

Key Terms

bank reconciliation internal financial report that explains and documents any differences that may exist between a balance within a checking account and the company's records

bank service fee fee often charged by a bank each month for management of the bank account

chief executive officer (CEO) executive within a company with the highest ranking title who has the overall responsibility for the management of a company; reports to the board of directors

chief financial officer (CFO) corporation officer who reports to the CEO and oversees all of the accounting and finance concerns of a company

collusion private cooperation or agreement, between more than one person, primarily for a deceitful, illegal, or immoral cause or purpose

Committee of Sponsoring Organizations (COSO) independent, private-sector group whose five sponsoring organizations periodically identify and address specific accounting issues or projects related to internal controls

control lapse when there is a deviation from standard control protocol that leads to a failure in the internal control and/or fraud prevention processes or systems

cooking the books (also, financial statement fraud) financial statements are used to conceal the actual financial condition of a company or to hide specific transactions that may be illegal

cybersecurity practice of protecting software, hardware, and data from digital attacks

deposit in transit deposit that was made by the business and recorded on its books but has not yet been recorded by the bank

external auditor generally works for an outside CPA firm or his or her own private practice and conducts audits and other assignments, such as reviews

financial statement fraud using financial statements to conceal the actual financial condition of a company or to hide specific transactions that may be illegal

fraud act of intentionally deceiving a person or organization or misrepresenting a relationship in order to secure some type of benefit, either financial or nonfinancial

fraud triangle concept explaining the reasoning behind a person's decision to commit fraud; the three elements are perceived opportunity, rationalization, and incentive

imprest account account that is only debited when the account is established or the total ending balance is increased

internal auditor employee of an organization whose job is to provide an independent and objective evaluation of the company's accounting and operational activities

internal control system sum of all internal controls and policies within an organization that protect assets and data

internal controls systems used by an organization to manage risk and diminish the occurrence of fraud, consisting of the control environment, the accounting system, and control activities

nonsufficient funds (NSF) check check written for an amount that is greater than the balance in the checking account

outstanding check check that was written and deducted from the financial records of the company but has not been cashed by the recipient, so the amount has not been removed from the bank account

petty cash fund amount of cash held on hand to be used to make payments for small day-to-day purchases

Public Company Accounting Oversight Board (PCAOB) organization created under the Sarbanes-Oxley Act to regulate conflict, control disclosures, and set sanction guidelines for any violation of regulation

publicly traded company company whose stock is traded (bought and sold) on an organized stock

exchange

revenue recognition accounting for revenue when the company has met its obligation on a contract

Sarbanes-Oxley Act (SOX) federal law that regulates business practices; intended to protect investors by enhancing the accuracy and reliability of corporate financial statements and disclosures through governance guidelines including sanctions for criminal conduct

special purpose entities separate, often complicated legal entities that are often used to absorb risk for a corporation

Summary

8.1 Analyze Fraud in the Accounting Workplace

- The fraud triangle helps explain the mechanics of fraud by examining the common contributing factors of perceived opportunity, incentive, and rationalization.
- Due to the nature of their functions, internal and external auditors, through the implementation of effective internal controls, are in excellent positions to prevent opportunity-based fraud.

8.2 Define and Explain Internal Controls and Their Purpose within an Organization

- A system of internal control is the policies combined with procedures created by management to protect the integrity of assets and ensure efficiency of operations.
- The system prevents losses and helps management maintain an effective means of performance.

8.3 Describe Internal Controls within an Organization

- Principles of an effective internal control system include having clear responsibilities, documenting operations, having adequate insurance, separating duties, and setting clear responsibilities for action.
- Internal controls are applicable to all types of organizations: for profit, not-for-profit, and governmental organizations.

8.4 Define the Purpose and Use of a Petty Cash Fund, and Prepare Petty Cash Journal Entries

- The purpose of a petty cash fund is to make payments for small amounts that are immaterial, such as postage, minor repairs, or day-to-day supplies.
- A petty cash account is an imprest account, so it is only debited when the fund is initially established or increased in amount. Transactions to replenish the account involve a debit to the expenses and a credit to the cash account (e.g., bank account).

8.5 Discuss Management Responsibilities for Maintaining Internal Controls within an Organization

- It is the responsibility of management to assure that internal controls of a company are effective and in place.
- Though management has always had responsibility over internal controls, the Sarbanes-Oxley Act has added additional assurances that management takes this responsibility seriously, and placed sanctions against corporate officers and boards of directors who do not take appropriate responsibility.
- Sarbanes-Oxley only applies to public companies. Even though the rules of this act only apply to public companies, proper internal controls are an important aspect of all businesses of any size. Tone at the top is a key component of a proper internal control system.

8.6 Define the Purpose of a Bank Reconciliation, and Prepare a Bank Reconciliation and Its Associated Journal Entries

- The bank reconciliation is an internal document that verifies the accuracy of records maintained by the depositor and the financial institution. The balance on the bank statement is adjusted for outstanding

checks and uncleared deposits. The record balance is adjusted for service charges and interest earned.

- The bank reconciliation is an internal control document that ensures transactions to the bank account are properly recorded, and allows for verification of transactions.

8.7 Describe Fraud in Financial Statements and Sarbanes-Oxley Act Requirements

- Financial statement fraud has occurred when financial statements intentionally hide illegal transactions or fail to accurately reflect the true financial condition of an entity.
- Cooking the books can be used to create false records to present to lenders or investors. It also is used to hide corporate looting of funds and other resources, or to increase stock prices. Cooking the books is an intentional action and is often achieved through the manipulation of the entity's revenues or accounts receivable.
- Health South and Enron were used as examples of past corporate financial fraud.
- The section takes a brief look at the current state of SOX compliance.



Multiple Choice

1. **LO 8.1** Which of the following would a fraudster perceive as a pressure?
 - A. lack of management oversight
 - B. everyone does it
 - C. living beyond one's means
 - D. lack of an internal audit function
2. **LO 8.2** Internal control is said to be the backbone of all businesses. Which of the following is the best description of internal controls?
 - A. Internal controls ensure that the financial statements published are correct.
 - B. The only role of internal controls is to protect customer data.
 - C. Internal controls and company policies are important to protect and safeguard assets and to protect all company data and are designed to protect the company from fraud.
 - D. Internal controls are designed to keep employees from committing fraud against the company.
3. **LO 8.3** What is the best way for owners of small businesses to maintain proper internal controls?
 - A. The owner must have enough knowledge of all aspects of the company and have controls in place to track all assets.
 - B. Small businesses do not need to worry about internal controls.
 - C. Small businesses should make one of their employees in charge of all aspects of the company, giving the owner the ability to run the company and generate sales.
 - D. Only managers need to be concerned about internal controls.
4. **LO 8.3** Which of the following is *not* considered to be part of the internal control structure of a company?
 - A. Ensure that assets are kept secure.
 - B. Monitor operations of the organization to ensure maximum efficiency.
 - C. Publish accurate financial statements on a regular basis.
 - D. Ensure assets are properly used.