

Cash, Fraud, and Internal Control

Chapter 8

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Fundamental Accounting Principles
3rd Edition

Chapter 8 Learning Objectives

CONCEPTUAL

C1 Define internal control and identify its purpose and principles.

C2 Define cash and cash equivalents and explain how to report them.

ANALYTICAL

A1 Compute the days' sales uncollected ratio and use it to assess liquidity.

PROCEDURAL

P1 Apply internal control to cash receipts and payments.

P2 Explain and record petty cash fund transactions.

P3 Prepare a bank reconciliation.

P4 *Appendix 8A* Describe use of documentation and verification to control cash payments.

Learning Objective C1

Define internal control
and identify its purpose
and principles.

Internal Control System

Policies and procedures used to:

- Protect assets.
- Ensure reliable accounting.
- Promote efficient operations.
- Uphold company policies.

Principles of Internal Control

Internal control principles common to all companies:

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.

Internal Control: Establish Responsibilities

Establish responsibilities:

1. Tasks should be clearly established.
2. Tasks should be assigned to one person.
3. Can then determine who is at fault.

Internal Control: Maintain Adequate Records

Maintain Adequate Records:

1. Protects assets.
2. Helps managers monitor company activities.
3. Includes:
 1. Detailed records.
 2. Use of chart of accounts.
 3. Preprinted forms.
 4. Prenumbered sales slips.
 5. Computerized point-of-sale systems.

Internal Control: Insure Assets and Bond Key Employees

Insure Assets and Bond Key Employees:

1. Assets should be insured against losses.
2. Employees handling a lot of cash and other assets should be bonded.
3. Bonded means the company has purchased an insurance policy against theft by that employee.

Internal Control: Separate Recordkeeping from Custody of Assets

Separate Recordkeeping from Custody of Assets:

1. Person who controls or has access to assets must not have access to that asset's accounting records.
2. Reduces risk of theft or waste of an asset.
3. Employees would need to collude, agree in secret to commit fraud under this control.

Internal Control: Divide Responsibility for Related Transactions

Divide Responsibility for Related Transactions:

1. Responsibility for a transactions should be divided between two or more individuals.
2. Ensures work of one person acts as a check on the other to prevent fraud or errors.
3. Called separation of duties.

Internal Control: Apply Technological Controls

Apply Technological Controls:

1. Cash registers make an electronic file/record of each sale.
3. Time clock records exact time employee works.
4. Personal scanners limit access to authorized individuals.

Internal Control: Perform Regular and Independent Reviews

Perform Regular and Independent Reviews

1. Helps ensure that procedures are followed.
2. Preferably done by auditors not directly involved in the activities.
3. Auditors evaluate the efficiency and effectiveness of internal controls.

Discussion Question

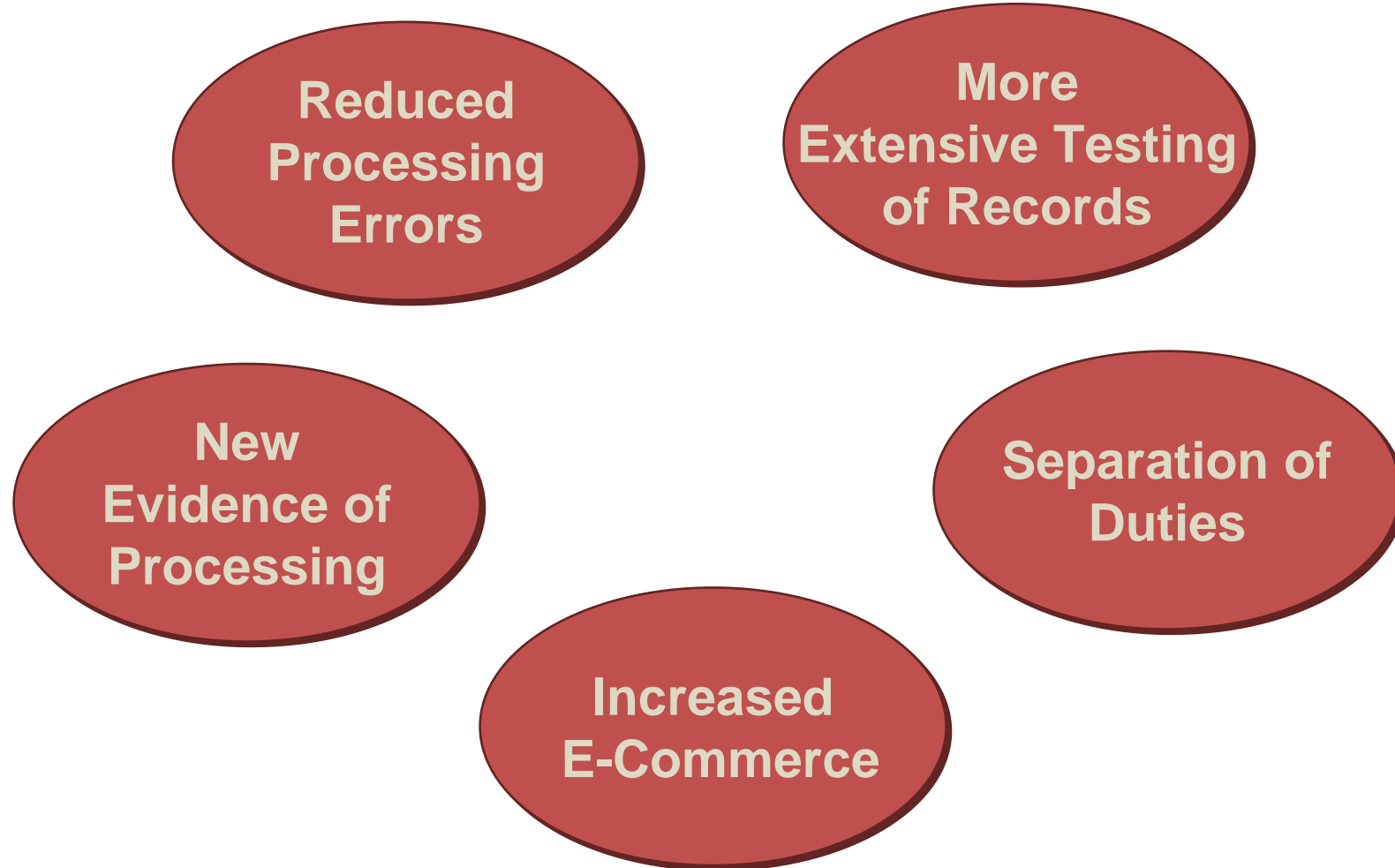
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Discussion Question

Q: Internal control procedures are important in every business, but at what stage in the development of a business do they become especially critical?

Internal control procedures become especially critical when the manager of a business can no longer control the business through personal supervision and direct participation.

Technology, Fraud, and Internal Control



Limitations of Internal Control

Human Error

Carelessness
Misjudgment
Confusion

Human Fraud

Intentionally
defeating internal
controls for
personal gain

Human fraud triple-threat:
Opportunity, Pressure, Rationalization

Cost-benefit principle: costs of internal controls
must not exceed their benefits.

Learning Objective C2

Define cash and cash equivalents and explain how to report them.

Control of Cash

An effective system of internal control that protects cash and cash equivalents should meet three basic guidelines:

Handling cash
is separated from
recordkeeping for
cash.

Cash receipts
are promptly
deposited in a
bank.

Cash disbursements
are made by check
or electronic funds
transfer.

Cash, Cash Equivalents, and Liquidity

Cash and similar assets are called liquid assets because they can be readily used to pay current liabilities.

Cash

Currency, coins, and deposits in bank accounts. Also includes items such as customer checks, cashier checks, certified checks, and money orders.

Cash Equivalents

Short-term, highly liquid investments that are:

1. Readily convertible to a known cash amount.
2. Insignificant risk of changes in value.

Cash Management

The goals of cash management are twofold:

1. Plan cash receipts to meet cash payments when due.
2. Keep a minimum level of cash necessary to operate.

Effective cash management involves applying the following cash management strategies:

- Encourage collection of receivables.
- Delay payment of liabilities.
- Keep only necessary assets.
- Plan expenditures.
- Invest excess cash.

Discussion Question

Q: Which of the following assets-- inventory, building, accounts receivable, or cash-- is most liquid? Which is less liquid?

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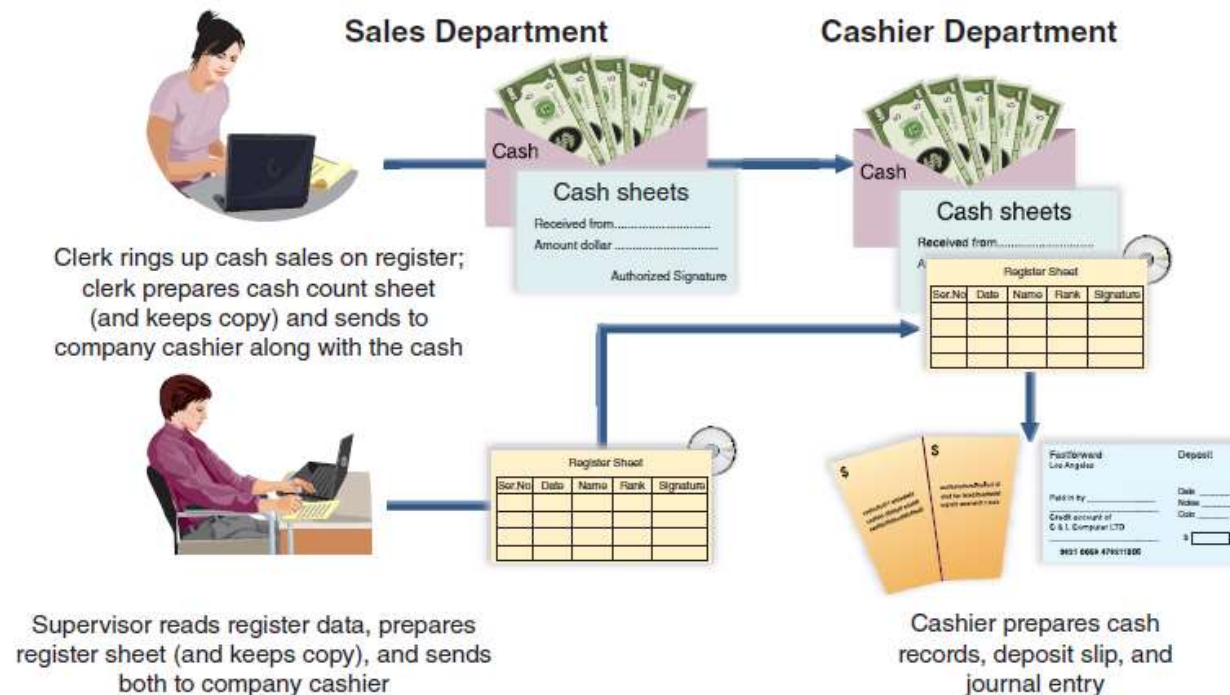
Cash is most liquid; and least liquid is a building. The four assets ordered from most to least liquid are: cash, accounts receivable, inventory, and building.

Learning Objective P1

Apply internal control to
cash receipts and
payments.

Over-the-Counter Cash Receipts

This graphic illustrates that none of the people involved can make a mistake or divert cash without the difference being revealed.



Cash Over and Short: Overage

Sometimes errors in making change are discovered from differences between the cash in the cash register and the record of the amount of cash receipts.

If a cash register's record shows \$550 but the count of cash in the register is \$555, we would prepare the following journal entry:

Cash.....	555	
Cash Over and Short		5
Sales.....		550
<i>Record cash sales and a cash overage.</i>		

Cash Over and Short: Shortage

Sometimes errors in making change are discovered from differences between the cash in the cash register and the record of the amount of cash receipts.

On the other hand, if a cash register's record shows \$625 but the count of cash in the register is \$621, the entry to record cash sales and its shortage is:

Cash.....	621	
Cash Over and Short.....	4	
Sales.....		625
<i>Record cash sales and a cash shortage.</i>		

Cash Receipts by Mail

Two people are assigned the task of opening the mail.

The cashier deposits the cash in a bank.

The recordkeeper records the amounts received in the accounting records.

Control of Cash Payments

Control of cash payments important as most large thefts are from payment of fictitious invoices.

Keys to Controlling Cash Payments:

- Require all payments to be made by check.
- Deny access to accounting records except for those who have the authority to sign checks.

Cash Budget:

- Includes projected cash receipts and cash disbursements.

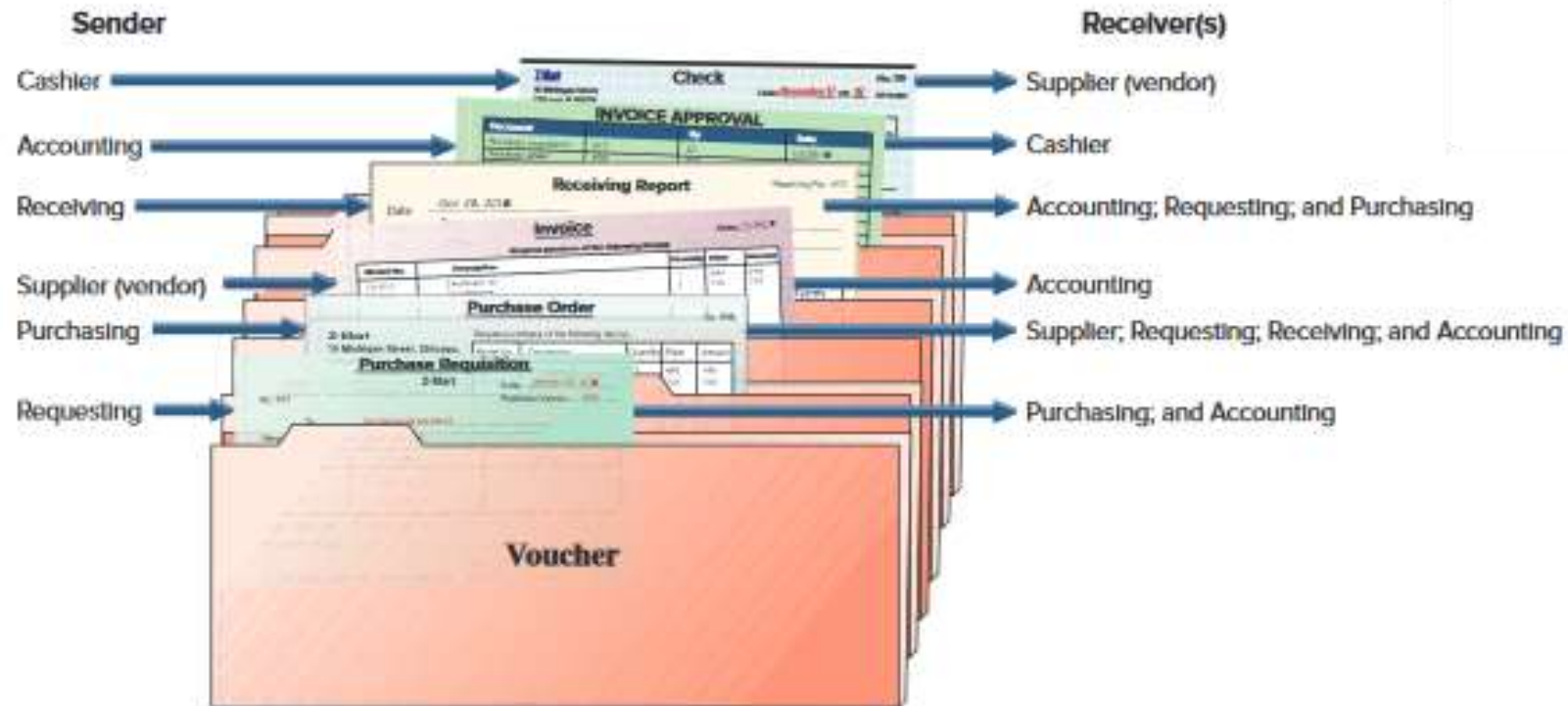
Voucher System of Control

A voucher system establishes procedures for:

1. Verifying, approving, and recording liabilities for eventual cash payments.
2. Issuing checks for payment of verified, approved, and recorded liabilities.

Voucher System of Control (continued)

Exhibit 8.1



Learning Objective P2

Explain and record petty cash fund transactions.

Petty Cash System of Control

Small payments for items such as:

- Shipping fees
- Minor repairs and
- Low-cost supplies

Operating a Petty Cash Fund

Nov. 1	Petty Cash	75	
	Cash		75
	<i>Establish a petty cash fund.</i>		

After the petty cash fund is established, the Petty Cash account is not debited or credited again unless the amount of the fund is changed.

Illustrating a Petty Cash Fund

Summary of petty cash receipts:

Exhibit
8.3

Petty Cash Payments Report		
Miscellaneous Expense		
Nov. 27	Tile cleaning	\$ 46.50
Merchandise Inventory (transportation-In)		
Nov. 5	Transport of merchandise purchased	15.05
Delivery Expense		
Nov. 18	Customer's package delivered	5.00
Office Supplies Expense		
Nov. 15	Purchase of office supplies immediately used	4.75
Total		<u>\$71.30</u>

Reimbursement of Petty Cash Fund

Cash payments report is used in making the journal entry to reimburse the fund.
Debit each of the expenses and credit Cash.

Nov. 27	Miscellaneous Expenses	46.50	
	Merchandise Inventory	15.05	
	Delivery Expense	5.00	
	Office Supplies Expense	4.75	
	Cash*		71.30
	<i>Reimburse petty cash. *\$75 fund bal. — \$3.70 cash remaining.</i>		

Increasing or Decreasing a Petty Cash Fund

To increase, debit Petty Cash and credit Cash.

Nov. 27	Petty Cash	25	
	Cash		25
	<i>Increase petty cash fund from \$75 to \$100.</i>		

To decrease, debit Cash and credit Petty Cash.

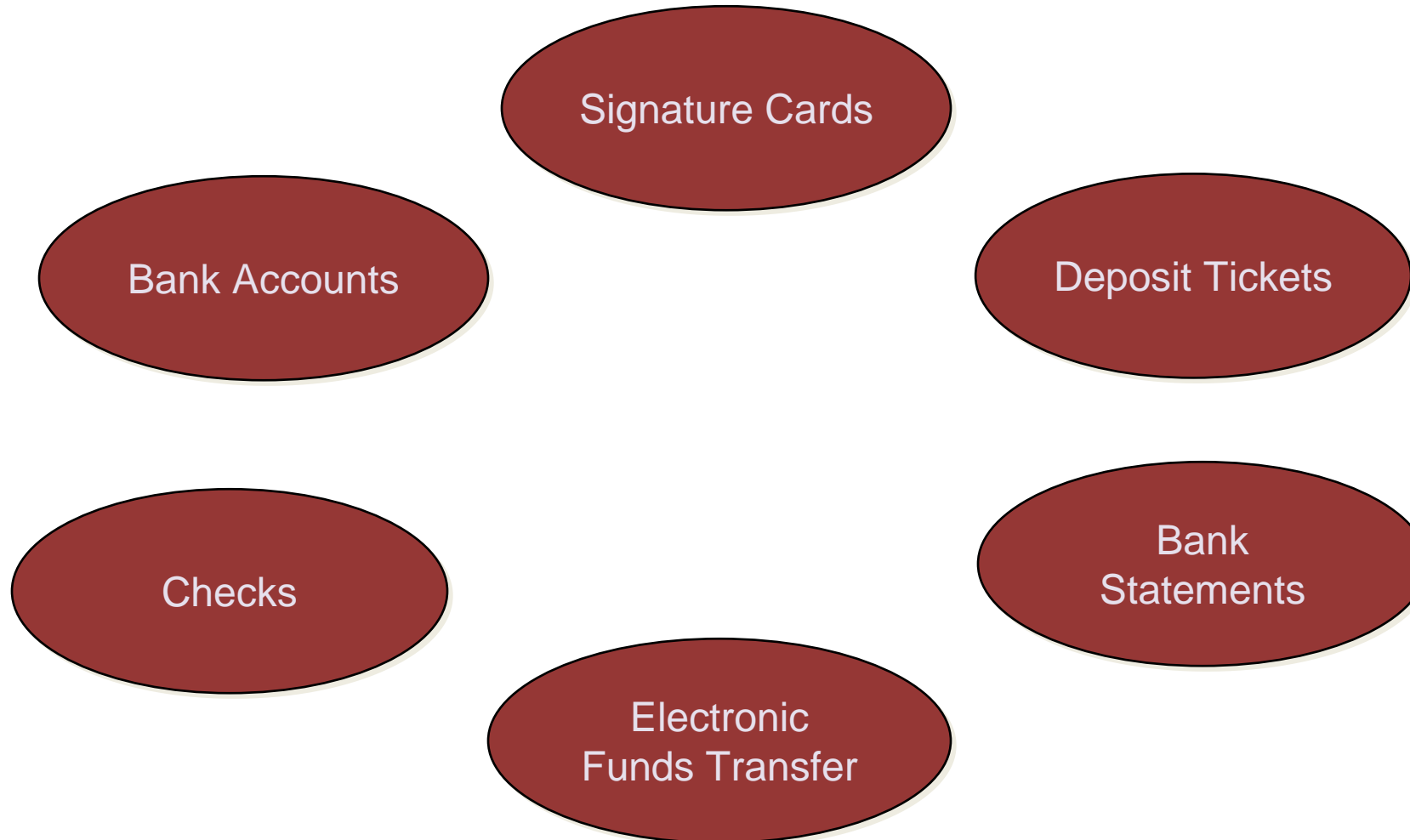
Nov. 27	Cash	20	
	Petty Cash		20
	<i>Decrease petty cash fund from \$75 to \$55.</i>		

Cash Over and Short

- If petty cashier fails to obtain a receipt for payment or overpays an amount, cash over or short will result.
- Petty cash payments report plus cash left in account will not equal the fund balance.
- Shortage: difference is debited to Cash Over and Short.
- Overage: difference is credited to Cash Over and Short.



Basic Bank Services



Deposit Ticket

1. Used to deposit money in the bank.
2. Lists cash and checks along with the amounts.
3. Serves as proof of deposit.

Exhibit 8.4

Front

DEPOSIT TICKET

Date October 2 20 21

VideoBuster Company
901 Main Street
Hillcrest, NY 11749

Deposit checks
(Memo)

FN First National
Hillcrest, New York 11750
1:01241049711: 457923 • 02 75

CASH	CURRENCY	36	50
	COIN		
LIST CHECKS SIMPLY			
TOTAL FROM OTHER SIDE		203	50
TOTAL		240	00
NET DEPOSIT		240	00

USE OTHER SIDE FOR ADDITIONAL LISTINGS. BE SURE EACH ITEM IS PROPERLY ENDORSED.

Back

CHECKS LIST SIMPLY	DOLLARS	CENTS
1 14-287/939	90	50
2 82-759/339	82	80
3 76-907/919	30	20
4		
5		
6		
7		
8		
9		
10		
11		
12		
13		
14		
TOTAL	203	50

ENTER TOTAL ON THE FRONT OF THIS TICKET

Check

1. Used to withdraw money from the bank.
2. Includes maker, signor of check; payee; and payer (bank).

Check
Maker → **VideoBuster Company**
901 Main Street
Hillcrest, NY 11749

No. 438
October 3 20 21 99-DT/101

Payee → Pay to the order of Hillcrest Lighting \$ 375.⁰⁰/₁₀₀
Three Hundred and Seventy-Five Dollars and ⁰⁰/₁₀₀ Dollars

Payer → **FN** First National
Hillcrest, New York 11750

Memo Store Lighting Design for

.0124104971. 457923 • 002438

Remittance Advice

Detach this portion before cashing

Date	Description	Gross Amount	Deductions	Net Amount
10-3-21	Lighting design, Invoice No. 4658	\$375.00	—	\$375.00

VideoBuster Company, Hillcrest, NY

Exhibit
8.5

Bank Statement

Usually once a month, the bank sends each depositor a bank statement showing the activity in the account.

FN First National
Hillcrest, New York 11750

Bank Statement
Member FDIC

VideoBuster Company
901 Main Street
Hillcrest, NY 11749

October 31, 2021
Statement Date

494 504 2
Account Number

Previous Balance	Total Checks and Debits	Total Deposits and Credits	Current Balance
1,610	723	1,163	2,050

Checks and Debits			Deposits and Credits	
Date	No.	Amount	Date	Amount
Oct. 3	121	375	Oct. 2	240
Oct. 12		23 DM	Oct. 15	100 EFT
Oct. 14	122	70	Oct. 16	330
Oct. 16	123	25 EFT	Oct. 23	485 CM
Oct. 23	125	15	Oct. 31	8 IN
Oct. 25		20 NSF 10 DM		
Oct. 26	127	185		

Symbols: **CM**—Credit Memo **EC**—Error Correction **NSF**—Non-Sufficient Funds **SC**—Service Charge
DM—Debit Memo **IN**—Interest Earned **EFT**—Electronic Funds Transfer **OD**—Overdraft

Exhibit
8.6

Learning Objective P3

Prepare a bank
reconciliation.

EFT – electronic fund transfer

- Automatic transfers from one bank account to another.
- Pre-arranged fund transfer by the company to make payment on some expenses:
- Example:
 - Monthly rental
 - Utilities bill
 - Advertising expense

Bank does not usually notify the company until end of the month. The amount shows on bank statements.

NSF checks – non sufficient fund

- When an NSF check occurs, the company has deposited a customer's check, but the customer did not have enough funds to cover the check. The company must adjust the balance of the cash account downward to reverse the increase in cash it recorded at the time of the deposit.
- Dr Cash
- Cr Accounts receivable
- But in fact the amount is not added to your bank
- Dr Accounts receivable
- Cr Cash

Bank Reconciliation

A bank reconciliation is prepared to explain differences between the checking account balance in the depositor's records and the balance on the bank statement.

Bank Balance Adjustments

Add deposits in transit.
Subtract outstanding checks.
Add or subtract corrections of bank errors.

Book Balance Adjustments

Add interest earned and unrecorded cash receipts.
Subtract bank fees and NSF checks.
Add or subtract corrections of book errors.

Note/EFT

- 1) VideoBuster's bank balance is \$2,050. VideoBuster's cash account book balance is \$1,405
- 2) VideoBuster's \$145 deposit in the bank's night depository on October 31 is not listed on its bank statement.
- 3) VideoBuster's comparison of canceled checks with its books shows two checks outstanding: No. 124 for \$150 and No. 126 for \$200.
- 4) VideoBuster's bank statement shows the bank collected a note receivable and increased VideoBuster's account for \$485. The bank statement also shows \$8 for interest earned that was not yet recorded on the books.
- 5) Deductions on VideoBuster's bank statement that are not yet recorded include (a) a \$23 charge for check printing and (b) an NSF check for \$30.

VIDEOBUSTER Bank Reconciliation October 31, 2021			
①	Bank statement balance	\$ 2,050	
②	Add		
	Deposit of Oct. 31 in transit	<u>145</u>	
		2,195	
③	Deduct		
	Outstanding checks		
	No. 124	\$150	
	No. 126	<u>200</u>	
		350	
④	Adjusted bank balance	<u>\$1,845</u>	
⑤	Book balance		\$ 1,405
⑥	Add		
	Collected note	\$485	
	Interest earned	<u>8</u>	
		493	
			1,898
	⑦ Deduct		
	Check printing charge	23	
	NSF check	<u>30</u>	
		53	
	⑧ Adjusted book balance		<u>\$1,845</u>
	Balances are equal (reconciled)		

Adjusting Entries from a Bank Reconciliation

Only items reconciling the book balance require adjustment.

Collection of Note

Oct. 31	Cash	485	
	Notes Receivable		485
	<i>Record note collected by bank.</i>		

Interest Earned

Oct. 31	Cash	8	
	Interest Revenue		8
	<i>Record interest earned in checking account.</i>		

Check Printing

Oct. 31	Miscellaneous Expenses	23	
	Cash		23
	<i>Check printing charge.</i>		

NSF Check

Oct. 31	Accounts Receivable—T. Woods	30	
	Cash		30
	<i>Charge Woods's account for \$30 NSF check.</i>		

Discussion Question

Q: What are the limitations of internal control?

Discussion Question

Q: What are the limitations of internal control?

The limitations of internal control arise from two sources: the human element (human error or human fraud) and the cost-benefit principle.

P 8-4A: The following information is available to reconcile Branch Company's book balance of cash with its bank statement cash balance as of July 31.

- a. On July 31, the company's Cash account has a \$27,497 debit balance, but its July bank statement shows a \$27,233 cash balance.
- b. Check No. 3031 for \$1,482, Check No. 3065 for \$382, and Check No. 3069 for \$2,281 are outstanding checks as of July 31.
- c. Check No. 3056 for July rent expense was correctly written and drawn for \$1,270 but was erroneously entered in the accounting records as \$1,250.
- d. The July bank statement shows the bank collected \$7,955 cash on a note for Branch. Branch had not recorded this event before receiving the statement.
- e. The bank statement shows an \$805 NSF check. This check had been received from a customer, Evan Shaw. Branch has not yet recorded this check as NSF.
- f. The July statement shows a \$25 bank service charge. It has not yet been recorded in miscellaneous expenses because no previous notification has been received.
- g. Branch's July 31 daily cash receipts of \$11,514 were placed in the bank's night depository on that date but do not appear on the July 31 bank statement.

Required:

- 1. Prepare the bank reconciliation for this company as of July 31.
- 2. Prepare the journal entries necessary to make the company's book balance of cash equal to the reconciled cash balance as of July 31.

P4-2A

a. On July 31, the company's Cash account has a \$27,497 debit balance, but its July bank statement shows a \$27,233 cash balance.

Branch Company

Bank Reconciliation

July 31

Bank statement Balance	\$27,233	Book Balance	\$27,497
------------------------	----------	--------------	----------

b. Check No. 3031 for \$1,482, Check No. 3065 for \$382, and Check No. 3069 for \$2,281 are outstanding checks as of July 31.

Branch Company

Bank Reconciliation

July 31

Bank statement Balance	\$27,233	Book Balance	\$27,497
------------------------	----------	--------------	----------

Deduct

Checks No. 3031	\$1,482
-----------------	---------

3065	382
------	-----

3069	2,281
------	-------

c. Check No. 3056 for July rent expense was correctly written and drawn for \$1,270 but was erroneously entered in the accounting records as \$1,250.

Branch Company

Bank Reconciliation

July 31

Bank statement Balance	\$27,233	Book Balance	\$27,497
------------------------	----------	--------------	----------

Deduct

Checks No. 3031	\$1,482
-----------------	---------

3065	382
------	-----

3069	2,281
------	-------

Deduct

Error (Check 3065) \$20

d. The July bank statement shows the bank collected \$7,955 cash on a note for Branch. Branch had not recorded this event before receiving the statement.

Branch Company
Bank Reconciliation

July 31

Bank statement Balance	\$27,233	Book Balance	\$27,497
------------------------	----------	--------------	----------

Add

Proceeds from note 7,955

Deduct

Checks No. 3031	\$1,482
-----------------	---------

3065	382
------	-----

3069	2,281
------	-------

Deduct

Error (Check 3065)	\$20
--------------------	------

e. The bank statement shows an \$805 NSF check. This check had been received from a customer, Evan Shaw. Branch has not yet recorded this check as NSF.

Branch Company
Bank Reconciliation

July 31

Bank statement Balance	\$27,233	Book Balance	\$27,497
		Add	
		Proceeds from note	7,955
Deduct		Deduct	
Checks No. 3031	\$1,482	Error (Check 3065)	\$20
3065	382	NSF	805
3069	2,281		

f. The July statement shows a \$25 bank service charge. It has not yet been recorded in miscellaneous expenses because no previous notification has been received.

Branch Company
Bank Reconciliation

July 31

Bank statement Balance	\$27,233	Book Balance	\$27,497
		Add	
		Proceeds from note	7,955
Deduct		Deduct	
Checks No. 3031	\$1,482	Error (Check 3065)	\$20
3065	382	NSF	805
3069	2,281	Service charge	25

g. Branch's July 31 daily cash receipts of \$11,514 were placed in the bank's night depository on that date but do not appear on the July 31 bank statement.

Branch Company
Bank Reconciliation
July 31

Bank statement Balance	\$27,233	Book Balance	\$27,497
Add		Add	
Deposits of July 31	11,514	Proceeds from note	7,955
Deduct		Deduct	
Checks No. 3031	\$1,482	Error (Check 3065)	\$20
3065	382	NSF	805
3069	2,281	Service charge	25

Branch Company

Bank Reconciliation

July 31

Bank statement Balance	\$27,233	Book Balance	\$27,497
Add		Add	
Deposits of July 31	11,514	Proceeds from note	\$7,955
Deduct		Deduct	
Checks No. 3031	\$1,482	Error (Check 3065)	\$20
3065	382	NSF	805
3069	2,281	Service charge	25
Adjusted bank balance	\$34,602	Adjusted book balance	\$34,602

BRANCH COMPANY Bank Reconciliation July 31			
Bank statement balance	\$27,233	Book balance	\$27,497
Add		Add	
Deposit of <u>July 31</u>	<u>11,514</u>	Proceeds from note	<u>7,955</u>
	38,747		35,452
Deduct		Deduct	
Checks No. 3031\$1,482		NSF check	\$ 805
3065 382		Service charge	25
3069 <u>2,281</u>	<u>4,145</u>	Error (Check 3056) ..	<u>20</u>
Adjusted bank balance	<u>\$34,602</u>	Adjusted book balance	<u>\$34,602</u>

P4-2A

Prepare the journal entries necessary to make the company's book balance of cash equal to the reconciled cash balance as of July 31.

BRANCH COMPANY
Bank Reconciliation
July 31

Bank statement balance	\$27,233	Book balance	\$27,497
Add		Add	
Deposit of July 31	<u>11,514</u>	Proceeds from note	<u>7,955</u>
	38,747		35,452
Deduct		Deduct	
Checks No. 3031\$1,482		NSF check	\$ 805
3065 382		Service charge	25
3069 <u>2,281</u>	<u>4,145</u>	Error (Check 3056).. <u>20</u>	<u>850</u>
Adjusted bank balance	<u>\$34,602</u>	Adjusted book balance	<u>\$34,602</u>

July 31

Dr. Cash	7,955	
Cr. Notes Receivable	7,955	
Dr. Accounts Receivable—E. Shaw	805	
Cr. Cash	805	
Dr. Miscellaneous Expenses	25	
Cr. Cash	25	
Dr. Rent Expense	20	
Cr. Cash	20	

End of Chapter 8