CHAPTER 4

Internal Controls, Accounting for Cash, and Ethics

LEARNING OBJECTIVES

After you have mastered the material in this chapter, you will be able to:

1 Identify the key elements of a strong system of internal control.

2 Prepare a bank reconciliation.

3 Discuss the role of ethics in the accounting profession.

4 Describe the auditor's role in financial reporting.

CHAPTER OPENING

In the first three chapters, we covered the basics of the accounting system. By now you should understand how basic business events affect financial statements and how the accounting cycle works. Accounting is an elegant system that when implemented correctly provides meaningful information to investors and other stakeholders. However, without effective control, the accounting system can be manipulated in ways that may overstate business performance. This can lead investors to make bad decisions, which can result in huge losses when the true performance is revealed. This chapter discusses the importance of internal control systems. The chapter also discuses accounting for cash, an area where good internal controls are critical. The chapter concludes with a discussion on the importance of ethical conduct in the accounting profession.

The Curious Accountant

On December 11, 2008, Bernard Madoff was arrested on suspicion of having defrauded the clients of his investment company, **Bernard L. Madoff Investments** (BMI), of $50 billion. Later estimates would put the losses at over $60 billion. Although his clients believed the money they sent to BMI was being invested in the stock market, it was actually just being deposited into bank accounts.

Mr. Madoff was accused of operating the largest Ponzi scheme in history. Clients were sent monthly statements falsely showing that their investments were earning income and growing at a steady rate, even when the overall stock market was falling. When individual investors asked to withdraw their funds, they were simply given money that had been deposited by other investors.

This fraudulent system works as long as more new money is being deposited than is being withdrawn. Unfortunately for BMI, with the severe stock-market decline of 2008 too many clients got nervous and asked to withdraw their money, including the gains they believed they had earned over the years. At this point the Ponzi scheme failed.

How could such a pervasive fraud go undetected for so long? (Answer on page 136.)

KEY FEATURES OF INTERNAL CONTROL SYSTEMS

LO 1

Identify the key elements of a strong system of internal control.

During the early 2000s a number of accounting related scandals cost investors billions. In 2001, **Enron**'s share price went from \$85 to \$0.30 after it was revealed that the company had billions of dollars in losses that were not reported on the financial statements. Several months later, **WorldCom** reported an \$11 billion accounting fraud, which included hundreds of millions in personal loans to then CEO, Bernie Ebbers.

The Enron and WorldCom accounting scandals had such devastating effects that they led congress to pass the Sarbanes-Oxley Act of 2002 (SOX). SOX requires public companies to evaluate their *internal control* and to publish those findings with their SEC filings. **Internal control** is the process designed to ensure reliable financial reporting, effective and efficient operations, and compliance with applicable laws and regulations. Safeguarding assets against theft and unauthorized use, acquisition, or disposal is also part of internal control.

Section 404 of Sarbanes-Oxley requires a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting by public companies. This section includes an assessment of the controls and the identification of the framework used for the assessment. The framework established by The Committee of Sponsoring Organizations of the Treadway Commission (COSO) in 1992 is the de facto standard by which SOX compliance is judged. COSO's framework titled *Internal Control—An Integrated Framework* recognizes five interrelated components including:

1. *Control Environment.* The integrity and ethical values of the company, including its code of conduct, involvement of the board of directors, and other actions that set the tone of the organization.
2. *Risk Assessment.* Management's process of identifying potential risks that could result in misstated financial statements and developing actions to address those risks.
3. *Control Activities.* These are the activities usually thought of as "the internal controls." They include such things as segregation of duties, account reconciliations, and information processing controls that are designed to safeguard assets and enable an organization to timely prepare reliable financial statements.
4. *Information and Communication.* The internal and external reporting process, and includes an assessment of the technology environment.
5. *Monitoring.* Assessing the quality of a company's internal control over time and taking actions as necessary to ensure it continues to address the risks of the organization.

In 2004 COSO updated the framework to help entities design and implement effective enterprise-wide approaches to risk management. The updated document is titled *Enterprise Risk Management (ERM)—An Integrated Framework.* The ERM framework introduces an enterprise-wide approach to risk management as well as concepts such as risk appetite, risk tolerance, and portfolio view. While SOX applies only to U.S. public companies, the ERM framework has been adopted by both public and private organizations around the world.

The ERM framework does not replace the internal control framework. Instead, it incorporates the internal control framework within it. Accordingly, companies may decide to look to the ERM framework both to satisfy their internal control needs and to move toward a fuller risk management process.

While a detailed discussion of the COSO documents is beyond the scope of this text, the following overview of the more common *control activities* of the internal control framework is insightful.

Separation of Duties

The likelihood of fraud or theft is reduced if collusion is required to accomplish it. Clear **separation of duties** is frequently used as a deterrent to corruption. When duties are separated, the work of one employee can act as a check on the work of another employee. For example, a person selling seats to a movie may be tempted to steal money received from customers who enter the theater. This temptation is reduced if the person staffing the box office is required to issue tickets that a second employee collects as people enter the theater. If ticket stubs collected by the second employee are compared with the cash receipts from ticket sales, any cash shortages would become apparent. Furthermore, friends and relatives of the ticket agent could not easily enter the theater without paying. Theft or unauthorized entry would require collusion between the ticket agent and the usher who collects the tickets. Both individuals would have to be dishonest enough to steal, yet trustworthy enough to convince each other they would keep the embezzlement secret. Whenever possible, the functions of *authorization, recording,* and *custody of assets* should be performed by separate individuals.

Quality of Employees

A business is only as good as the people it employs. Cheap labor is not a bargain if the employees are incompetent. Employees should be properly trained. In fact, they should be trained to perform a variety of tasks. The ability of employees to substitute for one another prevents disruptions when co-workers are absent because of illnesses, vacations, or other commitments. The capacity to rotate jobs also relieves boredom and increases respect for the contributions of other employees. Every business should strive to maximize the productivity of every employee. Ongoing training programs are essential to a strong system of internal control.

Bonded Employees

The best way to ensure employee honesty is to hire individuals with *high levels of personal integrity.* Employers should screen job applicants using interviews, background checks, and recommendations from prior employers or educators. Even so, screening programs may fail to identify character weaknesses. Further, unusual circumstances may cause honest employees to go astray. Therefore, employees in positions of trust should be bonded. A **fidelity bond** provides insurance that protects a company from losses caused by employee dishonesty.

Required Absences

Employees should be required to take regular vacations and their duties should be rotated periodically. Employees may be able to cover up fraudulent activities if they are always present at work. Consider the case of a parking meter collection agent who covered the same route for several years with no vacation. When the agent became sick, a substitute collected more money each day than the regular reader usually reported. Management checked past records and found that the ill meter reader had been understating the cash receipts and pocketing the difference. If management had required vacations or rotated the routes, the embezzlement would have been discovered much earlier.

Procedures Manual

Appropriate accounting procedures should be documented in a **procedures manual.** The manual should be routinely updated. Periodic reviews should be conducted to ensure that employees are following the procedures outlined in the manual.

Authority and Responsibility

Employees are motivated by clear lines of authority and responsibility. They work harder when they have the authority to use their own judgment and they exercise reasonable caution when they are held responsible for their actions. Businesses should prepare an **authority manual** that establishes a definitive *chain of command.* The authority manual should guide both specific and general authorizations. **Specific authorizations** apply to specific positions within the organization. For example, investment decisions are authorized at the division level while hiring decisions are authorized at the departmental level. In contrast, **general authority** applies across different levels of management. For example, employees at all levels may be required to fly coach or to make purchases from specific vendors.

Prenumbered Documents

How would you know if a check were stolen from your check book? If you keep a record of your check numbers, the missing number would tip you off immediately. Businesses also use prenumbered checks to avoid the unauthorized use of their bank accounts. In fact, prenumbered forms are used for all important documents such as purchase orders, receiving reports, invoices, and checks. To reduce errors, prenumbered forms should be as simple and easy to use as possible. Also, the documents should allow for authorized signatures. For example, credit sales slips should be signed by the customer to clearly establish who made the purchase, reducing the likelihood of unauthorized transactions.

Physical Control

Employees walk away with billions of dollars of business assets each year. To limit losses, companies should establish adequate physical control over valuable assets. For example, inventory should be kept in a storeroom and not released without proper authorization. Serial numbers on equipment should be recorded along with the name of the individual who is responsible for the equipment. Unannounced physical counts should be conducted randomly to verify the presence of company-owned equipment. Certificates of deposit and marketable securities should be kept in fireproof vaults. Access to these vaults should be limited to authorized personnel. These procedures protect the documents from fire and limit access to only those individuals who have the appropriate security clearance to handle the documents.

In addition to safeguarding assets, there should be physical control over the accounting records. The accounting journals, ledgers, and supporting documents should be kept in a fireproof safe. Only personnel responsible for recording transactions in the journals should have access to them. With limited access, there is less chance that someone will change the records to conceal fraud or embezzlement.

Performance Evaluations

Because few people can evaluate their own performance objectively, internal controls should include independent verification of employee performance. For example, someone other than the person who has control over inventory should take a physical count of inventory. Internal and external audits serve as independent verification of performance. Auditors should evaluate the effectiveness of the internal control system as well as verify the accuracy of the accounting records. In addition, the external auditors attest to the company's use of generally accepted accounting principles in the financial statements.

Limitations

A system of internal controls is designed to prevent or detect errors and fraud. However, no control system is foolproof. Internal controls can be circumvented by collusion among employees. Two or more employees working together can hide embezzlement by covering for each other. For example, if an embezzler goes on vacation, fraud will not be reported by a replacement who is in collusion with the embezzler. No system can prevent all fraud. However, a good system of internal controls minimizes illegal or unethical activities by reducing temptation and increasing the likelihood of early detection.

CHECK YOURSELF 4.1

What are nine features of an internal control system?

Answer

The nine features follow.

1. Separating duties so that fraud or theft requires collusion.
2. Hiring and training competent employees.
3. Bonding employees to recover losses through insurance.

4. Requiring employees to be absent from their jobs so that their replacements can discover errors or fraudulent activity that might have occurred.
5. Establishing proper procedures for processing transactions.
6. Establishing clear lines of authority and responsibility.
7. Using prenumbered documents.
8. Implementing physical controls such as locking cash in a safe.
9. Conducting performance evaluations through independent internal and external audits.

ACCOUNTING FOR CASH

For financial reporting purposes, **cash** generally includes currency and other items that are payable *on demand,* such as checks, money orders, bank drafts, and certain savings accounts. Savings accounts that impose substantial penalties for early withdrawal should be classified as *investments* rather than cash. Postdated checks or IOUs represent *receivables* and should not be included in cash. As illustrated in Exhibit 4.1, most companies combine currency and other payable on demand items in a single balance sheet account with varying titles.

Companies must maintain a sufficient amount of cash to pay employees, suppliers, and other creditors. When a company fails to pay its legal obligations, its creditors can force the company into bankruptcy. Even so, management should avoid accumulating more cash than is needed. The failure to invest excess cash in earning assets reduces profitability. Cash inflows and outflows must be managed to prevent a shortage or surplus of cash.

Controlling Cash

Controlling cash, more than any other asset, requires strict adherence to internal control procedures. Cash has universal appeal. A relatively small suitcase filled with high-denomination currency can represent significant value. Furthermore, the rightful owner of currency is difficult to prove. In most cases, possession constitutes ownership. As a result, cash is highly susceptible to theft and must be carefully protected. Cash is most susceptible to embezzlement when it is received or disbursed. The following controls should be employed to reduce the likelihood of theft.

Cash Receipts

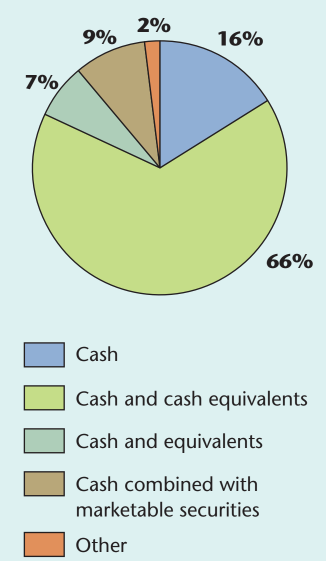
A record of all cash collections should be prepared immediately upon receipt. The amount of cash on hand should be counted regularly. Missing amounts of money can be detected by comparing the actual cash on hand with the book balance. Employees who receive cash should give customers a copy of a written receipt. Customers usually review their receipts to ensure they have gotten credit for the amount paid and call any errors to the receipts clerk's attention. This not only reduces errors but also provides a control on the clerk's honesty. Cash receipts should be deposited in a bank on a timely basis. Cash collected late in the day should be deposited in a night depository. Every effort should be made to minimize the amount of cash on hand. Keeping large amounts of cash on hand not only increases the risk of loss from theft but also places employees in danger of being harmed by criminals who may be tempted to rob the company.

Cash Payments

To effectively control cash, a company should make all disbursements using checks, thereby providing a record of cash payments. All checks should be prenumbered, and unused checks should be locked up. Using prenumbered checks allows companies to easily identify lost or stolen checks by comparing the numbers on unused and canceled checks with the numbers used for legitimate disbursements.

EXHIBIT 4.1

Balance Sheet Classifications That Include the Word Cash



Data Source: AICPA, *Accounting Trends and Techniques*.

REALITY BYTES

THE COST OF PROTECTING CASH

Could you afford to buy a safe like the one shown here? The vault is only one of many expensive security devices used by banks to safeguard cash. By using checking accounts, companies are able to avoid many of the costs associated with keeping cash safe. In addition to providing physical control, checking accounts enable companies to maintain a written audit trail of cash receipts and payments. Checking accounts represent the most widely used internal control device in modern society. It is difficult to imagine a business operating without the use of checking accounts.

The duties of approving disbursements, signing checks, and recording transactions should be separated. If one person is authorized to approve, sign, and record checks, he or she could falsify supporting documents, write an unauthorized check, and record a cover-up transaction in the accounting records. By separating these duties, the check signer reviews the documentation provided by the approving individual before signing the check. Likewise, the recording clerk reviews the work of both the approving person and the check signer when the disbursement is recorded in the accounting records. Thus writing unauthorized checks requires trilevel collusion.

Supporting documents with authorized approval signatures should be required when checks are presented to the check signer. For example, a warehouse receiving order should be matched with a purchase order before a check is approved to pay a bill from a supplier. Before payments are approved, invoice amounts should be checked and payees verified as valid vendors. Matching supporting documents with proper authorization discourages employees from creating phony documents for a disbursement to a friend or fictitious business. Also, the approval process serves as a check on the accuracy of the work of all employees involved.

Supporting documents should be marked *Paid* when the check is signed. If the documents are not indelibly marked, they could be retrieved from the files and resubmitted for a duplicate, unauthorized payment. A payables clerk could collude with the payee to split extra cash paid out by submitting the same supporting documents for a second payment.

All spoiled and voided checks should be defaced and retained. If defaced checks are not retained, an employee could steal a check and then claim that it was written incorrectly and thrown away. The clerk could then use the stolen check to make an unauthorized payment.

Checking Account Documents

The previous section explained the need for businesses to use checking accounts. A description of four main types of forms associated with a bank checking account follows.

Signature Card

A bank **signature card** shows the bank account number and the signatures of the people authorized to sign checks. The card is retained in the bank's files. If a bank employee is unfamiliar with the signature on a check, he or she can refer to the signature card to verify the signature before cashing the check.

Deposit Ticket

Each deposit of cash or checks is accompanied by a **deposit ticket,** which normally identifies the account number and the name of the account. The depositor lists the individual amounts of currency, coins, and checks, as well as the total deposited, on the deposit ticket.

Bank Check

A written check affects three parties: (1) the person or business writing the check (the *payer*); (2) the bank on which the check is drawn; and (3) the person or business to whom the check is payable (the *payee*). Companies often write **checks** using multicopy, prenumbered forms, with the name of the issuing business preprinted on the face of each check. A remittance notice is usually attached to the check forms. This portion of the form provides the issuer space to record what the check is for (e.g., what invoices are being paid), the amount being disbursed, and the date of payment. When signed by the person whose signature is on the signature card, the check authorizes the bank to transfer the face amount of the check from the payer's account to the payee.

Bank Statement

Periodically, the bank sends the depositor a **bank statement.** The bank statement is presented from the bank's point of view. Checking accounts are liabilities to a bank because the bank is obligated to pay back the money that customers have deposited in their accounts. Therefore, in the bank's accounting records a customer's checking account has a *credit* balance. As a result, **bank statement debit memos** describe transactions that reduce the customer's account balance (the bank's liability). **Bank statement credit memos** describe activities that increase the customer's account balance (the bank's liability). Since a checking account is an asset (cash) to the depositor, a *bank statement debit memo* requires a *credit entry* to the cash account on the depositor's books. Likewise, when a bank tells you that it has credited your account, you will debit your cash account in response.

Bank statements normally report (a) the balance of the account at the beginning of the period; (b) additions for customer deposits made during the period; (c) other additions described in credit memos (e.g., for interest earned); (d) subtractions for the payment of checks drawn on the account during the period; (e) other subtractions described in debit memos (e.g., for service charges); (f) a running balance of the account; and (g) the balance of the account at the end of the period. The sample bank statement in Exhibit 4.2 on the next page illustrates these items. Normally, the canceled checks or copies of them are enclosed with the bank statement.

RECONCILING THE BANK ACCOUNT

LO 2

Prepare a bank reconciliation.

Usually the ending balance reported on the bank statement differs from the balance in the depositor's cash account as of the same date. The discrepancy is normally attributable to timing differences. For example, a depositor deducts the amount of a check from its cash account when it writes the check. However, the bank does not deduct the amount of the check from the depositor's account until the payee presents it for payment, which may be days, weeks, or even months after the check is written. As a result, the balance on the depositor's books is lower than the balance on the bank's books. Companies prepare a **bank reconciliation** to explain the differences between the cash balance reported on the bank statement and the cash balance recorded in the depositor's accounting records.

Determining True Cash Balance

A bank reconciliation normally begins with the cash balance reported by the bank which is called the **unadjusted bank balance.** The adjustments necessary to determine the amount of cash that the depositor actually owns as of the date of the bank statement are then added to and subtracted from the unadjusted bank balance. The final total is the **true cash balance.** The true cash balance is independently reached a second time by making adjustments to the **unadjusted book balance.** The bank account is reconciled when the true cash balance determined from the perspective of the unadjusted

EXHIBIT 4.2

FIRST STATE BANK
of Frisco County

2121 Westbury Drive • Harrison, Nevada • 54269 - 0001

Green Shades Resorts, Inc
1439 Lazy Lane
Harrison, Nevada 54275 - 0023

Account Number
53-9872-3

Checking Account Summary	*On This Date*	*Your Balance Was*	*Deposits Added*	*No. Deposits*	*Checks Paid*	*No. Checks*
	8/31/2012	4,779.86	3,571.72	5	4,537.22	22
	Other Debits	*Resulting in a Balance of*		*On This Date*		*Enclosures*
	297.91	3,516.45		9/30/2012		29

Checks and Debits		*Deposits and Credits*	*Date*	*Balance*
15.82	24.85	600.25	9/3	5,339.44
249.08	497.00		9/5	4,593.36
42.53	124.61		9/7	4,426.22
79.87	859.38		9/8	3,486.97
685.00	742.59	711.43	9/9	2,770.81
25.75	38.98		9/12	2,706.08
36.45	59.91		9/14	2,609.72
	8.40 DM	940.00 CM	9/15	3,541.32
61.40		689.47	9/18	4,169.39
289.51 NS			9/19	3,879.88
71.59	82.00		9/21	3,726.29
312.87			9/24	3,413.42
25.00		630.57	9/27	4,018.99
227.00			9/28	3,791.99
95.06	180.48		9/30	3,516.45

LEGEND – NS Nonsufficient Funds • DM Debit Memo • CM Credit Memo

FIRST STATE BANK OF FRISCO COUNTY

bank balance agrees with the true cash balance determined from the perspective of the unadjusted *book* balance. The procedures a company uses to determine the *true cash balance* from the two different perspectives are outlined here.

Adjustments to the Bank Balance

A typical format for determining the true cash balance beginning with the unadjusted bank balance is

	Unadjusted bank balance
+	Deposits in transit
−	Outstanding checks
=	True cash balance

Deposits in transit. Companies frequently leave deposits in the bank's night depository or make them on the day following the receipt of cash. Such deposits are called **deposits in transit.** Because these deposits have been recorded in the depositor's accounting records but have not yet been added to the depositor's account by the bank, they must be added to the unadjusted bank balance.

Outstanding checks. These are disbursements that have been properly recorded as cash deductions on the depositor's books. However, the bank has not deducted the amounts from the depositor's bank account because the checks have not yet been presented by the payee to the bank for payment; that is, the checks have not cleared the bank. **Outstanding checks** must be subtracted from the unadjusted bank balance to determine the true cash balance.

Adjustments to the Book Balance

A typical format for determining the true cash balance beginning with the unadjusted book balance is as follows.

	Unadjusted book balance
+	Accounts receivable collections
+	Interest earned
−	Bank service charges
−	Non-sufficient-funds (NSF) checks
=	True cash balance

Accounts receivable collections. To collect cash as quickly as possible, many companies have their customers send payments directly to the bank. The bank adds the collection directly to the depositor's account and notifies the depositor about the collection through a credit memo that is included on the bank statement. The depositor adds the amount of the cash collections to the unadjusted book balance in the process of determining the true cash balance.

Interest earned. Banks pay interest on certain checking accounts. The amount of the interest is added directly to the depositor's bank account. The bank notifies the depositor about the interest through a credit memo that is included on the bank statement. The depositor adds the amount of the interest revenue to the unadjusted book balance in the process of determining the true cash balance.

Service charges. Banks frequently charge depositors fees for services performed. They may also charge a penalty if the depositor fails to maintain a specified minimum cash balance throughout the period. Banks deduct such fees and penalties directly from the depositor's account and advise the depositor of the deduction through a debit memo that is included on the bank statement. The depositor deducts such **service charges** from the unadjusted book balance to determine the true cash balance.

Non-sufficient-funds (NSF) checks. **NSF checks** are checks that a company obtains from its customers and deposits in its checking account. However, when the checks are submitted to the customers' banks for payment, the banks refuse payment because there is insufficient money in the customers' accounts. When such checks are returned, the amounts of the checks are deducted from the company's bank account balance. The company is advised of NSF checks through debit memos that appear on the bank statement. The depositor deducts the amounts of the NSF checks from the unadjusted book balance in the process of determining the true cash balance.

Correction of Errors

In the course of reconciling the bank statement with the cash account, the depositor may discover errors in the bank's records, the depositor's records, or both. If an error is found on the bank statement, an adjustment for it is made to the unadjusted bank balance to determine the true cash balance, and the bank should be notified immediately to correct its records. Errors made by the depositor require adjustments to the book balance to arrive at the true cash balance.

Certified Checks

A **certified check** is guaranteed for payment by a bank. Whereas a regular check is deducted from the customer's account when it is presented for payment, a certified check is deducted from the customer's account when the bank certifies that the check is good.

Certified checks, therefore, *have* been deducted by the bank in determining the unadjusted bank balance, whether they have cleared the bank or remain outstanding as of the date of the bank statement. Since certified checks are deducted both from bank and depositor records immediately, they do not cause differences between the depositor and bank balances. As a result, certified checks are not included in a bank reconciliation.

Illustrating a Bank Reconciliation

The following example illustrates preparing the bank reconciliation for Green Shades Resorts, Inc. (GSRI). The bank statement for GSRI is displayed in Exhibit 4.2. Exhibit 4.3 illustrates the completed bank reconciliation. The items on the reconciliation are described below.

Adjustments to the Bank Balance

As of September 30, 2012, the bank statement showed an unadjusted balance of $3,516.45. A review of the bank statement disclosed three adjustments that had to be made to the unadjusted bank balance to determine GSRI's true cash balance.

1. Comparing the deposits on the bank statement with deposits recorded in GSRI's accounting records indicated there was $724.11 of deposits in transit.
2. An examination of the returned checks disclosed that the bank had erroneously deducted a $25 check written by Green Valley Resorts from GSRI's bank account. This amount must be added back to the unadjusted bank balance to determine the true cash balance.
3. The checks returned with the bank statement were sorted and compared to the cash records. Three checks with amounts totaling $235.25 were outstanding.

After these adjustment are made GSRI's true cash balance is determined to be $4,030.31.

EXHIBIT 4.3

GREEN SHADES RESORTS, INC.
Bank Reconciliation
September 30, 2012

Unadjusted bank balance, September 30, 2012	$3,516.45
Add: Deposits in transit	724.11
Bank error: Check drawn on Green Valley Resorts charged to GSRI	25.00
Less: Outstanding checks	

Check No.	Date	Amount
639	Sept. 18	$ 13.75
646	Sept. 20	29.00
672	Sept. 27	192.50

Total	(235.25)
True cash balance, September 30, 2012	$4,030.31
Unadjusted book balance, September 30, 2012	$3,361.22
Add: Receivable collected by bank	940.00
Error made by accountant (Check no. 633 recorded as $63.45 instead of $36.45)	27.00
Less: Bank service charges	(8.40)
NSF check	(289.51)
True cash balance, September 30, 2012	$4,030.31

Adjustments to the Book Balance

As indicated in Exhibit 4.3, GSRI's unadjusted book balance as of September 30, 2012, was $3,361.22. This balance differs from GSRI's true cash balance because of four unrecorded accounting events:

1. The bank collected a $940 account receivable for GSRI.
2. GSRI's accountant made a $27 recording error.
3. The bank charged GSRI an $8.40 service fee.
4. GSRI had deposited a $289.51 check from a customer who did not have sufficient funds to cover the check.

Two of these four adjustments increase the unadjusted cash balance. The other two decrease the unadjusted cash balance. After the adjustments have been recorded, the cash account reflects the true cash balance of $4,030.31 ($3,361.22 unadjusted cash balance + $940.00 receivable collection + $27.00 recording error − $8.40 service charge − $289.51 NSF check). Because the true balance determined from the perspective of the bank statement agrees with the true balance determined from the perspective of GSRI's books, the bank statement has been successfully reconciled with the accounting records.

Updating GSRI's Accounting Records

Each of the adjustments to the book balance must be recorded in GSRI's financial records. The effects of each adjustment on the financial statements are as follows.

ADJUSTMENT 1 ***Recording the $940 receivable collection increases cash and reduces accounts receivable.***

The event is an asset exchange transaction. The effect of the collection on GSRI's financial statements is

Assets			=	Liab.	+	Equity	Rev.	−	Exp.	=	Net Inc.	Cash Flow
Cash	+	Accts. Rec.										
940	+	(940)	=	NA	+	NA	NA	−	NA	=	NA	940 OA

ADJUSTMENT 2 ***Assume the $27 recording error occurred because GSRI's accountant accidentally transposed two numbers when recording check no. 633 for utilities expense.***

The check was written to pay utilities expense of $36.45 but was recorded as a $63.45 disbursement. Since cash payments are overstated by $27.00 ($63.45 − $36.45), this amount must be added back to GSRI's cash balance and deducted from the utilities expense account, which increases net income. The effects on the financial statements are

Assets	=	Liab.	+	Equity	Rev.	−	Exp.	=	Net Inc.	Cash Flow
Cash	=			Ret. Earn.						
27	=	NA	+	27	NA	−	(27)	=	27	27 OA

ADJUSTMENT 3 ***The $8.40 service charge is an expense that reduces assets, stockholders' equity, net income, and cash.***

The effects are

Assets	=	Liab.	+	Equity	Rev.	−	Exp.	=	Net Inc.	Cash Flow
Cash	=			Ret. Earn.						
(8.40)	=	NA	+	(8.40)	NA	−	8.40	=	(8.40)	(8.40) OA

ADJUSTMENT 4 ***The $289.51 NSF check reduces GSRI's cash balance.***

When it originally accepted the customer's check, GSRI increased its cash account. Because there is not enough money in the customer's bank account to pay the check, GSRI didn't actually receive cash so GSRI must reduce its cash account. GSRI will still try to collect the money from the customer. In the meantime, it will show the amount of the NSF check as an account receivable. The adjusting entry to record the NSF check is an asset exchange transaction. Cash decreases and accounts receivable increases. The effect on GSRI's financial statements is

Assets			=	Liab.	+	Equity	Rev.	−	Exp.	=	Net Inc.	Cash Flow
Cash	+	Accts. Rec.										
(289.51)	+	289.51	=	NA	+	NA	NA	−	NA	=	NA	(289.51) OA

Answers to The Curious Accountant

As this chapter explains, separation of duties is one of the primary features of a good system of internal controls. However, separation of duties is not designed to detect fraud at the very top level of management. Mr. Madoff ran BMI with almost complete control; he had no boss.

Even with a good system of internal controls, there is always some level of trust required in business. Mr. Madoff had an excellent reputation in the investment community. He had even been the president of the NASDAQ. His investors trusted him and assumed they could depend on his independent auditor to detect any major problems with the way BMI was investing, or not investing, their money.

Federal prosecutors believe that BMI's auditor, David Friehling, did very little in the way of properly auditing BMI's books. In fact, on March 18, 2009, he also was arrested and charged with falsely certifying BMI's financial statements. He faces up to 105 years in prison if convicted.

On March 12, 2009, the 70-year-old Mr. Madoff pled guilty to 11 felony charges. On June 29, 2009, he was sentenced to a term of 150 years in prison.

CHECK YOURSELF 4.2

The following information was drawn from Reliance Company's October bank statement. The unadjusted bank balance on October 31 was $2,300. The statement showed that the bank had collected a $200 account receivable for Reliance. The statement also included $20 of bank service charges for October and a $100 check payable to Reliance that was returned NSF. A comparison of the bank statement with company accounting records indicates that there was a $500 deposit in transit and $1,800 of checks outstanding at the end of the month. Based on this information, determine the true cash balance on October 31.

Answer Since the unadjusted book balance is not given, start with the unadjusted bank balance to determine the true cash balance. The collection of the receivable, the bank service charges, and the NSF check are already recognized in the unadjusted bank balance, so these items are not used to determine the true cash balance. Determine the true cash balance by adding the deposit in transit to and subtracting the outstanding checks from the unadjusted bank balance. The true cash balance is $1,000 ($2,300 unadjusted bank balance + $500 deposit in transit − $1,800 outstanding checks).

IMPORTANCE OF ETHICS

LO 3

Discuss the role of ethics in the accounting profession.

The chapter began with a discussion of the importance of internal control systems in preventing accounting scandals. After the Enron and WorldCom scandals and the passage of the Sarbanes-Oxley Act, much more attention has been paid to establishing effective internal control systems. However, despite this increase in legislation and awareness, accounting scandals continue to occur. In 2008, **Lehman Brothers** declared bankruptcy after it was discovered that the company had kept more than $50 billion in loans off the balance sheet by classifying them as sales. Several months later, Bernie Madoff used a Ponzi scheme to leave his investors with more than $21.2 billion in cash losses. These examples illustrate that legislation alone will not prevent accounting scandals. To prevent a scandal it is necessary to develop a culture that fosters and promotes ethical conduct.

The accountant's role in society requires trust and credibility. Accounting information is worthless if the accountant is not trustworthy. Similarly, tax and consulting advice is useless if it comes from an incompetent person. The high ethical standards required by the profession state "a certified public accountant assumes an obligation of self-discipline above and beyond requirements of laws and regulations." The **American Institute of Certified Public Accountants** requires its members to comply with the **Code of Professional Conduct.** Section I of the Code includes six articles that are summarized in Exhibit 4.4. The importance of ethical conduct is universally recognized across a broad spectrum of accounting organizations. The Institute of Management Accountants requires its members to follow a set of Standards of Ethical Conduct. The Institute of Internal Auditors also requires its members to subscribe to the organization's Code of Ethics.

Common Features of Criminal and Ethical Misconduct

Unfortunately, it takes more than a code of conduct to stop fraud. People frequently engage in activities that they know are unethical or even criminal. The auditing profession has identified three elements that are typically present when fraud occurs.

1. The availability of an opportunity.
2. The existence of some form of pressure leading to an incentive.
3. The capacity to rationalize.

EXHIBIT 4.4

Articles of AICPA Code of Professional Conduct

Article I Responsibilities
In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities.

Article II The Public Interest
Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism.

Article III Integrity
To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity.

Article IV Objectivity and Independence
A member should maintain objectivity and be free of conflicts of interest in discharging professional responsibilities. A member in public practice should be independent in fact and appearance when providing auditing and other attestation services.

Article V Due Care
A member should observe the profession's technical and ethical standards, strive continually to improve competence and the quality of services, and discharge professional responsibility to the best of the member's ability.

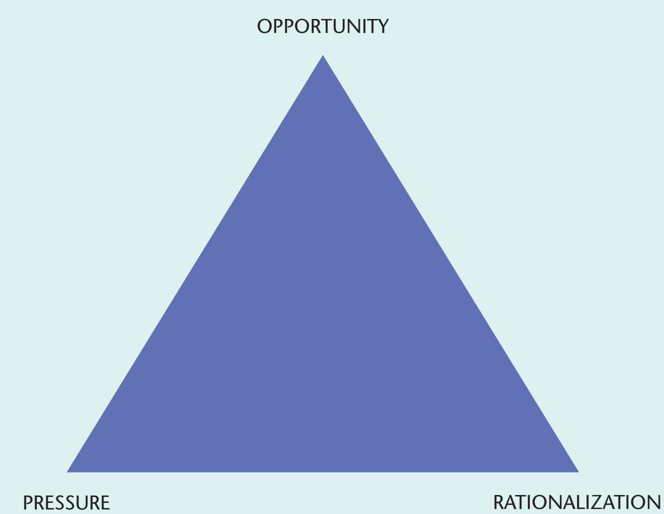
Article VI Scope and Nature of Services
A member in public practice should observe the principles of the Code of Professional Conduct in determining the scope and nature of services to be provided.

The three elements are frequently arranged in the shape of a triangle as shown in Exhibit 4.5.

Opportunity is shown at the head to the triangle because without opportunity fraud could not exist. The most effective way to reduce opportunities for ethical or criminal misconduct is to implement an effective set of internal controls. *Internal controls* are policies and procedures that a business implements to reduce opportunities

EXHIBIT 4.5

The Fraud Triangle



for fraud and to assure that its objectives will be accomplished. Specific controls are tailored to meet the individual needs of particular businesses. For example, banks use elaborate vaults to protect cash and safety deposit boxes, but universities have little use for this type of equipment. Even so, many of the same procedures are used by a wide variety of businesses. The internal control policies and procedures that have gained widespread acceptance are discussed in a subsequent chapter.

Only a few employees turn to the dark side even when internal control is weak and opportunities abound. So, what causes one person to commit fraud and another to remain honest? The second element of the fraud triangle recognizes **pressure** as a key ingredient of misconduct. A manager who is told "either make the numbers or you are fired" is more likely to cheat than one who is told to "tell it like it is." Pressure can come from a variety of sources.

- Personal vices such as drug addiction, gambling, and promiscuity.
- Intimidation from superiors.
- Personal debt from credit cards, consumer and mortgage loans, or poor investments.
- Family expectations to provide a standard of living that is beyond one's capabilities.
- Business failure caused by poor decision making or temporary factors such as a poor economy.
- Loyalty or trying to be agreeable.

The third and final element of the fraud triangle is **rationalization.** Few individuals think of themselves as evil. They develop rationalizations to justify their misconduct. Common rationalizations include the following.

- Everybody does it.
- They are not paying me enough. I'm only taking what I deserve.
- I'm only borrowing the money. I'll pay it back.
- The company can afford it. Look what they are paying the officers.
- I'm taking what my family needs to live like everyone else.

Most people are able to resist pressure and the tendency to rationalize ethical or legal misconduct. However, some people will yield to temptation. What can accountants do to protect themselves and their companies from unscrupulous characters? The answer lies in personal integrity. The best indicator of personal integrity is past performance. Accordingly, companies must exercise due care in performing appropriate background investigations before hiring people to fill positions of trust.

Ethical misconduct is a serious offense in the accounting profession. A single mistake can destroy an accounting career. If you commit a white-collar crime, you normally lose the opportunity to hold a white-collar job. Second chances are rarely granted; it is extremely important that you learn how to recognize and avoid the common features of ethical misconduct. To help you prepare for the real-world situations you are likely to encounter, we include ethical dilemmas in the end-of-chapter materials. When working with these dilemmas, try to identify the (1) opportunity, (2) pressure, and (3) rationalization associated with the particular ethical situation described. If you are not an ethical person, accounting is not the career for you.

ROLE OF THE INDEPENDENT AUDITOR

LO 4

Describe the auditor's role in financial reporting.

As previously explained, financial statements are prepared in accordance with certain rules called *generally accepted accounting principles (GAAP)*. Thus, when General Electric publishes its financial statements, it is saying, "here are our financial statements prepared according to GAAP." How can a financial analyst know that a company really did follow GAAP? Analysts and other statement users rely on **audits** conducted by **certified public accountants (CPAs).**

The primary roles of an independent auditor (CPA) are summarized below:

1. Conducts a financial audit (a detailed examination of a company's financial statements and underlying accounting records).
2. Assumes both legal and professional responsibilities to the public as well as to the company paying the auditor.
3. Determines if financial statements are *materially* correct rather than *absolutely* correct.
4. Presents conclusions in an audit report that includes an opinion as to whether the statements are prepared in conformity with GAAP. In rare cases, the auditor issues a disclaimer.
5. Maintains professional confidentiality of client records. The auditor is not, however, exempt from legal obligations such as testifying in court.

The Financial Statement Audit

What is an audit? There are several types of audits. The type most relevant to this course is a **financial statement audit,** often referred to as simply a financial audit. The financial audit is a detailed examination of a company's financial statements and the documents that support those statements. It also tests the reliability of the accounting system used to produce the financial reports. A financial audit is conducted by an **independent auditor.**

The term *independent auditor* typically refers to a *firm* of certified public accountants. CPAs are licensed by state governments to provide services to the public. They are to be as independent of the companies they audit as is reasonably possible. To help assure independence, CPAs and members of their immediate families may not be employees of the companies they audit. Further, they cannot have investments in the companies they audit. Although CPAs are paid by the companies they audit, the audit fee may not be based on the outcome of the audit.

Although the independent auditors are chosen by, paid by, and can be fired by their client companies, the auditors are primarily responsible to *the public.* In fact, auditors have a legal responsibility to those members of the public who have a financial interest in the company being audited. If investors in a company lose money, they sometimes sue the independent auditors in an attempt to recover their losses, especially if the losses were related to financial failure. A lawsuit against auditors will succeed only if the auditors failed in their professional responsibilities when conducting the audit. Auditors are not responsible for the success or failure of a company. Instead, they are responsible for the appropriate reporting of that success or failure. While recent debacles such as Bernard Madoff Investments produce spectacular headlines, auditors are actually not sued very often, considering the number of audits they perform.

Materiality and Financial Audits

Auditors do not guarantee that financial statements are absolutely correct—only that they are free from *material* misstatements. This is where things get a little fuzzy. What is a *material misstatement?* The concept of materiality is very subjective. If **ExxonMobil** inadvertently overstated its sales by $1 million, would this be material? In 2009, ExxonMobil had approximately $311 billion of sales! A $1 million error in computing sales at ExxonMobil is like a $1 error in computing the pay of a person who makes $311,000 per year—not material at all! An error, or other reporting problem, is **material** if knowing about it would influence the decisions of an *average prudent investor.*

Financial audits are not directed toward the discovery of fraud. Auditors are, however, responsible for providing *reasonable assurance* that statements are free from material misstatements, whether caused by errors or fraud. Also, auditors are responsible for evaluating whether internal control procedures are in place to help prevent material misstatements due to fraud. If fraud is widespread in a company, normal audit procedures should detect it.

Accounting majors take at least one and often two or more courses in auditing to understand how to conduct an audit. An explanation of auditing techniques is beyond the scope of this course, but at least be aware that auditors do not review how the company accounted for every transaction. Along with other methods, auditors use statistics to choose representative samples of transactions to examine.

Types of Audit Opinions

Once an audit is complete, the auditors present their conclusions in a report that includes an *audit opinion.* There are three basic types of audit opinions.

An **unqualified opinion,** despite its negative-sounding name, is the most favorable opinion auditors can express. It means the auditor believes the financial statements are in compliance with GAAP without qualification, reservation, or exception. Most audits result in unqualified opinions because companies correct any reporting deficiencies the auditors find before the financial statements are released.

The most negative report an auditor can issue is an **adverse opinion.** An adverse opinion means that one or more departures from GAAP are so material that the financial statements do not present a fair picture of the company's status. The auditor's report explains the unacceptable accounting practice(s) that resulted in the adverse opinion being issued. Adverse opinions are very rare because public companies are required by law to follow GAAP.

A **qualified opinion** falls between an unqualified and an adverse opinion. A qualified opinion means that for the most part, the company's financial statements are in compliance with GAAP, but the auditors have reservations about something in the statements. The auditors' report explains why the opinion is qualified. A qualified opinion usually does not imply a serious accounting problem, but users should read the auditors' report and draw their own conclusions.

If an auditor is unable to perform the audit procedures necessary to determine whether the statements are prepared in accordance with GAAP, the auditor cannot issue an opinion on the financial statements. Instead, the auditor issues a **disclaimer of opinion.** A disclaimer means that the auditor is unable to obtain enough information to confirm compliance with GAAP.

Regardless of the type of report they issue, auditors are only expressing their judgment about whether the financial statements present a fair picture of a company. They do not provide opinions regarding the investment quality of a company.

The ultimate responsibility for financial statements rests with the executives of the reporting company. Just like auditors, managers can be sued by investors who believe they lost money due to improper financial reporting. This is one reason all business persons should understand accounting fundamentals.

Confidentiality

The **confidentiality** rules in the AICPA's code of ethics for CPAs prohibits auditors from *voluntarily disclosing* information they have acquired as a result of their accountant-client relationships. However, accountants may be required to testify in a court of law. In general, federal law does not recognize an accountant-client privilege as it does with attorneys and clergy. Some federal courts have taken exception to this position, especially as it applies to tax cases. State law varies with respect to accountant-client privilege. Furthermore, if auditors terminate a client relationship because of ethical or legal disagreements and they are subsequently contacted by a successor auditor, they are required to inform the successor of the reasons for the termination. In addition, auditors must consider the particular circumstances of a case when assessing the appropriateness of disclosing confidential information. Given the diverse legal positions governing accountant-client confidentiality, auditors should seek legal counsel prior to disclosing any information obtained in an accountant-client relationship.

To illustrate, assume that Joe Smith, CPA, discovers that his client Jane Doe is misrepresenting information reported in her financial statements. Smith tries to convince Doe to correct the misrepresentations, but she refuses to do so. Smith is required by the code of ethics to terminate his relationship with Doe. However, Smith is not permitted to disclose Doe's dishonest reporting practices unless he is called on to testify in a legal hearing or to respond to an inquiry by Doe's successor accountant.

With respect to the discovery of significant fraud, the auditor is required to inform management at least one level above the position of the employee who is engaged in the fraud and to notify the board of directors of the company. Suppose that Joe Smith, CPA, discovers that Jane Doe, employee of Western Company, is embezzling money from Western. Smith is required to inform Doe's supervisor and to notify Western's board of directors. However, Smith is prohibited from publicly disclosing the fraud.

<< A Look Back

The policies and procedures used to provide reasonable assurance that the objectives of an enterprise will be accomplished are called *internal controls.* While the mechanics of internal control systems vary from company to company, the more prevalent features include the following.

1. *Separation of duties.* Whenever possible, the functions of authorization, recording, and custody should be exercised by different individuals.
2. *Quality of employees.* Employees should be qualified to competently perform the duties that are assigned to them. Companies must establish hiring practices to screen out unqualified candidates. Furthermore, procedures should be established to ensure that employees receive appropriate training to maintain their competence.
3. *Bonded employees.* Employees in sensitive positions should be covered by a fidelity bond that provides insurance to reimburse losses due to illegal actions committed by employees.
4. *Required absences.* Employees should be required to take extended absences from their jobs so that they are not always present to hide unscrupulous or illegal activities.
5. *Procedures manual.* To promote compliance, the procedures for processing transactions should be clearly described in a manual.
6. *Authority and responsibility.* To motivate employees and promote effective control, clear lines of authority and responsibility should be established.
7. *Prenumbered documents.* Prenumbered documents minimize the likelihood of missing or duplicate documents. Prenumbered forms should be used for all important documents such as purchase orders, receiving reports, invoices, and checks.
8. *Physical control.* Locks, fences, security personnel, and other physical devices should be employed to safeguard assets.
9. *Performance evaluations.* Because few people can evaluate their own performance objectively, independent performance evaluations should be performed. Substandard performance will likely persist unless employees are encouraged to take corrective action.

Because cash is such an important business asset and because it is tempting to steal, much of the discussion of internal controls in this chapter focused on cash controls. Special procedures should be employed to control the receipts and payments of cash. One of the most common control policies is to use *checking accounts* for all payments except petty cash disbursements.

A *bank reconciliation* should be prepared each month to explain differences between the bank statement and a company's internal accounting records. A common reconciliation format determines the true cash balance based on both bank and book records. Items that typically appear on a bank reconciliation include the following:

Unadjusted bank balance	xxx	Unadjusted book balance	xxx
Add		Add	
Deposits in transit	xxx	Interest revenue	xxx
		Collection of receivables	xxx
Subtract		Subtract	
Outstanding checks	xxx	Bank service charges	xxx
		NSF checks	xxx
True cash balance	xxx	True cash balance	xxx

Agreement of the two true cash balances provides evidence that accounting for cash transactions has been accurate.

The chapter discussed the importance of ethics in the accounting profession. The *American Institute of Public Accountants* requires all of its members to comply with the *Code of Professional Conduct.* Situations where *opportunity, pressure,* and *rationalization* exist can lead employees to conduct unethical acts, which, in cases like Enron, have destroyed the organization. Finally, the chapter discussed the auditor's role in financial reporting, including the materiality concept and the types of audit opinions that may be issued.

A Look Forward >>

The next chapter focuses on more specific issues related to accounts receivables and inventory. Accounting for receivables and payable was introduced in Chapter 2, using relatively simple illustrations. For example, we assumed that customers who purchased services on account always paid their bills. In real business practice, some customers do not pay their bills. Among other topics, Chapter 5 examines how companies account for uncollectible accounts receivable.

Accounting for inventory was discussed in Chapter 3. However, we assumed that all inventory items were purchased at the same price. This is unrealistic given that the price of goods is constantly changing. Chapter 5 discusses how to account for inventory items that are purchased at different times and different prices.

A step-by-step audio-narrated series of slides is provided on the text website at www.mhhe.com/edmondssurvey3e.

www.mhhe.com/edmondssurvey3e

SELF-STUDY REVIEW PROBLEM

The following information pertains to Terry's Pest Control Company (TPCC) for July:

1. The unadjusted bank balance at July 31 was $870.
2. The bank statement included the following items:
   (a) A $60 credit memo for interest earned by TPCC.
   (b) A $200 NSF check made payable to TPCC.
   (c) A $110 debit memo for bank service charges.
3. The unadjusted book balance at July 31 was $1,400.

4. A comparison of the bank statement with company accounting records disclosed the following:
   (a) A $400 deposit in transit at July 31.
   (b) Outstanding checks totaling $120 at the end of the month.

Required

Prepare a bank reconciliation.

Solution

TERRY'S PEST CONTROL COMPANY Bank Reconciliation July 31	
Unadjusted bank balance	$ 870
Add: Deposits in transit	400
Less: Outstanding checks	(120)
True cash balance	$1,150
Unadjusted book balance	$1,400
Add: Interest revenue	60
Less: NSF check	(200)
Less: Bank service charges	(110)
True cash balance	$1,150

KEY TERMS

Adverse opinion 141
American Institute of Certified Public Accountants 137
Audits 139
Authority manual 127
Bank reconciliation 131
Bank statement 131
Bank statement credit memo 131
Bank statement debit memo 131
Cash 129
Certified check 133
Certified public accountants (CPAs) 139
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QUESTIONS

1. What motivated congress to pass the Sarbanes-Oxley Act (SOX) of 2002?
2. Define the term *internal control*.
3. Explain the relationship between SOX and COSO.
4. Name and briefly define the five components of COSO's internal control framework.
5. Explain how COSO's *Enterprise Risk Management—An Integrated Framework* project relates to COSO's *Internal Control—An Integrated Framework* project.
6. List several control activities of an effective internal control system.
7. What is meant by *separation of duties?* Give an illustration.
8. What are the attributes of a high-quality employee?
9. What is a fidelity bond? Explain its purpose.
10. Why is it important that every employee periodically take a leave of absence or vacation?
11. What are the purpose and importance of a procedures manual?
12. What is the difference between specific and general authorizations?

13. Why should documents (checks, invoices, receipts) be prenumbered?
14. What procedures are important in the physical control of assets and accounting records?
15. What is the purpose of independent verification of performance?
16. What items are considered cash?
17. Why is cash more susceptible to theft or embezzlement than other assets?
18. Giving written copies of receipts to customers can help prevent what type of illegal acts?
19. What procedures can help to protect cash receipts?
20. What procedures can help protect cash disbursements?
21. What effect does a debit memo in a bank statement have on the Cash account? What effect does a credit memo in a bank statement have on the Cash account?
22. What information is normally included in a bank statement?
23. Why might a bank statement reflect a balance that is larger than the balance recorded in the depositor's books? What could cause the bank balance to be smaller than the book balance?
24. What is the purpose of a bank reconciliation?
25. What is an outstanding check?
26. What is a deposit in transit?
27. What is a certified check?
28. How is an NSF check accounted for in the accounting records?
29. Name and comment on the three elements of the fraud triangle.
30. What are the six articles of ethical conduct set out under section I of the AICPA's Code of Professional Conduct?

MULTIPLE-CHOICE QUESTIONS

Multiple-choice questions are provided on the text website at www.mhhe.com/edmondssurvey3e.

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EXERCISES

All applicable Exercises are available with McGraw-Hill's *Connect Accounting.*

Exercise 4-1 *SOX and COSO's Internal Control Frameworks* LO 1

Required

a. Explain what the acronym SOX refers to.
b. Define the acronym COSO and explain how it relates to SOX.
c. Name and briefly define the five components of COSO's internal control framework.
d. Define the acronym ERM and explain how it relates to COSO's internal control framework.

Exercise 4-2 *Control activities of a strong internal control system* LO 1

Required

List and describe nine control activities of a strong internal control system discussed in this chapter.

Exercise 4-3 *Internal controls for small businesses* LO 1

Required

Assume you are the owner of a small business that has only two employees.

a. Which of the internal control procedures are most important to you?
b. How can you overcome the limited opportunity to use the separation-of-duties control procedure?

Exercise 4-4 *Internal control for cash* LO 1

Required

a. Why are special controls needed for cash?
b. What is included in the definition of *cash*?

LO 1

Exercise 4-5 *Internal control procedures to prevent deception*

Emergency Care Medical Centers (ECMC) hired a new physician, Ken Major, who was an immediate success. Everyone loved his bedside manner; he could charm the most cantankerous patient. Indeed, he was a master salesman as well as an expert physician. Unfortunately, Major misdiagnosed a case that resulted in serious consequences to the patient. The patient filed suit against ECMC. In preparation for the defense, ECMC's attorneys discovered that Major was indeed an exceptional salesman. He had worked for several years as district marketing manager for a pharmaceutical company. In fact, he was not a physician at all! He had changed professions without going to medical school. He had lied on his application form. His knowledge of medical terminology had enabled him to fool everyone. ECMC was found negligent and lost a $3 million lawsuit.

Required

Identify the relevant internal control procedures that could have prevented the company's losses. Explain how these procedures would have prevented Major's deception.

LO 1

Exercise 4-6 *Internal control procedures to prevent embezzlement*

Bell Gates was in charge of the returns department at The Software Company. She was responsible for evaluating returned merchandise. She sent merchandise that was reusable back to the warehouse, where it was restocked in inventory. Gates was also responsible for taking the merchandise that she determined to be defective to the city dump for disposal. She had agreed to buy a tax planning program for one of her friends at a discount through her contacts at work. That is when the idea came to her. She could simply classify one of the reusable returns as defective and bring it home instead of taking it to the dump. She did so and made a quick $150. She was happy, and her friend was ecstatic; he was able to buy a $400 software package for only $150. He told his friends about the deal, and soon Gates had a regular set of customers. She was caught when a retail store owner complained to the marketing manager that his pricing strategy was being undercut by The Software Company's direct sales to the public. The marketing manager was suspicious because The Software Company had no direct marketing program. When the outside sales were ultimately traced back to Gates, the company discovered that it had lost over $10,000 in sales revenue because of her criminal activity.

Required

Identify an internal control procedure that could have prevented the company's losses. Explain how the procedure would have stopped the embezzlement.

LO 2

Exercise 4-7 *Treatment of NSF check*

Rankin Stationery's bank statement contained a $250 NSF check that one of its customers had written to pay for supplies purchased.

Required

a. Show the effects of recognizing the NSF check on the financial statements by recording the appropriate amounts in a horizontal statements model like the following one:

Assets			=	Liab.	+	Equity	Rev.	−	Exp.	=	Net Inc.	Cash Flow
Cash	+	Accts. Rec.										

b. Is the recognition of the NSF check on Rankin's books an asset source, use, or exchange transaction?

c. Suppose the customer redeems the check by giving Rankin $270 cash in exchange for the bad check. The additional $20 was a service fee charged by Rankin. Show the effects on the financial statements in the horizontal statements model in Requirement *a.*

d. Is the receipt of cash referenced in Requirement *c* an asset source, use, or exchange transaction?

Exercise 4-8 *Adjustments to the balance per books* LO 2

Required

Identify which of the following items are added to or subtracted from the unadjusted *book balance* to arrive at the true cash balance. Distinguish the additions from the subtractions by placing a + beside the items that are added to the unadjusted book balance and a − beside those that are subtracted from it. The first item is recorded as an example.

Reconciling Items	Book Balance Adjusted?	Added or Subtracted?
Outstanding checks	No	N/A
Interest revenue earned on the account		
Deposits in transit		
Service charge		
Automatic debit for utility bill		
Charge for checks		
NSF check from customer		
ATM fee		

Exercise 4-9 *Adjustments to the balance per bank* LO 2

Required

Identify which of the following items are added to or subtracted from the unadjusted *bank balance* to arrive at the true cash balance. Distinguish the additions from the subtractions by placing a + beside the items that are added to the unadjusted bank balance and a − beside those that are subtracted from it. The first item is recorded as an example.

Reconciling Items	Bank Balance Adjusted?	Added or Subtracted?
Bank service charge	No	N/A
Outstanding checks		
Deposits in transit		
Debit memo		
Credit memo		
ATM fee		
Petty cash voucher		
NSF check from customer		
Interest revenue		

Exercise 4-10 *Adjusting the cash account* LO 2

As of June 30, 2012, the bank statement showed an ending balance of $13,879.85. The unadjusted Cash account balance was $13,483.75. The following information is available:

1. Deposit in transit, $1,476.30.
2. Credit memo in bank statement for interest earned in June, $35.
3. Outstanding check, $1,843.74.
4. Debit memo for service charge, $6.34.

Required

Determine the true cash balance by preparing a bank reconciliation as of June 30, 2012, using the preceding information.

LO 2

Exercise 4-11 *Determining the true cash balance, starting with the unadjusted bank balance*

The following information is available for Hamby Company for the month of June:

1. The unadjusted balance per the bank statement on June 30 was $68,714.35.
2. Deposits in transit on June 30 were $1,464.95.
3. A debit memo was included with the bank statement for a service charge of $25.38.
4. A $4,745.66 check written in June had not been paid by the bank.
5. The bank statement included a $944 credit memo for the collection of a note. The principal of the note was $859, and the interest collected amounted to $85.

Required

Determine the true cash balance as of June 30 (*Hint:* It is not necessary to use all of the preceding items to determine the true balance.)

LO 2

Exercise 4-12 *Determining the true cash balance, starting with the unadjusted book balance*

Crumbley Company had an unadjusted cash balance of $6,450 as of May 31. The company's bank statement, also dated May 31, included a $38 NSF check written by one of Crumbley's customers. There were $548.60 in outstanding checks and $143.74 in deposits in transit as of May 31. According to the bank statement, service charges were $30, and the bank collected a $450 note receivable for Crumbley. The bank statement also showed $18 of interest revenue earned by Crumbley.

Required

Determine the true cash balance as of May 31. (*Hint:* It is not necessary to use all of the preceding items to determine the true balance.)

LO 3

Exercise 4-13 *AICPA Code of Professional Conduct*

Walter Walker owns and operates Walker Enterprises. Walter's sister, Sarah, is the independent public accountant for Walker Enterprises. Sarah worked for the Walker Enterprises for five years before she started her independent CPA practice. Walter considered hiring a different accounting firm but ultimately decided that no one knew his business as well as his sister.

Required

Use the AICPA Code of Professional Conduct to evaluate the appropriateness of Sarah's client relationship with Walker Enterprises.

LO 3

Exercise 4-14 *AICPA Code of Professional Conduct*

Courtney Simmons owns the fastest growing CPA practice in her local community. She attributes her success to her marketing skills. She makes a special effort to get to know her clients personally. She attends their weddings, anniversary celebrations, and birthday parties on a regular basis. Courtney always brings lavish presents, and her clients reciprocate by showering her with expensive gifts on her special occasions. This social activity consumes a lot of time. Indeed, it has cut into the time she once spent on continuing education. Even so, her practice has grown at the rate of 25 percent per year for the last three years. Courtney could not be happier with her progress.

Required

Use the AICPA Code of Professional Conduct to evaluate the appropriateness of Courtney's marketing strategy.

LO 3

Exercise 4-15 *Fraud triangle*

Bill Perry is a CPA with a secret. His secret is that he gambles on sports. Bill knows that his profession disapproves of gambling, but considers the professional standards to be misguided in his case. Bill really doesn't consider his bets to be gambling because he spends a lot of time studying sports facts. He believes that he is simply making educated decisions based on facts. He argues that using sports, facts to place bets is no different than using accounting information to buy stock.

Required

Use the fraud triangle as a basis to comment on Bill Perry's gambling activities.

Exercise 4-16 *Confidentiality and the auditor*

LO 4

West Aston discovered a significant fraud in the accounting records of a high profile client. The story has been broadcast on national airways. Aston was unable to resolve his remaining concerns with the company's management team and ultimately resigned from the audit engagement. Aston knows that he will be asked by several interested parties, including his friends and relatives, the successor auditor, and prosecuting attorneys in a court of law to tell what he knows. He has asked you for advice.

Required

Write a memo that explains Aston's disclosure responsibilities to each of the interested parties.

Exercise 4-17 *Auditor responsibilities*

LO 4

You have probably heard it is unwise to bite the hand that feeds you. Independent auditors are chosen by, paid by, and can be fired by the companies they audit. What keeps the auditor independent? In other words, what stops an auditor from blindly following the orders of a client?

Required

Write a memo that explains the reporting responsibilities of an independent auditor.

PROBLEMS

All applicable Problems are available with McGraw-Hill's *Connect Accounting*.

Problem 4-18 *Using internal control to restrict illegal or unethical behavior*

LO 1

Required

For each of the following fraudulent acts, describe one or more internal control procedures that could have prevented (or helped prevent) the problems.

a. Everyone in the office has noticed what a dedicated employee Jennifer Reidel is. She never misses work, not even for a vacation. Reidel is in charge of the petty cash fund. She transfers funds from the company's bank account to the petty cash account on an as-needed basis. During a surprise audit, the petty cash fund was found to contain fictitious receipts. Over a three-year period, Reidel had used more than $4,000 of petty cash to pay for personal expenses.

b. Bill Bruton was hired as the vice president of the manufacturing division of a corporation. His impressive resume listed a master's degree in business administration from a large state university and numerous collegiate awards and activities, when in fact Bruton had only a high school diploma. In a short time, the company was in poor financial condition because of his inadequate knowledge and bad decisions.

c. Havolene Manufacturing has good internal control over its manufacturing materials inventory. However, office supplies are kept on open shelves in the employee break room. The office supervisor has noticed that he is having to order paper, tape, staplers, and pens with increasing frequency.

Problem 4-19 *Preparing a bank reconciliation*

LO 2

CHECK FIGURE

True Cash Balance, August 31, 2012: $16,260

Bob Carson owns a card shop, Card Talk. The following cash information is available for the month of August, 2012.

As of August 31, the bank statement shows a balance of $17,000. The August 31 unadjusted balance in the Cash account of Card Talk is $16,000. A review of the bank statement revealed the following information:

1. A deposit of $2,260 on August 31, 2012, does not appear on the August bank statement.
2. It was discovered that a check to pay for baseball cards was correctly written and paid by the bank for $4,040 but was recorded on the books as $4,400.

3. When checks written during the month were compared with those paid by the bank, three checks amounting to $3,000 were found to be outstanding.
4. A debit memo for $100 was included in the bank statement for the purchase of a new supply of checks.

Required

Prepare a bank reconciliation at the end of August showing the true cash balance.

LO 2

eXcel

Problem 4-20 *Missing information in a bank reconciliation*

The following data apply to Superior Auto Supply Inc. for May 2012.

1. Balance per the bank on May 31, $8,000.
2. Deposits in transit not recorded by the bank, $975.
3. Bank error; check written by Allen Auto Supply was charged to Superior Auto Supply's account, $650.
4. The following checks written and recorded by Superior Auto Supply were not included in the bank statement:

CHECK FIGURE
Unadjusted Cash Balance, May 31, 2012: $5,565

3013	$ 385
3054	735
3056	1,900

5. Note collected by the bank, $500.
6. Service charge for collection of note, $10.
7. The bookkeeper recorded a check written for $188 to pay for the May utilities expense as $888 in the cash disbursements journal.
8. Bank service charge in addition to the note collection fee, $25.
9. Customer checks returned by the bank as NSF, $125.

Required

Determine the amount of the unadjusted cash balance per Superior Auto Supply's books.

LO 2

eXcel

Problem 4-21 *Adjustments to the cash account based on the bank reconciliation*

CHECK FIGURE
b. No book adjustment

Required

Determine whether the following items included in Yang Company's bank reconciliation will require adjustments or corrections on Yang's books.

a. An $877 deposit was recorded by the bank as $778.
b. Four checks totaling $450 written during the month of January were not included with the January bank statement.
c. A $54 check written to **Office Max** for office supplies was recorded in the general journal as $45.
d. The bank statement indicated that the bank had collected a $330 note for Yang.
e. Yang recorded $500 of receipts on January 31, which were deposited in the night depository of the bank. These deposits were not included in the bank statement.
f. Service charges of $22 for the month of January were listed on the bank statement.
g. The bank charged a $297 check drawn on Cave Restaurant to Yang's account. The check was included in Yang's bank statement.
h. A check of $31 was returned by the bank because of insufficient funds and was noted on the bank statement. Yang received the check from a customer and thought that it was good when it was deposited into the account.

Problem 4-22 *Bank reconciliation and adjustments to the cash account* LO 2

The following information is available for Cooters Garage for March 2012:

CHECK FIGURE

a. True Cash Balance, March 31, 2012: $16,398

BANK STATEMENT
HAZARD STATE BANK
215 MAIN STREET
HAZARD, GA 30321

Cooters Garage	Account number
629 Main Street	62-00062
Hazard, GA 30321	March 31, 2012

Beginning balance 3/1/2012	$15,000.00
Total deposits and other credits	7,000.00
Total checks and other debits	6,000.00
Ending balance 3/31/2012	16,000.00

Checks and Debits		Deposits and Credits	
Check No.	Amount	Date	Amount
1462	$1,163.00	March 1	$1,000.00
1463	62.00	March 2	1,340.00
1464	1,235.00	March 6	210.00
1465	750.00	March 12	1,940.00
1466	1,111.00	March 17	855.00
1467	964.00	March 22	1,480.00
DM	15.00	CM	175.00
1468	700.00		

The following is a list of checks and deposits recorded on the books of Cooters Garage for March 2012:

Date	Check No.	Amount of Check	Date	Amount of Deposit
March 1	1463	$ 62.00	March 1	$1,340.00
March 5	1464	1,235.00	March 5	210.00
March 6	1465	750.00		
March 9	1466	1,111.00	March 10	1,940.00
March 10	1467	964.00		
March 14	1468	70.00	March 16	855.00
March 19	1469	1,500.00	March 19	1,480.00
March 28	1470	102.00	March 29	2,000.00

Other Information

1. Check no. 1462 was outstanding from February.
2. A credit memo for collection of accounts receivable was included in the bank statement.
3. All checks were paid at the correct amount.
4. The bank statement included a debit memo for service charges.
5. The February 28 bank reconciliation showed a deposit in transit of $1,000.
6. Check no. 1468 was for the purchase of equipment.
7. The unadjusted Cash account balance at March 31 was $16,868.

Required

a. Prepare the bank reconciliation for Cooters Garage at the end of March.
b. Explain how the adjustments described above affect the cash account.

LO 1, 2

CHECK FIGURE

a. True Cash Balance, Jun 30, 2012: $2,093

Problem 4-23 *Bank reconciliation and internal control*

Following is a bank reconciliation for Surf Shop for June 30, 2012:

	Cash Account	Bank Statement
Balance as of 6/30/2012	$ 1,618	$ 3,000
Deposit in transit		600
Outstanding checks		(1,507)
Note collected by bank	2,000	
Bank service charge	(25)	
NSF check	(1,500)	
Adjusted cash balance as of 6/30/2012	$ 2,093	$ 2,093

When reviewing the bank reconciliation, Surf's auditor was unable to locate any reference to the NSF check on the bank statement. Furthermore, the clerk who reconciles the bank account and records the adjusting entries could not find the actual NSF check that should have been included in the bank statement. Finally, there was no specific reference in the accounts receivable supporting records identifying a party who had written a bad check.

Required

a. Prepare a corrected bank reconciliation.

b. What is the total amount of cash missing, and how was the difference between the "true cash" per the bank and the "true cash" per the books hidden on the reconciliation prepared by the former employee?

c. What could Surf's Shop do to avoid cash theft in the future?

LO 3

Problem 4-24 *Fraud Triangle*

Pete Chalance is an accountant with a shady past. Suffice it to say that he owes some very unsavory characters a lot of money. Despite his past, Pete works hard at keeping up a strong professional image. He is a manager at Smith and Associates, a fast-growing CPA firm. Pete is highly regarded around the office because he is a strong producer of client revenue. Indeed, on several occasions he exceeded his authority in establishing prices with clients. This is typically a partner's job but who could criticize Pete, who is most certainly bringing in the business. Indeed, Pete is so good that he is able to pull off the following scheme. He bills clients at inflated rates and then reports the ordinary rate to his accounting firm. Say, for example, the normal charge for a job is $2,500. Pete will smooth talk the client, then charge him $3,000. He reports the normal charge of $2,500 to his firm and keeps the extra $500 for himself. He knows it isn't exactly right. Even so, his firm gets its regular charges and the client willingly pays for the services rendered. He thinks to himself, as he pockets his ill-gotten gains, who is getting hurt anyway?

Required

The text discusses three common features (conditions) that motivate ethical misconduct. Identify and explain each of the three features as they appear in the above scenario.

LO 4

Problem 4-25 *Materiality and the auditor*

Sharon Waters is an auditor. Her work at two companies disclosed inappropriate recognition of revenue. Both cases involved dollar amounts in the $100,000 range. In one case. Waters considered the item material and required her client to restate earnings. In the other case, Waters dismissed the misstatement as being immaterial.

Required

Write a memo that explains how a $100,000 misstatement of revenue is acceptable for one company but unacceptable for a different company.

Problem 4-26 ***Types of audit reports*** **LO 4**

Jim Morris is a partner of a regional accounting firm. Mr. Morris was hired by a client to audit the company's books. After extensive work, Mr. Morris determined that he was unable to perform the appropriate audit procedures.

Required

a. Name the type of audit report that Mr. Morris should issue with respect to the work that he did accomplish.

b. If Mr. Morris had been able to perform the necessary audit procedures, there are three types of audit reports that he could have issued depending on the outcome of the audit. Name and describe these three types of audit reports.

ANALYZE, THINK, COMMUNICATE

ATC 4-1 Business Application Case *Understanding real-world annual reports*

Use the **Target Corporation**'s annual report in Appendix B to answer the following questions.

Required

a. Instead of "Cash," the company's balance sheet uses the account name "Cash and cash equivalents." How does the company define cash equivalents?

b. The annual report has two reports in which management is clearly identified as having responsibility for the company's financial reporting and internal controls. What are the names of these reports and on what pages are they located?

ATC 4-2 Group Assignment *Bank reconciliations*

The following cash and bank information is available for three companies at June 30, 2012.

Cash and Adjustment Information	Peach Co.	Apple Co.	Pear Co.
Unadjusted cash balance per books, 6/30	$45,620	$32,450	$23,467
Outstanding checks	1,345	2,478	2,540
Service charge	50	75	35
Balance per bank statement, 6/30	48,632	37,176	24,894
Credit memo for collection of notes receivable	4,500	5,600	3,800
NSF check	325	145	90
Deposits in transit	2,500	3,200	4,800
Credit memo for interest earned	42	68	12

Required

a. Organize the class into three sections and divide each section into groups of three to five students. Assign Peach Co. to section 1, Apple Co. to section 2, and Pear Co. to section 3.

Group Tasks

(1) Prepare a bank reconciliation for the company assigned to your group.

(2) Select a representative from a group in each section to put the bank reconciliation on the board.

Class Discussion:

b. Discuss the cause of the difference between the unadjusted cash balance and the ending balance for the bank statement. Also, discuss types of adjustment that are commonly made to the bank balance and types of adjustment that are commonly made to the unadjusted book balance.

ATC 4-3 Research Assignment *Investigating Cash and Management Issues at Smucker's*

Using the most current Form 10-K available on EDGAR, or the company's website, answer the following questions about the J. M. Smucker Company. Instructions for using EDGAR are in Appendix A. *Note: In some years the financial statements, footnotes, etc., portion of Smucker's annual report have been located at the end of the Form 10-K, in or just after "Item 15."*

Required

a. Instead of "Cash," the company's balance sheet uses the account name "Cash and cash equivalents." How does the company define cash equivalents?

b. The annual report has two reports in which management clearly acknowledges its responsibility for the company's financial reporting and internal controls. What are the names of these reports and on what pages are they located?

ATC 4-4 Writing Assignment *Internal control procedures*

Sarah Johnson was a trusted employee of Evergreen Trust Bank. She was involved in everything. She worked as a teller, she accounted for the cash at the other teller windows, and she recorded many of the transactions in the accounting records. She was so loyal that she never would take a day off, even when she was really too sick to work. She routinely worked late to see that all the day's work was posted into the accounting records. She would never take even a day's vacation because they might need her at the bank. Adam and Jammie, CPAs, were hired to perform an audit, the first complete audit that had been done in several years. Johnson seemed somewhat upset by the upcoming audit. She said that everything had been properly accounted for and that the audit was a needless expense. When Adam and Jammie examined some of the bank's internal control procedures, it discovered problems. In fact, as the audit progressed, it became apparent that a large amount of cash was missing. Numerous adjustments had been made to customer accounts with credit memorandums, and many of the transactions had been posted several days late. In addition, there were numerous cash payments for "office expenses." When the audit was complete, it was determined that more than $100,000 of funds was missing or improperly accounted for. All fingers pointed to Johnson. The bank's president, who was a close friend of Johnson, was bewildered. How could this type of thing happen at this bank?

Required

Prepare a written memo to the bank president, outlining the procedures that should be followed to prevent this type of problem in the future.

ATC 4-5 Ethical Dilemma *I need just a little extra money*

John Riley, a certified public accountant, has worked for the past eight years as a payroll clerk for Southeast Industries, a small furniture manufacturing firm in the Northeast. John recently experienced unfortunate circumstances. His teenage son required major surgery and the medical bills not covered by John's insurance have financially strained John's family.

John works hard and is a model employee. Although he received regular performance raises during his first few years with Southeast. John's wages have not increased in three years. John asked his supervisor, Bill Jameson, for a raise. Bill agreed that John deserved a raise, but told him he could not currently approve one because of sluggish sales.

A disappointed John returned to his duties while the financial pressures in his life continued. Two weeks later, Larry Tyler, an assembly worker at Southwest, quit over a dispute with management. John conceived an idea. John's duties included not only processing employee terminations but also approving time cards before paychecks were issued and then distributing the paychecks to firm personnel. John decided to delay processing Mr. Tyler's termination, to forge timecards for Larry Tyler for the next few weeks, and to cash the checks himself. Since he distributed paychecks, no one would find out, and John reasoned that he was really entitled to the extra money anyway. In fact, no one did discover his maneuver and John stopped the practice after three weeks.

Required

a. Does John's scheme affect Southeast's balance sheet? Explain your answer.

b. Review the AICPA's Articles of Professional Conduct and comment on any of the standards that have been violated.

c. Identify the three elements of unethical and criminal conduct recognized in the fraud triangle.