Exam Review for Chapter 6

Employee Fraud and Cash Audits

Several pressures/motivations might lead an honest person to commit fraud:

*Egocentric pressures/motivations*

* My father was wealthy, and I need to be wealthy too.
* My friends admire cars, and I need to have an expensive one.

*Ideological pressures/motivations*

* Because the company sells tobacco and alcohol, it doesn’t deserve to make a profit.
* I can award the government housing grants to best use without the HUD red tape. (Justifying diversion of funds in government housing programs.)
* Employee embezzles company funds from an electric utility company for the purpose of paying expenses of an anti-nuclear protest organization,

*Economic pressures/motivations*

I need to:

* Pay college tuition.
* Pay hospital bills for my parent with cancer.
* Pay gambling debts.
* Buy drugs.
* Pay alimony and child support.
* Pay for high life style (homes, cars, boats).
* Finance business or stock speculation losses.
* Report good financial results.

The **three factors** increasing the probability of fraud (triangle)

1. Motive
2. Opportunity and
3. Rationalization

An audit plan of substantive procedures for cash would include:

* request client to prepare bank reconciliations.
* prepare a schedule of interbank transfers for a period of ten business days before and after year-end date.
* obtain a written client representation concerning compensating balance agreements.

**Joint Custody Example**

The mail which includes payments should be opened by two people.

When auditing financial statements and finding indications of a possible misappropriation of assets, independent auditors should:

* investigate fully to determine the total amount of the misappropriation.
* determine which accounts are affected and the amount by which they are overstated or understated.
* determine the methods by which the misappropriation was carried out.
* identify a person(s) who are likely responsible for the misappropriation and obtain evidence about some other fraud indications in their work.

*Measuring performance and awarding bonuses based on short-term operating results* would increase the probability of fraud in a company.

Types of known misstatement

* an inaccuracy in processing data.
* the misapplication of accounting principles
* a difference between the classification of a reported financial statement element and the classification according to generally accepted accounting principles.

*Measure the time lag between the date of recording cash receipts in the books to the date of deposit credit in the bank* is ordinarily considered an "extended procedure" during the independent audit of financial statements.

If an employee alters the amount of a check after it has cleared the bank, the change can be detected by *comparing the magnetic imprint of the amount paid to the amount written on the check face*.

*The total of the accounts receivable subsidiary ledger balances is less than the accounts receivable control account* would be consistent with an employee taking cash receipts from customers on account.

In the audit of cash the auditor obtains a bank cutoff statement primarily to *test the propriety of items appearing on the client's year-end bank reconciliation*.

Auditors ordinarily send a standard confirmation request to all banks with which the client has done business during the year under audit, regardless of the year-end balances. A purpose of this procedure is to *seek information about contingent liabilities and security agreements*.

To gather evidence regarding the bank's balance in a bank reconciliation, an auditor would examine all of the following:

* cutoff bank statement.
* bank confirmation.
* year-end bank statement.

An auditor usually confirm on one form Cash in bank and collateral for loans.

An unrecorded check issued during the last week of the year would most likely be discovered by the auditor when the cutoff bank statement is reconciled.

An auditor wishes to perform tests of controls on a client's cash disbursements procedures. If the control activities leave no audit trail of documentary evidence, the auditor most likely will test the activities by **observation and inquiry**.

In order for auditors to be able to recognize potential fraud, they must be aware of the basic characteristics of fraud such as:

* Intentional deception.
* Taking unfair or dishonest advantage of other people.
* Perpetration for the benefit or detriment of the organization.

An auditor who discovers that client employees have committed an illegal act that has a material effect on the client's financial statements most likely would withdraw from the engagement *if the client does not take the remedial action that the auditor considers necessary*.

An auditor would least likely initiate a discussion with a client's audit committee concerning *the maximum dollar amount of misstatements that could exist without causing the financial statements to be materially misstated*.

The elements of the "fraud triangle"

* Motive is a cause that pressures people into action.
* Opportunity refers to a situation that allows someone with motive to carry out fraud.
* A lack of integrity describes a person who does not stick to the social or organizational ethical code.
* Fraud is most common when these three factors exist together.

Your client is in the process of acquiring another company. You have been requested to verify that cash for the company being acquired is properly stated. The audit technique that will yield the most persuasive evidence is ***preparation and review of standard bank confirmation inquiries***.

**Restrictive endorsement on all checks** should be performed by the persons opening the mail and recording payments.

**Positive Pay Systems** allows a company at the end of the business day to send its bank a listing of all checks written during the day including the check number, payee, and amount. When a check is sent to the bank for payment the bank compares the payee and the amount with the listing provided by the company.

Most fraud investigators utilize the fraud triangle theory. A new theory called the fraud diamond has been proposed. An element of the fraud diamond that is not an element of the fraud triangle is **Capability.**