cHAPTER 6

CASH, fraud, AND Internal Control

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| Chapter Outline |
| **I. Fraud and Internal Control** |
| A. Purpose of Internal Control 1. Internal Control System—policies and procedures used to: | | | | | |
| a. Protect assets  b. Ensure reliable accounting  c. Promote efficient operations  d. Uphold company policies | | | | | |
| 2. Sarbanes-Oxley Act (SOX) Requires managers and auditors of companies whose stock is traded on an exchange (called *public companies*) to document and verify internal controls.  3. Committee of Sponsoring Organizations (COSO) | | | | | |
| B. Principles of Internal Control | | | | | |
| 1. Establish Responsibilities  2. Maintain Adequate Records  3. Insure Assets and Bond Key Employees  4. Separate Recordkeeping from Custody of Assets  5. Divide Responsibility for Related Transactions  6. Apply Technological Controls  7. Perform Regular and Independent Reviews | | | | | |
| C. Technology, Fraud, and Internal Control Technology allows quick access to information. Examples of how technology impacts internal control: | | | | | |
| 1. Reduced Processing Errors—technology reduces but does not eliminate errors in processing information.  2 More Extensive Testing of Records—technology allows large samples to be quickly checked for accuracy.  3. New Evidence of Processing—technology allows recording additional transaction details not possible with manual systems.  4. Separation of Duties—must be carefully distributed among fewer employees.  5. Increased E-Commerce—increases risks of credit card number theft, computer viruses and online impersonation.  D. Blockchain as a Control – viewed as a new, more secure type of accounting ledger which is continuously and simultaneously updated and verified. Makes it impossible for the ledger to be modified without a detailed record of changes. Records cannot be destroyed or hidden as the record is shared and stored by multiple users. | | | | | |
| E. Limitations of Internal Control | | | | | |
| 1. Human Element    1. Error: carelessness, misjudgment, or confusion    2. Fraud: opportunity, pressure, rationalization   2. *Cost-benefit constraint*—the costs of internal controls must not exceed their benefits. | | | | | |
| **II. Control of Cash**—Basic guidelines for control of cash and cash equivalents include: handling of cash must be separate from recordkeeping of cash, cash receipts are promptly deposited in bank, and payments of cash are by check. | |
| A. Cash, Cash Equivalents, and Liquidity | | | | | | |
| 1. *Liquidity* refers to a company’s ability to pay for its current liabilities. | | | | | | |
| 2. *Cash* includes currency, coins, and deposits in bank.  3. *Cash equivalents* (examples; short-term U.S. Treasury bills) are short‑term, highly liquid investment assets meeting two criteria: | | | | | | |
| a. Readily convertible to a known cash amount.  b. Close enough to their maturity date so that market value will not greatly change. | | | | | | |
| B. Cash Management   1. Goals of cash management   a. Plan cash receipts to meet cash payments when due  b. Keep minimum level of cash necessary to operate   1. Effective cash management strategies: | | | | | | |
| 1. Encourage collection of receivables 2. Delay payment of liabilities until last possible day allowed 3. Keep only necessary assets 4. Plan expenditures 5. Invest excess cash | | | | | | |
| C. Control of Cash Receipts Procedures for protecting cash received over-the-counter and by mail: | | | | | | |
| 1. Over-the-Counter Cash Receipts—receipts from sales should be recorded on a cash register at the time of each sale.  2. Cash Over and Short—income statement account used to record cash shortages and overages.  3. Cash Receipts by Mail—two people should be assigned to open mail and person who opens the mail creates list. | | | | | | |
| D. Control of Cash Payments—to safeguard against theft:   1. Use a cash budget to summarize receipts and payments. | | | | | | |
| 1. Require all payments be made by checks. (Exception—small payments made from petty cash fund.) 2. Deny access to accounting records to anyone other than the owner who has the authority to sign checks. | | | | | | |
| 1. *Voucher system* of control establishes procedures for:    1. Verifying, approving, and recording liabilities for cash payments.    2. Issuing checks for payment of verified, approved, and recorded liabilities.   (Documents in a voucher system are listed and explained in appendix notes.) | | | |
| 1. Petty cash system of control:    1. Write and cash a check to establish petty cash fund. Record as a debit to Petty Cash and credit to Cash. (Petty Cash account is debited or credited only when the fund is established or fund is increased or decreased.)    2. Assigning a petty cashier (custodian) to account for the amounts expended and to keep receipts. | | | |
| * 1. Reimbursement—debit the expenses or other items paid for with petty cash and credit Cash for the amount reimbursed to the petty cash fund. | | | |
| * 1. Record any petty cash shortages/overages. | | | |
| **III. Banking Activities as Controls** | | | |
| A. Basic Bank Services Bank accounts permit depositing money for safeguarding and helps control withdrawals. **Electronic funds transfer (EFT)** is an electronic communication transfer of cash from one party to another. | | | |
| 1. Bank Statement Shows activities of a bank account and is used to prove the accuracy of the depositor’s cash records in preparing a bank reconciliation.   1. Bank Reconciliation—a report that explains *(reconciles)* the difference between the balance of a checking account according to the depositor’s records and the balance reported on the bank statement. | | | |
| 2. Purpose of Bank Reconciliation  Factors causing the bank statement balance to differ from the depositor’s book balance are: | | | |
| a. Outstanding checks  b. Deposits in transit  c. Deductions for bank fees and NSF checks  d. Additions for collections and interest  e. Errors by either the bank or depositor | | | |
| 3. Steps in preparing the bank reconciliation: | | | | |
| a. Enter the bank balance of the cash account (*balance per bank*).  b. Add any unrecorded deposits *(deposits in transit)* and any bank errors that understate the bank balance.  c. Subtract any *outstanding checks* and bank errors that overstate the bank balance. | | | | |
| d. Compute the *adjusted bank balance*.  e. Enter the company’s balance of the Cash account (*balance per book*).  f. Add any unrecorded cash receipts, interest earned, and errors that under­state the book balance. | | | | |
| g. Subtract any unrecorded bank fees, NSF checks, and errors that overstate the book balance. | | | | |
| h. Compute the *adjusted book balance.*  i. Verify the two adjusted balances from steps d and h are equal. If yes, they are reconciled. If not, check for accuracy and missing data to achieve reconciliation. | | | | |
| 4. Adjusting entries from a Bank Reconciliation | | | | |
| * 1. All reconciling additions to book balance are debits to cash. Credit depends on reason for addition (Example: Credit Notes Receivable when bank collected note).   b. All reconciling subtractions from book balance are credits to cash. Debit depends on reason for subtraction. (Examples: Debit Miscellaneous Expense for bank service charge and Accounts Receivable/customer for NSF checks.) | | | |
| **IV. Decision Analysis**—**Days’ Sales Uncollected** | | | | |
| 1. Also called *days’ sales in receivables.* 2. Used to estimate how much time is likely to pass before the current amount of accounts receivable is received in cash. Used to determine if cash is being collected quickly enough to pay upcoming obligations.   C. Calculated by dividing current balance of accounts receivable by net sales and multiplying the result by 365. | | | | |
| **V. Documentation and Verification (Appendix 6A)** | | | | |
| Important documents of a voucher system of control include:  A.Purchase Requisition—lists the merchandise needed and requests that it be purchased.  B.Purchase Order—used by purchasing department to place an order with a vendor (seller or supplier).  C.Invoice—an itemized statement of goods prepared by the vendor (copy sent to buyer) listing the customer’s name, items sold, sales prices, and terms of sale.  D.Receiving Report—used by receiving department to verify that goods conform to purchase order. | | | | |
| E.Invoice Approval—used by accounting department to verify all necessary documents related to a purchase are assembled and approve payment of the related invoice.  F.Voucher—can be a folder used to hold all documents related to a given transaction and authorizes its recording. | | | | |