COURSE TITLE: FINANCIAL ACCOUNTING

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CHAPTER 7: FRAUD, INTERNAL CONTROL, AND CASH

CHAPTER

7 | Fraud, Internal Control, and Cash

FRAUD, INTERNAL CONTROL, AND CASH

Fraud and Internal Control	Cash Controls	Control Features: Use of a Bank	Reporting Cash
• Fraud • Internal control • Principles of internal control activities • Limitations	• Cash receipts controls • Cash disbursements controls • Petty cash fund controls	• Making bank deposits • Writing checks • Bank statements • Reconciling the bank account • Electronic funds transfer (EFT) system	• Cash equivalents • Restricted cash

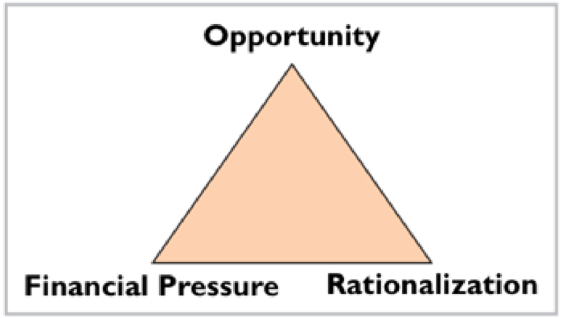
✔ The Navigator

UNDERSTANDING FRAUD

- **Fraud involves dishonest acts by employees that result in personal benefit at a cost to the employer.**
- **Common Types:** Misappropriation of assets, Fraudulent financial reporting etc.

❑ **Fraud Triangle:** The **three main factors that contribute to fraudulent activity** are depicted by the fraud triangle .

- **Opportunity:** Weaknesses in internal controls to determine and detect fraud.
- **Pressure:** caused by too much debt or, they might commit fraud because they want to lead a lifestyle that they cannot afford on their current salary..
- **Rationalization:** Justifying dishonest behavior.



Example: A bookkeeper in a small company diverted $750,000 of bill payments to a personal bank account over a three-year period. A shipping clerk with 28 years of service shipped $125,000 of merchandise to himself. exploiting weak internal controls.

INTERNAL CONTROL OVERVIEW

- Internal control is a process designed to provide reasonable assurance(high level of confidence but not absolute that audit finding or report is free from material misstatement) regarding the achievement of objectives related to operations, reporting, and compliance.

- Internal control comprises methods and measures adopted within an organization to :

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

- **Internal control systems have five primary components as listed below:**

- **Control Environment**
- **Risk Assessment**
- **Control Activities**
- **Information and Communication**
- **Monitoring**

INTERNAL CONTROL SYSTEMS

Internal control systems have five primary components as listed below:

- **Control Environment:** It is the responsibility of top management to make it clear that the **organization values integrity and that unethical activity will not be tolerated**.
- **Risk Assessment:** Companies must **identify and analyze the various risk factors** for the business and must determine how to manage these risks.
- **Control Activities:** To reduce the occurrence of fraud, management must **design policies and procedures to address the specific risks faced by the company**.
- **Information and Communication:** Ensuring **relevant information is communicated both down and up the organization,** as well as communicate information to appropriate external parties.
- **Monitoring:** Internal control systems must be **monitored periodically** for their adequacy.

SIX PRINCIPLES OF INTERNAL CONTROL ACTIVITIES

- ❑ Establishment of Responsibility
- ❑ Segregation of Duties
- ❑ Documentation Procedures
- ❑ Physical Controls
- ❑ Independent Internal Verification
- ❑ Human Resource Controls

SIX PRINCIPLES OF INTERNAL CONTROL ACTIVITIES

❑ **Establishment of Responsibility:**

- ➢ Assigning responsibility to specific employees.
- ➢ Establishing responsibility often requires limiting access only to authorized personnel, and then identifying those personnel.When one person is in charge of something, it's easier to know who is responsible if something goes wrong.
- ➢ **Example:** Only one employee is allowed to handle cash at the register. This way, if there's a mistake or missing money, it's easier to track.

❑ **Segregation of Duties:**

- ➢ Different individuals should be responsible for **related activities. It reduces the risk of errors or fraud if more than one person is involved.**
- ➢ For example, the personnel that design and program computerized systems should not be assigned duties related to day-to-day use of the system.

SIX PRINCIPLES OF INTERNAL CONTROL ACTIVITIES

❑ **Documentation Procedures:**

- ➢ Using prenumbered documents and accounting for all documents.
- ➢ It helps track transactions and makes sure nothing is missing or duplicated.
- ➢ **Example:** Sales receipts are numbered so if #104 is missing, you’ll notice.

❑ **Physical Controls:**

- ➢ Physical controls relate to the safeguarding assets through physical measures.
- ➢ Use locks, safes, cameras, or other physical tools to protect assets.
- ➢ **Example:**A company keeps cash in a locked safe and uses security cameras.

SIX PRINCIPLES OF INTERNAL CONTROL ACTIVITIES

- **Independent Internal Verification:**
  - This principle involves the r**eview of data prepared by employees**.Regular checks by independent personnel.
  - Someone not involved in the task double-checks the work.It adds a second layer of review to catch mistakes or fraud.
  - **Example:** A manager who doesn’t handle sales checks the daily sales report.
- **Human Resource Controls:**
  - Background checks and training for employees. Check employees before hiring and train them well. It helps hire trustworthy people and prepare them to do their jobs right.
  - **Example:**
    Before hiring, a company checks a person’s background and gives training on company rules.

LIMITATIONS OF INTERNAL CONTROL

Companies generally design their systems of internal control to provide reasonable assurance of proper safeguarding of assets and reliability of the accounting records.

- **Human Error:** Mistakes due to fatigue or misunderstanding.
- **Collusion:** Employees working together to bypass controls. Occasionally, two or more individuals may work together to get around prescribed controls. Such **collusion** can significantly reduce the effectiveness of a system, **eliminating the protection offered by segregation of duties**.
- **The size of the business:** it may also impose limitations on internal control. Small companies often find it difficult to segregate duties or to provide for independent internal verification. Cost of implementing controls may outweigh benefits.

BANK RECONCILIATION

- The bank and the depositor maintain independent records of the depositor’s checking account. It is assumed that the respective balances will always agree.
- In fact, the **two balances are seldom** the same at any given time, and both balances differ from the “correct” or “true” balance. Therefore, it is necessary to ensure the **company's cash records match the bank's records** this process is called **reconciling the bank account.**

❖**The need for agreement has two causes:**

1. **Time lags** that prevent one of the parties from recording the transaction in the same period as the other party.
2. **Errors** by either party in recording transactions.

Example: A company finds that its bank balance is higher due to unrecorded deposits.

RECONCILIATION PROCEDURE

The bank reconciliation should be prepared by an employee who has no other responsibilities pertaining to cash. The following steps should reveal all the reconciling items that cause the difference between the two balances.

Step 1. Deposits in transit. Compare the individual deposits listed on the bank statement with deposits in transit from the preceding bank reconciliation and with the deposits per company records or duplicate deposit slips. **Deposits recorded by the depositor that have not been recorded by the bank are the deposits in transit. Add these deposits to the balance per bank.**

Step 2. Outstanding checks. Compare the paid checks shown on the bank statement with (a) checks outstanding from the previous bank reconciliation, and (b) checks issued by the company as recorded in the cash payments journal (or in the check register in your personal checkbook). **Issued checks recorded by the company but that have not yet been paid by the bank are outstanding checks. Deduct outstanding checks from the balance per bank.**

RECONCILIATION PROCEDURE

Step 3. Errors. When you do a bank reconciliation, sometimes you find **mistakes**.

If **your company made a mistake** in recording an amount (like writing £169 instead of £196 for a check), **you need to fix it in your own records**. In this example, you would subtract £27 from your book balance to correct the error. These kinds of mistakes are called **depositor's errors** because they are errors you made in your records. On the other hand, if the **bank made a mistake** (like showing a wrong amount on your bank statement), that affects the bank's balance, not yours. These are called **bank errors**.

Step 4. Bank memoranda. Bank memoranda are notes or messages from the bank that tell you about fees or payments they made on your behalf. Bank memoranda tell you about money the bank took out or added to your account that you haven't recorded yet. When you do reconciliation, you update your books to include these changes. For example, **the company would deduct from the balance per books a £15 debit memorandum for bank service charges. Similarly, it would add to the balance per books £35 of interest earned.**

BANK RECONCILIATION ILLUSTRATED

- The bank statement for Laird Company plc in Illustration 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

- ✓ An **NSF check** stands for **"Non-Sufficient Funds"** check.
- ✓ It's a **check someone writes to you**, but when the bank tries to pay you, **there isn't enough money in the person's bank account to cover the check**. So, the check **bounces** or is **not honored** by the bank.

BANK RECONCILIATION ILLUSTRATED

LAIRD COMPANY plc Bank Reconciliation April 30, 2017		
Cash balance per bank statement		£ 15,907.45
Add: Deposits in transit		2,201.40
		18,108.85
Less: Outstanding checks		
No. 453	£3,000.00	
No. 457	1,401.30	
No. 460	1,502.70	5,904.00
Adjusted cash balance per bank		**£12,204.85**
Cash balance per books		£ 11,589.45
Add: Collection of note receivable £1,000, plus interest earned £50, less collection fee £15	£1,035.00	
Error in recording check no. 443	36.00	1,071.00
		12,660.45
Less: NSF check	425.60	
Bank service charge	30.00	455.60
Adjusted cash balance per books		**£12,204.85**

BANK RECONCILIATION

2. The information below relates to the Cash account in the ledger of Ansel A/S.

Balance June 1—€17,150; Cash deposited—€64,000.
Balance June 30—€17,704; Checks written—€63,746.

The June bank statement shows a balance of €16,422 on June 30 and the following memoranda.

Credits		Debits	
Collection of €1,500 note plus interest €30	€1,530	NSF check: Anne Adams	€425
Interest earned on checking account	€35	Safety deposit box rent	€55

At June 30, deposits in transit were €4,750, and outstanding checks totaled €2,383.

Instructions

(a) Prepare the bank reconciliation at June 30.
(b) Prepare the adjusting entries at June 30, assuming (1) the NSF check was from a customer on account, and (2) no interest had been accrued on the note.

Solution

2. (a)

ANSEL A/S
Bank Reconciliation
June 30

Cash balance per bank statement		€16,422
Add: Deposits in transit		4,750
		21,172
Less: Outstanding checks		2,383
Adjusted cash balance per bank		€18,789
Cash balance per books		€17,704
Add: Collection of note receivable (€1,500 + €30)	€1,530	
Interest earned	35	1,565
		19,269
Less: NSF check	425	
Safety deposit box rent	55	480
Adjusted cash balance per books		€18,789

(b)

June 30	Cash	1,530	
	Notes Receivable		1,500
	Interest Revenue		30
30	Cash	35	
	Interest Revenue		35
30	Accounts Receivable (Anne Adams)	425	
	Cash		425
30	Miscellaneous Expense	55	
	Cash		55

BANK RECONCILIATION

Assignment

E7-12, P7-3A