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Module 7

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Instructions:

Click on any of the underlined titles in the table of contents to be directed to that section of the module. Click on the <**back**> symbol to return to the table of contents.

Video Lectures

Because seeing and hearing is sometimes better than just reading, I have prepared two video lectures for this module. After you read through the sections below, click here to play or to download the videos:

Petty Cash and Petty Cash Funds: http://youtu.be/nRy2TGmTicc
Bank Statement Reconciliation: http://youtu.be/ytg3K4kqGeQ

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Module 7 Summary

I. Liquidity Management

A. It is impossible to discuss the *Cash* account without touching on the subject of ***liquidity management***.

1. As we learned in Module 1, cash is the company's life-blood, and *liquidity* refers to the company's ability to obtain cash when it is needed. Good *liquidity management* practices ensure that cash is available or will be available when needed, but they also see to it that excessive cash balances are avoided.

2. This last statement may confuse you. Having too much money is a problem? It is easy to understand why the company would want to make sure it has *enough* cash on hand to carry on business operations, but why would the company ever worry about having *too much* cash?

a. This is because every asset invested in the company is "expensive." In other words, all assets (including cash) have a cost. Think about it this way:

1. Some of the money that is used for operations or to purchase the company's assets comes from creditors' loans. The creditors expect to receive the interest on the loans they have made to the company, and if they are not paid they will sue and force the company into bankruptcy.

2. They remaining money that the company uses for operations and asset purchases comes from the owner (or the stockholders, if the business is a corporation). Business owners and stockholders expect to earn some minimum rate of return on the investments they have made in their companies. If a company cannot provide it, the owner (or its stockholders) will decide to close the business down and invest elsewhere.

3. To summarize, all the money that goes into the company is provided by creditors and owners, and the creditors and the owners must be paid for the use of

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their funds. If the business cannot make those payments, it will fail.

B. Where does the money come from to pay the necessary interest to the creditors and provide the required returns to the owners? There is only one place it can come from - the assets themselves!

1. That is, the assets have to be used *profitably*, and the income they produce must be sufficient to cover the company's interest obligations and still provide the owners with the returns they require.

2. Any asset that is not used profitably is a drain on the company's resources, and may even result in the company's failure.

C. Our conclusion? The company will want to avoid holding any asset (whether they it is an equipment item, a building, a receivable, or an excessively high cash balance) that does not contribute to profits. Therefore, there are no free rides for assets. Each asset must pay for itself or it is outta here!

II. Accounting for Cash Balances

A. What is ***Cash***? In order for an item to be reported on the balance sheet as part of the *Cash* account balance, it should represent something that already is cash or that the bank would accept as a deposit and would credit to the company's account. Cash is also *unrestricted*. That is, the company can use it whenever it wants and for any purpose that it wants. Restricted account balances (such as funds held in restricted accounts for loan repayments, corporate dividends, taxes, etc.) should not be classified as unrestricted cash on the balance sheet.

1. Items that can be reported as part of the *Cash* balance on the balance sheet are coins and currency on hand, undeposited checks and money orders from customers, and bank checking account balances.

2. Some items, such as bank certificates of deposit, savings accounts, Treasury Bills, Money Market accounts and other similar items may appear to be things that could be called *Cash* on the balance sheet. However, if there are restrictions that would prevent the company from quickly converting the item into a known amount of cash, it

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should be reported as an *Investment* rather than a part of the general cash account balance.

Here are some definitions!

*A **certificate of deposit** (called a **CD**) is a bank account balance that pays slightly higher rates of interest than savings accounts or checking accounts. The bank is able to pay a higher rate because the depositor agrees to keep the money on deposit for a set period of time, and agrees to give up some or all of the interest if the money is taken out of the bank before the maturity date of the CD. **Treasury bills** (called **T-bills**) are short-term notes issued by the US government. Investors may buy the bills directly from the government, paying a price that is less than the bill's maturity value. When the bill matures, the buyer is paid the maturity value and collects the interest that has been earned. **Money market accounts** are mutual fund or special bank accounts that invest in CD's, T-bills, and in other short-term debt instruments. They function like bank accounts, and often allow their investors to write checks against their account balances. Their share values do not fluctuate, and they sometimes pay higher rates of interest than their investors can earn at their banks or in single T-Bill investments.*

B. Which of these items can be called "Cash" on the balance sheet? Only those that are ***cash equivalents.*** *Cash equivalents* are defined as short-term (90 days or less), highly liquid investments that can be easily converted into a known amount of cash. They are often combined with the cash balance and reported as a single item on the balance sheet called ***Cash and Cash Equivalents***.

C. ***Compensating balances*** are minimum account balances that a bank can require a company to maintain. These balances, by definition, must be maintained at the bank and are not available for other uses, and so would generally not be classified as a cash equivalent. Compensating balance restrictions must be disclosed in the notes that accompany the financial statement.

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III. Internal Control Over Cash Transactions

A. Internal control over cash is a large concern in any business because cash is the most "liquid" of a company's assets (that is, it is very "portable" and it is accessed several times a day since a great many transactions involving cash occur every business day).

B. When ***cash is received through the mail*** two or more employees should open the mail and count the cash. As the mail is opened, three

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records of the money received along with the name of the sender should be created. One copy is sent along with the money to the Cashier, who makes the bank deposit. Another goes to the Accounting Department to be recorded, and one is kept in the receiving department.

1. As another internal control feature, companies often have customers return a ***remittance advice*** with their payments.

2. This is a form or merely a small area on the bill itself in which the customer enters the amount that is being remitted. This will be used to verify the amount that the receiving department records as having been received.

C. When ***cash is received over the counter*** cash registers should be positioned so that customers can observe the figures being rung up. There should be a sealed tape inside the register, or an electronic means of recording the sales that are rung up, that the employee cannot access. At the end of the employee's shift, a manager should take the tape out of the machine (or access the electronic record), count the remaining money, and record the day's receipts. The employee should verify the manager's count. The Cashier makes the bank deposit, and the accounting department records the sales.

1. The entry to record the daily sales deposit would be:

	Debit	Credit
Cash	***$X***	
Sales		***$X***

2. Errors can easily be made when change is made from the cash register, resulting in a cash shortage or overage at the end of the day. These discrepancies are recorded in a special ***Cash Short and Over*** account. A debit entry to this account reflects a cash shortage (an expense). A credit entry represents a cash overage (which is reported as revenue).

   a. The entry to record the day's sales when a cash shortage occurs is:

	Debit	Credit
Cash	***$X***	
Cash Short and Over	***X***	
Sales		***$X***

   b. The entry to record the day's sales when a cash overage occurs is:

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Cash	***$X***	
Cash Short and Over		***$X***
Sales		***X***

c. Remember, a debit balance in this account is reported among expenses on the income statement. A credit balance is reported as revenue. We will discuss this account in more detail later in the module.

D. ***Purchases and cash disbursements*** should be controlled by ensuring that cash is paid only when authorized, and that authorization is based upon the receipt of source documents that verify the amount and existence of the obligation.

1. Since purchases and payments affect many departments and employees (e.g., requesting department, purchasing agent, receiving department, cashier, and accounting department), proper separation of duties requires many steps.

2. The steps of requesting the purchase, receiving approval, choosing the vendor, placing the order, receiving the items, inspecting them, delivering them to the requesting department, making timely payment, and recording the purchase should all be documented and verified by at least one other party.

3. The documents used should include a formal purchase requisition, purchase order, invoice, receiving report, check authorization, and written check.

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Video Lecture
After you read through the sections below, click here to play or to download the video:

Bank Statement Reconciliation: ***http://youtu.be/ytg3K4kqGeQ***

IV. Bank Reconciliations and Internal Control

A. The bank delivers a ***bank statement*** to its depositors each month, either by mail or electronically. The bank statement summarizes all the activity in the account since the previous statement and reports an ending balance amount. The information reported in the statement includes the following:

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- The opening balance for the bank account (amount in the account as of the previous statement).
- The ending balance for the bank account (amount in the account as of the closing date for the statement).
- The amount of interest, if any, earned on the account balance during the statement period.
- Any service charges assessed by the bank for this statement period.
- Checks that have cleared the bank.
- Deposits made to the account.
- Any other transactions that affect the balance of the account (for example, automatic payments or deposits or ATM withdrawals or deposits).

B. The ***bank balance*** (the amount of cash in the account that is reported on the bank statement) will likely differ from the cash balance on the company's books (the ***book balance***). These differences are usually explainable, and are often caused by timing delays. However, differences can also be caused by errors in the bank's records or in the company's own accounts.

Here's an example! *Suppose you receive your April 30 bank statement on May 5. You will have recorded any deposits or payments that occurred during the first 5 days of May in your own check register, but they will not be shown on the bank statement. This will cause a difference between the bank statement balance and your book balance, but it is only caused by timing differences and is not the result of any errors. Suppose, though, that you also wrote a check for $100 during the period, and the bank recorded it as $1,000. This* ***bank error*** *will also cause a difference between your Cash account balance and the bank statement balance, and it is a serious one that needs to be corrected. However, it might not even be discovered, let alone corrected, unless you take the time to compare your record of deposits and payments with the bank statement record!*

C. Therefore, good internal control calls for the company to ***reconcile*** the monthly bank statement against the company's own records in order to verify the accuracy of both sets of data. After all, if the company compares its *Cash* account records with the amounts reported on the bank statement, it will be able to find and correct errors in its own accounts, and it may even find errors in the bank's records. This enhances internal control over the cash that is in the bank.

1. The ***bank reconciliation*** and the ***reconciliation report*** are completed periodically. The formal bank reconciliation report

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merely lists the bank and book cash balances, and then adjusts them by adding and subtracting the items that are responsible for the differences between them. The end result is two balances that are equal, and that represent the correct cash account balance.

2. The word *reconcile* simply means "to resolve differences," or "to bring into agreement." And the *bank reconciliation report* does just that!

D. The items that cause differences and that are reported on the bank reconciliation report include the following: *deposits in transit, outstanding checks, NSF checks, bank service charges, notes collected by the bank, interest earned* on the bank balance, and *bank or bookkeeping errors*. The process of reconciling the bank balance simply requires that the above items be identified, and that the balance which is "wrong" because it doesn't include them or because an error has been made, be "corrected." This is done by adding or subtracting the missing item or the amount of the error to the balance that is incorrect because of the error.

Helpful Hint: *Did you catch that? If you follow the procedure described above, bank reconciliations are really pretty easy things to do. Once an item that causes a difference between the book balance and the bank balance is identified, just follow these steps:*

(1) Ask yourself, "Who didn't know about this – the bank or the company? Whose balance is wrong?"

(2) Once you know which balance is "wrong," the next question to ask yourself is "What do I do to correct the incorrect balance - do I add or subtract the amount in question?"

(3) Once you know whose balance is wrong and what you need to do to correct it, then go to the reconciliation report and do it!

Here is a summary of the items that are typically listed on the bank reconciliation report, which balances that are affected by them, and the "correction" that is needed:

1. ***Deposits in transit*** are the deposits that were made by the company after the bank statement was prepared by the bank. Therefore, they have been correctly recorded in the company accounts, but they are not on the bank statement.
   - Who hasn't recorded this? The bank – so the bank balance is wrong.
   - To "correct" the reported bank balance, it will be necessary to *add the deposits in transit to the bank balance*.

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2. ***Outstanding checks*** are similar to deposits in transit. They represent checks that were written by the company and recorded in the company's accounts, but they were not received by the bank and were not cleared against the bank account as of the statement date.
    - Who hasn't recorded this? The bank – so the bank balance is wrong.
    - To "correct" the reported bank balance, it will be necessary to subtract the outstanding checks from the bank balance.

3. ***Bank service charges*** may be levied against the account by the bank for check printing, monthly maintenance, or other reasons. When they are charged to the depositor, the bank simply reduces the account balance by the amount of the charge. These are reported on the bank statement as *debit memorandums* (or "debit memos' for short), and they are usually shown with a code "DM" or "SC." The company will find out about them when it receives the bank statement.
    - Who hasn't recorded this yet? The company – so the book balance is wrong.
    - It will be necessary to "correct" the cash account balance by subtracting service charges from the company's balance.

4. ***NSF checks*** are customers' checks deposited by the company, but returned by the bank because there was not enough cash in the customers' bank accounts to cover the checks. The customer's check will have "bounced" (*NSF* stands for "non-sufficient funds"). The company will have recorded this deposit in its accounts, but the deposit will not have actually occured.
    - Who hasn't recorded this yet? The company – so the book balance is wrong.
    - To "correct" the company's cash account balance, it will be necessary to subtract the NSF check amount from the company's balance.

5. Other ***fees*** may also be charged to the account by the bank for specific events, such as fees for note collections, for NSF checks, or for making a line of credit available for the company. Like service charges, these fees are coded "DM" or "SC" on the statement, and the company will find out about them when it reviews the bank statement.
    - Who hasn't recorded this yet? The company – so the book balance is wrong.
    - It will be necessary to "correct" the cash account balance by subtracting service charges from the company's balance.

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6. ***Note collections*** by the bank may or may not be included on the bank reconciliation. Notes receivable create internal control challenges for companies because they often represent large amounts of cash. The company wants to ensure the collection of the note, of course, but having large amounts of cash on hand does raise internal control concerns. In order to avoid having to process the collection internally, the company may arrange for its bank to collect the note and immediately deposit the payment into the company's account. If the company has followed up with the bank, as it should, and verified that the collection has taken place, it will probably have recorded the collection in its own accounts. In that case, the bank records will agree with the company's accounts, and the note collection will not appear on the bank reconciliation. If, however, the company did not record the collection, the note and its interest must be listed on the reconciliation report.
   - Who hasn't recorded this yet? The company – so the book balance is wrong.
   - It will be necessary to "correct" the cash account balance by adding the note and its interest to the company's balance.

7. ***Bank errors*** can and do happen from time to time. It is possible for the bank to charge the company for another company's check or to credit the company for another company's deposit. A check or deposit amount might also be recorded incorrectly, or a service charge could be incorrectly applied to the company's account. If any of these errors are discovered during the bank reconciliation process, the bank will have to be notified so that it can correct its records.
   - Depending on the type of error and its effect, a bank error will be *added or subtracted from the bank balance*.

8. ***Book errors*** are made by the depositor in his or her own records. A payment might not be recorded at all, or it might be recorded twice. The same thing could happen with a deposit. Mistakes made in recording the amount of a deposit or a check are inevitable.
   - Depending on the type of error and its effect, a book error will be *added or subtracted from the book balance.*

E. A sample bank reconciliation report template is shown below, and a detailed example follows.

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Bank Reconciliation			
Bank Statement Information:			
Balance Per Bank Statement			*$X*
Add:			
Deposits in Transit	*$X*		
Bank Errors	*+$X*	=	*+$X*
Subtract:			
Outstanding Checks	*$X*		
Bank Errors	*+$X*	=	*-$X*
Adjusted Balance			*$X*
Information from Company's Books:			
Balance Per Company Books			*$X*
Add:			
Note Collected by Bank	*$X*		
Interest on Collected Note	*+$X*		
Interest Earned on Account	*+$X*		
Errors in Company Accounts	*+$X*	=	*+$X*
Subtract:			
NSF Check	*$X*		
Bank Service Charges and Fees	*$X*		
Errors in Company Accounts	*$X*	=	*-$X*
Adjusted Balance			*$X*

D. The bank reconciliation is a formal report that should be printed and filed (or saved electronically) for audit and internal control purposes.

E. **Required Journal Entries**

1. Any adjustment to the company's bank account balance on the bank reconciliation form represents a change in the *Cash* account balance that the company has not yet recorded.

2. Therefore, any item listed as an adjustment to the company's book balance must also be journalized and posted to the *Cash* account in the company's general ledger.

Here's an Example!

Suppose the November bank statement shown below is received by Acme Service Company on December 10:

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First Bank

Acme Service Company
1313 Mockingbird Lane
Freeport, IL 61032

Bank Statement	
November 1 – November 30	
Beginning Balance:	$ 5,000
Deposits/Credits:	4,050
Checks/Debits:	(5,875)
Ending Balance:	$ 3,175

Debits				Credits		
Date	Check #	Amount		Date	Code	Amount
11/01	1045	400		11/22	DR	3,500
11/5	1046	2,000		11/29	DR	548
11/5	1047	1,000		11/30	CM	2
11/9	1048	250				
11/10	1049	500				
11/13	1050	50				
11/14	NSF	50				
11/14	1051	250				
11/21	1052	200				
11/24	1053	225				
11/29	1055	600				
11/29	DC	149				
11/30	ATM	200				
11/30	SC	1				
Total		5,875				4,050

Code:	Explanation:
ATM	- Automated teller machine withdrawal
DC	- Debit card payment
SC	- Service charge
DM	- Debit memorandum
DR	- Deposit receipt
CM	- Credit memorandum

The bank statement reports a bank balance of $3,175. However, the company's Cash account balance is $4,832. In order to verify the book balance and to check for errors,

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a bank reconciliation report is prepared. The items that account for differences between the bank balance and the book balance are the following:

1. *Outstanding checks: Check #1054 for $230 and #1056 for $10.*
2. *Deposits in transit: Deposit after hours made on 11/30: $1,825.*
3. *Bank service charge: $1.*
4. *NSF check returned by bank: $50.*
5. *Interest earned on account balance: $2.*
6. *The bank recorded check #1053 as $225 when the actual amount was $198. The bank promised to correct the error when the bookkeeper called and reported it.*
7. *The deposit of cash from of $548 from the collection of a customer's account balance on 11/29 was recorded incorrectly as $544 in the company's accounts.*

Bank Reconciliation			
Bank Statement Information:			
Balance Per Bank Statement			*$3,175*
Add:			
Deposits in Transit	*$1,825*		
Bank Errors	*+ 27*	*=*	*+ 1,852*
Total			*$5,027*
Subtract:			
Outstanding Checks	*$ 240*		
Bank Errors	*+ 0*	*=*	*(240)*
Adjusted Balance			*$4,787*
Information from Company's Books:			
Balance Per Company Books			*$4,832*
Add:			
Interest Earned on Account	*$ 2*		
Errors in Company Accounts	*+ 4*	*=*	*+ 6*
Total			*$4,838*
Subtract:			
NSF Check	*$ 50*		
Bank Service Charge	*+ 1*		
Errors in Company Accounts	*+ 0*	*=*	*(51)*
Adjusted Balance			*$4,787*

Note that two errors were identified when the bank reconciliation was prepared. This illustrates the importance of the bank reconciliation in providing for internal control over the company's cash assets. Note also that the report shows that four adjustments were made to the company's book balance. These four items represent things that did affect the company's cash balance that the company had not recorded. Therefore, after completing the report, it will be time to record these items in the company's accounts.

The following four entries will be journalized and posted to the general ledger:

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Cash	***2***	
Interest Revenue		***2***
To record interest earned on bank account balance		

Cash	***4***	
Accounts Receivable		***4***
To correct error in recording collection of cash on account		

Accounts Receivable	***50***	
Cash		***50***
To reduce cash balance for NSF check and record customer's obligation to pay		

Miscellaneous Expense *	***1***	
Cash		***1***
To record monthly bank service fee		

** Service Charge Expense, Bank Fees or some other account might be used here as well.*

Video Lecture

After you read through the sections below, click here to play or to download the video:

Petty Cash and Petty Cash Funds: **http://youtu.be/nRy2TGmTicc**

V. Petty Cash Funds

A. Basic internal control policies for cash require that payments be made by check or credit card, as much as possible. This ensures that only authorized persons (those whose names are on the bank signature card) have access to the company's cash. It also guarantees that the payment will be listed along with all the others when the bank or credit card reconciliation report is prepared, and that the amount, the payee, and the payment authorization will then be verified.

B. Unfortunately, it is sometimes impossible or very inconvenient to pay by check or to use a credit card. Therefore, to allow for the use of cash in those instances, firms may establish a ***petty cash fund***. Cash is withdrawn from the company's bank account, and the cash is placed in a locked petty cash box. The asset account ***Petty Cash*** is debited when the fund is established:

Petty Cash	***X***	
Cash		***X***

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C. Internal control policies must be established for the petty cash fund. A petty cashier should be appointed, and this person should know the company's policies regarding which payments can be made from petty cash and which cannot. The petty cashier is given sole access to the money in the fund, and is made responsible for safeguarding the fund and ensuring that company cash payment policies are followed.

D. As payments are made out of petty cash, the petty cashier records the amount and purpose of the expenditure on a *petty cash voucher*. The petty cashier signs the voucher to verify that the payment was authorized. The person receiving the cash verifies the amount and purpose by also signing the form. An example of a petty cash voucher is shown below.

PETTY CASH VOUCHER	No. 565
Date:	11/23/20XX
Amount:	$ 1.20
Payee:	US Postal Service
Account:	Misc. Exp.
Purpose:	Postage due on mail delivery.
Fund Cashier: Meg Carr	Received by: John Forseith

E. When the petty cash fund is replenished (usually at the end of the month), the vouchers are sorted and classified by account, and an entry is made to record the payments that were made. The form of the entry is as follows:

? Expense	***X***	
? Asset	***X***	
Cash		***X***

Here's an Example! *Suppose $60 was paid from the petty cash fund during November. The vouchers from the petty cash fund are sorted on November 30. The total amount of payments that can be classified as supplies purchases are $25. Those that can be recorded as delivery expense expenditures are $20, and those that should be recorded as miscellaneous expense expenditures total $15. The entry to record the replenishment of the petty cash fund is the following:*

Miscellaneous Expense	***15***	
Delivery Expense	***20***	
Office Supplies	***25***	
Cash		***60***

To record payments from petty cash and to replenish the fund

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F. Note that ***Petty Cash*** was not debited or credited in the entry above. Students often think that two entries should be made, one to record the payment from *Petty Cash* and the other to record the payment of cash to replenish the fund:

(1) *Miscellaneous Expense* 15
Delivery Expense 20
Office Supplies 25
Petty Cash 60
To record payments from the petty cash fund

(2) *Petty Cash* 60
Cash 60
To record the payment of cash to replenish the fund

While this two-entry approach does "work" and is not really incorrect, it is not used in practice. Instead of crediting *Petty Cash* in one entry and then turning around and debiting it in another, the two entries are combined and the debit and credit to *Petty Cash* are eliminated:

Miscellaneous Expense 15
Delivery Expense 20
Office Supplies 25
~~*Petty Cash* 60~~
~~*Petty Cash* 60~~
Cash 60
To record payments from petty cash and to replenish the fund

The credit to Petty Cash and the debit to Petty Cash are eliminated when the two entries are combined.

The old bookkeeping rule is that *Petty Cash* is never debited unless the fund is being established for the first time or enlarged, and *Petty Cash* is never credited unless the fund is being closed or diminished in size.

G. **Cash Over and Short**. In the example above, we assumed that the amounts recorded on the petty cash vouchers equaled the amount of cash needed to replenish the fund. In other words, we assumed that all the petty cash expenditures were properly recorded, that no errors were made when the amounts were entered on the petty cash vouchers, and that no errors were made in counting out the cash from the petty cash fund.

1. In reality, these errors are made from time to time, and differences between the cash needed to replenish the fund and the amount recorded on the petty cash vouchers do occur. And they present a bit of an accounting problem.

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2. For example, suppose that $50 is needed in order to replenish the fund, but only $45 of expenditures ($20 for supplies and $25 for miscellaneous expenses) were recorded on the petty cash vouchers. We can credit Cash for the $50, and debit the appropriate asset and expense accounts for $45, but how should the missing $5 be recorded? Since we cannot determine how the $5 was spent, we record it as an expense, instead of an asset. This is in keeping with the accounting ***principle of conservatism*** (see below). And since we cannot identify the particular expense account that should be debited, we debit a catch-all expense account called account ***Cash Short and Over***.

Miscellaneous Expense	***25***	
Office Supplies	***20***	
Cash Short and Over	***5***	
Cash		***50***

3. The ***accounting principle of conservatism*** tells us that when we are faced with a choice regarding the way something is to be recorded, we should always make the more *conservative* choice. This means that when we have nothing else to base a decision upon, we should choose the alternative that gives us less net income instead of more income, or fewer net assets instead of more net assets. In this case, it is more conservative to record the missing $5 as an expense rather than an asset.

4. Of course, we don't always come up "cash short" at the end of the month. We might also come up "***cash over***."

   a. Suppose we only needed $40 in order to replenish the petty cash fund in the example above. The vouchers indicate that $45 of expenditures were made, though, so we are now $5 "over" instead of "short."

   b. We would make the entry as before, except that this time the *Cash Short and Over* account would be credited instead of debited:

Miscellaneous Expense	***25***	
Office Supplies	***20***	
Cash Short and Over		***5***
Cash		***40***

   c. When the *Cash Short and Over* account has a debit balance it is reported among the General and Administrative

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Expenses on the income statement. When it has a credit balance, it is reported among "Other Revenues." Over time, the balance should swing between debit and credit (expense and revenue) evenly. After all, errors tend to occur randomly and should result in credit differences about as often as they result in debit differences.

5. The illustration below summarizes the way that debit and credit differences are recorded.

If Cash is "Short"			If Cash is "Over"		
? Expense	***X***		***? Expense***	***X***	
? Asset	***X***		***? Asset***	***X***	
Cash Short and Over	***X***		***Cash Short and Over***		***X***
Cash		***X***	***Cash***		***X***

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VI. A voucher system may also be used to provide for an optimal degree of internal control over cash payments.

A. A voucher is a form that is completed before any expenditure can be made. It lists the purpose of the expenditure and provides a space for the written signature of the party who is authorized to approve the payment.

B. In a voucher system, every expenditure (except for those made from petty cash) is made to pay a properly completed and authorized voucher. Only certain individuals are authorized to approve various types of vouchers and only certain persons are authorized to write checks and pay them, so the system ensures that only authorized expenditures are made and that the correct amounts are paid to the appropriate parties.

C. Under a voucher system, responsibility must be assigned to specific individuals for the authorization of expenditures, the custody of assets, verification of liabilities, and the timely payment of various obligations.

D. The use of a voucher system requires many steps and leads to inefficiencies in the day to day operation of the business, but it does provide for extremely tight internal control over cash payments and generates a good ***audit trail*** (a record that ties an expenditure to the source document that underlies it) for the company's disbursements.

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VII. Using Accounting Information to Evaluate Liquidity

A. The current ratio and quick ratio were introduced in Module 4, and these analytical tools do measure a company's liquidity position. Another financial ratio, which is very similar, is also used to evaluate short-term solvency and liquidity. The ***doomsday ratio*** compares the amount of Cash and Cash Equivalents the company has on hand (that it can use immediately to pay its current liabilities) to the current liabilities.

B. The Doomsday Ratio is calculated by dividing Cash and Cash Equivalents by current liabilities:

$$\textit{Doomsday Ratio} = \frac{\textit{Cash and Cash Equivalents}}{\textit{Total Current Liabilities}}$$

C. The greater the ratio, the greater the company's very short-term, "crisis-level" liquidity. Since nearly all of the current assets that will later be collected in cash (accounts receivable, inventory, etc. have been omitted), the doomsday ratio will nearly always be a good deal below a value of one.

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Supplemental Exercises

You may use the following practice exercises to reinforce your understanding of material presented in this module. The answer key is provided, but try to work the exercise out first "without looking."

1. Prepare a bank reconciliation for Grayco Company at July 31, 20XX from the information presented below. After completing the bank reconciliation, make the journal entries required on Grayco's books.

    a. Cash according to the accounting records at July 31 amounted to $36,401. The bank statement showed a balance of $30,407.
    b. The cash receipts of $5,464 on July 31 were mailed to the bank but not received by the bank until August. Checks written in July but not listed on the bank statement totaled $500.
    c. The paid checks returned by the bank included a stolen check for $882 which had been paid in error by the bank after Grayco had issued a stop payment order to the bank. The bank was at fault, and the bank manager, Speed Spearman, agreed to correct Grayco's account balance.
    d. The following memoranda accompanied the bank statement:
        1. A debit memo of $13 for service charges.
        2. A debit memo attached to a $680 customer's check which was marked "NSF."
        3. A credit memo for $550, representing a $500 note collected by the bank for Grayco. Interest earned on the note was $60, and the bank had charged a $10 collection fee.
    e. A check was written by the company for the purchase of $5 of office supplies was returned with the canceled checks, but the transaction had erroneously not been recorded by Grayco.

2. On September 12, Repo Company decides to establish a petty cash fund and writes a check for $350, payable to Bertha Berbank, the person responsible for petty cash. Bertha cashed the check on the same day, and deposited the cash in the petty cash box kept at her desk. On September 30, the petty cash vouchers were sorted, and the cash in the box was counted. The following results were obtained:

Office Supplies	$ 100
Postage Expense	69
Delivery Expense	23
Miscellaneous Expense	66
Cash in Petty Cash Box	102

    a. Make the entries necessary to record the establishment of the petty cash fund on September 12, and those required to record the replenishment of the petty cash fund on September 30.

    b. Suppose the postage expense amounted to $65 instead of $69. What entry would be made to record the replenishment of the petty cash fund?

    c. Suppose the postage expense amounted to $73 instead of $69. What entry would be made to record the replenishment of the petty cash fund?

    d. Suppose, when recording the replenishment of the fund in (c.) above, management increases the size of the petty cash fund to $500. What entry would now be made?

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SOLUTIONS TO PRACTICE EXERCISES

1. Bank Reconciliation

Balance per Bank Statement	30,407
Add: Deposits in Transit	5,464
Bank Error	882
Subtract: Outstanding Checks	(500)
Adjusted Balance	36,253

Balance per Books	36,401
Add: Note Collection (500 + 60 -10)	550
Subtract: Bookkeeping error	(5)
Service Charge	(13)
NSF Check	(680)
Adjusted Balance	36,253

Entries:

Date	Account	Debit	Credit
July 31	Cash	550	
	Miscellaneous Expense	10	
	Notes Receivable		500
	Interest Revenue		60
July 31	Office Supplies	5	
	Miscellaneous Expense	13	
	Accounts Receivable	680	
	Cash		698

	Date	Account	Debit	Credit
2. a.	Sept 12	Petty Cash	360	
		Cash		360
	Sept 30	Office Supplies	100	
		Postage Expense	69	
		Freight-In	23	
		Miscellaneous Expense	66	
		Cash (360-102)		258
b.	Sept 30	Office Supplies	100	
		Postage Expense	65	
		Freight-In	23	
		Miscellaneous Expense	66	
		Cash Short or Over	4	
		Cash (360-102)		258
c.	Sept 30	Office Supplies	100	
		Postage Expense	73	
		Freight-In	23	
		Miscellaneous Expense	66	
		Cash Short or Over		4
		Cash (360-102)	262	258
d.	Sept 30	Office Supplies	100	
		Postage Expense	73	
		Freight-In	23	
		Miscellaneous Expense	66	
		Petty Cash	140	
		Cash Short or Over		4
		Cash (500-102)		398

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