# Chapter 5 Study Guide: Fraud, Internal Control, and Cash

## 1. Introduction to Fraud and Internal Control

## 2. The Three Key Elements of Fraud

Fraud can typically be explained through the **Fraud Triangle**, which identifies the three conditions that must be present for fraud to occur:

- **Pressure**: An individual may feel pressure to meet financial goals or personal needs (e.g., financial difficulties or unrealistic performance targets).
- **Opportunity**: An individual perceives that they have the opportunity to commit fraud without getting caught (e.g., weak internal controls).
- **Rationalization**: The individual justifies the fraudulent behavior, often by convincing themselves that it's for the greater good or that they "deserve" the benefits.

## 3. Internal Control Systems

Internal controls are policies and procedures designed to:

- Protect assets from theft or misuse.
- Ensure the accuracy and reliability of financial reporting.
- Promote operational efficiency and effectiveness.
- Ensure compliance with laws and regulations.

## Key components of an internal control system:

- **Control Environment**: The overall attitude of management regarding internal control and ethical behavior.
- **Risk Assessment**: The process of identifying potential risks that could affect the achievement of business objectives.
- **Control Activities**: Specific actions taken to mitigate identified risks (e.g., authorization of transactions, physical controls over assets).
- **Information and Communication**: Systems that provide necessary information to stakeholders and ensure that employees understand their roles in the internal control system.
- **Monitoring**: Ongoing evaluations to ensure that internal controls are effective and working as intended.

## 4. Common Internal Control Procedures

- **Separation of Duties**: Dividing responsibilities so that no one individual controls all aspects of a transaction. For example, the person who approves purchases should not be the same person who handles payments.
- **Physical Controls**: Safeguarding assets through physical means, such as locked safes, secure storage, and restricted access to cash.
- **Authorization**: Transactions should be authorized by appropriate personnel before they are executed.
- **Reconciliation**: Regularly comparing records (e.g., bank statements) to ensure that the company's records are accurate.
- **Documentation**: Ensuring that all transactions are properly documented and that there is a clear audit trail.

## 5. The Role of Cash in Internal Control

- Cash is one of the most liquid assets, making it a prime target for theft. Effective internal control over cash is essential to prevent fraud.

  ### Key cash control procedures:

  - **Cash Receipts**: All cash received should be recorded immediately, deposited in a bank, and monitored for proper authorization.
  - **Cash Disbursements**: Payments should be made by check or electronic transfer, and proper documentation should be required for each payment.
  - **Bank Reconciliation**: Regularly comparing the company's records to the bank's records ensures that discrepancies are identified and corrected promptly.

## 6. The Sarbanes-Oxley Act of 2002 (SOX)

- The **Sarbanes-Oxley Act** was enacted to prevent fraud and protect investors by enhancing the accuracy and reliability of corporate disclosures. SOX mandates that companies:
  - Establish and maintain an adequate internal control structure and procedures for financial reporting.
  - Implement procedures for evaluating the effectiveness of internal controls.
  - The CEO and CFO must personally certify the accuracy of financial reports.

  SOX has had a significant impact on internal control and corporate governance, particularly for publicly traded companies.

## 7. Cash and Cash Equivalents

- **Cash**: Includes currency, coins, and amounts held in checking and savings accounts.

- **Cash Equivalents**: Short-term, highly liquid investments that are easily convertible to known amounts of cash (e.g., Treasury bills, money market funds).

## 8. Bank Reconciliation

- **Bank Reconciliation**: The process of comparing the company's cash records to the bank's records and adjusting for differences (e.g., outstanding checks, deposits in transit, bank fees).
    - **Bank Statement**: A record provided by the bank showing all deposits, withdrawals, and balances.
    - **Book Balance**: The cash balance shown in the company's general ledger.

### Adjustments to the book balance:

- Add: Bank collections and interest earned by the bank on behalf of the company.
- Subtract: Bank service charges or NSF checks.

### Adjustments to the bank statement:

- Add: Deposits in transit.
- Subtract: Outstanding checks.

## 9. Key Terms to Know

- **Fraud**
- **Internal Control**
- **Fraud Triangle**
- **Separation of Duties**
- **Physical Controls**
- **Bank Reconciliation**
- **Sarbanes-Oxley Act (SOX)**
- **Cash Equivalents**
- **Risk Assessment**
- **Control Activities**
- **Monitoring**
- **Authorization**
- **Reconciliation**
- **Documentation**

# Practice Questions for Chapter 5: Fraud, Internal Control, and Cash

# Answers to Practice Questions

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## Problem 1.1: Fraud Triangle

- **Pressure**: The employee feels pressure to meet sales targets and avoid losing their job.
- **Opportunity**: The accounting system does not flag errors, providing the employee with the opportunity to manipulate the records.
- **Rationalization**: The employee justifies the fraud by planning to pay the company back in the future.

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## Problem 2.1: Identifying Internal Control Procedures

- A) **Correct**: CEO approval of expenditures ensures oversight.
- B) **Incorrect**: Vacation approval is not related to financial control.
- C) **Incorrect**: Taking home company assets is a violation of internal control.
- D) **Correct**: Lockbox systems prevent theft of cash receipts.
- E) **Correct**: Requiring signatures on large payments ensures authorization.

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## Problem 3.1: Bank Reconciliation

**Bank Reconciliation for ABC Inc. on January 31:**

- **Bank Statement Balance**: $9,000
- Add: **Deposits in Transit**: $700
- Subtract: **Outstanding Checks**: $1,200
- Adjusted Bank Balance: $9,000 + $700 - $1,200 = **$8,500**
- **Book Balance**: $8,500
- Subtract: **Bank Service Fees**: $25
- Adjusted Book Balance: $8,500 - $25 = **$8,475**

The reconciled balances indicate a discrepancy of $25, which can be attributed to the bank service fee.

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## Problem 4.1: Cash Control Procedures

1. **Immediate Recording**: Record all cash receipts immediately to prevent misappropriation.
2. **Segregation of Duties**: Separate responsibilities for cash handling, recording, and reconciliation.
3. **Regular Deposits**: Deposit cash receipts frequently to minimize the risk of theft.

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## Problem 5.1: Sarbanes-Oxley Compliance

1. The company must **establish an internal control system** for financial reporting.
2. The **CEO and CFO must certify** the accuracy of the company's financial statements.

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## Problem 6.1: Evaluating Internal Controls

- **Weaknesses**: The cashier has too much responsibility. Combining duties of receiving, depositing, and recording cash transactions creates an opportunity for fraud.
- **Improvements**: The duties should be separated—one person should receive the payments, another should deposit them, and a third should record the transactions.