THEME: DETECTING ACCOUNTING ERRORS

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ACCOUNTING TERM: Transposition Error

A transposition error occurs when two or more numbers are reversed or transposed for each other. For example, if the number 48 is written as 84.

FEATURE ARTICLE: Detecting Accounting Errors

Anybody who works with accounting knows that errors are made by everyone. That means even the brightest and the best succumb to making errors from time to time. It's just a fact of life. The axiom that is drilled into the heads of accountants is to always "prove your work". This is usually learned the hard way until it is demonstrated clearly that proving your work is the shortest path to reaching the goal. The pain of having to redo hours of work because of sloppy habits gets burned deeply into the nervous system.

Okay, so you are proving your work as you go. What happens when you find that an account doesn't balance? Or, that a balance simply can't be right? At this point, it's time to don a detective's hat and start an investigation. There is a culprit or two lurking in those books and it's your job to "smoke em out". How to proceed? Where to begin? It seems like the error or errors could be hiding anywhere. The first thing to do is to start looking for clues. Before you get started, it helps to know the face of your adversaries for there are a number of them. The following is a list of the main types of errors with some examples:

1. Errors of principle - When a transaction is recorded against the fundamental principles of accounting.

- Purchase of a fixed asset that should be capitalized gets expensed instead.
- Recording a personal expense as a business expense.
- Recording a capital contribution as a loan when there is no intention to treat it that way.

2. Errors of omission – A transaction is either wholly or partially not recorded in the books.

- Forgetting to record the depreciation for a given period.
- Failing to record some out-of pocket expenses.
- Not recording a required adjustment to inventory.

3. **Errors of commission** – An entry is incorrectly recorded when posting.

- Original entry error: When an incorrect figure is entered in the records and posted to the correct account. For example, if recording $1,000 rent payment to Rent Expense as $100. Or, the number 9 is read as a number 4, etc.

- Calculation error: When recording a journal entry from a calculator tape that has an error in it.

- Reversal of entries: The amount is correct, the accounts used are correct, but the account that should have been debited is credited and vice versa.

- Transposition error: Two numbers have inadvertently reversed, such as 27 is written as 72, or 84 as 48.

- Compensating errors: Two equal and opposite errors leave the books in balance. This type of error is rare, and can be because a deliberate second error has been made to force the balancing of the records or to conceal a fraud.

This list offers a profile that describes the nature of each error. That's all well and good but how do you go about finding clues? The first order of business is to make sure to use good technique and organization in the initial preparation of financial statements.

For instance, the material required to prepare financial statements usually consists of current bank statements, a check register, payroll reports, a sales or cash deposit journal, and any notes regarding transactions that may require a general journal entry. This material should be scanned by you to make sure it is complete. This is an important step because the information from the scan is recorded in your brain for further reference if needed. A small bit of this information can provide an important clue to a mystery you are trying to solve.

The next step is to prepare the bank reconciliation. I recommend this be done manually because in the doing of the bank reconciliation your mind continues to gather information details related to deposits and expenses.

After a set of financial statements has been prepared, the first thing to do is prove that the cash account balance ties to the reconciled bank balance. If it doesn't then it is time to pull out your most important error finding tool. It's called the Detail of the General Ledger (GL) report. This report shows every debit and credit entry made to a specific GL account. Simply go to the Cash account, look at the total increases and decreases and compare them to the bank reconciliation balance. The error has to be there.

You may be wondering why I haven't mentioned running a Trial Balance. In the old days when we had to manually post to the GL we would run a Trial Balance. A trial balance was a list of all the credit and debit entries in the GL. If the total credits did not equal the total debits we would know there was an error. This was helpful because we could catch an error before preparing the financial statements. Nowadays a trial balance isn't necessary because, if after posting any group of entries the credits don't equal the debits, the computer will let you know.

This means that when the computer generates financial statements they "will" be in balance. However, just because they are in balance does not mean that each individual GL account balance is correct. Therefore, the next thing to be done is to prove what GL balances you can with other computer reports. For the rest of the accounts, apply the "test of reasonableness". What is the "test of reasonableness"? If rent expense is $1,000 per month and the profit and loss report shows a zero balance, then that doesn't make sense. Most likely the $1,000 got posted to the wrong account. How do you find out where it got posted? Usually the computer will print a transaction register that shows exactly what was entered into the computer. Find the rent check on the transaction register to see where it got posted.

What balances can be easily proved with comparative reports? Cash will be the most important by comparing it to the bank reconciliation. Accounts receivable is compared to the Accounts Receivable detail report; Accounts Payable is compared to the Accounts Payable detail report; Payroll taxes and wages can be compared to the payroll reports; Notes Payable to amortization schedules; Sales to a sales journal if you have one; etc. All others should be carefully looked at to see if they make sense using the test of reasonableness.

This proving process can take less than a half an hour and should be done for each financial statement that is prepared. It's wise to keep in mind here Murphy's Law, because the month the balances are not proved will be the month that has the big, glaring error.

QUESTION: How Are Accounting Errors Corrected?

How errors are corrected depends of course on the type of error. For instance, a really fascinating feature of transposition errors is they are divisible by nine. Try it and see. Take 96 and subtract 69. It equals 27. Divided by 9 it equals 3. Try another such as 12 and 21. The difference is 9. How about a large number such as 756 and 657? The difference is 99. Weird isn't it? So the first thing to look for if you are out of balance on something is to see if it divides by nine. If it does, most often it will be a transposition error. What then? All that can be done is to scan your numbers and look for possibilities. If you are working with a column or a tape, have someone read them back to you. For instance, if you have run a calculator tape on your check register have someone read the amounts on the check register to you while you compare them to what is on the tape.

Another approach, when calculating a column of debits and a column of credits that don't equal, is to divide the difference by two. Take that number and run down the column of numbers to see if that same number is there. If so, this would mean a number was simply posted to the wrong column.

For instance, if $1,000 was put in the wrong column, that column would be overstated by $1,000. The other column would be understated by $1,000, thereby rendering the difference to be $2,000. Divide $2,000 by 2 to arrive at $1,000. Scan the columns for $1,000 and determine if that amount was posted to the right column.

Most of the time when working with computerized accounting systems you should write a general journal entry to correct an error. This way, you have a audit trail of what happened. I caution you against simply making the change directly into the system "after" you have posted. Quickbooks is the only system I know of where you can do this. Yes, sometimes you can get away with it. But, on there are those occasions where the only way you can figure out what happened, (perhaps months later) is by tracing back each transaction. It can be very frustrating to find there is no information to refer back to.

Sometimes when writing a journal entry to correct an error it is easy to mix up the debit and the credit. For instance, let's say there is a $5.00 debit in the Employee Payroll Tax liability account. It should have been a debit to the Employer Payroll Tax expense account. The correcting journal entry required is a debit to Employer Payroll Tax and a credit to Employee Payroll Tax for $5.00. Instead, the end result turns out to be a $10.00 debit in Employee Payroll Tax instead of $0.00. This calls for another correcting journal entry for $10.00. Sad to say this still happens to me after 27 years in the business.

Another thing to keep in mind is to use the Miscellaneous Suspense account when an error can't be found right away. More specifically, if you are trying to clear an account and there is still a balance in it and the financials need to be completed, reclassify the amount into the Suspense account and finish what you are working on. The figure will remain in the Suspense account until the answer is found.

Also, let's say there is an error in some expense account. It is not material, meaning that the size of the error will make no difference at all to the readers of the financial statements. You simply cannot find it. It is obvious that it got posted to some other unknown expense account. Leave it alone. The bottom line profit or loss will not be affected. All that is wrong is two of the expense accounts are slightly off. The time it takes to find a small error like that is not worth the benefit of finding it.

Lastly, what if there is some amount left over in an account and you have no idea where it came from or where to put it. If it is not material, take the leap and post it to Miscellaneous Expense. If you feel inspired, add a note to why this entry is being made. It's not a capital crime. Sometimes "stuff" happens. Use common sense. Get rid of it and move on.

TIP: Finding And Fixing Bank Reconciliation Errors

First, look at this list of the types of the most common bank reconciliation errors you might run into:

Book Side:

1. Beginning balance is incorrect
2. Deposit totals are incorrect.
3. Check register total is incorrect.
4. Some bank charges on the bank statement were unaccounted for.
5. A transposition error occurred.
6. There was an addition or subtraction error.

Bank Side:

7. The bank's beginning balance was not recorded correctly.
8. A last month's deposit-in-transit was not included.
9. This month's deposit-in-transit was not included.
10. An outstanding check is not actually outstanding.
11. A check that is outstanding is not recorded as outstanding.

Next, here are ten tips on finding errors in a bank reconciliation that come directly from my Real Life Accounting for Non-Accountants online course:

1. Determine the amount you are off between the Book and Bank balance. Is the Book balance higher or lower than the Bank?

2. Does the amount seem familiar? Scan your lists of deposits, checks and outstanding checks. Scan the bank statement.

3. If you do find the exact number you will have to think out how that number could be causing the problem.

4. If you don't find the number then you need to determine whether your problem is related to increases or decreases on the Book side.

A KEY Point - Analysis Techniques that Work

Find the summary credit amount on the bank statement and the summary amount of deposits on the Book side. Go back to the summary amount of credits from the bank statement. Begin with that figure in your calculator. Subtract any deposits-in-transit from last month and add any new deposits-in-transit. Subtract any deposit adjustments on the bank statement that are not included in your Book deposits. If your new number is different from your summary Book deposit number then either your entire problem is in the deposit section or part of it is. If it is the exact amount you are off then you know you are in the home stretch. If it comes out equal, your problem is in the decreases section.

Use the same process to find out how far you are off in the decreases section. Add all your Book decreases which will include checks, bank charges, and any other deductions to the bank balance that occurred during the month. Establish that total. Then find the total debits on the bank statement. Subtract last month's outstanding checks and add this month's outstanding checks. Add or subtract any other bank deductions that are not included on your Book side decreases. Compare the two totals. If it is not the exact amount you are off, but it is off, then combine the amount your are off in the deposit section and see if that combination is not the same as the original difference between Bank and Book .

5. If you determine that you are off in the decreases section then compare your check register tape against the bank checks. This has to be done check by check. Do not compare your check register that you checked off against the bank. If you do, you may miss the error again. Use the tape. This is a secret accounting technique. Most errors are found here. For instance, a 10 was taken as 100, or a 4 looked like a 9, or 3 like an 8. A number might have been skipped entirely, you just didn't see it. Another common error is adding a check that was voided. Voided checks should have a line drawn through them to make sure you don't add them in.

6. Part of Step Five is to also reestablish the new outstanding check list. Often an error shows up here. A check may have cleared but did not get taken off last month's list.

7. If no luck, so far, you need to systematically recheck every deduction that is listed on the bank statement. Sometimes, on the very last page a deduction may be listed and you didn't see it.

8. If you are still searching having rechecked all your lists including deposits, checks, all debit and credit memos and are still having no success then it is probably something stupid. At this point, check your beginning balance. Is it the same as last month's ending balance. Did you pick up the right Bank ending balance as the starting balance on your reconciliation's Bank side? Is your addition correct?

9. If you can't find the error by now your only recourse is to do it all over again. Go slowly, leave no stone unturned. It is there! If you have been thorough and careful to make sure you have accounted for every item on your Book side that occurred on the Bank side then the error *has* to be there.

10. Use the Stop and Rest technique if you are getting tired. You will be amazed how quickly you can find the error the next day.

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