# Chapter 8: Fraud, Internal Control, and Cash

<table>
<thead>
<tr>
<th>1</th>
<th>Control Activities</th>
</tr>
</thead>
</table>
| **DO IT!** | Identify which control activity is violated in each of the following situations, and explain how the situation creates an opportunity for a fraud.  
1. The person with primary responsibility for reconciling the bank account and making all bank deposits is also the company’s accountant.  
2. Wellstone Company’s treasurer received an award for distinguished service because he had not taken a vacation in 30 years.  
3. In order to save money spent on order slips and to reduce time spent keeping track of order slips, a local bar/restaurant does not buy prenumbered order slips. |
| **Solution** | 1. Violates the control activity of segregation of duties. Recordkeeping should be separate from physical custody. As a consequence, the employee could embezzle cash and make journal entries to hide the theft.  
2. Violates the control activity of human resource controls. Key employees must take vacations. Otherwise, the treasurer, who manages the company’s cash, might embezzle cash and use his position to conceal the theft.  
3. Violates the control activity of documentation procedures. If prenumbered documents are not used, then it is virtually impossible to account for the documents. As a consequence, an employee could write up a dinner sale, receive the cash from the customer, and then throw away the order slip and keep the cash. |

*Related exercise material: BE8-1, BE8-2, BE8-3, BE8-4, E8-1, and DO IT 8-1.*

<table>
<thead>
<tr>
<th>2a</th>
<th>Control Over Cash Receipts</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>DO IT!</strong></td>
<td>L. R. Cortez is concerned about the control over cash receipts in his fast-food restaurant, Big Cheese. The restaurant has two cash registers. At no time do more than two employees take customer orders and enter sales. Work shifts for employees range from 4 to 8 hours. Cortez asks your help in installing a good system of internal control over cash receipts.</td>
</tr>
<tr>
<td><strong>Solution</strong></td>
<td>Cortez should assign a separate cash register drawer to each employee at the start of each work shift, with register totals set at zero. Each employee should have access to only the assigned register drawer to enter all sales. Each customer should be given a receipt. At the end of the shift, the employee should do a cash count. A separate employee should compare the cash count with the register tape to be sure they agree. In addition, Cortez should install an automated system that would enable the company to compare orders entered in the register to orders processed by the kitchen.</td>
</tr>
</tbody>
</table>

*Related exercise material: BE8-5, BE8-6, BE8-7, E8-2, and DO IT 8-2a.*

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**Action Plan**  
✔ Familiarize yourself with each of the control activities summarized on page 287.  
✔ Understand the nature of the frauds that each control activity is intended to address.
Bateer Company established a $50 petty cash fund on July 1. On July 30, the fund had $12 cash remaining and petty cash receipts for postage $14, office supplies $10, and delivery expense $15. Prepare journal entries to establish the fund on July 1 and to replenish the fund on July 30.

**Solution**

<table>
<thead>
<tr>
<th>Date</th>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Petty Cash</td>
<td>50</td>
<td>Cash</td>
</tr>
<tr>
<td></td>
<td>(To establish petty cash fund)</td>
<td></td>
<td>50</td>
</tr>
<tr>
<td>30</td>
<td>Postage Expense</td>
<td>14</td>
<td>Cash</td>
</tr>
<tr>
<td></td>
<td>Supplies</td>
<td>10</td>
<td>Cash</td>
</tr>
<tr>
<td></td>
<td>Delivery Expense</td>
<td>15</td>
<td>Cash Over and Short</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td>38</td>
<td>Cash ($50 – $12)</td>
</tr>
<tr>
<td></td>
<td>(To replenish petty cash)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Related exercise material: BE8-9, E8-7, E8-8, and DO IT! 8-2b.

Sally Kist owns Linen Kist Fabrics. Sally asks you to explain how she should treat the following reconciling items when reconciling the company’s bank account: (1) a debit memorandum for an NSF check, (2) a credit memorandum for a note collected by the bank, (3) outstanding checks, and (4) a deposit in transit.

**Solution**

Sally should treat the reconciling items as follows.

1. NSF check: Deduct from balance per books.
2. Collection of note: Add to balance per books.
3. Outstanding checks: Deduct from balance per bank.
4. Deposit in transit: Add to balance per bank.

Related exercise material: BE8-11, BE8-12, BE8-13, BE8-14, E8-9, E8-10, E8-11, E8-12, E8-13, and DO IT! 8-3.
## DO IT! 4 Reporting Cash

Indicate whether each of the following statements is true or false.

1. Cash and cash equivalents comprise coins, currency (paper money), money orders, and NSF checks.
2. Restricted cash is classified as either a current asset or noncurrent asset, depending on the circumstances.
3. A company may have a negative balance in its bank account. In this case, it should offset this negative balance against cash and cash equivalents on the balance sheet.
4. Because cash and cash equivalents often include short-term investments, accounts receivable should be reported as the first item on the balance sheet.

### Solution

1. False. NSF checks should be reported as receivables, not cash and cash equivalents.  
2. True.  
3. False. Companies that have a negative balance in their bank accounts should report the negative balance as a current liability.  
4. False. Cash equivalents are readily convertible to known amounts of cash, and so near maturity (less than 3 months) that they are considered more liquid than accounts receivable and therefore are reported before accounts receivable on the balance sheet.

Related exercise material: E8-14, E8-15, and 8-4.

### Action Plan

- Understand how companies present cash and restricted cash on the balance sheet.
- Review the designations of cash equivalents and restricted cash, and how companies typically handle them.
### DO IT! Exercises

**Identify violations of control activities.** *(LO 1)*

**DO IT! 8-1** Identify which control activity is violated in each of the following situations, and explain how the situation creates an opportunity for fraud or inappropriate accounting practices.

1. Once a month, the sales department sends sales invoices to the accounting department to be recorded.
2. Leah Hutcherson orders merchandise for Rice Lake Company; she also receives merchandise and authorizes payment for merchandise.
3. Several clerks at Great Foods use the same cash register drawer.

**Design system of internal control over cash receipts.** *(LO 2)*

**DO IT! 8-2a** Gary Stanten is concerned with control over mail receipts at Gary’s Sporting Goods. All mail receipts are opened by Al Krane. Al sends the checks to the accounting department, where they are stamped “For Deposit Only.” The accounting department records and deposits the mail receipts weekly. Gary asks for your help in installing a good system of internal control over mail receipts.

**Make journal entries for petty cash fund.** *(LO 2)*

**DO IT! 8-2b** Wilkinson Company established a $100 petty cash fund on August 1. On August 31, the fund had $7 cash remaining and petty cash receipts for postage $31, office supplies $42, and miscellaneous expense $16. Prepare journal entries to establish the fund on August 1 and replenish the fund on August 31.

**Explain treatment of items in bank reconciliation.** *(LO 3)*

**DO IT! 8-3** Roger Richman owns Richman Blankets. He asks you to explain how he should treat the following reconciling items when reconciling the company’s bank account.

1. Outstanding checks.
2. A deposit in transit.
3. The bank charged to the company account a check written by another company.
4. A debit memorandum for a bank service charge.

**Analyze statements about the reporting of cash.** *(LO 4)*

**DO IT! 8-4** Indicate whether each of the following statements is true or false.

1. A company has the following assets at the end of the year: cash on hand $40,000, cash refund due from customer $30,000, and checking account balance $22,000. Cash and cash equivalents is therefore $62,000.
2. A company that has received NSF checks should report these checks as a current liability on the balance sheet.
3. Restricted cash that is a current asset is reported as part of cash and cash equivalents.
4. A company has cash in the bank of $50,000, petty cash of $400, and stock investments of $100,000. Total cash and cash equivalents is therefore $50,400.
CONTINUING PROBLEM

COOKIE CREATIONS: AN ENTREPRENEURIAL JOURNEY

(Note: This is a continuation of the Cookie Creations problem from Chapters 1 through 7.)

CC8 Part 1 Natalie is struggling to keep up with the recording of her accounting transactions. She is spending a lot of time marketing and selling mixers and giving her cookie classes. Her friend John is an accounting student who runs his own accounting service. He has asked Natalie if she would like to have him do her accounting. John and Natalie meet and discuss her business.

Part 2 Natalie decides that she cannot afford to hire John to do her accounting. One way that she can ensure that her cash account does not have any errors and is accurate and up-to-date is to prepare a bank reconciliation at the end of each month. Natalie would like you to help her.

Go to the book’s companion website, www.wiley.com/college/weygandt, to see the completion of this problem.