# CHAPTER 5

## DISCUSSION QUESTIONS

**1.** If a journal entry is for a legitimate expense, there will be an authentic document (e.g., a bill or invoice) from whoever was paid. If it is to cover up a theft of cash, either (1) there will be no source document to support the entry or (2) there will be a fictitious or forged document supporting the entry.

**2.** Revenues are usually overstated by creating fictitious receivables or by making an error that overstates receivables. When a receivable is debited, revenue is created. Total assets will be overstated if revenues are overstated.

**3.** There are five elements of a system of internal controls. Most important to accountants are (1) the control environment, and (2) control procedures.

**4.** Five different types of control procedures are (1) segregation of duties, (2) system of authorization, (3) documents and records, (4) physical safeguards, and (5) independent checks.

**5.** Among other activities, internal auditors independently evaluate the internal controls of an organization. One of the purposes of internal auditors is to provide integrity in financial reporting. Thus, by enhancing the internal controls, the credibility of financial statements is increased.

**6.** The purpose of a financial statement audit is to have independent, outside, competent individuals (CPAs) render an opinion on whether financial statements are prepared in accordance with GAAP and are fairly presented. Their opinion adds credibility to the financial statements.

**7.** Whether CPAs can be independent from the companies that they both audit and receive payment from is an issue that has long been debated. On the one hand, critics cannot point to very many cases where there was a true lack of independence that caused problems. On the other hand, there is a growing feeling that lack of independence is a problem. Recently, at the urging of the SEC, an Independence Standards Board was organized to deal with this issue.

**8.** The three types of business activities are operating activities, investing activities, and financing activities.

**9.** The purchase of inventory for resale to customers is classified as an operating activity rather than an investing activity because operating activities are associated with the primary purpose of a business. Purchasing inventory for resale is essential to selling a product. Investing activities are related to purchasing assets for use in the business.

**10.** Companies need more controls over cash than other assets because cash is the most liquid asset and the easiest one to lose and/or have stolen. It is very common to hear of cash being stolen, but very unusual to hear of major plant or intangible assets being misplaced.

**11.** The three most generally practiced controls for cash are:

**a.** Separation of the duties of accounting for and handling of cash.

**b.** Making daily deposits in a bank of all cash received.

**c.** Paying all obligations by prenumbered checks.

The purpose of all these controls is to protect and safeguard cash.

**12.** Some of the most common reasons for differences between bank balances and book balances are:

**a.** Outstanding checks.

**b.** Deposits in transit.

**c.** Errors by either the bank or the depositor.

**d.** Transactions that have been entered by the bank but not yet recorded by the company, such as (1) bank service charges, (2) collections for the company by the bank, (3) direct deposits, and (4) interest earned on the account.

**13.** Bank balance additions and deductions do not require adjusting entries because they are adjustments for the bank, not the depositor. Most adjustments (for example, deposits in transit and outstanding checks) take care of themselves over time, and the ones that do not (bank errors) are corrected by notifying the bank.

## PRACTICE EXERCISES

### PE 5–1 (LO4) Classifying Major Business Activities

Business Activity Type of Activity

a. Acquiring inventory for resale Operating

b. Buying and selling stocks and bonds of other companies Investing

c. Selling shares of stock to investors for cash Financing

d. Providing services to customers Operating

e. Buying property, plant, or equipment Investing

f. Acquiring and paying for other operating items Operating

g. Selling property, plant, or equipment Investing

h. Borrowing cash from creditors Financing

### PE 5–2 (LO4) Control of Cash

The correct answer is B. The specific balance in the cash account is usually not considered a control associated with cash. For any given company, the cash balance commonly falls well below the sum of inventory and accounts receivable.

### PE 5–3 (LO6) Bank Reconciliation

Balance per bank statement $ 61,000

Add: Deposits in transit 14,300

$ 75,300

Deduct: Outstanding checks (26,700)

Correct balance $ 48,600

Balance per books $ 48,680

Add: Interest earned 195

$ 48,875

Deduct: Bank service charge (275)

Correct balance $ 48,600

### PE 5–~~4~~ (LO6) Journal Entries from a Bank Reconciliation

Cash 195

Interest Revenue 195

Service Charge Expense 275

Cash 275

## EXERCISES

### E 5–1 (LO1) Accounting Errors––Transaction Errors

a. The asset account Equipment—Truck is understated by the cost of the truck. Maintenance Expense is overstated by the same amount. In the basic accounting equation, Assets and Equity are each understated. The overstated expense results in an understatement of income.

b. Cash is understated and Accounts Receivable is overstated. The accounting equation is not affected because both accounts are assets. Because no revenue or expense accounts are affected, income is not affected.

c. Accounts Receivable is overstated by the amount of the fictitious sales. Sales Revenue is also overstated by the same amount. In the accounting equation, Assets and Equity are both overstated. Because the revenue account is overstated, so is income.

d. Both Repairs Expense and Accounts Payable are understated by $300. In the accounting equation, Liabilities are understated and Equity is overstated. Income is overstated by $300 because of the expense understatement.

e. Unearned Revenue, a liability account, is understated by the amount of the prepayment received on December 31. Rent Revenue is overstated. In the accounting equation, Liabilities are understated and Equity is overstated. Income is overstated because of the revenue overstatement.

### E 5–2 (LO1) Errors in Financial Statements

Balance Sheet

Assets

Cash $ 2,600

Real estate properties (previously listed) 12,000,000

Property recorded as sold\* 3,600,000

Total assets $ 15,602,600

Liabilities

Accounts payable $ 200,000

Mortgage payable 12,000,000

Total liabilities $ 12,200,000

Equity

Capital stock $ 20,000

Retained earnings ($10,142,600– $6,760,000) 3,382,600

Total Equity $ 3,402,600

Total liabilities and Equity $ 15,602,600

\*$10,000,000 (sales price) – $6,400,000 (gain on sale) = $3,600,000 (property at cost)

Statement of Comprehensive Income

Revenues $ 0

Expenses 2,400,000

Net loss $(2,400,000)

Other comprehensive income 0

Comprehensive loss $(2,400,000)

*Note:* This is a real case where massive fraud was committed.

### E 5–3 (LO2) Internal Control Procedures

a. *Authorization*. The managers of the stores should follow the authorization policy and review all requests for large amounts of credit.

b. *Segregation of duties and independent checks on performance*. The bank reconciliation should be performed by a second individual, preferably someone not in the accounting department.

c. *Segregation of duties*. Various functions should be assigned to different people. If the record keeping and physical handling of inventory were performed by two separate individuals, the opportunity for theft would be greatly reduced.

d. *Adequate documents and records*. A well-designed document should be formatted so that it can be handled quickly and efficiently.

### E 5–4 (LO3) Internal Auditing—Staffing Internal Audits

Internal auditors should not be assigned to audit the activities they have previously performed. Internal auditors should be able to use professional judgment and objectivity in their work. Therefore, assignments should be made to avoid potential conflicts of interest. The standards for internal auditing state that situations like the one in this exercise are presumed to impair objectivity. When objectivity is impaired, the audit results are not reliable.

### E 5–5 (LO3) Internal Auditing

The correct answer is B. Internal auditors do not issue reports for external users regarding the reliability of the financial statements. Internal auditors cannot be relied on by outside parties to be objective. These reports are issued by external auditors because they are independent and presumed to be objective.

### E 5–6 (LO3) Internal Auditing—External Auditor’s Reliance on Internal Auditors

1. Internal auditors may have developed useful information that will help in the understanding of the internal control function. Internal auditors have two primary effects on the audit: (1) their existence and work may affect the nature, timing, and extent of audit procedures, and (2) CPAs may use internal auditors to provide direct assistance in performing procedures. For areas where there is high audit risk, the internal auditor’s work alone cannot eliminate the need for CPAs’ tests.

E 5–6 (LO3) (Continued)

2. The CPA should assess both the competence and objectivity of internal auditors. Competence is evaluated by considering education, experience, professional certification, audit policies, and various work policies. Objectivity is assessed by considering organizational status within the company and policies for assuring that internal auditors are objective with respect to the areas being audited. The level of management to which the internal auditors report affects the objectivity of the internal auditors.

### E 5–7 (LO3) External Auditors—Purpose of an Audit

The auditors’ report gives credibility to the financial statements. Auditors, as a group independent of management, should have an objective view and can report on a company’s activities without bias. Without a report from an independent auditor, a company’s financial statements would be less meaningful; the public would have little faith in financial statements issued by the inherently biased company.

### E 5–8 (LO3) Auditing Negligence

Of course, the case was much more complicated than portrayed in this exercise. However, it would be difficult for any auditor to observe the simultaneous counting of inventory at over 100 stores. Most auditors would select a few of the stores and observe the inventory counts at those stores. If the inventory-taking procedures seemed to be working well, they would assume that inventory-counting procedures throughout the entire company were acceptable. This exercise demonstrates the difficulty in performing a fraud-proof audit. In fact, audits can never detect all fraud.

E 5-9 (LO4) Control on Cash

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Procedure |  | IC Strength or Weakness |  | Related internal control principle |
| 1. |  | Weakness |  | Payment of all expenditures by prenumbered checks |
| 2. |  | Strength |  | Preparing a bank reconciliation regularly |
| 3. |  | Weakness |  | Separation of duties in handling of cash and accounting or cash |
| 4. |  | Strength |  | Separation of duties in handling of cash and accounting or cash |
| 5. |  | Strength |  | Daily deposit all cash receipts in banks |

E 5–10 (LO5) Purchases Discounts

Apr. 5

Inventory 52,500

Accounts Payable 52,500

Apr. 10

Accounts Payable 26,250

Cash 25,725

Inventory 525

Apr. 20

Accounts Payable 26,250

Cash 26,250

### E 5–11 (LO5) Purchases Returns and Allowance

Apr. 8

Accounts Payable 3,500

Inventory 3,500

Accounts Payable 300

Inventory 300

### E 5–12 (LO5) Payment for Various Expenses

July 1

Prepaid Insurance 36,000

Prepaid Rent 100,000

Cash 136,000

**July 5**

Miscellaneous Expense 1,500

Cash 1,500

**July 10**

Wages Payable 1,000,000

Cash 1,000,000

**July 31**

Rent Expense 100,000

Prepaid Rent 100,000

**Dec. 31**

Insurance Expense 18,000

Prepaid Insurance 18,000

### E 5–13 (LO5) Petty Cash Fund

**June 1**

Petty Cash 100

Cash 100

**June 30**

Postage Expense 10

Miscellaneous Expense 15

Freight-out 20

Office Supplies 8

Cash Over and Short 2

Cash 55

**July 1**

Petty Cash 20

Cash 20

### E 5–14 (LO6) Preparing a Bank Reconciliation

Bend Company

Bank Reconciliation

January 31, 2017

Balance per bank statement $204,008 Balance per books $228,909

*Additions to bank balance: Additions to book balance:*

Check in error 6,987 Interest earned 110

Deposits in transit 33,442

Total $244,437 Total $229,019

*Deductions from bank balance: Deductions from book balance:*

Outstanding checks (19,582) Service charges (64)

NSF check (4,100)

Adjusted bank balance $224,855 Adjusted book balance $224,855

### E 5–15 (LO6) Preparing a Bank Reconciliation

1. Derma Corporation

Bank Reconciliation

December 31, 2017

Balance per bank statement $87,450 Balance per books $81,200

*Additions to bank balance: Additions to book balance:*

Deposits in transit 5,000 Rent collected 1,000

Bank error 1,000 Note collected 2,300

Total $93,450 Total $84,500

*Deductions from bank balance: Deductions from book balance:*

Outstanding checks (9,200) NSF check returned (200)

Service charges (50)

Adjusted bank balance $84,250 Adjusted book balance $84,250

2. Cash 3,050

Accounts Receivable 200

Miscellaneous Expenses 50

Rent Revenue 1,000

Notes Receivable 2,000

Interest Revenue 300

*To record adjustments per the December bank*

*reconciliation.*

### E 5–16 (LO6) Reconciling Book and Bank Balances

1. Beginning balance $ 5,300

Deposits (September) 29,500

Less checks (September) (28,000)

Ending balance (cash account) $ 6,800

2. No additions are needed to the depositor's books.

3. NSF check $ 50

Bank service charge 10

Total deductions (depositor's books) $ 60

4. Deposits in transit ($29,500 – $27,000) $ 2,500

Cash on hand 200

Total additions (bank balance) $ 2,700

5. Outstanding checks ($28,000 – $27,300) $ 700

Total deductions (bank balance) $ 700

Jensen Company

Bank Reconciliation

September 30, 2017

Balance per bank statement $4,740 Balance per books $6,800

*Additions to bank balance:* *Additions to book balance:* 0

Deposits in transit 2,500\*

Cash on hand 200

Total $7,440 Total $6,800

*Deductions from bank balance: Deductions from book balance:*

Outstanding checks (700)\*\* NSF check (50)

Service charges (10)

Adjusted bank balance $6,740 Adjusted book balance $6,740

\* Deposits in transit=$29,500-$27,000=$2,500

\*\* Outstanding checks=$28,000-$27,300=$700

## PROBLEMS

P 5-1 (LO2) Internal Control Structure

**1. A 5. C**

**2. E 6. B**

**3. A**

**4. D**

### P 5–2 (LO4) Cash Fraud

1. This is an actual fraud case in a small bank that had severe internal control weaknesses. Obviously, Mac should not have:

(a) Been able to write checks and then reconcile the bank statement. There should have been a segregation of duties.

(b) Been the sole person approving exceptions to credit limits. As it turned out, Mac approved several exceptions to his personal loan limits and had extremely high personal loans and credit card balances.

(c) Had the internal auditors report to him. The internal auditors should report to someone other than the accounting personnel they are auditing. They usually report to a subset of the board of directors called the audit committee.

2. Mac perpetrated the fraud because he needed money. He was in extreme financial need because he was supporting two households and had made bad investments. In fact, at one point, Mac was paying alimony and child support greater than his take-home pay. Research shows that people commit fraud when they (1) face a nonshareable financial pressure, (2) perceive an opportunity to commit and conceal the dishonest act, and (3) find some way to rationalize the dishonest act as not being inconsistent with their personal code of ethics. Mac initially believed he was only “temporarily borrowing’’ to overcome a bad situation.

### P 5-3 (LO5) Accounting for Cash Payments, Petty Cash

**1. Petty cash should be replenished on a periodic basis or when the cash is low. It must be replenished on the statement of financial position date so that the expenses represented by the petty cash vouchers can be recorded in the proper accounting period.**

**2. Supplies 24.25**

**Postage Expense 50.00**

**Freight-Out 22.50**

**Meals Expense 31.25**

**Cash Over and Short 6**

**Cash 122**

**3. Petty Cash 50.00**

**Cash 50.00**

### P 5–4 (LO6) Preparing a Bank Reconciliation

1. Deposits in transit = $6,000.

The deposit for $6,000 recorded in the books on June 30 has not yet been recorded by the bank.

2. Outstanding checks = $2,660.

The checks written on June 26 ($1,300) and June 27 ($1,360) have not yet been cleared by the bank.

3. Milton Company

Bank Reconciliation

June 30, 2017

Balance per bank statement $30,390 Balance per books $29,190\*\*

*Additions to bank balance: Additions to book balance:*

Deposits in transit 6,000 Note collected by bank 4,140

Error in books 450

Total $36,390 Total $33,780

*Deductions from bank balance: Deductions from book balance:*

Outstanding checks (2,660) Service charges (50)

*Adjusted bank balance* $33,730 *Adjusted book balance* $33,730

\*\*$20,440 + $34,500 – $25,750 = $29,190

4. Cash 4,540

Miscellaneous Expenses 50

Notes Receivable 4,000

Interest Revenue 140

Supplies 450

*To record the adjustments per the June bank statement.*

5. If the cash account is not reconciled on a timely basis, adjustments such as those in item (4) will not be made and bank errors may not be discovered.

### P 5–5 (LO6) Determining Where the Cash Went

1. Amount suspected stolen is computed as follows:

Check #201 $38,400

Check #204 10,000

Check #205 8,116

Check #295 390

Suspected stolen $56,906

2. Kim accounted for the stolen money by overstating outstanding checks. The cover-up could have been prevented by having someone else reconcile the bank statement so there was a division of duties between writing checks (accounts payable) and reconciling the bank statement.

## ANALYTICAL ASSIGNMENTS

### AA 5–1 Auditing a Company

Discussion

The audit provided by Jones is very deficient. Jones was not completely independent in this case because of the promise to have the audit completed in two weeks to satisfy the bank loan procedure. Due professional care was not exercised in the performance of the audit. Certainly, the audit was not performed by a person having adequate technical training and proficiency as an auditor. It was inappropriate for Jones to hire the two students to conduct the audit. Indeed, the two students didn’t know how to conduct an audit and were only following instructions, which were not complete. The work was not adequately planned, and the assistants, the two students, were not properly supervised. Two hours of training is not sufficient; there should have been on-the-job supervision. The students were given no information concerning the internal control structure to be used in planning the audit and determining the extent of tests to be performed. Sufficient, competent evidence was not obtained. The report did not state that the financial statements were presented in accordance with GAAP. There were no informative disclosures (e.g., notes) with the financial statements.

### AA 5–2 *You Decide:* Which is more important—having a good system of internal controls or hiring honest employees?

Judgment Call

Issues to be discussed with this question are:

**1.** Both your uncle and your friend are partially right and partially wrong. Certainly, hiring employees with integrity is very important. In fact, it is one of the most important elements of the control environment.

**2.** However, the research shows very strongly that no one is above reproach and that anyone faced with the right pressures and opportunities can and will commit fraud. All it takes is a little rationalization such as “I’m only borrowing it and will pay it back,” or “You’d understand if you knew how badly I need it.” The reason a company has good internal control procedures or activities are to eliminate opportunities so that honest people won’t be tempted too much. Good controls make honest people better and dishonest people good.

**3.** Even so, however, you can never have perfect controls that will prevent and/or detect all fraud and that is why hiring honest employees is crucial.

### AA 5–3 *You Decide:* Can auditors rely on client personnel to assist them with their audit?

Judgment Call

Issues to be discussed with this question are:

* External auditors can use company employees to assist them with their work as long as they direct the work, plan what is going to be done, and make all decisions about what kind of audit evidence to gather. In this case, the client is trying to convince the auditor not to do something the auditor planned to do. The auditor should not accept the client’s representations because there could be fraud. To not look inside the containers would be relinquishing control of the audit to the client and that should never be done.

### AA 5–4 Philips

Real Company Analysis

**1. a.** Philips’ external auditor is KPMG Accountants N.V., a large international accounting firm.

**b.** KPMG completed the Philips audit for the fiscal year ended December 31, 2015, on February 23, 2016. Completion of the audit took 54 days. This was possible because all audit firms perform substantial tests on an ongoing basis throughout the year.

**2. a.** Philips’ management is responsible for Philips’ financial statements. This is an important point. The financial statements are *not* the responsibility of the external auditor; the external auditor is hired merely to verify the work of Philips in preparing the financial statements.

**b.** The paragraph on internal control says that Philips’ system of internal control is “a process designed to provide reasonable assurance” that transactions are properly recorded and that assets are safeguarded. As with any other system within a business, the system of internal control must meet a cost/benefit test. The interesting implication is that the appropriate amount of theft and fraud within a business is not zero because it simply costs too much to establish controls that will always safeguard all assets completely.

### AA 5–5 Circle K

Real Company Analysis

**1.** The fiscal year ended April 30, 1989, was a terrible one for Circle K. However, the auditor’s report for that year was a routine opinion without any qualifications. The 1989 audit report, by Arthur Andersen, states that “the financial statements … present fairly, in all material respects, the financial position of The Circle K Corporation … in conformity with generally accepted accounting principles.” The key insight here is that the audit report is not intended to be a red flag for investors that a company is in danger of bankruptcy. The audit report is simply a statement that the financial statements are a fair reflection of the company’s condition; any concerns must come from an investor’s examination of the financial statements themselves.

**2.** By the time the audit report for the year ended April 30, 1990, was completed (on July 25, 1990), Circle K was already deep into the proceedings associated with a Chapter 11 bankruptcy filing. Great uncertainty existed over whether the company would continue to exist, and if so, in what form. The auditor’s report, which goes on for seven paragraphs, states the following: “Because of the significance of the matters discussed in the preceding paragraphs, we are unable to express, and do not express, an opinion on the consolidated financial statements referred to above.” This is a disclaimer of opinion. Remember that one of the underlying assumptions of accrual accounting is the going concern assumption. Under this assumption, the accountant prepares the financial statements assuming that the company will continue to operate normally in the foreseeable future. For Circle K in 1990, this assumption was no longer valid; accounting procedures designed for normal circumstances were no longer guaranteed to give a fair representation of the company’s financial position. Accordingly, the auditor disclaimed an opinion on the financial statements.

### AA 5–6 Do the Financial Statements Give a True and Fair View?

International

**1.** TSMC’s 2015 audit report states: “In our opinion, the consolidated financial statements ... present fairly, in all material respects, the consolidated financial position of Taiwan Semiconductor Manufacturing Company Limited and subsidiaries… in conformity with the Regulations Governing the Preparation of Financial Reports by Securities Issuers, the International Financial Reporting Standards, International Accounting Standards interpretations as well as related guidance translated by Accounting Research and Development Foundation endorsed by the financial Supervisory Commission of the Republic of China with the effective dates.” This wording is usually interpreted to mean, “Yes, TSMC followed the accepted accounting rules.” So, to the extent that the accepted accounting rules provide a fair representation of the economic status of a company, TSMC’s financial statements give a “true and fair view.” However, the important point is that audit reports highlight a company’s compliance with the accounting rules, not the true and fair view.

**2.** Auditors in the United States are reluctant to submit to a “true and fair view” standard because it is an imprecise standard to support in court. Auditors are sued all of the time in the United States, much more so than in any other country. As such, U.S. auditors are interested in performing an audit that can be defended on the witness stand. It is much easier to convince the court that you verified whether a company followed generally accepted accounting principles than to convince the court that you verified that the financial statements gave a true and fair view.

### AA 5–7 Blowing the Whistle on Former Partners

Ethics

Ethically, the auditors would be torn between loyalty to their old friends and integrity to the standards of the audit profession. One further consideration is that in cases such as this, the mess invariably gets worse the longer it continues. In a sense, the auditors were doing their former partners/friends a favor by blowing the whistle early, rather than letting the fraud continue and worsen.

If the Chambers’ auditors had just ignored the accounting irregularities they found, their audit firm could have been liable for huge legal damages to be paid to misled shareholders in subsequent years when the truth was finally revealed. In addition, as word was finally revealed to the public that professionals at the audit firm had intentionally performed a poor audit in order to let their old partners get away with fraud, the reputation of the audit firm would have been badly damaged. It was clearly in the economic best interests of the audit firm for the auditors to blow the whistle.

The accounting announcement on March 17, 1992, was just the beginning of troubles for Chambers Development Company. Continuing business problems eventually forced the board of directors to put the company up for sale. Chambers was acquired by USA Waste on June 30, 1995.

## DISCUSSION QUESTIONS

**14.** The Public Company Accounting Oversight Board is charged with registering all public accounting firms that provide audits for public companies, establishing standards relating to the audit of those public companies, investigating and disciplining auditing firms when necessary, and enforcing compliance with the Sarbanes-Oxley Act.

**15.** Auditors are not allowed to provide certain nonaudit services for those companies that they audit. In addition, audit partners are required to rotate off an account every five years.

**16.** The Sarbanes-Oxley Act prohibits companies from making loans to their executive officers and directors.

SOLUTIONS TO “STOP & THINK”

***Stop & Think (p. 182):*** What could be done to ensure that errors, disagreements in judgment, and fraudulent financial reporting do not occur?

Numerous steps can be taken to minimize problems in the financial statements. Examples include establishing an internal control system to ensure that transactions are properly recorded and employing individuals to independently review the accounting system.

***Stop & Think (p. 188):*** What could auditors do to ensure that the financial reporting system in a company is working properly? Be specific.

Auditors would review the recording of transactions to ensure that the system is accounting for events properly. Auditors would physically verify that assets, such as buildings and inventory, exist. Auditors would also contact customers to verify account balances. This is just a partial list of the things that auditors, both internal and external, do to ensure that the financial reporting system is working properly.