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ACCOUNTING PRINCIPLES

TWELFTH EDITION

WILEY

8

Fraud, Internal Control, and Cash

Learning Objectives

1

Discuss fraud and the principles of internal control.

2

Apply internal control principles to cash.

3

Identify the control features of a bank account.

4

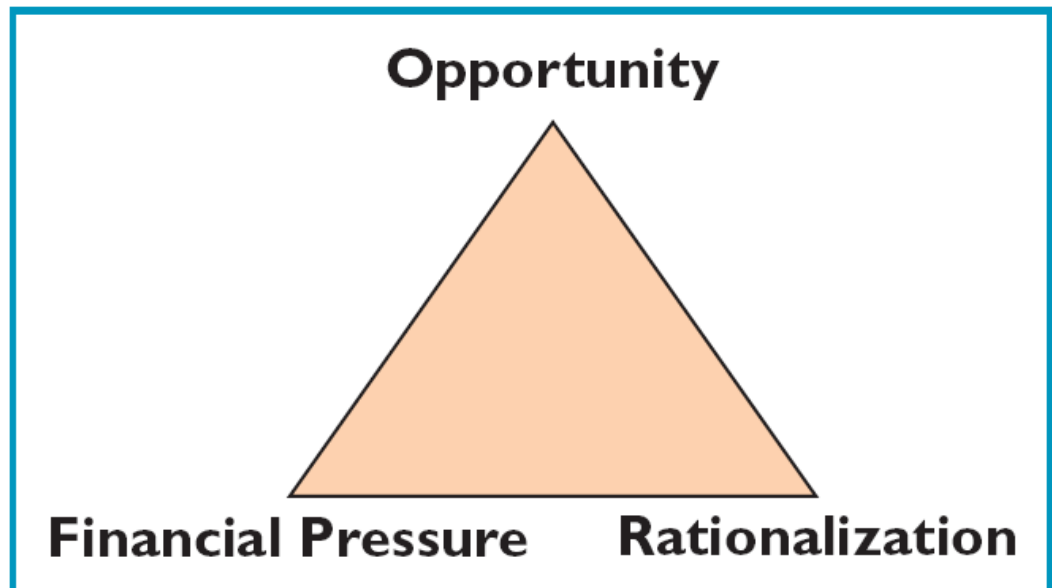
Explain the reporting of cash.

Fraud

Dishonest act by an employee that results in personal benefit to the employee at a cost to the employer.

Three factors that contribute to fraudulent activity.

Illustration 8-1
Fraud triangle



The Sarbanes-Oxley Act

- ◆ Applies to **publicly traded U.S. corporations**.
- ◆ Required to maintain a **system of internal control**.
- ◆ **Corporate executives and boards of directors** must ensure that these controls are reliable and effective.
- ◆ **Independent outside auditors** must attest to the adequacy of the internal control system.
- ◆ SOX created the **Public Company Accounting Oversight Board (PCAOB)**.

Internal Control

Methods and measures adopted to:

- Safeguard assets.
- Enhance the reliability of accounting records.
- Increase efficiency of operations.
- Ensure compliance with laws and regulations.

Internal Control

Five Primary Components:

- A control environment.
- Risk assessment.
- Control activities.
- Information and communication.
- Monitoring.

People, Planet, and Profit Insight

And the Controls Are . . .

Internal controls are important for an effective financial reporting system. The same is true for sustainability reporting. An effective system of internal controls for sustainability reporting will help in the following ways: (1) prevent the unauthorized use of data; (2) provide reasonable assurance that the information is accurate, valid, and complete; and (3) report information that is consistent with overall sustainability accounting policies. With these types of controls, users will have the confidence that they can use the sustainability information effectively. Some regulators are calling for even more assurance through audits of this information. Companies that potentially can cause environmental damage through greenhouse gases, as well as companies in the mining and extractive industries, are subject to reporting requirements. And, as demand for more information in the sustainability area expands, the need for audits of this information will grow.

Why is sustainability information important to investors? (Go to WileyPLUS for this answer and additional questions.)

Principles of Internal Control Activities

ESTABLISHMENT OF RESPONSIBILITY

- ◆ Control is most effective when only one person is responsible for a given task.
- ◆ Establishing responsibility often requires limiting access only to authorized personnel, and then identifying those personnel.



Transfer of cash drawers

ANATOMY OF A FRAUD

Maureen Frugali was a training supervisor for claims processing at Colossal Healthcare. As a standard part of the claims processing training program, Maureen created fictitious claims for use by trainees. These fictitious claims were then sent to the accounts payable department. After the training claims had been processed, she was to notify Accounts Payable of all fictitious claims, so that they would not be paid. However, she did not inform Accounts Payable about every fictitious claim. She created some fictitious claims for entities that she controlled (that is, she would receive the payment), and she let Accounts Payable pay her.

Total take: \$11 million

The Missing Control

Principles of Internal Control Activities

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.



Accounting employee A

Maintains cash
balances per books



Segregation of duties
(Accountability for assets)



Assistant cashier B

Maintains custody
of cash on hand

ANATOMY OF A FRAUD

Lawrence Fairbanks, the assistant vice-chancellor of communications at Aesop University, was allowed to make purchases of under \$2,500 for his department without external approval. Unfortunately, he also sometimes bought items for himself, such as expensive antiques and other collectibles. How did he do it? He replaced the vendor invoices he received with fake vendor invoices that he created. The fake invoices had descriptions that were more consistent with the communications department's purchases. He submitted these fake invoices to the accounting department as the basis for their journal entries and to the accounts payable department as the basis for payment.

Total take: \$475,000

The Missing Control

ANATOMY OF A FRAUD

Angela Bauer was an accounts payable clerk for Aggasiz Construction Company. She prepared and issued checks to vendors and reconciled bank statements. She perpetrated a fraud in this way: She wrote checks for costs that the company had not actually incurred (e.g., fake taxes). A supervisor then approved and signed the checks. Before issuing the check, though, she would “white-out” the payee line on the check and change it to personal accounts that she controlled. She was able to conceal the theft because she also reconciled the bank account. That is, nobody else ever saw that the checks had been altered.

Total take: \$570,000

The Missing Control

Principles of Internal Control Activities

DOCUMENTATION PROCEDURES

- ◆ 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.

No. 0127

No. 0126

No. 0125

No. 0124

No. 0123

CHELSEA VIDEO
125 MAIN STREET
CHELSEA, IL 60915

S O L D T O Firm Name Highpoint Electronic
Attention of Susan Malone, Sales Representative
Address 27 Circle Drive
Harding MI 48281
City State Zip

Date	Salesperson	Invoice No.	Invoice Date	Approved	Filed
5/8/17	Malone	781	5/4/17		
Catalogue No.	Description	Quantity	Price	Amount	
AR847248	Production Model Circuits (Inoperative)	1	500	\$500	

Prenumbered invoices

ANATOMY OF A FRAUD

To support their reimbursement requests for travel costs incurred, employees at Mod Fashions Corporation's design center were required to submit receipts. The receipts could include the detailed bill provided for a meal, or the credit card receipt provided when the credit card payment is made, or a copy of the employee's monthly credit card bill that listed the item. A number of the designers who frequently traveled together came up with a fraud scheme: They submitted claims for the same expenses. For example, if they had a meal together that cost \$200, one person submitted the detailed meal bill, another submitted the credit card receipt, and a third submitted a monthly credit card bill showing the meal as a line item. Thus, all three received a \$200 reimbursement.

Total take: \$75,000

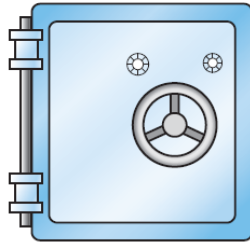
The Missing Control

Principles of Internal Control Activities

PHYSICAL CONTROLS



Television monitors and garment sensors to deter theft



Safes, vaults, and safety deposit boxes for cash and business papers



Alarms to prevent break-ins



Time clocks for recording time worked



Computer facilities with pass key access or fingerprint or eyeball scans

Illustration 8-2



Locked warehouses and storage cabinets for inventories and records

ANATOMY OF A FRAUD

At Centerstone Health, a large insurance company, the mailroom each day received insurance applications from prospective customers. Mailroom employees scanned the applications into electronic documents before the applications were processed. Once the applications are scanned they can be accessed online by authorized employees. Insurance agents at Centerstone Health earn commissions based upon successful applications. The sales agent's name is listed on the application. However, roughly 15% of the applications are from customers who did not work with a sales agent. Two friends—Alex, an employee in record keeping, and Parviz, a sales agent—thought up a way to perpetrate a fraud. Alex identified scanned applications that did not list a sales agent. After business hours, he entered the mailroom and found the hardcopy applications that did not show a sales agent. He wrote in Parviz's name as the sales agent and then rescanned the application for processing. Parviz received the commission, which the friends then split.

Total take: \$240,000

The Missing Control

Total take: \$240,000

The Missing Control

Physical controls. Centerstone Health lacked two basic physical controls that could have prevented this fraud. First, the mailroom should have been locked during nonbusiness hours, and access during business hours should have been tightly controlled. Second, the scanned applications supposedly could be accessed only by authorized employees using their passwords. However, the password for each employee was the same as the employee's user ID. Since employee user-ID numbers were available to all other employees, all employees knew all other employees' passwords. Unauthorized employees could access the scanned applications. Thus, Alex could enter the system using another employee's password and access the scanned applications.

Principles of Internal Control Activities

INDEPENDENT INTERNAL VERIFICATION

- ◆ Records periodically verified by an employee who is independent.
- ◆ Discrepancies reported to management.

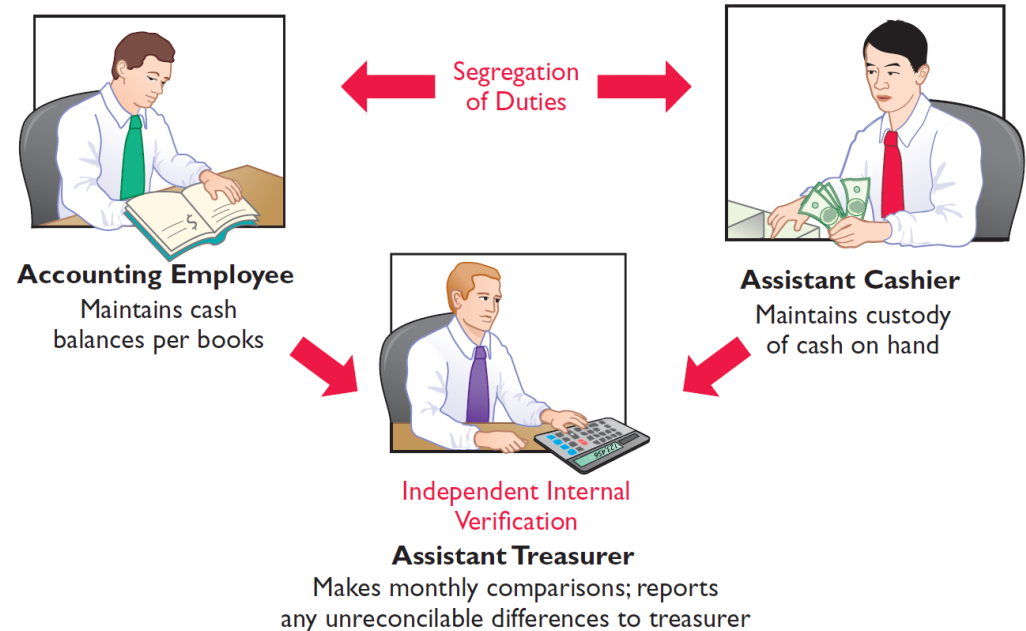


Illustration 8-3
Comparison of segregation of duties principle with independent internal verification principle

ANATOMY OF A FRAUD

Bobbi Jean Donnelly, the office manager for Mod Fashions Corporations design center, was responsible for preparing the design center budget and reviewing expense reports submitted by design center employees. Her desire to upgrade her wardrobe got the better of her, and she enacted a fraud that involved filing expense-reimbursement requests for her own personal clothing purchases. She was able to conceal the fraud because she was responsible for reviewing all expense reports, including her own. In addition, she sometimes was given ultimate responsibility for signing off on the expense reports when her boss was “too busy.” Also, because she controlled the budget, when she submitted her expenses, she coded them to budget items that she knew were running under budget, so that they would not catch anyone’s attention.

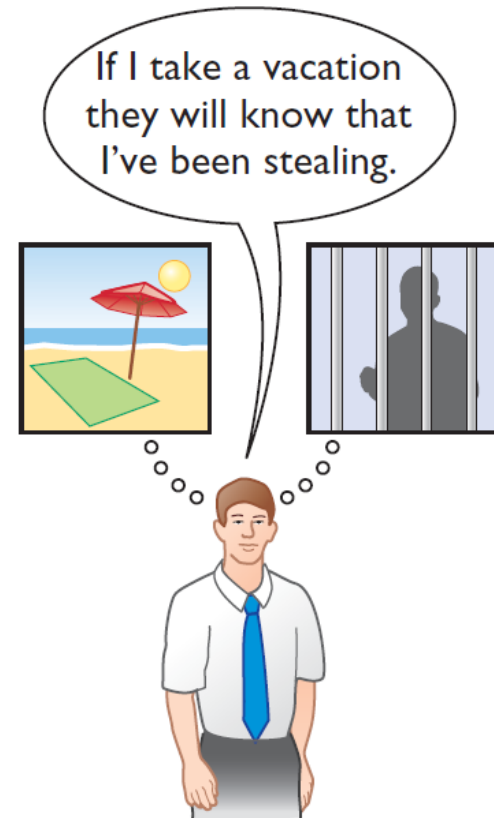
Total take: \$275,000

The Missing Control

Principles of Internal Control Activities

HUMAN RESOURCE CONTROLS

- ◆ Bond employees who handle cash.
- ◆ Rotate employees' duties and require vacations.
- ◆ Conduct background checks.



ANATOMY OF A FRAUD

Ellen Lowry was the desk manager and Josephine Rodriguez was the head of housekeeping at the Excelsior Inn, a luxury hotel. The two best friends were so dedicated to their jobs that they never took vacations, and they frequently filled in for other employees. In fact, Ms. Rodriguez, whose job as head of housekeeping did not include cleaning rooms, often cleaned rooms herself, “just to help the staff keep up.” Ellen, the desk manager, provided significant discounts to guests who paid with cash. She kept the cash and did not register the guest in the hotel’s computerized system. Instead, she took the room out of circulation “due to routine maintenance.” Because the room did not show up as being used, it did not receive a normal housekeeping assignment. Instead, Josephine, the head of housekeeping, cleaned the rooms during the guests’ stay.

Total take: \$95,000

The Missing Control

Accounting Across the Organization

SOX Boosts the Role of Human Resources

Under SOX, a company needs to keep track of employees' degrees and certifications to ensure that employees continue to meet the specified requirements of a job. Also, to ensure proper employee supervision and proper separation of duties, companies must develop and monitor an organizational chart. When one corporation went through this exercise, it found that out of 17,000 employees, there were 400 people who did not report to anyone. The corporation also had 35 people who reported to each other. In addition, if an employee complains of an unfair firing and mentions financial issues at the company, HR should refer the case to the company audit committee and possibly to its legal counsel.

Why would unsupervised employees or employees who report to each other represent potential internal control threats? (Go to WileyPLUS for this answer and additional questions.)

Limitations of Internal Control

- ◆ Costs should not exceed benefit.
- ◆ Human element.
- ◆ Size of the business.

Helpful Hint

Controls may vary with the risk level of the activity. For example, management may consider cash to be high risk and maintaining inventories in the stockroom as lower risk. Thus, management would have stricter controls for cash.

DO IT!

1

Control Activities

Identify which control activity is violated in each of the following situations, and explain how the situation creates an opportunity for a fraud.

1. The person with primary responsibility for reconciling the bank account and making all bank deposits is also the company's accountant.

Solution

- ◆ Violates the control activity of segregation of duties.
- ◆ Recordkeeping should be separate from physical custody.
- ◆ Employee could embezzle cash and make journal entries to hide the theft.

Identify which control activity is violated in each of the following situations, and explain how the situation creates an opportunity for a fraud.

2. Wellstone Company's treasurer received an award for distinguished service because he had not taken a vacation in 30 years.

Solution

- ◆ Violates the control activity of human resource controls.
- ◆ Key employees must take vacations.
- ◆ Treasurer, who manages the company's cash, might embezzle cash and use his position to conceal the theft.

Identify which control activity is violated in each of the following situations, and explain how the situation creates an opportunity for a fraud.

3. In order to save money spent on order slips and to reduce time spent keeping track of order slips, a local bar/restaurant does not buy prenumbered order slips.

Solution

- ◆ Violates the control activity of documentation procedures.
- ◆ If prenumbered documents are not used, then it is virtually impossible to account for the documents.
- ◆ An employee could write up a dinner sale, receive cash from the customer, and then throw away the order slip and keep the cash.

Cash Receipt Controls



Establishment of Responsibility

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

Illustration 8-4

Application of internal control principles to cash receipts

 An illustration of three stacked remittance advice forms. The top form is from 'Beyer Video' and includes fields for 'Form Name', 'Address of', 'Address', 'City', 'State', and 'Zip'. It also has a table with columns for 'Date', 'Description', 'Amount', 'Debit', 'Credit', and 'Total'. The forms are numbered 'No. 0125', 'No. 0124', and 'No. 0123' from top to bottom.

Documentation Procedures

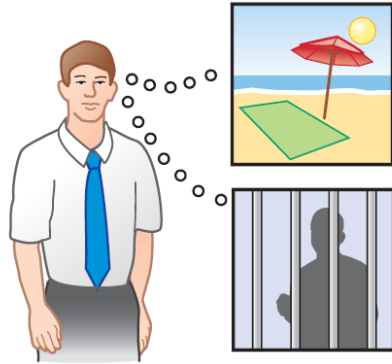
Use remittance advice (mail receipts), cash register tapes or computer records, and deposit slips



Segregation of Duties

Different individuals receive cash, record cash receipts, and hold the cash

Cash Receipt Controls

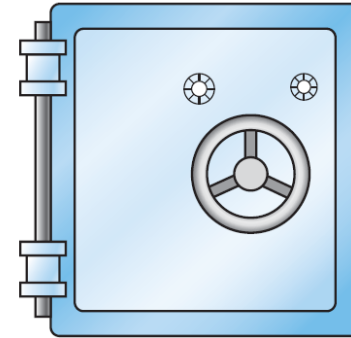


Human Resource Controls

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

Illustration 8-4

Application of internal control principles to cash receipts



Physical Controls

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



Independent Internal Verification

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

Cash Controls

OVER-THE-COUNTER RECEIPTS

Important internal control principle—segregation of record-keeping from physical custody.

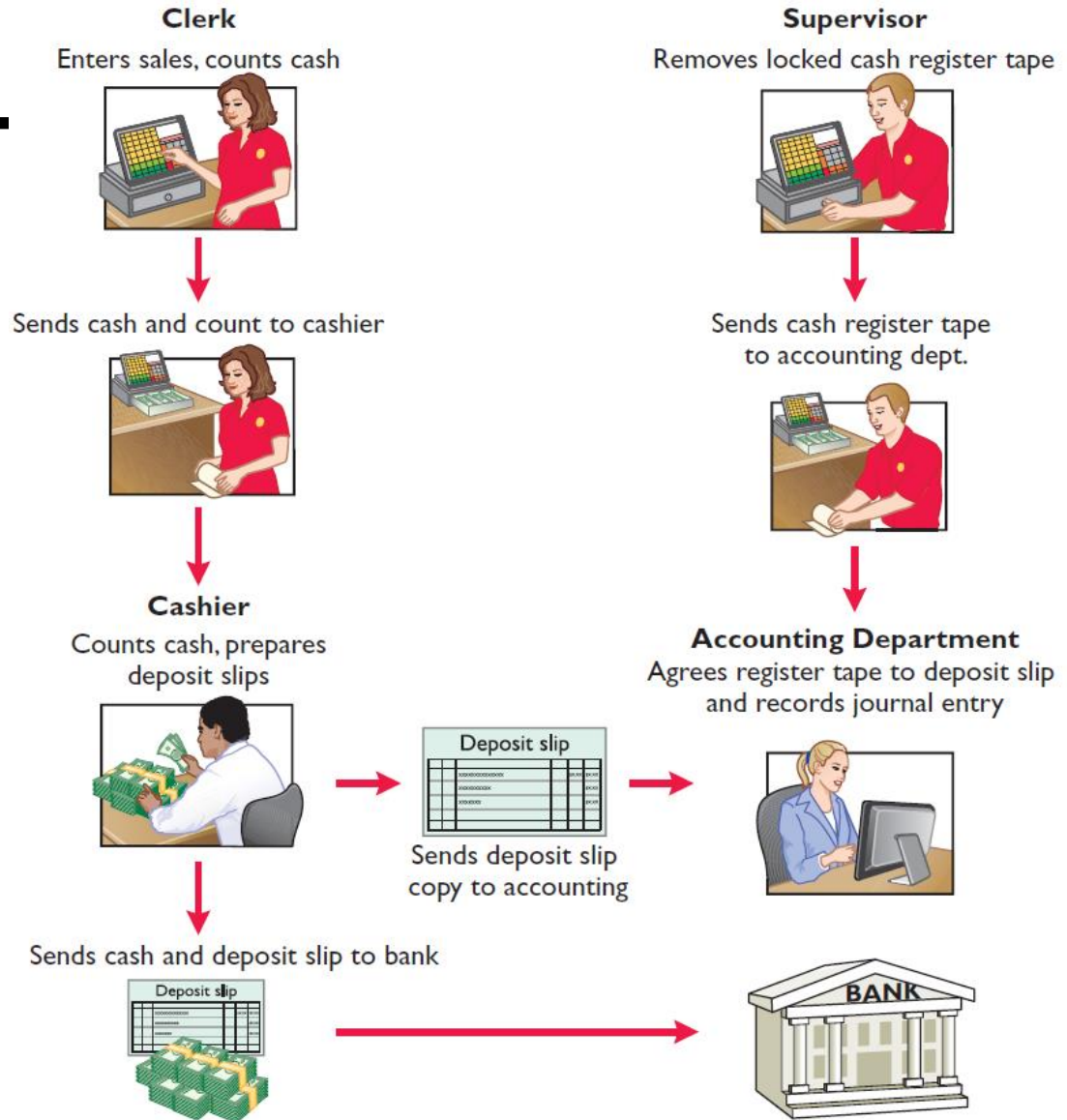


Illustration 8-5

Cash Receipt Controls

MAIL RECEIPTS

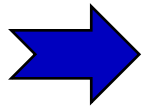
- ◆ Mail receipts should be **opened by two mail clerks**, a list prepared, and each check endorsed “For Deposit Only.”
- ◆ Each mail **clerk signs the list** to establish responsibility for the data.
- ◆ **Original copy of the list**, along with the checks, is sent to the cashier’s department.
- ◆ **Copy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

Cash Receipt Controls

Question

Permitting only designated personnel to handle cash receipts is an application of the principle of:

a. segregation of duties.



b. establishment of responsibility.

c. independent check.

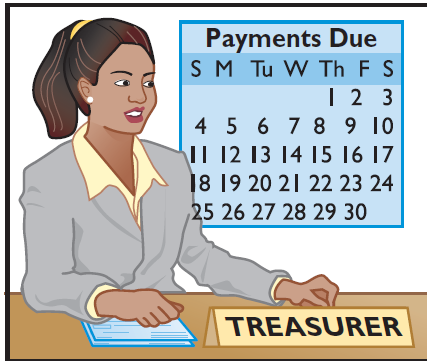
d. other controls.

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.

One exception is **payments for incidental amounts** that are paid out of **petty cash**.

Cash Disbursement



Establishment of Responsibility

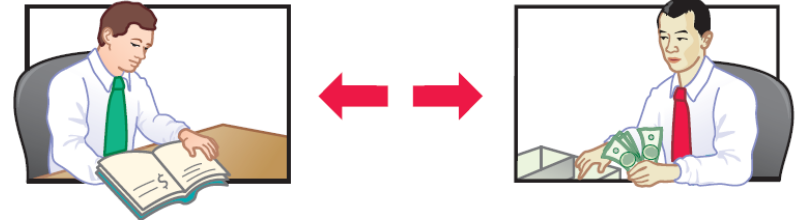
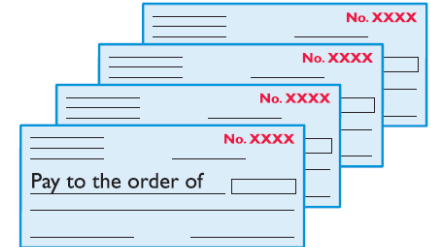
Only designated personnel are authorized to sign checks (treasurer) and approve vendors

Illustration 8-6

Application of internal control principles to cash disbursements

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

Cash Disbursement Controls

Independent Internal Verification

Compare checks to invoices; reconcile bank statement monthly



Human Resource Controls

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

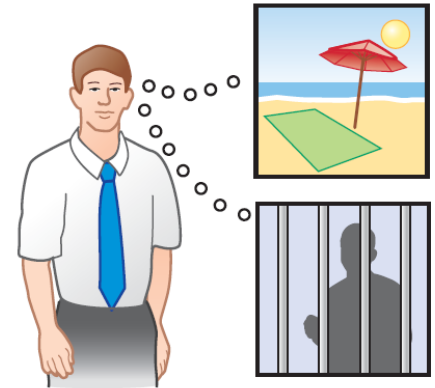
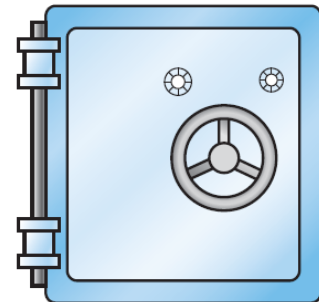


Illustration 8-6
Application of internal control principles to cash disbursements

Physical Controls

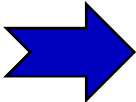
Store blank checks in safes, with limited access; print check amounts by machine in indelible ink



Cash Disbursement Controls

Question

The use of prenumbered checks in disbursing cash is an application of the principle of:

- a. segregation of duties.
- b. establishment of responsibility.
- c. physical, mechanical, and electronic controls.
-  d. documentation procedures.

Cash Disbursement Controls

VOUCHER SYSTEM CONTROLS

- ◆ A network of approvals by authorized individuals, acting independently, to ensure all disbursements by check are proper.
- ◆ A **voucher** is an authorization form prepared for each expenditure in a voucher system.

Petty Cash Fund

Petty Cash Fund - Used to pay small amounts.

Involves:

1. establishing the fund,
2. making payments from the fund, and
3. replenishing the fund.

ETHICS NOTE

Internal control over a petty cash fund is strengthened by (1) having a supervisor make surprise counts of the fund to confirm whether the paid petty cash receipts and fund cash equal the imprest amount, and (2) canceling or mutilating the paid petty cash receipts so they cannot be resubmitted for reimbursement.

Petty Cash Fund

ESTABLISHING THE PETTY CASH FUND

Illustration: If Laird Company decides to establish a \$100 fund on March 1, the journal entry is:

March 1	Petty Cash	100	
	Cash		100

Petty Cash Fund

REPLENISHING THE PETTY CASH FUND

Illustration: On March 15 Laird's petty cash custodian requests a check for \$87. The fund contains \$13 cash and petty cash receipts for postage \$44, freight-out \$38, and miscellaneous expenses \$5. The journal entry is:

March 15	Postage Expense	44	
	Freight-Out	38	
	Miscellaneous Expense	5	
	Cash		87

Petty Cash Fund

Illustration: Assume in the preceding example that the custodian had **only \$12 in cash** in the fund plus the receipts as listed. The request for reimbursement would therefore be for \$88, and Laird would make the following entry.

March 15	Postage Expense	44	
	Freight-Out	38	
	Miscellaneous Expense	5	
	Cash Over and Short	1	
	Cash		88

Ethics Insight

How Employees Steal

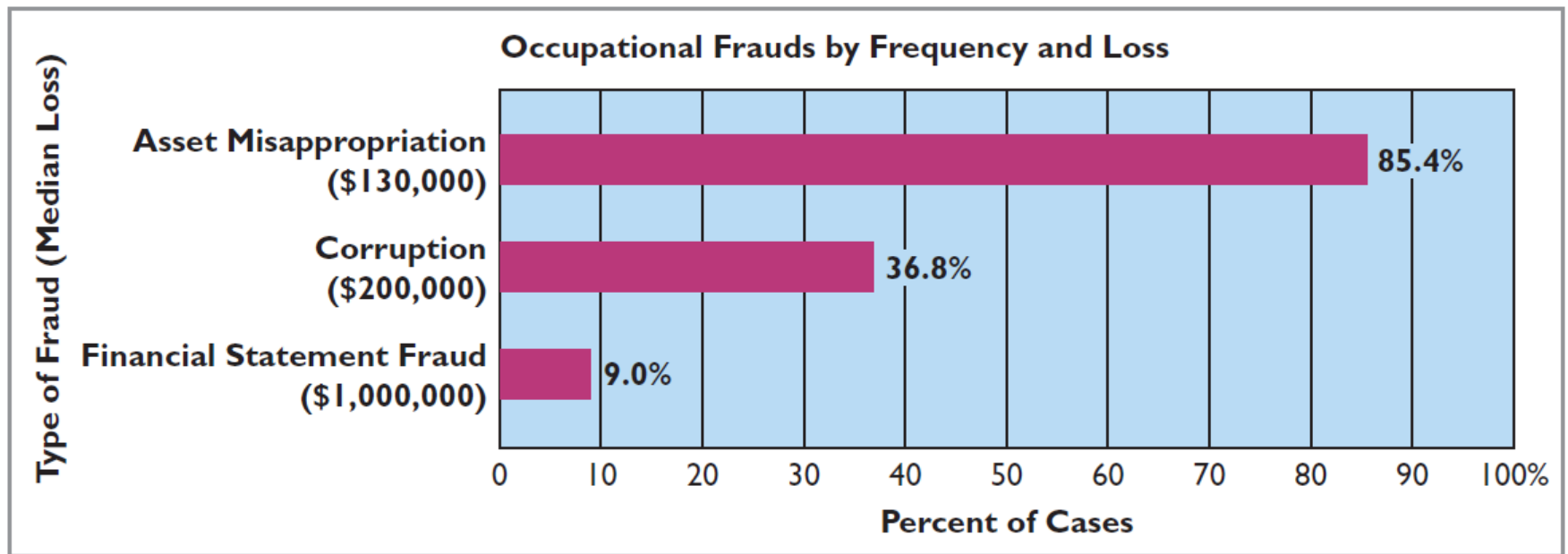
Occupational fraud is using your own occupation for personal gain through the misuse or misapplication of the company's resources or assets. This type of fraud is one of three types:

1. Asset misappropriation, such as theft of cash on hand, fraudulent disbursements, false refunds, ghost employees, personal purchases, and fictitious employees. This fraud is the most common but the least costly.
2. Corruption, such as bribery, illegal gratuities, and economic extortion. This fraud generally falls in the middle between asset misappropriation and financial statement fraud as regards frequency and cost.
3. Financial statement fraud, such as fictitious revenues, concealed liabilities and expenses, improper disclosures, and improper asset values. This fraud occurs less frequently than other types of fraud but it is the most costly.

Ethics Insight

How Employees Steal

The graph below shows the frequency and the median loss for each type of occupational fraud.



Source: 2014 Report to the Nations on Occupational Fraud and Abuse, Association of Certified Fraud Examiners, pp. 10–12.

DO IT!**2b**

Petty Cash Fund

Bateer Company established a \$50 petty cash fund on July 1. On July 30, the fund had \$12 cash remaining and petty cash receipts for postage \$14, office supplies \$10, and delivery expense \$15. Prepare journal entries to establish the fund on July 1 and to replenish the fund on July 30.

Solution

July 1	Petty Cash	50	
	Cash		50
30	Postage Expense	14	
	Supplies	10	
	Delivery Expense	15	
	Cash Over and Short		1
	Cash		38

Identify the control features of a bank account.

The use of a bank contributes significantly to good internal control over cash.

- ◆ Minimizes the amount of currency on hand.
- ◆ Creates a double record of bank transactions.
- ◆ Bank reconciliation.

Helpful Hint

Essentially, the bank statement is a copy of the bank's records sent to the customer (or available online) for review.

Making Bank Deposits

Authorized employee should make deposit.

Illustration 8-8

Bank code numbers

DEPOSIT TICKET

LAIRD COMPANY
77 West Central Avenue,
Midland, Michigan 48654

DATE April 19 2017

NBT National Bank & Trust
Midland, Michigan 48654

⑈012460497⑈ 457923⑈02 75

CHECKS AND OTHER ITEMS ARE RECEIVED FOR DEPOSIT SUBJECT TO THE PROVISIONS OF THE UNIFORM COMMERCIAL CODE OR ANY APPLICABLE COLLECTION AGREEMENT

CASH	CURRENCY	462	10
	COIN		
LIST CHECKS SINGLY			
TOTAL FROM OTHER SIDE		1116	80
TOTAL		1578	90
TOTAL FROM OTHER SIDE			
NET DEPOSIT		1578	90

74—102/724

USE OTHER SIDE FOR
ADDITIONAL LISTINGS

BE SURE EACH ITEM IS
PROPERLY ENDORSED

Front side

Reverse side

CHECKS	LIST SINGLY	DOLLARS	CENTS
1	74 - 331/724	175	40
2	61 - 157/220	292	60
3	19 - 401/710	337	55
4	22 - 815/666	165	72
5	15 - 360/011	145	53
6			
7			
8			
9			
10			
11			
12			
13			
14			
15			
16			
17			
18			
19			
TOTAL		1116	80
ENTER TOTAL ON THE FRONT OF THIS TICKET			

Writing Checks

Written order signed by depositor directing bank to pay a specified sum of money to a designated recipient.

Maker	→	LAIRD COMPANY 77 West Central Avenue, Midland, Michigan 48654	No. 448 <u>April 16 2017</u> 74—102/724
Payee	→	Pay to the order of <u>Watkins Wholesale Supply</u>	\$ <u>1525.00</u>
		<u>Fifteen hundred twenty-five and $\frac{00}{100}$</u> Dollars	
Payer	→	NBT National Bank & Trust Midland, Michigan 48654	<u>W.F. Paine</u>
		Memo _____	
		⑆012410497⑆ 457923⑈02 448	

Illustration 8-9
Check

Bank Statements


DEBIT MEMORANDUM

- ◆ Bank service charge.
- ◆ NSF (not sufficient funds).

CREDIT MEMORANDUM

- ◆ Collect notes receivable.
- ◆ Interest earned.

Illustration 8-10


National Bank & Trust
 Midland, Michigan 48654 Member FDIC

ACCOUNT STATEMENT

LAIRD COMPANY
 77 WEST CENTRAL AVENUE
 MIDLAND, MICHIGAN 48654

Statement Date/Credit Line Closing Date
 April 30, 2017

457923

ACCOUNT NUMBER

Balance Last Statement	Deposits and Credits		Checks and Debits		Balance This Statement
	No.	Total Amount	No.	Total Amount	
13,256.90	20	34,805.10	26	32,154.55	15,907.45

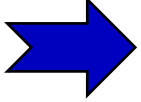
CHECKS AND DEBITS			DEPOSITS AND CREDITS		DAILY BALANCE	
Date	No.	Amount	Date	Amount	Date	Amount
4-2	435	644.95	4-2	4,276.85	4-2	16,888.80
4-5	436	3,260.00	4-3	2,137.50	4-3	18,249.65
4-4	437	1,185.79	4-5	1,350.47	4-4	17,063.86
4-3	438	776.65	4-7	982.46	4-5	15,154.33
4-8	439	1,781.70	4-8	1,320.28	4-7	14,648.89
4-7	440	1,487.90	4-9 CM	1,035.00	4-8	11,767.47
4-8	441	2,420.00	4-11	2,720.00	4-9	12,802.47
4-11	442	1,585.60	4-12	757.41	4-11	13,936.87
4-12	443	1,226.00	4-13	1,218.56	4-12	13,468.28
4-29	NSF	425.60	4-27	1,545.57	4-27	13,005.45
4-29	459	1,080.30	4-29	2,929.45	4-29	14,429.00
4-30	DM	30.00	4-30	2,128.60	4-30	15,907.45
4-30	461	620.15				

Symbols: **CM** Credit Memo **EC** Error Correction **NSF** Not Sufficient Funds **Reconcile Your Account Promptly**
DM Debit Memo **INT** Interest Earned **SC** Service Charge

Bank Statements

Question

The control features of a bank account do *not* include:

- 
- a. having bank auditors verify the correctness of the bank balance per books.
 - b. minimizing the amount of cash that must be kept on hand.
 - c. providing a double record of all bank transactions.
 - d. safeguarding cash by using a bank as a depository.

Reconciling the Bank Account

Reconcile balance per books and balance per bank to their “correct” or “true” balance.

Reconciling Items:

1. Deposits in transit.
2. Outstanding checks.
3. Bank memoranda.
4. Errors.

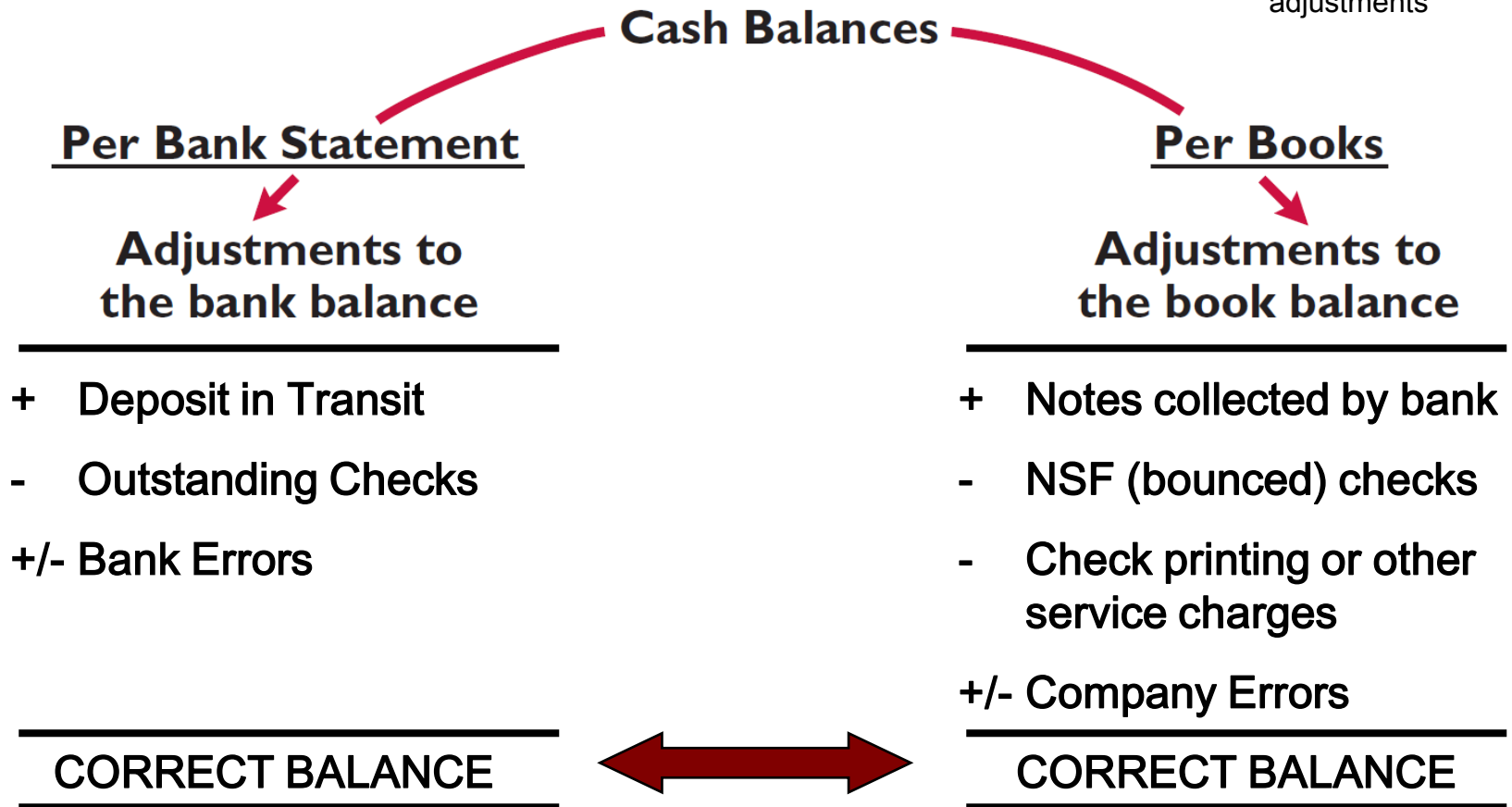


Time Lags

Reconciling the Bank Account

RECONCILIATION PROCEDURES

Illustration 8-11
Bank reconciliation
adjustments



RECONCILIATION PROCEDURES

BANK RECONCILIATION ILLUSTRATED

The bank statement for Laird Company (Illustration 8-10) shows a balance per bank of \$15,907.45 on April 30, 2017. On this date, the balance of cash per books is \$11,589.45. Using the four reconciliation steps, Laird determines the following reconciling items.

Step 1. Deposits in transit: April 30 deposit (received by bank on May 1).	\$2,201.40
Step 2. Outstanding checks: No. 453, \$3,000.00; no. 457, \$1,401.30; no. 460, \$1,502.70.	5,904.00
Step 3. Errors: Laird wrote check no. 443 for \$1,226.00 and the bank correctly paid that amount. However, Laird recorded the check as \$1,262.00.	36.00
Step 4. Bank memoranda:	
a. Debit—NSF check from J. R. Baron for \$425.60.	425.60
b. Debit—Charge for printing company checks \$30.00.	30.00
c. Credit—Collection of note receivable for \$1,000 plus interest earned \$50, less bank collection fee \$15.00.	1,035.00

RECONCILIATION PROCEDURES

Illustration: Prepare a bank reconciliation at April 30.

Cash balance per bank statement	\$15,907.45
Deposit in transit	2,201.40
Outstanding checks	(5,904.00)
Adjusted cash balance per bank	<u><u>\$12,204.85</u></u>

Cash balance per books	\$11,589.45
Error in check No. 443	36.00
NSF check	(425.60)
Bank service charge	(30.00)
Collection of notes receivable	1,035.00
Adjusted cash balance per books	<u><u>\$12,204.85</u></u>

Reconciling the Bank Account

ENTRIES FROM BANK RECONCILIATION

COLLECTION OF NOTE RECEIVABLE: Assuming interest of \$50 has not been accrued and collection fee is charged to Miscellaneous Expense, the entry is:

Apr. 30	Cash	1,035.00	
	Miscellaneous Expense	15.00	
	Notes Receivable		1,000.00
	Interest Revenue		50.00

ENTRIES FROM BANK RECONCILIATION

BOOK ERROR: The cash disbursements journal shows that check no. 443 was a payment on account to Andrea Company, a supplier. The correcting entry is:

Apr. 30	Cash	36.00	
	Accounts Payable		36.00

NSF CHECK: As indicated earlier, an NSF check becomes an account receivable to the depositor. The entry is:

Apr. 30	Accounts Receivable	425.60	
	Cash		425.60

ENTRIES FROM BANK RECONCILIATION

BANK SERVICE CHARGES: Depositors debit check printing charges (DM) and other bank service charges (SC) to Miscellaneous Expense. The entry is:

Apr. 30	Miscellaneous Expense	30.00	
	Cash		30.00

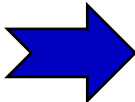
Illustration 8-13

Cash			
Apr. 30 Bal.	11,589.45	Apr. 30	425.60
30	1,035.00	30	30.00
30	36.00		
Apr. 30 Bal.	12,204.85		

Reconciling the Bank Account

Question

The reconciling item in a bank reconciliation that will result in an adjusting entry by the depositor is:

- a. outstanding checks.
- b. deposit in transit.
- c. a bank error.
-  d. bank service charges.

Electronic Funds Transfer (EFT) System

- ◆ Disbursement systems that uses **wire, telephone, or computers** to transfer cash balances between locations.
- ◆ **EFT** transfers normally result in **better internal control** since no cash or checks are handled by company employees.

Investor Insight

Madoff's Ponzi Scheme

No recent fraud has generated more interest and rage than the one perpetrated by Bernard Madoff. Madoff was an elite New York investment fund manager who was highly regarded by securities regulators. Investors flocked to him because he delivered very steady returns of between 10% and 15%, no matter whether the market was going up or going down. However, for many years, Madoff did not actually invest the cash that people gave to him. Instead, he was running a Ponzi scheme: He paid returns to existing investors using cash received from new investors. As long as the size of his investment fund continued to grow from new investments at a rate that exceeded the amounts that he needed to pay out in returns, Madoff was able to operate his fraud smoothly. To conceal his misdeeds, Madoff fabricated false investment statements that were provided to investors. In addition, Madoff hired an auditor that never verified the accuracy of the investment records but automatically issued unqualified opinions each year. Although a competing fund manager warned the SEC a number of times over a nearly 10-year period that he thought Madoff was engaged in fraud, the SEC never aggressively investigated the allegations. Investors, many of which were charitable organizations, lost more than \$18 billion. Madoff was sentenced to a jail term of 150 years.

DO IT!

3

Bank Reconciliation

Sally Kist owns Linen Kist Fabrics. Sally asks you to explain how she should treat the following reconciling items when reconciling the company's bank account: (1) a debit memorandum for an NSF check, (2) a credit memorandum for a note collected by the bank, (3) outstanding checks, and (4) a deposit in transit.

Solution

Sally should treat the reconciling items as follows.

- (1) NSF check:
- (2) Collection of note:
- (3) Outstanding checks:
- (4) Deposit in transit:

Cash Equivalents

Cash equivalents are short-term, highly liquid investments that are both:

1. Readily convertible to known amounts of cash, and
2. So near their maturity that their market value is relatively insensitive to changes in interest rates.

Restricted Cash

Cash that is not available for general use but rather is restricted for a special purpose.

Reporting Cash



DELTA AIR LINES, INC. Balance Sheet (partial) December 31, 2013 (in millions)

Assets

Current assets

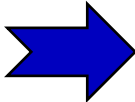
Cash and cash equivalents	\$2,844
Short-term investments	959
Restricted cash	122

Illustration 8-14
Balance sheet presentation
of cash

Reporting Cash

Question

Which of the following statements correctly describes the reporting of cash?

- a. Cash cannot be combined with cash equivalents.
- b. Restricted cash fund may be combined with Cash.
-  c. Cash is listed first in the current assets section.
- d. Restricted cash funds cannot be reported as a current asset.

Indicate whether each of the following is true or false.

1. Cash and cash equivalents are comprised of coins, currency (paper money), money orders, and NSF checks.
2. Restricted cash is classified as either a current asset or noncurrent asset, depending on the circumstances.
3. A company may have a negative balance in its bank account. In this case, it should offset this negative balance against cash and cash equivalents on the balance sheet.
4. Because cash and cash equivalents often include short-term investments, accounts receivable should be reported as the first item on the balance sheet.

False**True****False****False**



A Look at IFRS

LEARNING OBJECTIVE

5

Compare the accounting for fraud, internal control, and cash under GAAP and IFRS.

Relevant Facts

Similarities

- ◆ The fraud triangle discussed in this chapter is applicable to all international companies. Some of the major frauds on an international basis are **Parmalat** (Italy), **Royal Ahold** (the Netherlands), and **Satyam Computer Services** (India).
- ◆ Rising economic crime poses a growing threat to companies, with nearly one-third of all organizations worldwide being victims of fraud in a recent 12-month period.



A Look at IFRS

Relevant Facts

Similarities

- ◆ Accounting scandals both in the United States and internationally have re-ignited the debate over the relative merits of GAAP, which takes a “rules-based” approach to accounting, versus IFRS, which takes a “principles-based” approach. The FASB announced that it intends to introduce more principles-based standards.
- ◆ The accounting and internal control procedures related to cash are essentially the same under both IFRS and this textbook. In addition, the definition used for cash equivalents is the same.
- ◆ Most companies report cash and cash equivalents together under IFRS, as shown in this textbook. In addition, IFRS follows the same accounting policies related to the reporting of restricted cash.



A Look at IFRS

Relevant Facts

Differences

- ◆ The SOX internal control standards apply only to companies listed on U.S. exchanges. There is continuing debate over whether foreign issuers should have to comply with this extra layer of regulation.



A Look at IFRS

Looking to the Future

Ethics has become a very important aspect of reporting. Different cultures have different perspectives on bribery and other questionable activities, and consequently penalties for engaging in such activities vary considerably across countries.

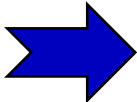
High-quality international accounting requires both high-quality accounting standards and high-quality auditing. Similar to the convergence of GAAP and IFRS, there is movement to improve international auditing standards. The International Auditing and Assurance Standards Board (IAASB) functions as an independent standard-setting body. It works to establish high-quality auditing and assurance and quality-control standards throughout the world. Whether the IAASB adopts internal control provisions similar to those in SOX remains to be seen. You can follow developments in the international audit arena at <http://www.ifac.org/iaasb/>.



A Look at IFRS

IFRS Self-Test Questions

Non-U.S companies that follow IFRS:

- a. do not normally use the principles of internal control activities described in this textbook.
- b. often offset cash with accounts payable on the balance sheet.
-  c. are not required to follow SOX.
- d. None of the above.



A Look at IFRS

IFRS Self-Test Questions

The Sarbanes-Oxley Act applies to:

- ➔ a. all U.S. companies listed on U.S. exchanges.
- b. all companies that list stock on any stock exchange in any country.
- c. all European companies listed on European exchanges.
- d. Both (a) and (c).



A Look at IFRS

IFRS Self-Test Questions

High-quality international accounting requires both high-quality accounting standards and:

- a. a reconsideration of SOX to make it less onerous.
- ➡ b. high-quality auditing standards.
- c. government intervention to ensure that the public interest is protected.
- d. the development of new principles of internal control activities.

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