Chapter 7 Accounting Study Guide

Mastering Your Chapter 7 Accounting Study Guide: Internal Controls, Cash, and Receivables

For many students, accounting principles represent a significant leap in both complexity and practical importance. By the time you arrive at Chapter 7, you have already built a foundation in the accounting cycle, journal entries, and financial statement preparation. Now, the focus shifts to safeguarding assets and ensuring the accuracy of financial information. This is where your **Chapter 7 Accounting Study Guide** becomes an indispensable tool. This chapter typically covers internal controls, cash management, and the handling of receivables—three pillars that support the integrity of any business. Whether you are preparing for a midterm or trying to understand how companies protect their resources, this detailed exploration will help you internalize the key concepts. Let us break down the essential components of this chapter so that you can study smarter, not harder.

Why Chapter 7 Matters in the Bigger Picture of Accounting

Before diving into the technical details, it is helpful to understand why this chapter holds such weight. In earlier chapters, you learned how to record transactions and prepare statements. Chapter 7 asks a different question: how do you ensure that those records are correct and that the assets behind them are safe? This is the heart of internal control. Without strong internal controls, even the most beautifully prepared financial statements are meaningless. Your **Chapter 7 Accounting Study Guide** is therefore not just about memorizing definitions; it is about learning a mindset of accountability and verification that will serve you throughout your entire accounting career.

The Foundation: Understanding Internal Control Systems

Internal control is the backbone of Chapter 7. It refers to the processes and procedures that a company uses to protect its assets, promote operational efficiency, ensure accurate accounting records, and encourage adherence to company policies. A strong internal control system is built on several core principles.

The Five Components of Internal Control

According to the Committee of Sponsoring Organizations of the Treadway Commission, known as COSO, there are five interrelated components of internal control. Your **Chapter 7 Accounting Study Guide** will almost certainly ask you to identify and explain these:

- **Control Environment**: This is the tone at the top. It includes the overall attitude, awareness, and actions of management and the board of directors regarding the importance of internal controls. An ethical culture is the foundation.
- **Risk Assessment**: Companies must identify and analyze the risks they face in achieving their objectives. For example, a retail store faces a high risk of cash theft, while a software company faces risks related to data security.
- **Control Activities**: These are the specific policies and procedures that help ensure management directives are carried out. They include approvals, authorizations, verifications, reconciliations, and segregation of duties.
- **Information and Communication**: Relevant financial and operational information must be identified, captured, and communicated in a timely manner. Employees must understand their roles and responsibilities within the control system.
- **Monitoring Activities**: Internal controls must be monitored over time. This can involve ongoing supervision, periodic audits, or a combination of both.

Understanding these five components is critical. When you review your **Chapter 7 Accounting Study Guide**, pay close attention to how each component applies to real-world scenarios. This is the kind of conceptual knowledge that examiners love to test.

The Principle of Segregation of Duties

Perhaps the single most important control activity is segregation of duties. The idea is simple: no single employee should be responsible for all phases of a transaction. Specifically, the following duties should be separated:

1. **Authorization**: Approving a transaction or activity.
2. **Custody**: Handling the asset involved in the transaction.
3. **Recording**: Making the accounting entries for the transaction.

For instance, the person who approves a purchase order should not be the same person who receives the inventory, and neither should be the person who records the journal entry. When you are studying, try to create your own examples of what could go wrong if duties are not segregated. This will make the concept stick far better than simple memorization.

Cash: The Most Vulnerable Asset

Cash is the lifeblood of any business, and it is also the asset most susceptible to theft and misappropriation. A significant portion of your **Chapter 7 Accounting Study Guide** will be dedicated to cash controls and accounting.

Bank Reconciliation: A Critical Control Activity

Cash comes into a business through various channels: over the counter at a retail store, through the mail from customers paying invoices, and via electronic transfers. Each channel requires specific controls.

For cash received over the counter, a point-of-sale system is essential. The system records the sale and provides a receipt to the customer. At the end of the day, the cash in the register should equal the total recorded sales. Any discrepancy should be investigated immediately.

For cash received through the mail, a common control is to have two employees open the mail together. One employee lists the checks received, and the other employee creates a duplicate list. The checks are then endorsed with a restrictive endorsement and deposited intact. The listing is sent to the accounting department for recording. This dual-custody approach drastically reduces the risk of theft.

Internal Controls Over Cash Disbursements

Just as important as controlling cash coming in is controlling cash going out. The primary tool here is the use of a voucher system. A voucher is an authorization form that must be approved before a payment is made. For every disbursement, there should be supporting documentation: a purchase order showing authorization, a receiving report showing the goods were received, and an invoice from the supplier. Only when all three documents match should a check be issued.

A key point in your **Chapter 7 Accounting Study Guide** is that all disbursements, except for very small amounts paid from a petty cash fund, should be made by check or electronic transfer. This creates a clear paper trail and ensures that every payment is authorized and recorded.

The Petty Cash Fund

Of course, it is impractical to write a check for every small expense, such as postage or office supplies. This is where the petty cash fund comes in. The operation of a petty cash fund follows a specific process:

- **Establishing the fund**: A check is written for a fixed amount, say $200, and cashed. The cash is placed in a lockbox under the control of a single custodian.
- **Making payments**: As small expenses are incurred, the custodian pays from the fund and obtains a receipt. A petty cash voucher is filled out for each payment.
- **Replenishing the fund**: When the fund runs low, the custodian totals the receipts and presents them to the accounting department. A check is issued for the exact amount of the receipts, restoring the fund to its original balance.

It is important to note that the journal entry to replenish the fund debits the various expense accounts and credits cash. The only time the Petty Cash account itself is debited or credited is when the fund is established or when the balance is changed.

No **Chapter 7 Accounting Study Guide** would be complete without a thorough discussion of bank reconciliations. A bank reconciliation is a process that explains the difference between the cash balance reported on the company's books and the cash balance reported on the bank statement. These differences arise because of timing differences and errors.

Steps in Preparing a Bank Reconciliation

The goal is to adjust both the book balance and the bank balance to arrive at the true cash balance. Here is the typical structure:

Starting with the bank statement balance:

- **Add**: Deposits in transit (deposits made by the company but not yet recorded by the bank).
- **Subtract**: Outstanding checks (checks written by the company but not yet presented to the bank for payment).
- **Add or Subtract**: Bank errors.

Starting with the book balance:

- **Add**: Collections made by the bank on behalf of the company (such as notes receivable collected), interest earned, and electronic funds transfers received.
- **Subtract**: Bank service charges, NSF checks (non-sufficient funds checks from customers), and electronic funds transfers paid.
- **Add or Subtract**: Company errors.

After these adjustments, both sides should equal the same adjusted cash balance. This is the amount that should appear on the company's balance sheet. Journal entries must then be made to update the company's books for any items that appeared on the bank statement but were not yet recorded in the company's ledger.

Practice preparing a bank reconciliation from scratch. This is one of the most common problems on accounting exams, and mastering it will give you confidence.

Accounts Receivable and Bad Debts

The third major topic in your **Chapter 7 Accounting Study Guide** is accounts receivable. Most businesses sell goods or services on credit, which creates an account receivable. However, not all customers pay their balances. The challenge for accountants is to report accounts receivable at the amount that is expected to be collected, not the total amount owed.

The Allowance Method for Uncollectible Accounts

The generally accepted accounting principle requires the use of the allowance method. Under this method, an estimate of uncollectible accounts is recorded as an adjusting entry at the end of each accounting period. This matches the bad debt expense against the revenues of the same period, following the matching principle.

The adjusting entry is:

- Debit: Bad Debt Expense
- Credit: Allowance for Doubtful Accounts (a contra asset account)

When a specific account is later determined to be uncollectible, it is written off with this entry:

- Debit: Allowance for Doubtful Accounts
- Credit: Accounts Receivable

Note that the write-off does not affect the income statement. It simply removes the receivable and the allowance. This is a critical point that often confuses students. The expense was already recorded in the period of the estimate, not in the period of the write-off.

Estimating Bad Debts

There are two primary methods for estimating bad debts, and your **Chapter 7 Accounting Study Guide** will require you to understand both.

The Percentage of Sales Method: This method focuses on the income statement. The company takes a percentage of its total credit sales for the period and records that amount as bad debt expense. The percentage is based on historical experience. This method is simple but does not consider the existing balance in the Allowance for Doubtful Accounts.

The Aging of Accounts Receivable Method: This method focuses on the balance sheet. The company analyzes its accounts receivable by how long they have been outstanding. Older receivables are much less likely to be collected. A different percentage is applied to each age category, and the total is the required ending balance in the Allowance for Doubtful Accounts. The adjusting entry for bad debt expense is then calculated to bring the allowance up to that required balance.

The aging method is generally considered more accurate and is widely used in practice. When you study, work through an example of an aging schedule and calculate the necessary adjusting entry.

Promissory Notes and Interest Calculation

Chapter 7 often introduces notes receivable. A note receivable is a written promise to pay a specific amount of money on a specified future date. Notes typically arise from lending money or from converting an overdue account receivable into a more formal arrangement.

Key terms to know include the **principal** (the amount borrowed), the **interest rate**, and the **maturity date**. Interest is calculated using a simple formula:

Interest = Principal × Annual Interest Rate × Time

Time is usually expressed as a fraction of a year. For example, if a 90-day note has a principal of $10,000 and an annual interest rate of 6%, the interest is calculated as:

$10,000 × 0.06 × (90/360)

