Accounting Fundamentals Lesson 4

4.0 Internal Control & Cash

Fraud in an intentional misrepresentation of facts made for the purpose of persuading another party to act in a way that causes injury or damage to that party.

The two most common types of fraud that impact financial statements are:

1. Misappropriation of assets
2. Fraudulent financial reporting

Enron Corporation and WorldCom Corporation are used as examples of companies that experienced fraudulent activities that led to the end of both companies and financial hardship for many individuals.

Shareholders and market reaction is highly related to managers' actions.

Directors are increasingly judged on profit and growth and have large bonuses at stake.

Companies and directors want to use reports to present the message they want investors to see and sometimes, that involves creative accounting.

Creative Accounting – term used to indicate the management of earnings that follow the rules but deviate from the intentions of those rules.

The terms innovative, aggressive and cooking the books are also sometimes used.

Creative Accounting is used to:

- Hide a bad year for the company
- Force a good year
- Continue the pressure to be the best
- Give an impression of stability or sustainability
- Boost assets to avoid take-over

Creative Accounting / Earnings Management Methods:

- Artificial Transactions to manipulate balance sheet and move profits
- Timing of Genuine transactions (accelerations)

  For example, a company receives upfront payment for a four-year service contract but records the full payment as sales of only the period that the payment is received.

- Prediction/Estimation
- Big Bath (Worsening a bad year to make next years considerably better)
- Cookie Jar Reserves (delay)
- Failing to record expenses

The fraud triangle - consists of the elements that make up virtually every fraud:

- Motive
- Opportunity
- Rationalization

The primary way that fraud, as well as unintentional errors, is prevented, detected, or corrected is through a proper system of internal control.

Example of Unintentional Error:

Transposition errors - simple error of data entry that occurs when two digits that are either individual or part of a larger sequence of numbers are reversed (transposed) when posting a transaction. Although this error is small and unintentional, it can result in huge financial losses or errors in some instances.

Internal control - a plan of organization and a system of procedures implemented by company management and the board of directors to accomplish five objectives.

1. Safeguarding assets
2. Encouraging employees to follow company policy
3. Promoting operational efficiency,
4. Ensuring accurate and reliable accounting records
5. Complying with legal requirements

Internal control can be broken down into five components:

1. Control environment
2. Risk assessment
3. Information system
4. Control procedures
5. Monitoring of controls

Internal control procedures include:

- Smart hiring practices and separation of duties
- Comparisons and compliance monitoring
- Adequate records
- Limited access
- Proper approvals

Accounting systems are relying more on information technology for record keeping, asset handling, approval, and monitoring.

Businesses also must implement safeguard controls, such as:

- Fireproof vaults
- Burglar alarms
- Security cameras

Internal controls related to e-commerce are necessary to combat stolen credit card numbers, computer viruses and Trojan horses, and phishing expeditions. Companies can employ encryption and firewalls to combat these risks.

Cash is the most liquid asset, and it is easy to conceal and relatively easy to steal.

Specific controls are in place to safeguard cash, and these documents are used to control a bank account: signature card, bank statement, deposit ticket, bank reconciliation, and check.

Internal Control Tips:

Cash payments:

A strong internal control happens when there is a good separation of duties. Example: Supervisor's request equipment, and the home office purchase the equipment.

A weak internal control would be when supervisors both request, purchase, and pay for equipment with little oversight by the home office.

Cash receipts:
A weak internal control happens when there is not good separation of duties. Example: The accountant both handles cash and accounts for cash.

A strong internal control would be when different people handle cash and account for cash.

4.1 Bank Reconciliation

The bank statement reports what the bank did with the customer's cash.

To ensure accurate cash records, a bank reconciliation is performed whereby differences between the bank balance and the book balance are compared and reconciled.

The bank side of the reconciliation includes the following items:

- Deposits in transit
- Outstanding checks
- Bank errors

The book side includes these items:

- Bank collections
- Electronic funds transfers
- Service charge
- Interest revenue
- Nonsufficient funds
- The cost of printed checks
- Book errors

The book adjustments must be journalized to complete the reconciliation process and bring the cash balance to the correct amount. Online banking is presented as well.

Cash must have certain controls in place that allow for better security. These include procedures for:

- Cash receipts over the counter
- Cash receipts by mail
- Controls over payment by cash

Additionally, establishing a petty cash fund to pay small expenditures is important.

Constructing and using a cash budget helps coordinate business activities. This budget allows a company to allocate cash to the appropriate places at the correct time.

Item #1. The bank statement for August 2013 shows an ending balance of $3,490.

Item #2. On August 31 the bank statement shows charges of $35 for the service charge for maintaining the checking account.

Item #3. On August 28 the bank statement shows a return item of $100 plus a related bank fee of $10. The return item is a customer's check that was returned because of insufficient funds. The check was also marked "do not redeposit."

Item #4. The bank statement shows a charge of $80 for check printing on August 20.

Item #5. The bank statement shows that $8 was added to the checking account on August 31 for interest earned by the company during the month of August.

Item #6. The bank statement shows that a note receivable of $1,000 was collected by the bank on August 29 and was deposited into the company's account. On the same day, the bank withdrew $40 from the company's account as a fee for collecting the note receivable.

Item #7. The company's cash account at the end of August shows a balance of $967.

Item #8. During the month of August the company wrote checks totaling more than $50,000. As of August 31 $3,021 of the checks written in August had not yet cleared the bank and $200 of checks written in June had not yet cleared the bank.

Item #9. The $1,450 of cash received by the company on August 31 was recorded on the company's books as of August 31. However, the $1,450 of cash receipts was deposited at the bank on the morning of September 1.

Item #10. On August 29 the company's Cash account shows cash sales of $145. The bank statement shows the amount deposited was actually $154. The company reviewed the transactions and found that $154 was the correct amount.

Balance per Bank Statement on Aug. 31, 2013	$ 3,490	***Item #1***
Adjustments:		
Deposits in transit	+ 1,450	***Item #9***
Outstanding checks	- 3,221	***item #8***
Bank errors	0	
Adjusted/Corrected Balance per Bank	**$ 1,719**	

Balance per Books on Aug. 31, 2013	$	967	***Item #7***
Adjustments:			
Bank service charges	-	35	***Item #2***
NSF checks & fees	-	110	***item #3***
Check printing charges	-	80	***item #4***
Interest earned	+	8	***item #5***
Note Receivable collected by bank	+	960	***item #6***
Errors in company's Cash account	+	9	***item #10***
Adjusted/Corrected Balance per Books	**$**	**1,719**	