Controlling and Reporting Cash

Essential Principles for Safeguarding Cash and Reporting It On Financial Statements

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Table of Contents

Reporting Cash

Cash Defined

Overview

The following discussion identifies items that are included in the definition of "Cash" and explains how and where cash appears on the financial statements.

Currency and Coin

Most of us are familiar with the money we carry in our wallets and the coins in our pockets. We refer to this paper and metal money as ***currency and coin***. Usually, most businesses keep a relatively small amount of this on hand—only as much as is needed to make change or pay for small expenditures.

Dollar-Labeled Items

Checks, money orders, stamps, and travelers' checks are examples of items labeled in dollar amounts. Are they cash?

Rule: Include as cash any dollar-labeled item that a bank will accept as a deposit.

Examples of Cash: Checks, money orders, travelers checks
Not Cash: Stamps (a prepaid expense) and coupons.

Bank Account Balances

Checking and savings account balances are also included in the definition of cash because these accounts must be paid to the depositor in the form of currency, on demand.

continued ►

Cash Defined, *continued*

Cash Equivalents

A few limited types of very short-term and very safe ("liquid") investments are considered to be the equivalent of cash. The most common examples are money market funds and short-term bank certificates of deposit and U.S. treasury securities with original maturities of not more than three months.

Not Cash Equivalents:

- Corporate stocks and bonds
- Any government securities with an original maturity longer than 3 months

How Cash Is Reported on the Balance Sheet

Typical Reporting

Normally cash is a current asset. Because assets on a balance sheet are usually presented in order of liquidity, cash should be the first asset shown—the most liquid of the current assets.

The total cash shown on a balance sheet includes all the items included in our definition of cash. This is often reported as "Cash and Cash Equivalents."

Restricted Cash

A cash balance is ***restricted*** when the cash can only be used for a specific purpose. For example, some cash may be designated exclusively for an asset purchase or for a loan repayment. Restricted cash is reported as a separate cash balance.

A restricted cash balance should be classified as either a short-term or long-term investment asset depending on when the cash is likely to be used.

Compensating Balances

A ***compensating balance*** is a minimum cash balance that a business is required to maintain in an account. Such a requirement usually occurs as part of a bank loan agreement. The part of the total cash that is a compensating balance must be disclosed in the notes to the financial statements.

Cash Reported on the Statement of Cash Flows

Same Definition

The statement of cash flows explains the change in the cash account balance between two balance sheet dates. Therefore, the definition of cash (including cash equivalents) is exactly the same on the statement of cash flows as it is on the balance sheet.

The format of the statement of cash flows classifies the causes of change in the cash balance into three activities: operating, investing, and financing. The net result of these three activities during the latest period, combined with the cash balance at the beginning of the period, equals the ending cash balance that is shown on the current balance sheet at the end of the period.

Controlling Cash

Internal Control

Definition

Internal control means the policies, procedures, and organizational design that a company uses for the purpose of:

- safeguarding assets,
- recording accurate and reliable accounting information, and
- encouraging operating efficiency.

Internal Control for Cash

Internal control is a big topic with many applications. In this material, however, we are primarily concerned with using internal control to safeguard cash. Cash is the easiest asset to steal and the most desirable asset. Cash thefts are often the most difficult to identify, and loss of cash can be extremely damaging to a business. For these reasons, it is essential to establish adequate internal control for cash. In the following sections, we will discuss the following widely used and important cash controls:

- Use of a checking or savings account
- The bank reconciliation
- The imprest petty cash system
- Use of credit cards
- The voucher system
- Cash receipts procedures
- Basic internal control principles that apply to all assets
- Internet and e-commerce requirements

continued ►

Internal Control, *continued*

Limitations

Internal control is not a guarantee against theft; it is intended to be a barrier to theft and to reduce the probability of asset loss. Human error and fraud are potentially serious weaknesses of internal control.

For example, several employees acting together to steal cash, called ***collusion***, can defeat an internal control system. Also, simple carelessness, neglect, or fatigue can weaken internal control. Finally, good internal control costs money. The cost required to maintain an internal control system should not exceed the losses that it prevents.

Using a Checking Account

Overview

A checking account is an important internal control device. It allows a business to minimize the use of currency and keep funds safe and helps control payments and receipts. A bank checking account also serves as an independent detailed record of cash received and paid. To properly use a checking account, you should understand the use of the following five items:

- Signature card
- Check
- Deposit form
- Bank statement
- Bank reconciliation

The Signature Card

A signature card is a bank document that is required to open a checking account. The card contains the signatures of people who are authorized to sign checks. A check is not valid without an authorized signature, and a bank will not process a check unless it has a signature that corresponds to a signature on the card.

The Check

A ***check*** is a document given by a maker to a payee that directs the maker's bank to pay a specified amount to the payee, on demand. The check is a "three-party document": the maker, the payee, and the bank.

Using a Checking Account, *continued*

Check Features

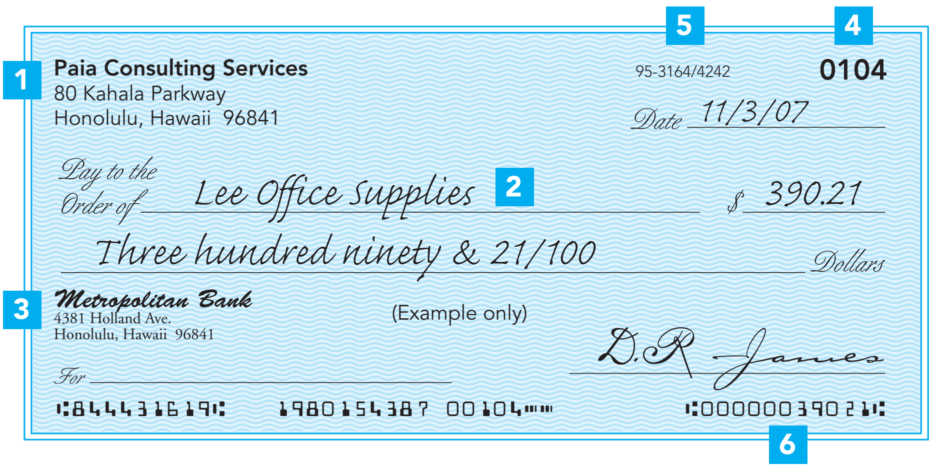
The example of a check below identifies the following features.

A check involves these three parties:

1. The ***maker*** (also called ***drawer*** or ***payor***) is the party who is making the payment and whose account is being reduced—here, the Paia company.
2. The ***payee*** is the party named on the check to receive the cash payment. Here, the payee is Lee Office Supplies.
3. The bank—here, Metropolitan—makes payment and reduces the maker's account.

Other features of the check are:

4. Check number: As an internal control device, checks are sequentially numbered so all checks are accounted for.
5. ABA (American Bankers' Association) number. This is a unique number that identifies a bank for check routing and processing in the banking system. This number is also used to identify each check listed on a deposit slip.
6. Cleared check amount. When a bank pays a check, the verified amount of actual payment is recorded in special magnetic ink characters on the lower right part of the check.



continued ▶

Using a Checking Account, *continued*

How Does a Check Get Paid?

When you write a check, the payee deposits the check in a bank account. If, by chance, the payee's bank happens to be the same as your bank, the bank simply transfers funds out of your account into the payee's account.

If the payee's account is in a different bank, that bank sends the check to another bank, called an intermediary bank. An intermediary bank sorts millions of checks from many banks and identifies each bank by its routing number—the first nine digits printed on the lower left corner of the check in the example above. The intermediary returns the check to your bank with a request for payment, and your bank verifies that there are sufficient funds in your account. If there are sufficient funds, your bank pays the intermediary and reduces your account. The intermediary bank then transfers payment to the payee's bank, and the amount becomes a deposit in the payee's account.

The back of a check is stamped to indicate payment; this is called a ***cleared check*** or a ***canceled check***. In some cases a check may clear in only a few days. In other cases, when the payee is slow to deposit, there may be a delay of more days or even weeks before the check is cleared.

In 2004, a federal law called the "Check Clearing for the 21st Century Act," also known as "Check 21" became effective. This law permits the processing of digital images of checks instead the actual physical checks. One result is that checks will be processed much faster and will be subtracted ("cleared") from a maker's account more quickly. Another result is that paper copies of checks are returned to the maker instead of the original checks. A copy may be used for proof of payment in the same manner as an original check.

The Deposit Form

A deposit form is used to identify the amount of the total deposit and the amount of cash and checks that are in a deposit. Deposit forms, like checks, are standard printed forms that show account number and customer and bank information.

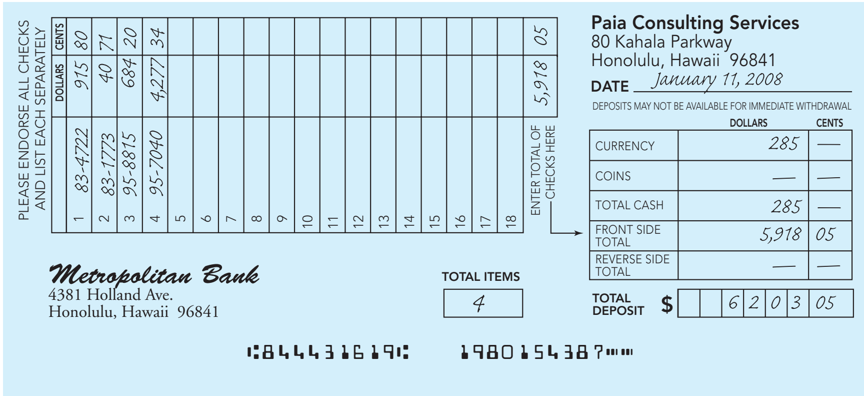
A completed deposit form should show:

1. The total amount of currency
2. The total amount of coins
3. The total amount of checks. List each check individually and show:
   - The part of the ABA number of each check deposited (item 5 in check example above) before the diagonal line (95-3164 in the example) followed by
   - The amount of the check

Using a Checking Account, *continued*

Example

The example below shows a typical deposit form.


PLEASE ENDORSE ALL CHECKS AND LIST EACH SEPARATELY

		DOLLARS	CENTS
1	83-4722	915	80
2	83-1773	40	71
3	95-8815	684	20
4	95-7040	4,277	34
5			
6			
7			
8			
9			
10			
11			
12			
13			
14			
15			
16			
17			
18			
ENTER TOTAL OF CHECKS HERE		5,918	05

Paia Consulting Services
80 Kahala Parkway
Honolulu, Hawaii 96841
DATE January 11, 2008
DEPOSITS MAY NOT BE AVAILABLE FOR IMMEDIATE WITHDRAWAL

	DOLLARS	CENTS
CURRENCY	285	—
COINS	—	—
TOTAL CASH	285	—
FRONT SIDE TOTAL	5,918	05
REVERSE SIDE TOTAL	—	—
TOTAL DEPOSIT	$ 6 2 0 3	05

Metropolitan Bank
4381 Holland Ave.
Honolulu, Hawaii 96841

TOTAL ITEMS 4

⑆844431619⑆ 1980154387⑈

Endorsed Checks

A check must be endorsed before it can be deposited. A ***check endorsement*** is a legal transfer by the payee to another party (in this case, a bank) of ownership of a check, and therefore the right to receive payment from the maker. There are two types of endorsements:

- ***Blank endorsement:*** The payee simply signs the back of the check. This makes the check payable to anyone who physically possesses it.
- ***Restrictive endorsement:*** The payee signs the back of the check but adds a restriction, such as "for deposit only" (or "pay Jane Doe only" if transferred to another individual). It is safer to use restrictive endorsements.

The Bank Statement

The ***bank statement*** is a report from a bank to the customer that shows in detail the bank's record of the account activity and balances for a specified period of time, generally monthly. An example of a bank statement is presented in the next section.

Coming Up . . .

The overview to this section indicated that an essential procedure used with a checking account is the bank reconciliation. The next section explains what a bank reconciliation is and the procedure for preparing one.

Check Your Understanding

Write the completed sentences on a separate sheet of paper.

Any item that a bank accepts as a · · · · · · · · can be considered to be cash. A few limited types of very short-term items that are very safe and are very liquid investments such as short-term bank certificate of deposits and money market funds are called · · · · · · · · · · · · · · · · and are treated as cash. Cash that can only be used for a specific purpose is called · · · · · · · · cash, and if not available to pay current liabilities is shown on the balance sheet as either a short- or long-term · · · · · · · ·, depending on the type of · · · · · · · ·. A minimum balance of cash that is required to maintained at all times is called a · · · · · · · · · · · · · · · ·, and this part of the cash balance must be disclosed in the · · · · · · · ·.

The essential means of protecting cash and other assets is called · · · · · · · · · · · · · · · ·, and a checking account is an important way of applying this protection to cash. The party who writes a check is called the · · · · · · · · and the party who will receive payment is called the · · · · · · · ·.

A check · · · · · · · · is a legal transfer of funds by the payee to another party of the right to receive payment from the maker. A · · · · · · · · · · · · · · · · transfers the right to receive payment to any party who physically holds a check. A · · · · · · · · · · · · · · · · transfers the right to receive payment to a specific party.

Answers

Any item that a bank accepts as a deposit can be considered to be cash. A few limited types of very short-term items that are very safe and are very liquid investments such as short-term bank certificate of deposits and money market funds are called cash equivalents and are treated as cash. Cash that can only be used for a specific purpose is called restricted cash, and if not available to pay current liabilities is shown on the balance sheet as either a short- or long-term investment, depending on the type of restriction. A minimum balance of cash that is required to maintained at all times is called a compensating balance, and this part of the cash balance must be disclosed in the footnotes.

The essential means of protecting cash and other assets is called internal control, and a checking account is an important way of applying this protection to cash. The party who writes a check is called the maker and the party who will receive payment is called the payee.

A check endorsement is a legal transfer of funds by the payee to another party of the right to receive payment from the maker. A blank endorsement transfers the right to receive payment to any party who physically holds a check. A restrictive endorsement transfers the right to receive payment to a specific party.

The Bank Reconciliation

Overview

What Is It?

A ***bank reconciliation*** is an analysis prepared by a depositor (a bank customer) that compares the cash balance in the depositor's books to the cash balance that shows on the bank statement.

There are really two records of cash. First, the depositor maintains accounting records that show receipts, payments, and cash balance. Second, the bank keeps its own record of receipts, payments, and cash balance, which it presents to the customer in the form of a bank statement. These two records seldom show the same cash balance.

What Does It Do?

The reconciliation: (1) corrects the bank statement balance for missing items located in the depositor's records and (2) corrects the depositor's book balance for missing items that are shown on the bank statement. The result is the same number for both records called the ***adjusted cash balance***, or the ***true cash balance*** or the ***reconciled cash balance***.

What Does It Look Like?

A bank reconciliation is divided into two sections: one section shows adjustments to the bank balance and the other section shows adjustments to the book balance. When the reconciliation is complete, the totals of both sections must agree. This is the reconciled cash balance. An example is shown on the next page.

Frequency

Bank reconciliations are prepared at regular intervals, such as monthly for smaller businesses and weekly for larger businesses (which require weekly bank statements).

Internal Control Rule

You may recall from our discussion on page 3 that internal control refers to the methods used to safeguard assets. The bank reconciliation is a very important internal control device for safeguarding cash.

Rule: For a bank reconciliation to function properly, *when an employee prepares a bank reconciliation, that employee must never be involved in receiving cash, paying cash, or have any other access to cash*.

If this rule is violated, the employee will be able to steal cash in various ways and hide the theft by falsifying the bank reconciliation.

continued ►

Overview, *continued*

Example

The example below shows the format of a completed bank reconciliation.

Montague Company
Bank Reconciliation
June 30, 2008

Balance Per Bank, June 30		$11,201.15
Add: deposit in transit		425.00
Less: outstanding checks		
#285	$128.73	
#287	205.00	
#290	300.75	634.48
Adjusted cash balance per bank, June 30		$10,991.67
Balance Per Books, June 30		$11,706.04
Less:		
Service charges	10.00	
NSF check	704.37	714.37
Adjusted cash balance per books, June 30		$10,991.67

Reconciled Balances

Adjustments to the bank balance

Adjustments to the book balance.

Reconciling Items

Overview

The reason that the cash balance on the depositor's (bank customer's) books and the cash balance on the bank statement seldom agree is that some items are included on one set of records but not on the other. These items are called *reconciling items*. They have three causes: Timing differences between books and bank, unrecorded bank charges and credits, and errors (books or bank.)