**ACCT 101**

**LECTURE NOTES – CH. 6: CASH, FRAUD, AND INTERNAL CONTROLS**

A 2014 study by the Association of Certified Fraud Examiners found that the typical business loses 5% of revenues each year due to fraud, with the median loss at $145,000. The study translates this loss to a global figure of $3.7 trillion. To protect against these losses, companies must employ guidelines known as Internal Controls, which we will be studying in chapter 6. In addition, we will learn more about cash and cash equivalents, which need purposeful protection. Finally, we will study banking activities as a tool for businesses to control cash, and revisit bank reconciliations. Read the 2014 fraud article using the link below:

<https://quickbooks.intuit.com/r/trends-stats/fraud-statistics-every-business-should-know/>

**FRAUD AND INTERNAL CONTROL**

**What is fraud?**

The Association of Certified Fraud Examiners defines fraud broadly as “any crime for gain that uses deception as its principal modus operandus [mode of operation] …Consequently, fraud includes any intentional or deliberate act to deprive another of property or money by guile, deception, or other unfair means.”

**What is the purpose of an internal control system?**

Generally, small companies can be controlled by ownership or management through direct operational participation. However, as companies grow their operations so that revenues, product offers, or service geographies expand, direct operational participation becomes more difficult. To maintain managerial control and to prevent fraud in this new environment, companies install a system of internal controls to protect assets, ensure reliable accounting, promote efficient operations, and uphold company policies. By having an effective internal control system, companies can help prevent losses, plan operations, and monitor company and employee performance, and ensure compliance with external regulations.

The Sarbanes-Oxley Act (SOX) of 2002 is a regulation passed by the US Congress in the wake of large accounting scandals at major US corporations that cost investors billions of dollars in losses, and loss of confidence in accounting information. SOX requires managers and auditors of public companies to document and certify the system of internal controls. Specific requirements include:

* Executives and boards of directors must install effective internal controls
* Auditors must evaluate internal controls
* Violators receive harsh penalties including prison time and severe fines
* Auditors’ work is overseen by the Public Company Accounting Oversight Board (PCAOB)

**What are the principles of internal controls?**

Internal controls will vary from company to company, based on size and type of business the company is engaged in. Below are key principles:

* **Establish Responsibilities**: responsibility for a task is clearly assigned to one person so fault can be easily determined if a problem arises. Example: if two cashiers use the same cash it is hard to determine who was responsible for missing cash.
* **Maintain adequate records:** good recordkeeping that is reliable and detailed helps companies keep track of assets, and prevent theft. A chart of accounts will help ensure transactions are entered into correct accounts. Example: an updated asset register (listing of all assets labeled by asset number) helps track and tabulate assets book values, acquisition date, accumulated depreciation, etc.
* **Insure assets and bond key employees:** assets should be adequately insured. Bonding employees means purchasing an insurance policy against losses from theft by an employee; bonding is especially helpful if employees handle high value assets. Example: a business owner who employs a manager to make cash deposits should bond that manager in case the manager absconds with the cash.
* **Separate recordkeeping from Custody of Assets:** a person who controls or has access to an asset cannot have access to that asset’s accounting records. Example: an employee who uses a company car will refrain from personal use if mileage needs to be reported into the company.
* **Divide Responsibility for Related Transactions:** also called separation of duties, responsibilities for a process should be divided by two or more individuals or departments so that one can serve as a check for the other. Example: if supplies are needed, there should be separate employees who place the order, receive the supplies, and issue the check to the vendor.
* **Apply Technological Controls:** the use of technology can help implement internal control by providing objective measurements, observations, and recordings of business activities. Example: new cash registers are equipped with timers that measure the amount of time the till is left open, which alerts management about how long cash is exposed or if a cashier is repeatedly counting cash, an indicator of theft.
* **Perform Regular and Independent Review:** review conducted by auditors not directly involved with the activities. Auditors can be internal or external, announced or unannounced. Example: many companies have an internal audit department that regularly observes company activities and reports on adherence to company policies.

**What is the impact of technology on fraud and internal control?**

Firms are increasingly using more technology in their operations, data processing, and reporting capabilities, but the following impacts of that technology on fraud and internal control should be considered.

* **Reduced Processing Errors:** technologically advanced systems reduce but do not eliminate errors in processing information.
* **More Extensive Testing of Records:** larger samples of data can be tested when records are in electronic vs manual form.
* **Limited Evidence of Processing:** technologically advanced systems can provide additional information (besides what is in actual data), such as an electronic record of who made an entry, date and time, source of entry, etc.
* **Separation of Duties:** individuals with control over programs and files should not be individuals engaging in activities related to cash and disbursements.
* **Increased E-Commerce:** E-commerce requires companies to be aware of and be able to mitigate additional technological risks: 1) credit card number theft, 2) computer viruses, 3) identity theft.

**What are the limitations of Internal Control?**

Human element: people can intentionally try to defeat internal controls if opportunity, pressure, and rationalization coincide in a situation.

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

**CONTROL OF CASH**

**Cash, Cash Equivalents, and Liquidity**

* **Cash:** currency, coins, money in bank accounts such as deposits, checking, and savings accounts, checks (customers, cashiers, certified, money orders).
* **Cash equivalents:** short term, highly liquid investments that are 1) readily convertible to a known cash amount, and 2) securities with an original maturity of 3 months or less from date of purchase.
* **Liquidity:** refers to a company’s ability to pay for its near-term obligations; also refers to how quickly as asset can be converted to cash. By definition, cash is the most liquid asset.

**What is Cash Management?**

Cash management is effectively managing the receipt and payment of cash, so that two goals are achieved: 1) cash receipts are sufficient to meet cash payments when due, and 2) a minimum level of cash that is required to operate is kept. The following 5 principles of cash management should be applied by the company’s treasurer:

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

**Control of Cash Receipts**

Cash can be received in a variety of ways including cash sales, collections on customers’ accounts, bank loans, sale of assets, to name a few. Regardless of how cash is received, control of cash begins the moment it is received to ensure proper recording and depositing. Over-the-counter sales and receipt by mail are described below:

* Over-the-counter sales: sales should be entered using a permanent and secure cash register that locks in a record of each transaction. Separation of duties requires a clerk to turn in the cash to a company cashier, who prepares cash records, deposit slip, and journal entry. A supervisor compares sales records from the register with actual cash received, and investigates any variances.
* Cash receipts by mail: at least two people must open mail to prevent theft. Record of cash receipt should be given to three parties: people opening mail, cashier who receives the deposit, and the recordkeeper. Once money is deposited, the records of each should agree with amount counted by bank. Incorrect customer balances are a check against people opening mail, bank deposit not matching record of cash receipt is check against cashier, and recordkeeper does not have access to cash.
* Cash Over and Short: the following are journal entries to record cash over and short. The overage or shortage is determined by difference between sales record and cash.

**Overage:**

Dr. Cash

Cr. Cash Over and Short

Cr. Sales

**Shortage:**

Dr. Cash

Dr. Cash Over and Short

Cr. Sales

**Control of Cash Disbursements**

Cash disbursements must be controlled to ensure that monies paid are for legitimate obligations and for the correct amounts. A core principle of cash disbursement is that payments should be generated by check, so a record of disbursements is created. An exception to this rule is the petty cash system, which we will examine, and the voucher system of control.

* **Voucher System of Control:** set of procedures and approvals designed to control cash disbursements and acceptance of obligations. Below is a typical flow of activities involved when companies purchase goods.
* **Petty Cash System of Control:** system where small payments are made in cash for items such as postage, courier fees, low cost supplies, donuts for meetings, etc. to avoid the time and cost of writing checks.

**Establish petty cash fund:** in this step, a petty cashier holds the funds and will pay directly out of the fund for various expenses, and collecting receipts that explain the spending.

Dr. Petty Cash

Cr. Cash (main bank acct.)

**To record expenses paid with petty cash fund, and replenish:** this step requires the company cashier to examine the receipts from the petty cashier to verify the amount spent.

Dr. Misc. Exp.

Dr. Other Exp.

Cr. Cash

**To increase the petty cash fund: To decrease the petty cash fund:**

Dr. Petty Cash. Dr. Cash

Cr. Cash Cr. Petty Cash

The guided example below shows journal entries related to the petty cash fund:

<http://www.viddler.com/embed/8f875fbe/?f=1&autoplay=0&player=full&disablebranding=0%22%20width=%22694%22%20height=%22520%22%20frameborder=%220%22%3E%3C/iframe%3E>

**BANKING ACTIVITIES AS CONTROLS**

The primary activity to learn here is the bank reconciliation, which should be familiar to you due to its introduction in ACCT 100. Below is the basic format that bank reconciliations must follow. After reconciling, the adjusted bank balance should equal the adjusted book balance, providing the business with assurance that the difference between the balances are understood. Journal entries to correct the cash balance are only performed on the book side adjustments.



The following guided example shows a bank reconciliation:

<http://www.viddler.com/embed/5f754e37/?f=1&autoplay=0&player=full&disablebranding=0%22%20width=%22694%22%20height=%22520%22%20frameborder=%220%22%3E%3C/iframe%3E>

After the bank reconciliation is completed, the company’s accounting records must be adjusted for any reconciling item listed under “Book balance.” The following table summarizes many common items adjusted.

|  |  |
| --- | --- |
| *Reconciling item* | *Journal entry required* |
| Collection of note receivable by the bank, with a collection charge | Dr. Cash  Dr. Collection Expense       Cr. Notes Receivable |
| Check printing charges or bank fees | Dr. Miscellaneous Expense       Cr. Cash |
| NSF check from a customer, including any bank fees | Dr. Accounts Receivable – Customer       Cr. Cash |
| Interest earned | Dr. Cash       Cr. Interest Revenue |

**RATIO ANALYSIS**

Days’ sales uncollected is a measure of how quickly a company can collect it’s A/R into cash. Note the result is a measure of *days.*

Accounts Receivable

Days’ sales uncollected = --------------------------- x 365

Net sales

The following link shows the calculation for the days’ sales uncollected ratio:

<http://www.viddler.com/embed/773985d3/?f=1&autoplay=0&player=full&disablebranding=0%22%20width=%22694%22%20height=%22520%22%20frameborder=%220%22%3E%3C/iframe%3E>