Chapter 4

Accounting chapter 4: cash and internal controls

companies issue incorrect financial students because:

- **errors** = create confusion and weaken investors' and creditor's confidence in accounting.
- **fraud** = occurs when a person intentionally deceives another person for personal gain or to damage that person.

ACFE (Association of certified Fraud Examiners)

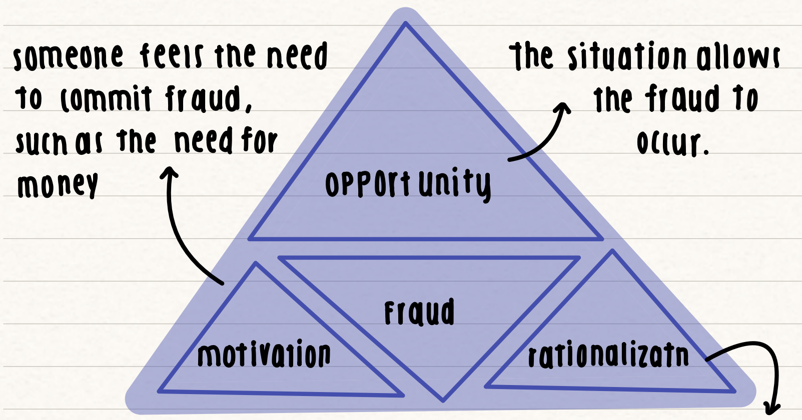
- ACFE defines **occupational fraud** as the use of one's occupation for personal enrichment through the deliberate misuse or the misapplication of the employer's resources.

sources of occupational fraud

- **misuse of company resources** = cash is the asset most commonly involved with fradulent activity.
- **financial statement manipulation** = those in charge of communicating financial accounting information falsify reports.

fraud triangle

Definition = three elements necessary for every fraud



justification for the deceptive act by the one commiting the fraud.

To help eliminate fraud, you **eliminate opportunity** by implementing formal procedures such as:

internal controls. = a company's plan to:

- safeguard the company's assets
- improve the accuracy and reliability of accounting information.

The quality of internal controls directly affects the quality of financial accounting

scandals

Manager's of the company act as caretakers of the company's assets. Two of the highest-profile cases of accounting fraud in U.S history are the collapses of:

- **Enron** = avoided reporting debt and losses
- **World Com** = overstated assets and profitability

Sarbanes-oxley act of 2002

congress passed the **Sarbanes-Oxley Act** (SOX) which applies to all companies that are required to file financial statements with the SEC.

Oversight board	The Public Company Accounting Oversight Board (PCAOB) has the authority to establish standards dealing with auditing, quality control, ethics, independence, and other activities relating to the preparation of audited financial reports. The board consists of five members who are appointed by the Securities and Exchange Commission.
Corporate executive accountability	Corporate executives must personally certify the company's financial statements and financial disclosures. Severe financial penalties and the possibility of imprisonment are consequences of fraudulent misstatement.
Nonaudit services	It's unlawful for the auditors of public companies to also perform certain nonaudit services, such as investment advising, for their clients.
Retention of work papers	Auditors of public companies must retain all work papers for seven years or face a prison term for willful violation.
Auditor rotation	The lead auditor in charge of auditing a particular company (referred to as the *audit partner)* must rotate off that company within five years and allow a new audit partner to take the lead.
Conflicts of interest	Audit firms are not allowed to audit public companies whose chief executives worked for the audit firm and participated in that company's audit during the preceding year.
Hiring of auditor	Audit firms are hired by the audit committee of the board of directors of the company, not by company management.
Internal control	Section 404 of the act requires (a) that company management document and assess the effectiveness of all internal control processes that could affect financial reporting and (b) that company auditors express an opinion on whether management's assessment of the effectiveness of internal control is fairly stated. Smaller companies are exempt from requirement (b).

internal controls

COSO: committee of sponsoring organizations is dedicated to improving the quality of financie reporting through among other things, effectiv internal controls. internal controls consists of five things. In the diagram in the next pag

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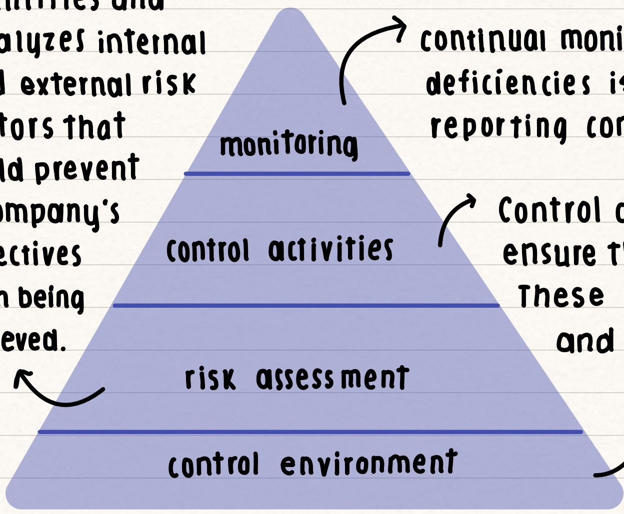
identifies and analyzes internal and external risk factors that could prevent a company's objectives from being achieved.



continual monitoring of internal activities and reporting of deficiencies is required. Monitoring includes formal procedures for reporting control deficiencies.

Control activities are the policies and procedures that help ensure that *management's directives* are being carried out. These activities include *authorizations*, reconciliations, and separation of duties.

The control *environment* sets the overall ethical tone of the company with respect to internal control. it includes formal policies related to management's philosophy, assignment of responsibilities, and organizational structure.

preventive controls

- Separation of duties