Chapter 8 — Fraud, Internal Control & Cash

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1 · Fraud and the fraud triangle

A fraud is a dishonest act by an employee that results in personal benefit at the company's expense. Understanding why fraud happens is the first step to preventing it — and it almost always traces back to three factors acting together.

The fraud triangle: The three conditions that make fraud likely: opportunity (a weakness in the system that can be exploited), financial pressure (a personal need for money), and rationalization (justifying the act to oneself). Of the three, a company has the most direct control over OPPORTUNITY.

Because opportunity is the leg management can shrink the most, internal control is aimed squarely at it. After a wave of corporate scandals, the Sarbanes-Oxley Act (SOX) required public companies to maintain and document adequate internal controls and made top management responsible for them.

2 · The six principles of internal control

Internal control is the set of methods a company uses to safeguard assets, keep its records accurate, and promote efficient, policy-compliant operations. Six principles do the heavy lifting.

- Establishment of responsibility — assign each task to one specific person; control is most effective when only one person handles a given job.
- Segregation of duties — the person who handles an asset should not also keep its records, and related activities should be split among different people.
- Documentation procedures — use prenumbered documents and record transactions promptly so nothing is missed or duplicated.
- Physical controls — safes, locked storage, alarms, computer passwords, and time clocks that physically protect assets and records.
- Independent internal verification — have someone review, compare, and reconcile the work of others, ideally on a surprise basis.
- Human resource controls — bond employees who handle cash, rotate duties and require vacations, and conduct background checks.

3 · What internal control can't do

Even a well-designed system has limits. The point is reasonable assurance, not a guarantee.

- Cost-benefit — controls must be worth more than they cost; a company won't spend $10,000 to prevent a $100 loss.
- Collusion — two or more employees working together can defeat a system built on segregation of duties.
- The human element — a tired or careless employee, or a manager who overrides controls, can undo them. Small companies with few employees find segregation of duties especially hard.

4 · Control over cash receipts

Cash is the asset most vulnerable to theft, so the principles are applied tightly to money coming in. The goal: every dollar received is recorded and deposited intact.

- Over-the-counter receipts — use a register the customer can see, and have a supervisor (not the cashier) compare the register total to the cash count.
- Mail receipts — open mail with two people present, and separate the person who handles the checks from the person who records them.
- Deposit receipts intact daily and keep the handling of cash separate from the recording of cash.

A weak vs. a strong control. If the same clerk receives cash AND records it in the accounts, that violates segregation of duties — the clerk could pocket cash and hide it in the books. The fix: one person receives and deposits the cash; a different person records the receipts; a third reconciles the two.

5 · Control over cash disbursements

Money going out is generally better controlled when it is paid by check or electronic funds transfer (EFT) rather than currency, because each payment leaves a record.

- Only authorized people sign checks (segregation from those who record cash), and checks are prenumbered.
- The person who approves the payment should not be the person who signs the check.
- Compare the invoice, receiving report, and purchase order before paying, and stamp the supporting documents PAID so they can't be paid twice.

6 · The petty cash fund

Paying for small items (postage, a delivery, a few supplies) by check is impractical, so companies keep a small imprest petty cash fund. 'Imprest' means it is set at a fixed amount and periodically restored to that amount.

- Establishing the fund — write one check for the fund amount: debit Petty Cash, credit Cash. This entry is made only once.
- Making payments — the custodian pays small bills and keeps a receipt for each; NO accounting entry is made as payments are made.
- Replenishing the fund — when it runs low, write a check to restore it: debit the various expenses shown by the receipts, credit Cash. Petty Cash is not touched.

Replenishing with a shortage. A $150 fund holds receipts for postage $52, delivery $38, and supplies $41 (total $131) and $17 in cash — but $150 - $131 = $19 should remain, so the fund is $2 short. The replenishing entry debits Postage $52, Delivery $38, Supplies $41, and Cash Over and Short $2 (a shortage is a debit), and credits Cash $133 (the $150 fund minus the $17 still on hand).

7 · Using a bank to help control cash

A bank account is itself a control device. Depositing all receipts and paying by check means the bank independently records every cash transaction — a second set of records to check the company's own against.

Each month the bank sends a statement of the account's activity. Its ending balance rarely equals the company's book balance on the same day, because of timing differences and items one party knows about before the other. Reconciling the two is how a company proves its cash is right.

8 · The bank reconciliation

A bank reconciliation explains the difference between the balance per bank and the balance per books, adjusting each to a correct, 'true' cash balance. The two adjusted balances must agree.

Reconciling items — bank side: Deposits in transit (recorded by the company but not yet by the bank) are ADDED to the bank balance; outstanding checks (written but not yet cleared) are SUBTRACTED. Bank errors are corrected on this side too.

Reconciling items — book side: Items the bank knew about first: ADD notes and interest the bank collected for you; SUBTRACT NSF (bounced) checks and bank service charges. Book errors are corrected on this side.

A reconciliation that balances. Balance per bank $15,000 + deposits in transit $3,000 - outstanding checks $4,500 = $13,500. Balance per books $12,900 + a $800 note collected by the bank - a $150 NSF check - a $50 service charge = $13,500. Both adjusted balances equal $13,500, so the account reconciles.

9 · Adjusting entries from the reconciliation

Only the BOOK-side reconciling items need journal entries — those are the things the company hadn't recorded yet. The bank-side items (deposits in transit, outstanding checks) need no entry; they'll clear on their own.

- Note collected by the bank (say $800, including $50 interest) — debit Cash $800, credit Notes Receivable $750 and Interest Revenue $50.
- NSF check from a customer ($150) — debit Accounts Receivable $150, credit Cash $150 (the customer still owes you).
- Bank service charge ($50) — debit a Bank Charge (Miscellaneous) Expense $50, credit Cash $50.

After posting these, the company's Cash account equals the reconciled true balance.

10 · Reporting cash

On the balance sheet, cash is a current asset — usually listed first because it is the most liquid. Companies report cash together with cash equivalents.

Cash equivalents: Short-term, highly liquid investments that mature within three months of purchase, such as Treasury bills and money market funds — close enough to cash to be reported with it.

What counts as cash. Cash in bank $42,000, petty cash $150, and a money-market investment maturing in two months $8,000 are reported together as 'Cash and cash equivalents' of $50,150. Excluded: accounts receivable, inventory, stock investments, and any restricted cash (cash set aside for a specific purpose, reported separately).