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GAAP Implementation Guide

Steven M. Bragg

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To Mom, who fulfilled the role wonderfully—a hug when I needed it, warm cookies at dinner, a lunchbox for school every day, and a sympathetic listener.

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PREFACE

There is a considerable amount of literature dealing with the rules of generally accepted accounting principles (GAAP). In all cases, they specify the rules to be applied to various accounting situations and present cogent examples to assist the reader. However, they do not give any advice regarding how to **implement** GAAP. This means that accountants have no way of knowing what controls, policies, procedures, forms, reports, or archiving requirements they should install that properly mesh with the latest GAAP. This book fills that void.

Though there is a brief summarization of GAAP comprising about one-third of each chapter, the primary intent of this book is to add new categories of information designed to assist the accountant in properly applying GAAP. Some of the following sections can be found in each chapter:

Definitions of Terms. Contains the terms most commonly used in the following Concepts and Examples section.

Concepts and Examples. A summary form of the more detailed GAAP found in the Wiley GAAP 2004 guide.

Decision Trees. Shows the decision factors required to interpret multiple options in the GAAP rules.

Policies. Identifies specific accounting policies a company can adopt in order to comply with GAAP, especially in terms of creating controls that mesh with GAAP.

Procedures. Lists specific procedures for the most common accounting transactions, modified to work within GAAP restrictions. These procedures can be easily modified for inclusion in a company's accounting procedures manual.

Controls. Itemizes specific controls allowing a company to retain the maximum level of control over its accounting systems while remaining in compliance with GAAP.

Forms and Reports. Gives templates for forms and reports that can be used in a GAAP-compliant accounting system.

Footnotes. Gives numerous examples of footnotes that can be used to describe GAAP-mandated financial disclosures.

Journal Entries. Shows hundreds of GAAP-compliant journal entries for most accounting transactions.

Recordkeeping. Notes the types of reports and other information to be retained as part of a comprehensive accounting system.

Chapters are sequenced in the same manner used for the GAAP 2004 guide published by John Wiley & Sons, covering such topics as receivables, investments, inventory, revenue recognition, liabilities, debt, leases, stockholders' equity, and foreign currency. The more rarely addressed GAAP topics are not included in this volume in the interests of conserving space, but the reader will find that the bulk of the GAAP issues that arise in daily accounting situations are covered.

The *GAAP Implementation Guide* is an ideal companion volume for the Wiley GAAP guide. It provides the practical application information needed to ensure that a company's accounting systems are fully capable of incorporating the most recent GAAP.

If you have any comments about this book, please contact the author at brasto@aol.com. Thank you!

Steven M. Bragg
Centennial, Colorado
March 2004

ABOUT THE AUTHOR

Steven Bragg, CPA, CMA, CIA, CPIM, has been the chief financial officer or controller of four companies, as well as a consulting manager at Ernst & Young and auditor at Deloitte & Touche. He received a master's degree in finance from Bentley College, an MBA from Babson College, and a Bachelor's degree in Economics from the University of Maine. He has been the two-time President of the 10,000-member Colorado Mountain Club, and is an avid alpine skier, mountain biker, and rescue diver. Mr. Bragg resides in Centennial, Colorado. He has written the following books:

Accounting and Finance for Your Small Business (Wiley)
Accounting Best Practices (Wiley)
Accounting Reference Desktop (Wiley)
Advanced Accounting Systems
Business Ratios and Formulas (Wiley)
Controllership (Wiley)
Cost Accounting (Wiley)
Design and Maintenance of Accounting Manuals (Wiley)
Essentials of Payroll (Wiley)
Financial Analysis (Wiley)
Just-in-Time Accounting (Wiley)
Managing Explosive Corporate Growth (Wiley)
Outsourcing (Wiley)
Planning and Controlling Operations (Wiley)
Sales and Operations for Your Small Business (Wiley)
The Controller's Function (Wiley)
The New CFO Financial Leadership Manual (Wiley)

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A special note of thanks to the acquisitions editor of this project, John DeRemigis, who has been so enthusiastic about it from the start.

1 RESEARCHING GAAP IMPLEMENTATION PROBLEMS

OVERVIEW

This chapter is designed to give pointers to additional information in areas besides GAAP concepts. Though there are Concepts and Examples sections in each of the following chapters that give summarized versions of the relevant GAAP issues, the primary focus of this book is to provide information about ancillary topics that allow one to implement GAAP, such as accounting policies and procedures, controls, and reporting footnotes. Unfortunately, there are no authoritative sources for these GAAP implementation topics. Instead, the sections of this chapter devoted to each implementation topic list some organizations that can provide additional information, as well as key books that summarize or discuss related topics, including the name of each book's author, publisher, and date of publication. But first, we will address the GAAP hierarchy of accounting standards and rules, followed by the general approach for researching GAAP-related issues.

The GAAP Hierarchy

Generally accepted accounting principles (GAAP) are standards and rules for reporting financial information, as established and approved by the Financial Accounting Standards Board.

There are three primary players in the promulgation of GAAP. First is the Financial Accounting Standards Board (FASB), which plays the lead role in establishing GAAP. Its Web site is located at www.fasb.org. Its mission is to "establish and improve standards of financial accounting for the guidance and education of the public, including issuers, auditors, and users of financial information." A subset of the FASB is the Emerging Issues Task Force (EITF), which (as its name implies) handles emerging accounting issues as soon as they become apparent, so that a standard approach can be created before any competing approaches come into use. This group typically deals with only very narrowly defined accounting issues, and its opinions are considered to be GAAP only if it can first reach a consensus opinion among its members. Finally, the American Institute of Certified Public Accountants (AICPA) is the principal representative body for certified public accountants within the United States. Its Web site is located at www.aicpa.org. It periodically issues research bulletins, audit and accounting guides, statements of position, and practice bulletins that, if approved by the FASB, are considered to be GAAP. Some GAAP is still ascribed to the Accounting Principles Board (APB), though this entity was phased out in 1973.

There are many documents issued by these three accounting entities that are considered part of GAAP. Each one is described in the following bullet points:[1]

- FASB Statements of Financial Accounting Standards. The highest form of GAAP, the SFAS series is the primary publication of the FASB, and is the most carefully formulated (and debated) of all GAAP documents.
- FASB Interpretations. Used to clarify Statements of Financial Accounting Standards or the pronouncements made by prior accounting entities that are still considered to be GAAP.
- APB Opinions. The primary publication of the old Accounting Principles Board, this was the equivalent of an SFAS prior to the formation of the FASB.
- FASB Technical Bulletins. Provide guidance on issues not covered by existing standards, and where the guidance is not expected to be costly or create a major change.
- AICPA Statements of Position. Provide guidance on financial accounting and reporting issues.
- AICPA Industry Audit and Accounting Guides. Provide guidance to auditors in examining and reporting on financial statements of entities in specific industries and provide standards on accounting problems unique to a particular industry.
- EITF Consensus Positions. Provide positions on the correct treatment of emerging accounting issues.
- AICPA Practice Bulletins. Provide guidance on narrowly defined accounting topics.
- FASB Implementation Guides. Provide notes on how to implement specific Statements of Financial Accounting Standards, written by the FASB staff. The guides are organized in a question, background, and answer format.

GAAP is organized in a descending pyramid of authoritative sources, as shown in Exhibit 1-1. It contains the following four categories:[2]

1. Category A is the most authoritative GAAP, containing the Statements of Financial Accounting Standards and related Interpretations (as promulgated by the FASB), as well as AICPA Accounting Research Bulletins and Opinions of the Accounting Principles Board.
2. Category B contains all FASB Technical Bulletins, as well as all AICPA Statements of Position and AICPA Industry Audit and Accounting Guides that have been approved by the FASB.
3. Category C includes consensus positions of the FASB's EITF, as well as those Practice Bulletins created by the AICPA's Accounting Standards Executive Committee that have been approved by the FASB. The positions of the EITF tend to cover such specialized topics that there is no more authoritative form of GAAP in Categories A or B, so these positions tend to be the most senior form of GAAP in their topical areas.
4. Category D includes implementation guides published by the FASB staff, as well as AICPA accounting interpretations and prevalent accounting practices.

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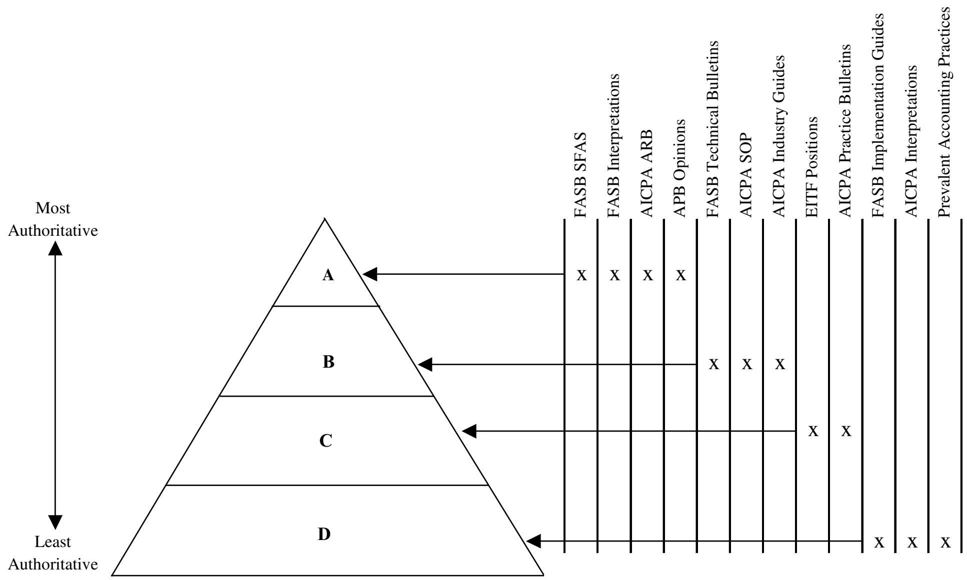
[1] *Adapted with permission from pp. 5-6 of Delaney, et. al.,* ***Wiley GAAP 2003*** *(John Wiley & Sons, Inc., Hoboken, NJ, 2002).*

[2] *Adapted with permission from p. 3 of Delaney, et. al.,* ***Wiley GAAP 2003*** *(John Wiley & Sons, Inc., Hoboken, NJ, 2002).*

Exhibit 1-1: The GAAP Source Pyramid



ARB = Accounting Research Bulletin
SFAS = Statement of Financial Accounting Standards
SOP = Statement of Position

Researching GAAP

The simplest approach to researching GAAP is to review the Concepts and Examples sections in this book. If this does not yield a detailed answer, a more comprehensive source of summarized GAAP information is the Wiley GAAP 2004 guide. The Wiley GAAP 2004 guide contains a more comprehensive Concepts section than this book, and also contains a list of authoritative pronouncements at its beginning, as well as the applicable page reference leading to a more complete discussion of the issues within the text. If this approach still does not yield a clear answer to a GAAP problem, one should review selected GAAP source documents, of which the most comprehensive is the FASB's Original Pronouncements and Accounting Standards three-volume series (noted in the following book list). It lists all FASB Statements of Standards, as well as AICPA Pronouncements, FASB Interpretations, FASB Concepts Statements, and FASB Technical Bulletins. Of particular use is the topical index located at the end of the third volume, which cross-references each topic to a GAAP source. Other more narrowly defined topics are covered by the other GAAP sources noted in the following book list. If these sources still do not yield a clear answer, one can ask other entities in the same industry how they are handling the issue (if only to obtain alternative solutions). If all else fails, use basic accounting theory to resolve the issue, or consult with a technical expert at a CPA firm. The most useful GAAP source documents are noted in the following book list:

Audit and Accounting Guides

Author: AICPA
Publisher: AICPA
Publication Date: Various

Emerging Issues Task Force Abstracts

Author: FASB
Publisher: FASB
Publication Date: Annually

FASB Staff Implementation Guides

Author: FASB
Publisher: FASB
Publication Date: Annually

Original Pronouncements and Accounting Standards

Author: FASB
Publisher: FASB
Publication Date: Annually

Statements of Position

Author: AICPA
Publisher: AICPA
Publication Date: Various

Researching Accounting Terminology

The best source of information about accounting terminology is the Statements of Financial Accounting Standards (SFAS), as published by the FASB. These Statements generally begin with a definitions section that provides both clear and comprehensive definitions. However, definitions are provided only for the limited topics covered in each SFAS, so it can take some time to locate a specific definition from the various SFAS documents. Definitions are also provided in a variety of lower-level GAAP documents. Another source of definitions is an online glossary of definitions maintained by the AICPA, which can be accessed at www.aicpa.org/members/glossary. Given the minimal time most accountants will allocate to researching accounting definitions, simpler forms of access are the accounting dictionaries noted in the following book list:

Dictionary of Accounting Terms

Author: John Clark
Publisher: AMACOM
Publication Date: 2003

Dictionary of Accounting Terms

Author: Joel Siegel and Jae Shim
Publisher: Barron's Education Series, Inc.
Publication Date: 1995

Researching Accounting Policies and Procedures

There is no standard set of policies and procedures related to GAAP. This information can be found within the Policies and related Procedures sections of each chapter in this book. Another source is books listing sample policies and procedures for generic company operations, as described in the first two books in the following list. An alternative is to use documentation manuals as guides for the construction of company-specific policies and procedures; the last two books in the following list can assist with this effort:

Best Practices in Policies and Procedures

Author: Stephen Page
Publisher: Process Improvement Publishing
Publication Date: 2002

Bizmanualz Accounting Policies, Procedures, and Forms

Author: Bizmanualz.com Inc.
Publisher: Bizmanualz.com Inc.
Publication Date: 2002

Design and Maintenance of Accounting Manuals

Author: Steven Bragg
Publisher: John Wiley & Sons, Inc.
Publication Date: 2003

Documentation Improvement Methods

Author: Athar Murtuza
Publisher: John Wiley & Sons, Inc.
Publication Date: 2002

Researching Accounting Controls

There is no standard source document itemizing the key control areas related to all types of GAAP. Instead, controls are either described in general terms through the reports issued by various accounting review committees (see the *COSO Implementation Guide* below) or else one must infer the correct types of controls to use based on various types of fraud that may occur (several examples are noted below). A good source for controls-related publications is the Institute of Internal Auditors, whose Web site is www.theiia.org. It is located in Altamonte Springs, Florida, and its phone number is 407-937-1100. Several reference books related to this topic are as follows:

COSO Implementation Guide

Author: James P. Roth
Publisher: Institute of Internal Auditors
Publication Date: 1995

Financial Crime Investigation and Control

Author: K. H. Spencer Pickett, Jennifer M. Pickett
Publisher: John Wiley & Sons, Inc.
Publication Date: 2002

Financial Reporting Fraud

Author: Charles Lundelius Jr.
Publisher: AICPA
Publication Date: 2003

Financial Statement Fraud

Author: Zabihollah Rezaee
Publisher: John Wiley & Sons, Inc.
Publication Date: 2002

Fraud 101

Author: Howard Davia
Publisher: John Wiley & Sons, Inc.
Publication Date: 2000

Internal Control Integrated Frameworks

Author: Coopers & Lybrand
Publisher: AICPA
Publication Date: 1994

Internal Control: A Manager's Journey

Author: K. H. Spencer Pickett
Publisher: John Wiley & Sons, Inc.
Publication Date: 2001

Process Development Life Cycle

Author: Albert Marcella Jr.
Publisher: Institute of Internal Auditors
Publication Date: 2001

Researching Accounting Forms and Reports

There is no single book or periodical containing a comprehensive set of forms or reports linked to GAAP. The best source is the Forms and Reports sections within this book. Another alternative is to review publications describing how to construct these documents. Such information can then be used to design forms and reports based on the specific accounting structures unique to a company. The following source book provides information about constructing forms and reports:

Design and Maintenance of Accounting Manuals

Author: Steven Bragg
Publisher: John Wiley & Sons, Inc.
Publication Date: 2003

Some examples of forms and reports can be found scattered through some of the larger accounting "how to" books, an example of which follows:

Controllership

Author: James Willson, et al.
Publisher: John Wiley & Sons, Inc.
Publication Date: 2003

Researching Accounting Footnotes

Source documents for GAAP will describe the general contents of footnotes to financial statements, but rarely give more than a few limited examples. A better source of information is a selection of examples culled from financial reports. One of the best sources is the *GAAP Financial Statement Disclosures Manual* listed in the following references. Another option is to access the Web site of the Securities and Exchange Commission at www.sec.gov and review the individual filings of various public companies, which can be accessed through the "Search for Company Filings" option on that Web page. The following source books can be used for additional information about footnote disclosures:

Financial Statement Presentation and Disclosure Practices for Employee Benefit Plans

Author: AICPA
Publisher: AICPA
Publication Date: 2000

Financial Statement Presentation and Disclosure Practices for Not-for-Profit Organizations

Author: Richard F. Larkin
Publisher: AICPA
Publication Date: 1999

GAAP Financial Statement Disclosures Manual

Author: George Georgiades
Publisher: Aspen Law & Business
Publication Date: 2002

The Coopers & Lybrand SEC Manual

Author: Robert Herz, et al.
Publisher: John Wiley & Sons, Inc.
Publication Date: 1997

Researching Accounting Journal Entries

Examples of journal entry formats are listed in the Journal Entry sections of each chapter in this book. In addition, one can consult the *Wiley GAAP* guide for the most recent year, which may include different examples of journal entries for a specific topic. Another good source is the most recent edition of the standard textbooks for intermediate accounting, advanced accounting, and cost accounting. The following books can be consulted for this information:

Intermediate Accounting

Author: Donald Keiso, et.al.
Publisher: John Wiley & Sons, Inc.
Publication Date: 2001

Advanced Accounting

Author: Debra Jeter et al.
Publisher: John Wiley & Sons, Inc.
Publication Date: 2001

Accounting Reference Desktop (Appendix B)

Author: Steven Bragg
Publisher: John Wiley & Sons, Inc.
Publication Date: 2002

Cost Accounting

Author: Steven Bragg
Publisher: John Wiley & Sons, Inc.
Publication Date: 2001

Researching Accounting Recordkeeping

Information about the proper time period over which to retain accounting documents is difficult to find, as are procedures and documentation for organizing and destroying documents. The principal organization concerning itself with these issues is the Association for Information Management Professionals, whose Web site is located at www.arma.org. It is located in Lenexa, Kansas, and its phone number is 800-422-2762. Some of its publications are as follows:

Records Retention Procedures

Author: Donald S. Skupsky
Publisher: Information Requirements Clearinghouse
Publication Date: 1995

Retention 6.0

Author: Zasio Enterprises
Publisher: Zasio Enterprises
Publication Date: 2002

Records Center Operations

Author: ARMA International Standards Task Force
Publisher: ARMA International
Publication Date: 2002

2 CASH, RECEIVABLES, AND PREPAID EXPENSES

DEFINITIONS OF TERMS

Accounts receivable. A current asset on the balance sheet, representing short-term amounts due from customers who have purchased on account.

Assignment. Creating a loan document using accounts receivable as the collateral. If the debtor is unable to pay back the loan, the creditor can collect the accounts receivable and retain the proceeds.

Cash. All petty cash, currency, held checks, certificates of deposit, traveler's checks, money orders, letters of credit, bank drafts, cashier's checks, and demand deposits that are held by a company without restriction, and which are readily available on demand.

Collateral. Assets that have been pledged to secure debtor repayment of a loan. If it cannot repay the loan, the creditor can sell the assets and retain the proceeds.

Factoring. The sale of accounts receivable to a third party, with the third party bearing the risk of loss if the accounts receivable cannot be collected.

Factor's holdback. That portion of the payment for an accounts receivable sale retained by the factor in expectation of product returns by customers.

Net realizable value. The expected revenue to be gained from the sale of an item or service, less the costs of the sale transaction.

Pledging. Assigning accounts receivable as collateral on company debt.

Recourse. The right of a creditor under a factoring arrangement to be paid by the debtor for any uncollectible accounts receivable sold to the creditor.

CONCEPTS AND EXAMPLES[1]

Cash

If there is a short-term restriction on cash, such as a requirement that it be held in a sinking fund in anticipation of the payment of a corresponding debt within a year, then it should still be itemized as a current asset, but as a separate line item. If there is a long-term restriction on cash, such as a compensating balance agreement that is linked to debt that will not be paid off within the current year, then the cash must be itemized as a long-term asset. Alternatively, if a compensating balance agreement is tied to a loan that matures within the current period, then it may be recorded separately as a current asset.

If a company issues checks for which there are not sufficient funds on hand, it will find itself in a negative cash situation as reported on its balance sheet. Rather than show a negative cash balance there, it is better to shift the amount of the excess checks back into the accounts payable liability account, thereby leaving the reported cash balance at or near zero.

Cash held in foreign currencies should be included in the cash account on the balance sheet, subject to two restrictions. First, it must be converted to US dollars at the prevailing exchange rate as of the balance sheet date. Second, the funds must be readily convertible into US dollars; if not (perhaps due to currency restrictions by the foreign government), the cash cannot properly be classified as a current asset, and instead must be classified as a long-term asset. This latter item is a key issue for those organizations that want to report the highest possible current ratio by shifting foreign currency holdings into the cash account.

Prepaid Expenses

Prepaid expenses are itemized as current assets on the balance sheet, and should include early payments on any expenditures that would have been made during the next 12 months. For example, prepayments on key man life insurance, rent, or association fees would be charged to this account. There should be a supporting schedule for this account, detailing each line item charged to it and the amortization schedule over which each item will be ratably charged to expense (see the sample report in the Recordkeeping section).

The prepaid expense account does **not** include deposits, since they are typically not converted back to cash until the end of the agreements requiring their original payment, which may be some years in the future. For example, the usual one-month rent deposit required

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[1] *Some portions of this section are adapted with permission from Chapters 13 and 15 of Bragg, **Accounting Reference Desktop**, John Wiley & Sons, Inc., Hoboken, NJ, 2002.*

with a building lease agreement cannot be paid back until the lease term has expired. Instead, deposits are usually recorded in the Other Assets or Deposits accounts, which are listed as noncurrent assets on the balance sheet.

Receivables—Presentation

The accounts receivable account tends to accumulate a number of transactions that are not strictly accounts receivable, so it is useful to define what should be stored in this account. An account receivable is a claim that is payable in cash, and which is in exchange for the services or goods provided by the company. This definition excludes a note payable, which is essentially a return of loaned funds, and for which a signed note is usually available as documentary evidence. A note payable should be itemized in the financial statements under a separate account. It also excludes any short-term funds loaned to employees (such as employee advances), or employee loans of any type that may be payable over a longer term. These items may be more appropriately stored in an Other Accounts Receivable or Accounts Receivable from Employees account. Also, one should not create an accrued account receivable to offset an accrued sale transaction (as may occur under the percentage-of-completion method of recognizing revenue from long-term construction projects); on the contrary, the accounts receivable account should contain only transactions for which there is a clear, short-term expectation of cash receipt from a customer.

Receivables—Collateral, Assignments, and Factoring

If a company uses its accounts receivable as **collateral** for a loan, then no accounting entry is required. An **assignment** of accounts receivable, where specific receivables are pledged as collateral on a loan and where customer payments are generally forwarded straight to the lender, also requires no accounting entry. However, if a company directly sells receivables with no continuing involvement in their collection, and with no requirement to pay back the creditor in case a customer defaults on payment of a receivable, then this is called **factoring**, and a sale transaction must be recorded (see the Decision Tree section for more information). Typically, this involves a credit to the Accounts Receivable account, a debit to the Cash account for the amount of the buyer's payment, and a Loss on Factoring entry to reflect extra charges made by the factor on the transaction. The amount of cash received from the factor will also be reduced by an interest charge that is based on the amount of cash issued to the company for the period when the factor has not yet received cash from the factored accounts receivable; this results in a debit to the Interest Expense account and a credit to the Accounts Receivable account.

A variation on this transaction is if the company draws down cash from the factor only when needed, rather than at the time when the accounts receivable are sold to the factor. This arrangement results in a smaller interest charge by the factor for the period when it is awaiting payment on the accounts receivable. In this instance, a new receivable is created that can be labeled "Due from Factoring Arrangement."

Another variation is when the factor holds back payment on some portion of the accounts receivable, on the grounds that there may be inventory returns from customers that can be charged back to the company. In this case, the proper entry is to offset the account receivable being transferred to the factor with a holdback receivable account. Once all receipt transactions have been cleared by the factor, any amounts left in the holdback account are eliminated with a debit to Cash (being paid by the factor) and a credit to the Holdback account.

A sample journal entry that includes all of the preceding factoring issues is shown in Exhibit 2-1. In this case, a company has sold $100,000 of accounts receivable to a factor, which requires a 10% holdback provision. The factor also expects to lose $4,800 in bad debts that it must absorb as a result of the transaction, and so pays the company $4,800 less than the face value of the accounts receivable, which forces the company to recognize a loss of $4,800 on the transaction. Also, the company does not elect to take delivery of all funds allowed by the factor in order to save interest costs; accordingly, it only takes delivery of $15,000 to meet immediate cash needs. Finally, the factor charges 18% interest for the thirty-day period that it is expected to take to collect the factored accounts receivable, which results in an interest charge of $200 on the $15,000 of delivered funds.

Exhibit 2-1: Sample Factoring Journal Entry

Cash	15,000	
Accounts receivable—factoring holdback	10,000	
Loss on factoring	4,800	
Interest expense	200	
Due from factoring arrangement	70,000	
Accounts receivable		100,000

If the company factors its accounts receivable, but the factor has recourse against the company for uncollectible amounts (which reduces the factoring fee) or if the company agrees to service the receivables subsequent to the factoring arrangement, then the company still can be construed as having retained control over the receivables. In this case, the factoring arrangement is considered to be a loan, rather than a sale of receivables, resulting in the retention of the accounts receivable on the company's balance sheet, as well as the addition of a loan liability. When receivables are sold with recourse, one should shift the expected amount of bad debts to be incurred from the Allowance for Bad Debts account to a Recourse Obligation account, from which bad debts will be subtracted as incurred.

Receivables—Sales Returns

When a customer returns goods to a company, the accountant should set up an offsetting sales contra account, rather than backing out the original sale transaction. The resulting transaction would be a credit to the Accounts Receivable account and a debit to the Contra account. There are two reasons for using this approach. First, a direct reduction of the original sale would impact the financial reporting in a prior period, if the sale originated in a prior period. Second, a large number of sales returns charged directly against the sales account would be essentially invisible on the financial statements, with management seeing only a reduced sales volume. Only by using (and reporting) an offsetting contra account can management gain some knowledge of the extent of any sales returns. If a company ships products on approval (i.e., customers have the right of return) and there is a history of significant returns, then it should create a reserve for sales returns based on historical rates of return. The offsetting sale returns expense account should be categorized as part of the cost of goods sold.

Example of reserve for sales made on approval

The Dusty Tome Book Company issues new versions of its books to a subscriber list that has purchased previous editions. Historically, it has experienced a 22% rate of return from these sales. In the current month, it shipped $440,000 of books to its subscriber list. Given the historical rate of return, Dusty Tome's controller expects to see $96,800 worth of books returned to the company. Accordingly, she records the following entry:

Sale return expense	96,800	
Reserve for sales returns		96,800

Receivables—Early Payment Discounts

Unless a company offers an exceedingly large early payment discount, it is unlikely that the total amount of this discount taken will have a material impact on the financial statements. Consequently, some variation in the allowable treatment of this transaction can be used. The most theoretically accurate approach is to initially record the account receivable at its discounted value, which assumes that all customers will take the early payment discount. Any cash discounts that are not taken will then be recorded as additional revenue. This results in a properly conservative view of the amount of funds that one can expect to receive from the accounts receivable. An alternative that results in a slightly higher initial revenue figure is to record the full, undiscounted amount of each sale in the accounts receivable, and then record any discounts taken in a sales contra account. One objection to this second approach is that the discount taken will be recognized only in an accounting period that is later than the one in which the sale was initially recorded (given the time delay usually associated with accounts receivable payments), which is an inappropriate revenue recognition technique. An alternative approach that avoids this problem is to set up a reserve for cash discounts taken in the period in which the sales occur, and offset actual discounts against it as they occur.

Receivables—Long-Term

If an account receivable is not due to be collected for more than one year, then it should be discounted at an interest rate that fairly reflects the rate that would have been charged to the debtor under a normal lending situation. An alternative is to use any interest rate that may be noted in the sale agreement. Under no circumstances should the interest rate be one that is less than the prevailing market rate at the time when the receivable was originated. The result of this calculation will be a smaller receivable than is indicated by its face amount. The difference should be gradually accrued as interest income over the life of the receivable.

Example of a long-term accounts receivable transaction

The Carolina Furniture Company (CFC) sells a large block of office furniture in exchange for a receivable of $82,000 payable by the customer in two years. There is no stated interest rate on the receivable, so the CFC controller uses the current market rate of 6% to derive a present value discount rate of 0.8900. She multiplies the $82,000 receivable by the discount rate of 0.8900 to arrive at a present value of $72,980, and makes the following entry:

Notes receivable	82,000	
Furniture revenue		72,980
Discount on notes receivable		9,020

In succeeding months, the CFC controller gradually debits the discount on the notes receivable account and credits interest income, so that the discount is entirely eliminated by the time the note receivable is collected. Also, note that the initial debit is to a notes receivable account, **not** accounts receivable, since this is not considered a current asset.

Receivables—Bad Debts

The accountant must recognize a bad debt as soon as it is reasonably certain that a loss is likely to occur, and the amount in question can be estimated with some degree of accuracy. For financial reporting purposes, the only allowable method for recognizing bad debts is to set up a bad debt reserve as a contra account to the accounts receivable account. Under this approach, one should estimate a long-term average amount of bad debt, debit the bad debt expense (which is most commonly kept in the operating expenses section of the income statement) for this percentage of the period-end accounts receivable balance, and credit the bad debt reserve contra account. When an actual bad debt is recognized, the accountant credits the accounts receivable account and debits the reserve. No offset is made to the sales account. If there is an unusually large bad debt to be recognized that will more than offset the existing bad debt reserve, then the reserve should be sufficiently increased to ensure that the remaining balance in the reserve is not negative.

There are several ways to determine the long-term estimated amount of bad debt for the preceding calculation. One is to determine the historical average bad debt as a proportion of the total credit sales for the past twelve months. Another option that results in a more accurate estimate is to calculate a different historical bad debt percentage based on the relative age of the accounts receivable at the end of the reporting period. For example, accounts aged greater than ninety days may have a historical bad debt experience of 50%, whereas those over thirty days have a percentage of 20%, and those below thirty days are at only 4%. This type of experience percentage is more difficult to calculate, but can result in a considerable degree of precision in the size of the bad debt allowance. It is also possible to estimate the bad debt level based on the type of customer. For example, one could make the case that government entities never go out of business, and so have a much lower bad debt rate than other types of customers. Whatever approach is used must be backed up quantitatively, so that an auditor can trace through the calculations to ensure that a sufficient bad debt reserve has been provided for.

Example of a bad debt reserve calculation

The Granny Clock Company has $120,000 of outstanding accounts receivable. Of that amount, $20,000 is more than ninety days old, while $41,000 is in the sixty- to ninety-day category. The company has historically experienced a loss rate of 25% on receivables more than ninety days old, a loss rate of 10% on receivables in the sixty- to ninety-day category, and 2% on all other receivables. Based on this information, the controller calculates a reserve of $1,180 on the current receivables ($59,000 x 2%), $4,100 for receivables in the sixty- to ninety-day category ($41,000 x 10%), and $5,000 for receivables older than ninety days ($20,000 x 25%), which totals $10,280. The company already has a reserve of $2,000 left over from the previous month, so the new entry is a debit to bad debt expense and a credit to the reserve for bad debts of $8,280 ($10,280 total reserve less the existing balance).

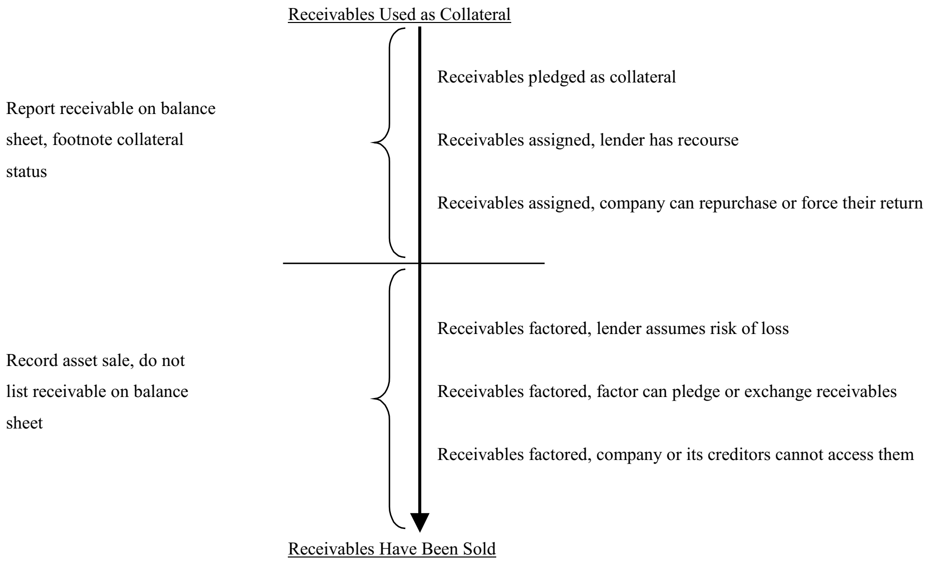
If an account receivable has been already written off as a bad debt and is then collected, the receipt should be charged against the bad debt reserve or to earnings. Incorrect treatment would be to create a new sale and charge the receipt against that, since this would artificially show a higher level of sales than really occurred.

DECISION TREES

Receivables—Ownership Decision

The main issue involving the use of accounts receivable as collateral or for assignment or factoring is how to treat these activities in the financial statements. The illustration in Exhibit 2-2 may be of some assistance. As shown in the exhibit, if receivables are pledged as collateral on a loan, or if they are assigned with recourse, or if the company has some means of forcing their return, then the company essentially has control over the receivables, and should continue to record them as such on its balance sheet. However, if the receivables purchaser has assumed the risk of loss, **and** can pledge or exchange the receivables to a third party, **and** the company or its creditors can no longer access the receivables for any reason, then the purchaser has control over the assets, and the selling company must record the sale of the receivables and remove them from its balance sheet. Thus, if there is any evidence that the selling company retains any aspect of control over the receivables, they must continue to be recorded on the selling company's balance sheet, with additional footnote disclosure of their status as collateral on a loan.

Exhibit 2-2: Reporting Status of Accounts Receivable



POLICIES

Cash

- **No accounts payable personnel shall be authorized to sign checks or approve money transfers.** This policy is designed to separate the preparation of accounts payable documents from their approval, thereby keeping a single person from falsely creating a payable and authorizing its payment to himself.
- **All check or money transfers exceeding $_____ shall be countersigned by the _____ position.** This policy provides for a second review of very large payments to ensure that they are appropriate, and to reduce the incidence of fraudulent transfers. Unfortunately, many banks do not review the existence of a second signature on a check, making this a less effective policy.
- **All check signers shall be adequately bonded.** This policy requires a company to retain an adequate level of bonding on its check signers to ensure that it will suffer no loss if a signer commits fraud. Bonding companies usually conduct a background review on check signers before agreeing to provide bond, which may give a company warning of previously unknown fraudulent employee activities, thereby allowing it to remove check signing authority from someone before they have the opportunity to commit fraud again.

Prepaid Expenses

- **All advances to employees must be repaid within three months.** This policy keeps a company from becoming a bank for employees. In addition, it rapidly draws down the balances due from employees, so there is a minimal risk of loss to the company if an employee quits work without having paid off the entire balance of an advance.

- **Employee advances shall be limited to __% of their annual pay.** This policy is designed to reduce the amount of money a company can have due from its employees, which mitigates its risk of nonpayment in the event of an employee departure.

Receivables

- **Allow the accounting staff to write off accounts receivable balances under $___ without management approval.** Though one could require management approval of all receivable write-offs in order to reduce the risk of false write-offs, this is not an efficient control point for very small balances. Instead, it is common to allow the write-off of small balances by the accounting staff, thereby avoiding time otherwise wasted by the management staff investigating these write-offs.
- **Require credit manager approval for all prospective sales exceeding customer credit limits.** A common problem for the credit department is to be rushed into granting credit when a salesperson lands a large sale, which tends to result in excessively large credit limits being granted. A better approach is to require an advance review of prospective sales by the credit manager, who can then tell the sales staff the maximum amount of credit the company is willing to grant before any sale is finalized.
- **Require formal annual reviews of all customer credit limits exceeding $______.** Customer financial situations change over time, making the initial credit limits granted to them incorrect. This is a particular problem when a customer is spiraling down toward bankruptcy, while the company blithely continues to grant it large amounts of credit. Annual reviews of large credit limits can mitigate this problem, though feedback from the collections staff will warn of possible customer problems well before any formal annual review would do so.
- **No factoring arrangements are allowed when receivables are used as collateral for other debts.** This policy prevents a company from violating the terms of a loan agreement under which it must retain its receivables as collateral, rather than reduce them through sale to a factor. Otherwise, the company could be seen as selling assets to the detriment of a secured lender, who would then have the right to call its loan to the company.

PROCEDURES

Cash—Apply Cash to Accounts Receivable

Use this procedure to apply cash received from customers to open accounts receivable balances:

1. Add up all daily cash receipts and match the paper tape of the summarization to the individual payments to ensure that the total is correct.
2. Go to the accounting software and access the cash application screen. At the top of the screen, enter today's date and the total amount to be applied.
3. For each customer payment, enter the customer number, individual check amount, the check number and date, and then tab to the detail section of the screen. The list of all open invoices for the customer will appear. Click on each invoice being paid and enter any discounts taken. After identifying all invoices paid by each customer, complete the transaction and move to the next customer from whom a check was received. Continue in this fashion until all receipts have been entered.

4. Print a daily cash receipts report and verify that the total on the report matches the total amount of cash received on the initial paper tape. Compare the remittance advices attached to individual checks to the daily cash receipts report to find the error, and correct it.
5. Press the "post cash" button to transfer all the receipts information to the general ledger.
6. Photocopy all checks received. Then staple the cash receipts report to the photocopies, and file the set of documents in the applied cash filing cabinet.

Cash—Receive and Deposit Cash

Use this procedure to receive cash from a variety of sources and deposit it into the company bank account.

1. Summarize all cash on an adding machine tape.
2. Enter all checks and cash received on a deposit slip. Verify that the deposit slip total and the adding machine tape total are the same. If not, recount the cash and checks.
3. Give the deposit slip and attached cash and checks to a second cash clerk, who compares the check total to the summary sheet forwarded from the mailroom. Reconcile any differences.
4. Photocopy all checks, including attached remittance advices, as well as the deposit slip. Verify that this packet of information matches the total to be sent to the bank in the deposit. Then send the photocopies to the accounts receivable staff, which will apply these payments to outstanding accounts receivable.
5. Send the completed deposit to the bank by courier.

Cash—Process Credit Card Payments

This procedure is useful for processing credit card payments through an Internet-based processing site.

1. Verify that the customer has supplied all information required for the credit card processing: name on the card, credit card number, expiration date, and billing address. Also retain the customer's phone number in case the payment is not accepted, so corrected information can be obtained.
2. Access the Internet credit card processing site and log in.
3. Enter all customer-supplied information on the Web screen, as well as the invoice number, amount to be billed, and a brief description of the billing.
4. If the transaction is not accepted, call the customer and review all supplied information to determine its accuracy. As an alternative, obtain information for a different credit card from the customer.
5. If the transaction is accepted, go to the accounting computer system and log in the cash receipt associated with the transaction. Date the transaction one day forward, since this more closely corresponds to the settlement date and corresponding receipt of cash.
6. Copy the invoice, stamp it with a "Paid in Full" stamp, and initial the stamp. Mail it to the person whose name was on the credit card (**not** the person listed on the invoice, if any), since this person will need it as a receipt.

Cash—Reconcile Petty Cash

Use this procedure to conduct a manual reconciliation of the petty cash balance in any petty cash box.

1. Access the general ledger account for the petty cash box and determine the amount of cash it should contain as of the last reconciliation.
2. Go to the petty cash box and add up all cash contained in the box. Subtract this amount from the box balance as of the last reconciliation and add any amounts deposited into the box during the interval since the last reconciliation. This calculation reveals the amount of missing cash that should be accounted for by expense vouchers.
3. Add up all vouchers in the box and compare this amount to the predetermined amount of missing cash. If they do not match, review petty cash procedures with the person responsible for it.
4. Create a journal entry summarizing the expenses represented by all vouchers in the box, as well as the amount of any shortfalls or overages. Staple the vouchers to this journal entry and give the packet to the general ledger accountant for entry into the general ledger.
5. Calculate the amount of cash that should be added to the petty cash box, based on usage levels, and recommend to the assistant controller in charge of accounts payable that this amount of cash be forwarded to the person responsible for the petty cash box.

Cash—Reconcile Bank Account

Use this procedure to reconcile any differences between the bank and company records of cash transactions. This procedure assumes that a computerized reconciliation module is available through the accounting software.

1. Verify that the beginning bank balance matches the beginning book record, net of reconciling items. If not, go back and fix the bank reconciliations for earlier periods.
2. Enter the ending bank balance on the computer screen.
3. Check off all company records of deposits in the computer system if they match the bank record of receipts. As you progress through this list, check off the deposit records on the bank statement that have also been checked off in the computer system. If there are any deposits that cannot be immediately reconciled, pull out the detailed deposit records for the days in question and determine which deposits are in error. Fix any deposit record differences and verify that the total book record of deposits matches the total bank record of deposits.
4. Scan the bank statement for any special charges levied by the bank that have not already been recorded in the company books. Enter these adjustments as a journal entry, and check off all recorded expenses of this type on the bank statement.
5. Check off all company checks in the computer system if they match the amount of checks recorded as having cleared on the bank statement. **It is not good enough to just match check numbers!** You must also verify the amount of each cleared check on the bank statement, since this can be a source of discrepancy.
6. If there are checks still listed on the bank statement that do not appear in the company records, then these are most likely manual checks that were not initially recorded in the company records. Also review these unrecorded checks to see if any

were fraudulently created. Enter these items in the computer system as manual checks.

7. If the bank statement reveals transfers between bank accounts, verify that these entries have been recorded in the computer system. If not, make journal entries to match the bank transaction record.
8. Verify that the bank ending balance now matches the company's records, net of any deposits or checks in transit. If not, repeat the foregoing steps. Then print two copies of the reconciliation report, filing one copy in the journal entry binder for the applicable month and one copy in the bank statement binder, next to the applicable bank statement.

Receivables—Print and Issue Invoices

Use this procedure to verify shipment of goods and then create invoices based on the shipments. This procedure assumes that the shipping department is logging out shipped goods from the computer system and tracking back orders, rather than the accounting staff.

1. Locate the shipping paperwork in the "shippers" box in the mailroom. The paperwork should include a copy of the shipping log and a copy of the bill of lading.
2. Verify that there is a bill of lading for every order listed on the shipping log, and also that all bills of lading are listed on the log. Then put the bills of lading in order, first by customer number and then by order number (if there is more than one order per customer). Next, check the "carrier" column on the shipping log—some will indicate shipment pickups by customers. For all other deliveries, the shipping department should have turned in a freight worksheet containing the cost of additional freight for each shipment. Locate these sheets, which will be used to determine the freight charge on each invoice.
3. Locate on each freight sheet the method of delivery, as well as the weight of the order. Cross-reference this information against the standard freight charge table, and write on the freight sheet the price of the freight to be billed to the customer.
4. Locate the signed customer order, which contains the pricing for the items shipped, as well as the bill-to customer name and address and the name of the salesperson to whom a commission will be paid.
5. Go to the computer system and access the customer information screen. Call up the customer name and verify that the invoice-to address and contact name are correct. If not, either change the existing information or add a new invoice-to address for the customer.
6. Go to the invoicing screen in the computer system and enter the customer name verified in the last step. Verify that the default salesperson listed on the screen is correct, or change it to match the salesperson name listed on the signed customer order. Enter the part numbers and quantities shipped that are listed on the shipping log, as well as the prices noted on the customer order. Enter the freight charge listed on the freight sheet.
7. Print two copies of the invoice and mail one to the customer. If the order is complete, also file the bill of lading, invoice, customer order, and freight sheet in the customer file. If the order is not complete, store the customer order form in a pending orders file for cross-referencing purposes when back-ordered items are shipped at a later date.

Receivables—Calculate the Bad Debt Reserve

Use this procedure to alter the bad debt reserve to reflect new billing and bad debt activity in a reporting period.

1. Print the accounts receivable aging report and review all invoices on the report that are at least sixty days old with the collections staff.
2. If the collections staff deems a reviewed invoice to be uncollectible, complete a bad debt authorization form for it and charge it off to the bad debt reserve account (see following procedure).
3. Once all receivables designated as bad debts have been cleared from the aging report, summarize the total amount written off during the reporting period, which can be obtained from the list of written-off invoices listed in the bad debt reserve account in the general ledger.
4. Enter the period's bad debt total as a running balance in an electronic spreadsheet alongside the remaining accounts receivable balance for the reporting period. Calculate the rolling three-month bad debt percentage of accounts receivable on this spreadsheet.
5. Multiply the rolling three-month bad debt percentage calculated from the spreadsheet by the remaining accounts receivable balance to determine the estimated amount of bad debt reserve required.
6. If the amount of estimated bad debt reserve is greater than the actual amount listed in the general ledger, make an entry crediting the bad debt reserve account for the difference, with the offsetting debit going to the bad debt expense account.

Receivables—Authorize Bad Debt Write-Offs

Use this procedure to formalize the process of writing off bad debts from the accounts receivable aging report.

1. At least once a month, review all outstanding accounts receivable on the accounts receivable aging report with the collections staff to see which invoices or portions of invoices must be written off, taking into account customer bankruptcy, history of collection problems, and the size of the amounts owed.
2. Complete the Bad Debt Write-Off Approval Form (see the Forms section). In particular, note on the form the reason for the write-off. If there is a systemic problem that is causing the write-off to occur, forward a copy of the completed form to the appropriate department for review.
3. Forward the form to the general ledger accountant, who will create a credit based on the information in the form and offset the credit against the outstanding customer invoice.
4. Summarize all completed bad debt forms at the end of each month and send the results to the general manager, showing the total write-off amounts attributable to each type of systemic problem.
5. Store the completed bad debt write-off forms in a separate binder and store them in the archives after year-end.

CONTROLS

Cash

The following controls can be used to reduce the risk of asset theft through the illegal transfer of cash:

- **Control check stock.** This is a key control. All check stock must be locked up when not in use. Otherwise, it is a simple matter for someone to take a check from the bottom of a check stack (where its loss will not be noticed for some time), forge a signature on it, and cash it. Be sure to keep the key or combination to the lock in a safe place, or else this control will be worthless.
- **Control signature plates.** This is a key control. Many companies use either signature plates or stamps to imprint an authorized signature on a check, thereby saving the time otherwise required of a manager to sign checks. If someone obtains access to a signature plate and some check stock, that person can easily pay himself the contents of the entire corporate bank account. The best control is to lock up signature plates in a different storage location than the check stock, so a perpetrator would be required to break into two separate locations in order to carry out a really thorough check fraud.
- **Separate responsibility for the cash receipt and cash disbursement functions.** If a person has access to both the cash receipt and disbursement functions, it is much easier to commit fraud by altering the amount of incoming receipts, and then pocket the difference. To avoid this, each function should be handled by different people within the organization.
- **Perform bank reconciliations.** Though widely practiced and certainly necessary, this is not a preventive control, and so should be implemented **after** the control of check stock and signature plates. Bank reconciliations are most effective when completed each day; this can be done by accessing the daily log of cash transactions through the company bank's Internet site. By staying up-to-date on reconciliations, evidence of fraudulent check activity can be discovered more quickly, allowing for faster remedial action.
- **Reconcile petty cash.** There tends to be a high incidence of fraud related to petty cash boxes, since money can be more easily removed from them. To reduce the incidence of these occurrences, unscheduled petty cash box reconciliations can be initiated, which may catch perpetrators before they have covered their actions with a false paper trail. This control can be strengthened by targeting those petty cash boxes that have experienced unusually high levels of cash replenishment requests.
- **Require that bank reconciliations be completed by people independent of the cash receipts and disbursement functions.** The bank reconciliation is intended to be a check on the activities of those accounting personnel handling incoming and outgoing cash, so it makes little sense to have the same people review their own activities by completing the reconciliation. Instead, it should be done by someone in an entirely different part of the department, and preferably by a senior person with a proven record of reliability.
- **Require that petty cash vouchers be filled out in ink.** Anyone maintaining a petty cash box can easily alter a voucher previously submitted as part of a legitimate transaction, and remove cash from the petty cash box to match the altered voucher. To avoid this, one should require that all vouchers be completed in ink. To be extra careful, one can even require users to write the amount of any cash transactions on vouchers in words instead of numbers (e.g., "fifty-two dollars" instead of $52.00"), since numbers can be more easily modified.
- **Compare the check register to the actual check number sequence.** If checks are prenumbered, one can compare the check numbers listed in the computer's check register to those on the checks. If a check were to be removed from the check stock, then this action would become apparent when the check number on the check stock no longer matches the check number in the computer system.

If the check stock is on a continuous sheet, as is used for sheet-fed dot matrix printers, then the more likely way for a perpetrator to steal checks would be to detach them from the top or bottom of the stack of check stock. In this case, one can detect the problem by keeping separate track of the last check number used, as well as of the last check number on the bottom of the stack. Unfortunately, many accounting clerks like to keep this list of check numbers used with the check stock, so a perpetrator could easily alter the last number listed on the sheet while stealing checks at the same time. Consequently, the list of check numbers used should be kept in a separate location.

- **Review uncashed checks.** Review all checks that have not been cashed within ninety days of their check dates. In a few cases, it may be possible to cancel the checks, thereby increasing the available cash balance. This review can also highlight checks that have gone astray. By placing stop payment orders on these checks, one can keep them from being incorrectly cashed by other parties, while new checks can be issued to the proper recipients.
- **Route incoming cash payments through a lockbox.** When customers are told to send payments directly to a bank lockbox, this eliminates a number of control points within a company, since it no longer has to physically handle any forms of cash. Some payments will inevitably still be mailed directly to the company, but the proportion of these payments will drop if customers are promptly asked to send future payments to the lockbox address.
- **Verify amount of cash discounts taken.** A cash receipts person can falsely report that customers are taking the maximum amount of early payment discounts when they have not actually done so, and pocket the amount of the false discount. This can be detected by requiring that photocopies of all incoming checks be made, and then tracing payments on which discounts have been taken back to the copies of the checks. This is a less common problem area, since it requires a perpetrator to have access to both the receipts and payments aspects of the accounting operation, and so is a less necessary control point.

Prepaid Expenses

The largest problem with prepaid expenses is that they tend to turn into a holding area for payments that should have been converted into expenses at some point in the past. There is also a potential for advances to be parked in this area that should have been collected. The following controls address these problems:

- **Reconcile all prepaid expense accounts as part of the month-end closing process.** By conducting a careful review of all prepaid accounts once a month, it becomes readily apparent which prepaid items should now be converted to an expense. The result of this review should be a spreadsheet that itemizes the nature of each prepaid item in each account. Since this can be a time-consuming process involving some investigative work, it is best to review prepaid expense accounts shortly before the end of the month, so that a thorough review can be conducted without being cut short by the time pressures imposed by the usual closing process.
- **Review all employee advances with the payroll and payables staffs at least once a month.** A common occurrence is for an employee to claim hardship prior to a company-required trip, and request a travel advance. Alternatively, an advance may be paid when an employee claims that he or she cannot make it to the next payroll check. For whatever the reason, these advances will be recorded in an employee advances account, where they can sometimes be forgotten. The best way to ensure re-