash fund is too large, some of the cash should be deposited into the firm's bank account (debit cash and credit petty cash).

Cash Transfer Accounts

When a firm transfers cash from one of their internal cash or checking accounts to

another one of their internal cash or checking accounts, an intermediate "cash transfer" account must be used. If not used, the transfer will be double-counted. Consider the following:

ABC transfers $10,000 from their operating checking account (account #101) to their payroll checking account (account #102) to meet the net pay for the coming pay period.

First, the journal entry is made for the $10,000 transfer out of the operating checking account, and recorded in the cash disbursements journal:

#102 Cash – Payroll Account	$10,000	
#101 Cash – Operating Account		$10,000
To transfer $10,000 from the operating to		
the payroll checking account to fund payday.		

Second, the journal entry is made for the $10,000 transfer into the payroll checking account, and recorded in the cash receipts journal:

#102 Cash – Payroll Account	$10,000	
#101 Cash – Operating Account		$10,000
To transfer $10,000 from the operating to		
the payroll checking account to fund payday.		

Effectively, this transfer between the firm's internal checking accounts ***double-counts*** the cash transfer. The solution is a "cash transfer" account (account #115), used to eliminate the double-counting:

#115 Cash – Transfer Account	$10,000	$10,000
#102 Cash – Payroll Account	$10,000	
#101 Cash – Operating Account		$10,000
To transfer $10,000 from the operating to		
the payroll checking account to fund payday.		

Bank Statement

Bank statements are provided monthly, either mailed to the account holder in paper form and/or accessed electronically. Technology makes it possible to access banking transactions on-line and in real time and even download transactions by type (cash disbursements v. cash receipts) and/or over specific time periods.

At a minimum, monthly bank statements provide bank records with respect to the

1. beginning of period balance,
2. checks, bank service charges, or other debits (cash disbursements) to the bank account during the period,
3. deposits or other credits (cash receipts) to the bank account during the period, and the
4. ending period balance, as follows:

Beginning balance	$xxx
Add: deposits and other credits	xx
Deduct: checks and other debits	(xx)
Ending balance	$xxx

Do not let the debits and credits listed on the bank statement confuse you. They are so labelled based on the bank's perspective. From the bank's perspective, cash (your asset) that you have in their bank is their liability. This is why, from the bank's perspective, debits and credits appear to be reversed.

Framework for the Basic Bank Reconciliation
Below is the framework for the basic bank reconciliation, with measures included:

	Bank statement balance	$5,000.00		Book balance	$3,950.00
Add:	Deposit(s) in transit	$300.00	**Add:**	Interest earned	$10.00
				Note receivable collection	$350.00
Subtotal:		$5,300.00	**Subtotal:**		$4,310.00
Deduct:	Outstanding check(s)	$1,300.00	**Deduct:**	Check printing charge	$35.00
				NSF check & service fee	$275.00
Equals:	Adjusted bank balance	$4,000.00	**Equals:**	Adjusted bank balance	$4,000.00

Start at the top of each column in the above example. On the left side is a bank statement balance of $5,000. On the right side is a book balance of $3,950. These two sides must be reconciled to the adjusted balance of $4,000 at the bottom of both left and right sides.

Where Did the "Book Balance" Come From?
Below is a T-account representation of (1) the beginning book balance of $600, (2) the cash receipts from the cash receipts journal for the month of $5,000, and (3) the cash disbursements from the cash disbursement journal for the month of $1,650. Note that the end of month book balance is $3,950, which matches with the above from the bank reconciliation:

Cash		
Beginning	$600	
Cash Receipts	5,000	
		$1,650 Cash Disbursements
Ending	$3,950	

Timing Differences
The bank reconciliation must account for *timing* differences between the bank and the firm for both outstanding checks and outstanding deposit – credits and debits to cash that are in transit. Timing differences are accounted for on the left (bank statement) side of the above bank reconciliation:

- **Outstanding check(s)** are those checks or electronic deductions from the firm's checking account that were written (or authorized) during the month and are recorded in the cash disbursements journal, but do not appear on the bank statement. They have not yet been deposited by the payee or "cleared" the bank. This represents a *timing* difference. The check has been appropriately deducted from the cash account on the firm's books, but is not reflected as a deduction of cash on the bank statement. These are, typically, checks written toward or at the end of the month. In the above case, a check or checks totaling $1,300 were included in the book balance of $3,950, but did not yet “clear” or show up in arriving at the $5,000 bank statement balance.

- **Deposit(s) in transit** (or **outstanding deposits**) are those deposits or electronic receipts that were made during the month and are recorded in the cash receipts journal, but do not appear on the bank statement. They, also, have not yet “cleared” the bank. This, also, represents a *timing* difference. The deposit has been appropriately added to the cash account on the firm’s books, but is not reflected as an increase in cash on the bank statement. These are, typically, deposits made toward or at the end of the month. In the above case, a deposit or deposits totaling $300 were included in your book balance of $3,950, but did not yet “clear” or show up in arriving at the $5,000 bank statement balance.

Deductions and Additions and Errors – Items Not Yet Recorded on the Books
Deductions, additions and corrections for errors are identified from the bank statement. They must be used to adjust the “book balance” of $3,950 (see bank reconciliation).

- **Deductions:** Some deposits might originate from customers with insufficient funds to cover the check (NSF or “not sufficient funds”). In this case, the check will “bounce” and the bank statement will indicate that the payee “kited” the check and the failure of the payee to honor the check they issued. This “bounced” check will show on the bank statement and you will have to adjust your “book balance.” In our fact pattern, a check in the amount of $250 “bounced” and the bank charged a $25 fee. Your books do not reflect this, so you will have to make a journal entry to adjust your “book balance.” Similarly, you must adjust your books for the $35 check printing charge.
- **Additions:** On occasion, banks will provide services for a fee. For example, your bank might make collections, for a fee, for a note receivable. The receipt of periodic payments for the note receivable will be credited to your bank account, along with any relevant service charge. In this case, the bank administers the collection for a monthly payment of $360 and charges you $10. The net amount credited by the bank to your account is $350.
- **Interest earned:** Interest rates are very low, and many business checking accounts do not pay interest, but this could change. For this reason, we will assume that your checking account balance was high enough to generate $10 in interest income. You did not know the precise amount of interest earned until your received the bank statement, so you must make a journal entry to record the $10 interest income not yet reflected in your “book balance” of $3,950.
- **Errors:** Human error is unavoidable. Both bank errors and your accounting errors on your internal, cash receipts and disbursements journals must be accounted for and corrected on the firm’s bank reconciliation.

Journal Entries from the Bank Reconciliation
Below are the journal entries for the “right side” of the bank reconciliation example used. All items not yet record on the books require a journal entry. They appear in the same sequence as that developed in the bank reconciliation, as follows:

Cash	$10	
Interest income		$10

Cash	$350	
Note receivable		$350

Miscellaneous expense	$35	
Cash		$35

Miscellaneous expense	$25	
Accounts receivable	$250	
Cash		$275

Bank Reconciliations – Bank Accounts Represent Strong Internal Control Devices
There is no asset that is more "liquid" than cash. Therefore, internal controls over cash must be very strong, providing for the separation (or segregation) of duties between (1) custody of cash, (2) record keeping for cash disbursements and cash receipts, and (3) the authorization of cash-related transactions. If a firm has weak internal controls over cash receipts and cash disbursements, the entire accounting and administrative system within a firm or organization may require greater scrutiny. In the case of a firm that is publicly traded and/or audited, this would take the form of an expanded audit scope and higher audit fees.

Appendix A

Cash Receipts Journal

All cash receipts are recorded in the cash receipts journal. The cash receipts journal is, therefore, referred to as the "original book of entry" for any transaction involving a cash receipt. Cash receipts are sometimes abbreviated as CRs. The cash receipts journal is summarized or totaled, monthly, and these monthly totals are used to prepare the bank reconciliation, using the related bank statement. A separate cash receipts journal is produced for each checking or savings account.

Below are five examples of cash receipts:

1 – $10,000 cash is deposited to open a new checking account for a new firm. Capital stock is issued.
2 – $1,000 cash is received, in advance, for a job to be completed for a client.
3 – $500 cash is received for a small job completed for a client during the first month of operations.
4 – $5,000 cash is borrowed from the bank, for 1 year. The entire amount is deposited.
5 – $2,000 cash is borrowed from a family member, also for 1 year. The entire amount is deposited.

If these transactions were recorded in general journal form, they would appear, as follows:

General Journal

Account Title	Debit	Credit
1 – Cash	$10,000	
1 - Capital Stock		$10,000
To record initial capitalization and issuance of capital stock.		
2 – Cash	$1,000	
2 – Unearned Revenue		$1,000
To record fees collected in advance of work to be completed.		
3 – Cash	$500	
3 – Revenue		$500
To record revenues earned and cash collected.		
4 – Cash	$5,000	
4 – Loan Payable - Bank		$5,000
To record receipt of a loan from the bank, payable in 1 year.		
5 – Cash	$2,000	
5 – Loan Payable – Uncle Bob		$2,000
To record loan received from Uncle Bob, payable in 1 year.		

If these same transactions were recorded in a cash receipts journal, where each and every transaction must necessarily result in a debit to cash, they would appear, as follows:

	DR Cash	CR Capital Stock	CR Unearned Revenue	CR Revenue	CR Loan Payable Bank	CR Loan Payable Uncle Bob
1	$10,000	$10,000				
2	$1,000		$1,000			
3	$500			$500		
4	$5,000				$5,000	
5	$2,000					$2,000
	$18,500	$10,000	$1,000	$500	$5,000	$2,000

The entire month of cash receipts could be collapsed into a single journal entry, as follows:

Cash	$18,500	
Capital stock		$10,000
Unearned revenue		$1,000
Revenue		$500
Loan payable - bank		$5,000
Loan payable – uncle Bob		$2,000

Appendix B

Cash Disbursements Journal

All cash disbursements are recorded in the cash disbursements journal. The cash disbursements journal is, therefore, referred to as the "original book of entry" for any transaction involving a cash disbursement. Cash disbursements are sometimes abbreviated as CDs. The cash disbursement journal is summarized or totaled, monthly, and these monthly totals are used to prepare the bank reconciliation, using the related bank statement. A separate cash disbursements journal is produced for each checking or savings account.

Below are five examples of cash disbursements:
1 – $2,400 cash is paid for insurance. This represented a $200 prepayment per month for 12 months.
2 – $1,000 cash is paid for rent for the first month of operations.
3 – $200 cash is paid for utilities for the month.
4 – $1,000 cash is paid for salary expense for employees for the month.
5 – $500 cash is paid for an account payable. This liability was incurred earlier in the month.

If these transactions were recorded in general journal form, they would appear, as follows:

General Journal

Account Title	Debit	Credit
1 – Prepaid Insurance	$2,400	
1 – Cash		$2,400
To record insurance, prepaid for 12 months.		
2 – Rent Expense	$1,000	
2 – Cash		$1,000
To record rent expense paid for the month.		
3 – Utilities Expense	$200	
3 – Cash		$200
To record utilities expense paid for the month.		
4 – Salaries Expense	$1,000	
4 – Cash		$1,000
To record salaries expense paid for the month.		
5 – Accounts Payable	$500	
5 – Cash		$500
To record payment of an account payable.		

If these same transactions were recorded in a cash disbursement journal, where each and every transaction must necessarily result in a credit to cash, they would appear, as follows:

	CR Cash	DR Prepaid Insurance	DR Rent Expense	DR Utilities Expense	DR Salaries Expense	DR Accounts Payable
1	$2,400	$2,400				
2	$1,000		$1,000			
3	$200			$200		
4	$1,000				$1,000	
5	$500					$500
	$5,100	$2,400	$1,000	$200	$1,000	$500

The entire month of cash disbursements could be collapsed into a single journal entry, as follows:

Prepaid insurance	$2,400	
Rent expense	$1,000	
Utilities expense	$200	
Salaries expense	$1,000	
Accounts payable	$500	
Cash		$5,100

Appendix C

Source Documentation

Accountants and auditors possess a high level of expertise in internal control-based source documentation.

Purchase Requisitions are completed and signed by department managers for consideration by the purchasing agent and/or department. It lists the items and quantities needed. A copy is retained by the (1) department requesting the purchase; a second copy is provided to the (2) purchasing agent and/or department; and a third copy is provided to the (3) accounting department. In today's business environment, purchase requisitions may be electronic, avoiding the need for paper and filing cabinets. Purchase requisitions are numbered, to maintain control and identify any lost purchase requisitions or interruptions in sequence.

Purchase Orders are issued by the purchasing agent and/or department when a purchase requested is placed with a supplier or vendor. Internal control is established and maintained, as a single department has the authority and responsibility for all purchases. The purchase order provides details with respect to the price, quantity, dates and other terms associated with the purchase. Again, a copy is retained by the (1) department requesting the purchase; a second copy is provided to the (2) purchasing agent and/or department; and a third copy is provided to the (3) accounting department. In addition, copies are provided to the (4) vendor, (5) receiving department (so they are advised of incoming items), and (6) a copy is retained by the purchasing department. Purchase orders are numbered, to maintain control and identify any lost purchase orders or interruptions in sequence.

Sales Invoice is a term used to characterize an itemized statement prepared by a vendor with the customer's name, price, quantity, and terms of items purchased. A copy is retained by the vendor and a copy is provided to the accounting department, for payment. Sales invoices are numbered, to maintain control and identify any lost sales invoices or interruptions in sequence.

Receiving Reports are produced and maintained by firms with receiving departments. The receiving department checks each shipment for quantity and consistency with the purchase order. Copies of receiving reports are provided to the (1) accounting department, the (2) requesting department, and the (3) purchasing department, while one copy is retaining by the (4) receiving department for its records.

The Invoice Approval Process is triggered by the receipt of the receiving report by the accounting department. The accounting department should have copies of the (1) purchase requisition, (2) purchase order, (3) sales invoice, and (4) receiving report.

Once all of these documents are assembled, payment can be authorized and a check can be processed for delivery to the vendor.

Appendix D

Accounting for Purchase Discounts

There are 2 methods used to account for purchase discounts. The **gross method** records purchases at their gross amount, ignoring any cash discounts. The **net method** records purchases at their net amount, assuming that cash discounts will always be taken by the purchaser. In the latter case, if the discount is not taken, the discount forgone is recorded in a ***discounts lost*** account, designed, specifically, to draw management's attention to these lost opportunities for review.

Both perpetual and periodic inventory systems under both gross and net methods are provided on the following page. In this case, the firm purchased $1,000 in goods with terms of 2/10, n/30. Notice that the amounts do not change, but the account titles do change (between perpetual and periodic systems).

Perpetual inventory illustration

Gross Method		
Inventory purchased		
Merchandise inventory	$1,000	
Accounts payable		$1,000
Discount taken		
Accounts payable	$1,000	
Cash		$980
Merchandise inventory		$20
Discount not taken		
No entry		
Invoice finally paid		
Accounts payable	$1,000	
Cash		$1,000

Net Method		
Inventory purchased		
Merchandise inventory	$980	
Accounts payable		$980
Discount taken		
Accounts payable	$980	
Cash		$980
Discount not taken		
Discounts lost	$20	
Accounts payable		$20
Invoice finally paid		
Accounts payable	$1,000	
Cash		$1,000

Periodic inventory illustration

Gross Method		
Inventory purchased		
Purchases	$1,000	
Accounts payable		$1,000
Discount taken		
Accounts payable	$1,000	
Cash		$980
Purchase discounts		$20
Discount not taken		
No entry		
Invoice finally paid		
Accounts payable	$1,000	
Cash		$1,000

Net Method		
Inventory purchased		
Purchases	$980	
Accounts payable		$980
Discount taken		
Accounts payable	$980	
Cash		$980
Discount not taken		
Discounts lost	$20	
Accounts payable		$20
Invoice finally paid		
Accounts payable	$1,000	
Cash		$1,000