Chapter 7 - FRAUD, INTERNAL CONTROL, AND CASH

LO 1: Define fraud and the principles of internal control.

- **Fraud:** Dishonest act by an employee that results in personal benefit to the employee at a cost to the employer.
- The three main factors that contribute to fraudulent activity are known as the **fraud triangle.**
    - **Opportunity**
    - **Financial Pressure**
    - **Rationalization** (Justify committing the fraud)
        - Employees may feel underpaid while their bosses are making a lot of money and use that as a reason to steal money from their employer.

- **Sarbanes-Oxley Act (SOX):** Purpose is to maintain public confidence and trust in the financial statements of reporting companies after numerous corporate scandals were uncovered during the early 2000s.
- The Sarbanes-Oxley:
    - Applies to **publicly traded** U.S. corporations.
    - Requires
        - Companies maintain a **system of internal control**.
        - **Corporate executives and boards of directors** to ensure that the controls in place are reliable and effective.
        - **Independent outside auditors** to attest to the adequacy of the internal control system.
    - Created the **Public Company Accounting Oversight Board (PCAOB)**.

INTERNAL CONTROL

- "A process designed to provide reasonable assurance regarding the achievement of company objectives related to operations, reporting, and compliance."
- The **PURPOSE of internal control** is to
    1. Safeguard assets.
    2. Enhance accuracy and reliability of accounting records.
    3. Increase efficiency of operations.
    4. Ensure compliance with laws and regulations.

- Internal control systems have 5 primary components.
    1. Control environment.
    2. Risk assessment.
    3. Control activities.
    4. Information and communication.
    5. Monitoring.

INTERNAL CONTROL ACTIVITIES

- These activities are the backbone of the company's efforts to address the risks it faces, such as fraud.
- The 6 principles of control activities are as follows:
  1. **Establishment of responsibility:** Control is most effective when only one person is responsible for a given task.
     - Requires limiting access only to authorized personnel, and then identifying those personnel.
  2. **Segregation of Duties:**
     - Different individuals should be responsible for related activities.
     - The responsibility for record-keeping for an asset should be separate from the physical custody of that asset.

  3. **Documentation Procedures:**
     - Signatures should be required on documents so that the company can identify the individual(s) responsible for the transaction or event.
     - Companies should use prenumbered documents, and all documents should be accounted for.
     - Employees should promptly forward source documents for accounting entries to the accounting department.
  4. **Physical Controls:** relate to safeguarding the assets and enhance the accuracy and reliability of the accounting records.

  5. **Independent Internal Verification:** Records periodically verified by an employee who is independent. Any discrepancy should be reported to management.

6. **Human Resource Controls:**
    - **Bond** employees who handle cash. **Bonding** involves obtaining insurance protection against theft by employees.
    - Rotate employees' duties and require employees to take vacations.
    - Conduct thorough background checks.

LIMITATIONS OF INTERNAL CONTROL

- Costs should **NOT** exceed benefits.
- Human element. This includes employee fatigue, carelessness, or indifference.
- Size of the business.

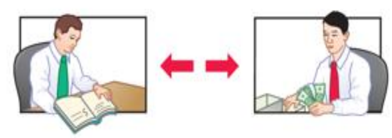
LO 2: Apply internal control principles to cash.

- Cash is the asset most susceptible to fraudulent activities.

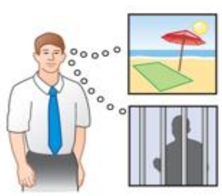
CASH RECEIPT CONTROLS

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

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

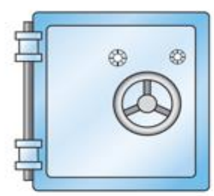


Segregation of Duties
Different individuals receive cash, record cash receipts, and hold the cash



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

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



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

Cash Over and Short: difference between the actual cash is the cash register and the record of the amount of cash receipts on the cash register tape.

Ex 1) Cash register's record shows $400 but count of cash in cash register is $425.

Cash	425	
Cash Over and Short		25
Sales Revenue		400

*** If Cash in Register > Record of Cash, then <u>CREDIT</u> Cash Over and Short for difference. (CASH OVERAGE)**

Ex 2) Cash register's record shows $300 but count of cash in cash register is $290.

Cash	290	
Cash Over and Short	10	
Sales Revenue		300

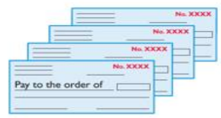
*** If Cash in Register< Record of Cash, then <u>DEBIT</u> Cash Over and Short for difference. (CASH SHORTAGE).**

- **Mail receipts:**
  - Mail receipts should be opened by two people, a list prepared, and each check endorsed **"For Deposit Only."**
  - Each mail clerk signs the list to establish responsibility for the data.
  - Original copy of the list, along with the checks, is sent to the cashier's department.
  - Copy of the list is sent to the accounting department for recording. Clerks also keep a copy.

CASH DISBURSEMENT CONTROLS

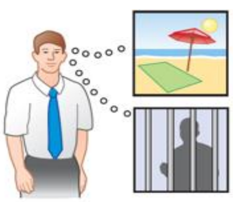
- Generally, internal control over cash disbursements is more effective when companies pay by check or electronic funds transfer (EFT) rather than by cash.

Establishment of Responsibility
Only designated personnel are authorized to sign checks (treasurer) and approve vendors



Documentation Procedures
Use prenumbered checks and account for them in sequence; each check must have an approved invoice; require employees to use corporate credit cards for reimbursable expenses; stamp invoices "paid"

Segregation of Duties
Different individuals approve and make payments; check-signers do not record disbursements



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

Independent Internal Verification
Compare checks to invoices; reconcile bank statement monthly

Physical Controls
Store blank checks in safes, with limited access; print check amounts by machine in indelible ink

- **Voucher System Controls:** "A network of approvals by authorized individuals, acting independently, to ensure that all disbursements by check are proper."
  - A **voucher** is "an authorization form prepared for each expenditure in a voucher system."
  - A voucher system includes 2 journal entries…
    1. Records the liability when the voucher is issued.
    2. Records the payment of the liability that relates to the voucher.
  - For the purchase of goods, a voucher is supported by the supplier's invoice, a purchase order, and a receiving report.
    - To make sure that **what was ordered** was **what was actually received** and that the **company was billed the correct amount** before paying the bill.

LO 3: Identify the control features of a bank account.

- The use of a bank contributes significantly to good internal control over cash because it…
  1. Minimizes the amount of currency on hand.
  2. Creates a double record of bank transactions.
  3. Provides a **bank reconciliation:** "the process of comparing the bank's balance with the company's balance, and explaining the differences to make them agree."

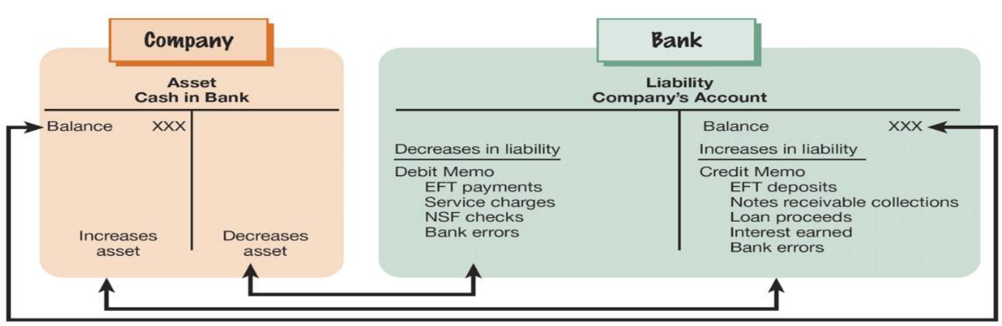
ELECTRONIC FUNDS TRANSFERS (EFTS)

- Are "disbursement systems that use wire, telephone, or computers to transfer cash from one location to another."
- Use is quite common. **(Many employers offer their employees direct deposit for their pay.)**
- Normally result in better internal control since no cash or checks are handled by company employees.

BANK STATEMENT

- "A summary of transactions which is mailed each month or available online."
- Prepared from **THE BANK'S PERSEPECTIVE.**
  - **<u>CREDIT Memorandum</u>**: This means an **INCREASE** in the company's account at the bank. (Example: Deposit). It is a credit memo for the bank because every deposit the bank receives is an increase in the bank's liabilities (accounts payable to the depositor.)
    - Are made for the following:
      1. Deposits made by electronic funds transfer (EFT)
      2. Collections of notes receivable for the company
      3. Proceeds for a loan made to the company by the bank
      4. Interest earned on the company's account
      5. Correction (if any) of bank errors

  - **<u>DEBIT Memorandum</u>**: This means a **DECREASE** in the company's account at the bank. (Example: Payment). Payments by the depositor reduces the amount of money in their bank account which reduces the bank's liabilities (accounts payable to the depositor.)
    - Are made for the following:
      1. Payments made by electronic funds transfer (EFT)
      2. Service charges
      3. Customer checks returned for not sufficient funds (NSF checks)
      4. Correction (if any) of bank errors



BANK RECONCILIATION

- The bank and the company maintain independent records of the company's checking account. Therefore, the two balances are seldom the same at any given time.
- Purpose is to reconcile the difference between the **depositor's records** and those of the **bank** to prove the accuracy of the records.
- After adjustments are made the **ADJUSTED BANK BALANCE = ADJUSTED BOOK BALANCE**.
- The **ADJUSTED BOOK CASH BALANCE** is what is reported on the company's balance sheet.

- **Key Terms/ Differences**

  1. Deposits in Transit: *deposits recorded by the depositor but NOT BY BANK.*
  (Ex: Nick deposits $200 in the bank on October 31. He records the deposit as an increase in cash in his books, but the bank does not increase Nick's bank account balance because the bank didn't fully process the transaction by the end of October.)

  2. Outstanding Checks: *written by the depositor, deducted on the depositor's records, sent to people who are owed money, but NOT RECORDED BY THE BANK.*
  (Ex: Sara wrote a $175 check to her village to pay her water bill on December 30. As soon as she writes the check and mails the check, she deducts $175 from her cash account balance. Her bank does not deduct the $175 from her account until the village cashes Sara's check or deposits it in their account. If the village deposits Sara's check in their bank on January 6, the deduction of cash from Sara's account would be on the January bank statement, not December.)

  3. NSF (Nonsufficient Funds Check): *A check a depositor deposits in their account from another party that is NOT COLLECTIBLE because the other party does not have funds in their account.*
  (Ex: Tom receives a check for rent for $400 for the month of January from Sam. As soon as he receives the check he increases his cash account in his records by $400. When he gives it to the bank, the bank can't fully process the transaction because Sam doesn't have $400 in her account to pay Tom. The bank doesn't increase Tom's account by $400, even though Tom increased the cash account in his books.)

- **ADJUSTING ENTRIES ARE ONLY DONE FOR <u>BOOK SIDE OF BANK RECONCILIATION</u>. <u>*DON'T WRITE*</u> ADJUSTING ENTRIES FOR ADJUSTMENTS TO THE BANK SIDE.**

RECONCILIATION PROCEDURE

Steps 1-6: Adjusting the cash balance according to the bank.

1. Enter the **cash balance according to bank** from ending cash balance according to the bank statement.
2. Add (+) deposits not recorded by bank. (**Deposits in Transit)**
3. Add (+) any **BANK ERRORS** that **understate cash**. For example, the bank erroneously took $500 out of Company A's account, even though the check for payment was written by company B. $500 would have to be added back to Company A's bank account balance.
4. Deduct (-) **outstanding checks** that have not been paid by the bank.
5. Deduct (-) any **BANK ERRORS** that **overstate cash**. For example, the bank erroneously issued a credit memo to Company A for collecting $1,000 from a note that was meant for Company B. The $1,000 would have to be subtracted from Company A's bank account balance.
6. Determine the **adjusted cash balance per bank** by totaling the adjustments and adding or (subtracting) from the cash balance according to the bank.

Steps 7-12: Adjusting the cash balance according to the company's books.

7. Enter the **cash balance per books** from the ending cash balance in the ledger.
8. Add (+) credit memos (other deposits) that were on the bank statement, but not recorded by the company. (Examples: interest earned, banks collections of notes receivable, electronic funds transfers from customers paying their accounts online, etc.)
9. Add (+) any **BOOK (COMPANY) ERRORS** that **understate cash**. For example, Company A wrote out a check to a supplier for $500, but the accounting clerk recorded the check as $5,000. The difference of $4,500 ($5,000-$500) needs to be added back to the company's cash balance because it was $4,500 too low.
10. Deduct (-) debit memos (other payments) that were on the bank statement, but not recorded by the company. (Examples: Bank service charge, NSF check, etc.)
11. Deduct (-) any **BOOK (COMPANY)** that **overstate cash**. For example, Company A wrote out a check to a supplier for $700, but the accounting clerk recorded the check as $70. The difference of $630 ($700-$70) needs to be subtracted from the company's cash balance because it was $630 too high.
12. Determine the **adjusted cash balance per books** by totaling the adjustments and adding or (subtracting) from the cash balance per books.

13. Final Step: Verify the Adjusted Balance Per Bank = Adjusted Balance Per Books

Bank Reconciliation

BANK BALANCE	BOOK BALANCE
Bank Statement Balance	Book Balance
ADD:	ADD:
1. Deposits in transit	1. Any bank collections on behalf of the depositor minus any service fee
2. Bank errors that understate cash	2. Interest Earned
	3. Book errors that understate cash
SUBTRACT:	SUBTRACT:
1. Outstanding Checks	1. Bank Service Charge
2. Bank errors that overstate cash	2. NSF (Nonsufficient Funds Check)
	3. Book errors that overstate cash
ADJUSTED BANK BALANCE =	ADJUSTED BOOK BALANCE

SIMPLE BANK RECONCILIATION EXAMPLE

The following data were gathered to use in reconciling the bank statement of Photo Op:

Balance per bank	$14,500
Balance per company records	13,875
Bank service charges	75
Deposit in transit	3,750
NSF check	800
Outstanding checks	5,250

a) What is the adjusted balance on the bank reconciliation?

Apex Company

Bank Reconciliation

BANK BALANCE			**BOOK BALANCE**		
Cash balance according to Bank Statement	$	14,500	Cash balance according to Apex Company	$	13,875
Adjustments			**Adjustments**		
ADD:			**ADD:**		
Deposits in transit	$	3,750	**SUBTRACT:**		
			Bank Service Charge	$	(75)
SUBTRACT:			NSF (Nonsufficient Funds Check)	$	(800)
Outstanding Checks	$	(5,250)			
ADJUSTED BANK BALANCE	**$**	**13,000**	**ADJUSTED BOOK BALANCE**	**$**	**13,000**

b) Journalize any necessary entries for Photo Op based on the bank reconciliation.
(**ENTRIES FROM BOOK ADJUSTMENTS *ONLY***)

b.	Accounts Receivable	800	
	Miscellaneous Expense	75	
	Cash		875

- Accounts Receivable is debited for $800 because a NSF check becomes an accounts receivable to the depositor.
- Bank Service Charge is debited to Miscellaneous Expense for $75.
- Cash is credited for $875 because cash went down.

COMPLEX BANK RECONCILIATION EXAMPLE

The Hartman Boat Company's bank statement for the month of November showed a balance per bank of $7,000. The company's Cash account in the general ledger had a balance of $5,659 at November 30. Other information is as follows:

(1) Cash receipts for November 30 recorded on the company's books were $6,000 but this amount does not appear on the bank statement. **(Deposit in Transit)**

(2) The bank statement shows a debit memorandum for $40 for check printing charges. **(Book adjustment)**

(3) Check No. 119 payable to Maris Company was recorded in the cash payments journal and cleared the bank for $248. A review of the accounts payable subsidiary ledger shows a $36 credit balance in the account of Maris Company and that the payment to them should have been for $284. **(No adjustment)**

(4) The total amount of checks still outstanding at November 30 amounted to $5,800. **(Outstanding Checks)**

(5) Check No. 138 was correctly written and paid by the bank for $409. The cash payment journal reflects an entry for Check No. 138 as a debit to Accounts Payable and a credit to Cash in Bank for $490. (**BOOK ERROR** that **UNDERSTATES cash**. Too much cash was taken out. The difference of $81 ($490-$409) needs to be added to the book side.)

(6) The bank returned an NSF check from a customer for $560. **(Book adjustment)**

(7) The bank included a credit memorandum for $2,060 which represents collection of a customer's note by the bank for the company; principal amount of the note was $2,000 and interest was $60. Interest has not been accrued. **(Book adjustment)**

(a) Prepare a bank reconciliation for the Hartman Boat Company at November 30.

(a)

HARTMAN BOAT COMPANY
Bank Reconciliation
November 30

Cash balance per bank		$ 7,000
Add: (1) Deposit in transit		6,000
		13,000
Less: (4) Outstanding checks		5,800
Adjusted cash balance per bank		**$ 7,200**
Cash balance per books		$ 5,659
Add: (5) Accounts payable error	$ 81	
(7) Collect $2,000 note and interest $60	2,060	2,141
		7,800
Less: (2) Check printing	40	
(6) NSF check	560	600
Adjusted cash balance per books		**$ 7,200**

(Cash bal. + A/P err. + Note coll. – print. char. – NSF check)

*****Note: Item (3) is not a reconciling item.** Both the bank and book records were $36 short. No difference between them.

Complex Bank Reconciliation Example (Cont.)

(b) Prepare any adjusting entries necessary as a result of the bank reconciliation.

	Date	Debit	Credit
Cash	**Nov. 30**	81	
Accounts Payable			81
(To correct error in recording Check No. 138)			
Cash	**Nov. 30**	2,060	
Notes Receivable			2,000
Interest Revenue			60
(To record collection of note receivable and interest by the bank)			
Miscellaneous Expense	**Nov. 30**	40	
Cash			40
(To record check printing charges)			
Accounts Receivable	**Nov. 30**	560	
Cash			560
(To record NSF check)			

LO 4: Explain the reporting of cash and the basic principles of cash management.

- **Cash**: includes currency, coins, amounts on deposit in bank accounts, checking accounts (demand deposits), and many savings accounts (called time deposits.)
  - Checks that are dated LATER than the current date **(post-dated checks)** are NOT included in cash.
- Balance sheet reports the amount of cash available at a given point in time.
  - Listed first in the current assets section.
  - Includes cash on hand, cash in banks, and petty cash.
- Statement of cash flows shows the sources and uses of cash during a period of time.

DELTA AIR LINES, INC. Balance Sheet (partial) December 31, 2013 (in millions)	
Assets	
Current assets	
Cash and cash equivalents	**$2,844**
Short-term investments	959
Restricted cash	**122**

- **Cash Equivalents:** short-term, highly-liquid investments meeting 2 CRITERIA.
  1) Readily convertible to a known cash amount.
  2) Sufficiently close to their due date so that their market value is not sensitive to interest rate changes. **(usually investments purchased WITH-IN 3 MONTHS.)**

- **Restricted Cash:** Cash that is not available for general use but rather is restricted for a special purpose.

BASIC PRINCIPLES OF CASH MANAGEMENT

- Management of cash is the responsibility of the company **treasurer**.
- 5 basic principles of cash management are the following:
  1. Increase the speed of receivables collection.
  2. Keep inventory levels low.
  3. Monitor the payment of liabilities.
  4. Plan the timing of major expenditures.
  5. Invest idle cash.

CASH BUDGETING

- **A cash budget** shows anticipated cash flows, usually over a one- to two-year period.
    1. Cash receipts
    2. Cash disbursements
    3. Financing activities
- Enables the company to plan ahead to cover possible cash shortfalls and to make investments of idle funds.
- Contributes to more effective cash management.

ANY COMPANY	
Cash Budget	
Beginning cash balance	$X,XXXX
Add: **Cash receipts** (itemized)	X,XXXX
Total available cash	X,XXXX
Less: **Cash disbursements** (itemized)	(X,XXX)
Excess (Deficiency) of available cash over disbursements	X,XXXX
Financing	
Add: **Borrowings**	X,XXX
Less: **Repayments**	X,XXX
Ending Cash Balance	**$X,XXX**

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

MARTIAN COMPANY	
Cash Budget	
Beginning cash balance	$ 16,500.00
Add: **Cash receipts** for March	$ 210,000.00
Total available cash	$ 226,500.00
Less: **Cash disbursements** for March	$ (220,000.00)
Excess (Deficiency) of available cash over disbursements	$ 6,500.00
Financing	
Add: Borrowings	**$ 8,500.00**
Ending Cash Balance	**$ 15,000.00**

*Borrowings = $15,000 minimum balance required - $6,500 excess of available cash over disbursements

LO 5: Explain the operation of a petty cash fund.

Petty Cash: cash fund used for small payments that are likely to be made in a short period of time such as a week or month (Ex: postage, paper, envelopes, pens, etc.). Part of an imprest (financial accounting) system used to establish the fund, withdraw from the fund, or reimburse the fund.

1. **Set up of petty cash fund.** Ex) Big M's Construction established a petty cash fund on October 1. A $200 check was written by the company, cashed, and the proceeds given to Mike, the petty cashier. The journal entry on October 1 is

Petty Cash	200	
Cash		200

*****AFTER THE PETTY CASH FUND IS ESTABLISHED, THE PETTY CASH FUND IS NOT DEBITED OR CREDITED AGAIN UNLESS THE AMOUNT OF THE FUND HAS CHANGED.**

2. **Replenish the petty cash fund.** Ex) Petty cash payments report and all receipts are given to Big M's Construction petty cashier Mike in exchange for a $150 check to reimburse the fund. Mike cashes the check and puts the $150 cash in the petty cash box. The following are expenses that the petty cash covered….

Delivery Expense…………….$20
Office Supplies Expense……$40
Miscellaneous Expenses …$70
Postage Expense……………..$20

Delivery Expense	20	
Office Supplies Expense	40	
Miscellaneous Expense	70	
Postage Expense	20	
Cash		150

***Companies should replenish a petty cash fund **at the end of the accounting period, regardless of the cash in the fund.**

3. **Increase or Decrease the petty cash fund.** Ex) Big M's Construction decades to increase the petty cash fund from $200 to $225.

Petty Cash	25	
Cash		25

*****When replenishing the petty cash fund there may by a cash overage or shortage. If this is the case use the cash over and short account for any difference.**

Ex: The petty cash fund is established on January 1 for $200. At the end of January, $9 in petty cash is on hand, but only $190 of receipts were found. There should be $10 left in the fund ($200-$190). However, there is $9 in the fund which means there is a $1 missing. This $1 difference would be debited to the **cash over and short** account.