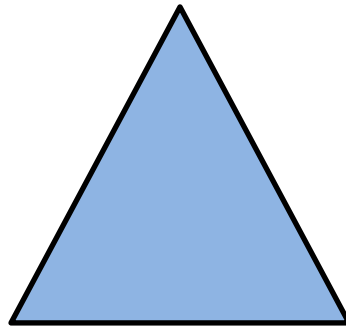


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CONCEPT: FRAUD AND THE FRAUD TRIANGLE

- **Fraud** – a dishonest act by an employee for personal benefit at the cost of the employer
 - Stealing money from the cash register
 - Stealing Inventory from the warehouse
 - Creating fake invoices paid by the company



- **Opportunity** – the workplace environment must provide an opportunity to commit fraud
 - The most important element of the fraud triangle
 - Example: Cash registers are not counted at the end of the day
- **Incentive (or Financial Pressure)** – the reason the employee wants to commit fraud
 - Example: The employee is behind on bill payments.
 - Example: The employee wants to live a lavish life.
- **Personality to Rationalize** – the employee must feel OK with the dishonest behavior
 - Example: The employee believes they are underpaid and deserve more money.
- To minimize the opportunity to commit fraud, companies use **internal controls**
 - **Internal Controls** safeguard assets, make financial information more reliable, and ensure compliance with laws

CONCEPT: SARBANES-OXLEY ACT

- The early 2000s were famous for huge accounting scandals at companies like _____ and _____
 - In response, Congress passed the **Sarbanes-Oxley Act (SOX)** to rebuild confidence in financial information
- The key features of the Sarbanes-Oxley Act include:
 - **PCAOB** – Created the **Public Company Accounting Oversight Board**
 - Basically the auditors of the auditors
 - **Executive accountability** – The CEO and CFO are now required to _____ and certify financial statements
 - **Nonaudit services** – Illegal for auditors to perform _____ services for their client, like _____
 - **Workpaper retention** – Auditors are required to hold onto important documents for seven years
 - **Auditor rotation** – the lead auditor of an engagement must be rotated at least every five years
 - **Conflicts of interest** – Audit firms cannot audit companies where the executives used to work for the auditors
 - **Audit committee** – Audit firms must be hired by an audit committee of the Board of Directors, not management
 - **Internal Controls** – Management must assess the effectiveness of internal controls and the auditors must test
 - **Internal Controls** safeguard assets, make financial information more reliable, and ensure compliance

CONCEPT: FIVE COMPONENTS OF INTERNAL CONTROLS

- **Internal Controls** safeguard assets, make financial information more reliable, and ensure compliance with laws
 - The **COSO framework** provides a guide to creating effective internal controls

Five Components of Effective Internal Control

1. **Control Environment** – management must make it clear that the company values integrity
 - Organizational Structure; Management Operating Style “_____”; Employee Code of Conduct
2. **Risk Assessment** – identifying factors that create internal and external risks to the company
 - Competitive threats; Changes in regulation; weaknesses in Internal Controls
3. **Control Activities** – policies and procedures that address specific company risks
 - Physical Controls (safe, locks); Documentation Procedures (numbered documents)
 - *Separation of duties* – more than one person is necessary to complete a task
 - _____ and _____ custody of assets should be separated to different people
4. **Monitoring** – continually checking that internal controls are working correctly
5. **Information and Communication** must be captured in the system correctly and in a timely manner

CONCEPT: PRINCIPLES OF CONTROL ACTIVITIES

● **Control Activities** are the foundation of a company's internal control efforts to reduce fraud. The six principles are:

- **Establishment of Responsibility** – only ____ person should be responsible for a given task
- **Separation of Duties** – more than one person is necessary to complete a task

Example: One employee _____ goods, _____ receipt of goods, and _____ supplier

Possible fraud:

- Employee orders from a particular supplier because they are _____, rather than price or quality
- The company may pay _____ or inaccurate invoices because the invoices are not verified
- The employee could _____ goods from the company

Possible solution: _____

- Ordering Goods → Receiving Goods → Paying Supplier

- **Documentation Procedures** – use pre-numbered documents and make sure all documents are accounted for
- **Physical Controls** – safeguarding physical assets
 - Safes; locked warehouses; passwords; alarms; sensors on merchandise
- **Independent Internal Verification** – a separate employee periodically _____ another employee's work
- **Human Resource Controls**:
 - **Bonding** – obtaining insurance for employee's who handle cash as protection against employee theft
 - **Mandatory vacations** – fraud is usually discovered while the employee is on vacation
 - **Background Checks** on employees reduce the risk of hiring risky employees

CONCEPT: LIMITATIONS OF INTERNAL CONTROLS

- No system of internal controls is perfect. Fraud can still occur for several reasons:
 - **Human Element** – Employees may be careless or indifferent towards internal control procedures
 - **Collusion** – two or more employees working together to commit fraud
 - **Executive Override** – top level executives are usually the final verification on a transaction
 - A low-level employee needs authorization from the CFO for a transaction
 - The CFO can authorize his own transactions; say, for a personal jet ski
 - **Size of the business** – small businesses may not have enough employees to properly segregate duties
 - The cost (i.e. hiring more employees) may outweigh the benefit (i.e. internal control)
- For these reasons, we say that effective internal controls provide _____ over:
 - The **safeguarding** of assets
 - The **reliability** of financial information

CONCEPT: PETTY CASH

- The company will regularly spend money on trivial items, such as _____ or _____
 - **Petty Cash** – a small cash fund for paying trivial expenses
- A Company creates the petty cash fund by _____ a custodian for petty cash and giving them the cash:

Clutch Prep appoints Alvaro, the office manager, to be in charge of the new petty cash fund, giving him \$100.

Journal Entry:

<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Equity</u>
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- Throughout the period, the custodian will _____ items using the petty cash.
 - The custodian MUST keep vendor _____ and an internal pre-numbered petty cash _____
 - _____ journal entries are made during the period for these purchases
- Eventually, we must _____ the petty cash fund

Alvaro submits a request for an \$84 check to replenish the petty cash fund. Alvaro's receipts in the petty cash box include \$42 for postage, \$18 for supplies, and \$24 for deliveries.

Journal Entry for Expenses:

Journal Entry to Replenish Petty Cash:

<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Equity</u>
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- If the receipts and the expenses don't match up, we use the **Cash Over and Short** account for the discrepancy

Alvaro notes that \$17 are left in his petty cash fund and asks for a \$83 check to replenish the fund. Alvaro's receipts in the petty cash box include \$42 for postage, \$18 for supplies, and \$24 for deliveries.

Journal Entry for Expenses:

Journal Entry to Replenish Petty Cash:

<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Equity</u>
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CONCEPT: BANK RECONCILIATION

- Cash is the most liquid asset and easiest to steal. Specific internal controls for cash are necessary.
 - **Bank Reconciliation** – checking the bank cash balance and book records and adjusting for the differences
 - The bank records and the Cash account generally show a difference due to a _____

Bank Column of Reconciliation – Some events are recorded by the company before the bank records the transactions:

Deposits in transit	The Company has deposited a check and increased its cash balance, but the bank has not shown this deposit yet.	_____ deposits in transit to the bank balance
Outstanding checks	The Company has written a check and reduced its cash balance, but the bank has not shown the payment yet.	_____ outstanding checks from the bank balance
Bank errors	The bank occasionally makes errors, especially in accounting problems.	_____ effects of errors

Book Column of Reconciliation (cash account) – Some events are recorded by the bank before the company finds out:

Bank collections	Bank collects cash on our behalf but the Company did not know the cash was received until the bank statement arrived	_____ bank collections to book
Electronic Funds Transfer (EFT)	Bank collects (or pays) cash on our behalf but the Company did not know the cash was received until the bank statement arrived	_____ EFT receipts and _____ EFT payments from the book
Service Charge	The bank charged us a fee, but we never recorded it	_____ fees from book
Interest revenue	The company earned interest in the bank account, but never recorded it	_____ interest revenue to book
Nonsufficient Funds (NSF) Checks	Company recorded that a customer paid them, but the check did not go through	_____ NSF checks from book
Book errors	The accountant occasionally makes errors, especially in accounting problems.	_____ effects of errors

PRACTICE: A company has a current balance in its Cash account of \$3,400. The bank statement arrived showing a bank balance of \$5,900. Prepare the cash reconciliation noting the following events:

- Deposits in transit total \$600
- EFT receipt of dividend revenue of \$900
- Bank error: the bank deducted \$100 for a check written by another company.
- Service charge \$20
- NSF check from a customer \$50
- Book error: Company Check no. 333 was recorded for \$510. The actual amount paid on account was \$150.
- Outstanding checks total \$2,010

CONCEPT: JOURNAL ENTRIES FOR BANK RECONCILIATION

- After the bank reconciliation is complete, we must make journal entries for every item in the _____ column

Bank collections	
Electronic Funds Transfer (EFT)	
Service Charge	
Interest revenue	
Nonsufficient Funds (NSF) Checks	
Book errors	

PRACTICE: Create the journal entries from the information in the bank reconciliation:

Unadjusted Book Balance	\$3,400	Unadjusted Bank Balance	\$5,900
Add:		Add:	
EFT receipt of dividend revenue	\$900	Deposits in Transit	\$600
Book error – Check #333	\$360	Bank error	\$100
Subtract:		Subtract:	
Service Charge	\$20	Outstanding Checks	\$2,010
NSF check	\$50		
Adjusted Book Balance	<u>\$4,590</u>	Adjusted Bank Balance	<u>\$4,590</u>