**CHAPTER 7**

**CONTROL AND ACCOUNTING INFORMATION SYSTEMS**

**SUGGESTED ANSWERS TO DISCUSSION QUESTIONS**

**7.1 Answer the following questions about the audit of Springer’s Lumber & Supply**

a. **What deficiencies existed in the internal environment at Springer’s?**

The "internal environment" refers to the tone or culture of a company and helps determine how risk consciousness employees are. It is the foundation for all other ERM components, providing discipline and structure. It is essentially the same thing as the control environment in the internal control framework.

The internal environment also refers to management's attitude toward internal control, and to how that attitude is reflected in the organization's control policies and procedures. At Springer's, several deficiencies in the control environment are apparent:

1. Management authority is concentrated in three family members, so there are few, if any, checks and balances on their behavior. In addition, several other relatives and friends of the family are on the payroll.
2. Since the company has a "near monopoly" on the business in the Bozeman area, few competitive constraints restrain prices, wages, and other business practices.
3. Lines of authority and responsibility are loosely defined, which make it difficult to identify who is responsible for problems or decisions.
4. Management may have engaged in "creative accounting" to make its financial performance look better, which suggests a management philosophy that could encourage unethical behavior among employees.
5. **Do you agree with the decision to settle with the Springers rather than to prosecute them for fraud and embezzlement? Why or why not?**

Whether or not to settle with the Springers is a matter of opinion, with reasonable arguments on both sides of the issue.

* The reasons for reaching a settlement are clearly stated: the difficulty of obtaining convictions in court, and the possible adverse effects on the company's market position.
* On the other hand, the evidence of fraud here seems strong. If this kind of behavior is not penalized, then the perpetrators may be encouraged to do it again, with future adverse consequences to society.

1. **Should the company have told Jason and Maria the results of the high-level audit? Why or why not?**

Whether or not Jason and Maria should have been told the results of the high-level audit is also a matter of opinion. The investigative team is apparently trying to keep its agreement to maintain silence by telling as few people as possible what really happened. On the other hand, Jason and Maria were the ones who first recognized the problems; it seems only right that they be told about the outcome.

Many lessons may be drawn from this story.

1. Auditors should view the condition of an organization's control environment as an important indicator of potential internal control problems.
2. Fraud is more easily perpetrated and concealed when many perpetrators are involved, and especially when management is involved.
3. Purchasing and payroll are two areas that are particularly vulnerable to fraud.
4. Determining whether fraud has actually occurred is sometimes quite difficult, and proving that it has occurred is even more difficult.
5. Frauds do occur, so auditors must always be alert to the possibility of fraud.
6. Auditors should not accept management's explanations for questionable transactions at face value, but should do additional investigative work to corroborate such explanations.

**7.2** **Effective segregation of duties is sometimes not economically feasible in a small business. What internal control elements do you think can help compensate for this threat?**

Small companies can do the following things to compensate for their inability to implement an adequate segregation of duties:

* Effective supervision and independent checks performed by the owner/manager may be the most important element of control in situations where separation of functions cannot be fully achieved. In very small businesses, the owner-manager may find it necessary to supervise quite extensively. For example, the manager could reconcile the bank account, examine invoices, etc.
* Fidelity bonding is a second form of internal control that is critical for persons holding positions of trust that are not entirely controlled by separation of functions.
* Document design and related procedures are also important to internal control in this situation. Documents should be required with customer returns to encourage customer audit.
* Document design should include sequential prenumbering to facilitate subsequent review.
* Where appropriate, employees should be required to sign documents to acknowledge responsibility for transactions or inventories.
* In small organizations, management can use computers to perform some of the control functions that humans perform in manual systems. For example, the computer can:
  + Check all customer numbers to make sure they are valid
  + Automatically generate purchase orders and have a member of management or a designated buyer authorize them.
  1. **One function of the AIS is to provide adequate controls to ensure the safety of organizational assets, including data. However, many people view control procedures as “red tape.” They also believe that, instead of producing tangible benefits, business controls create resentment and loss of company morale. Discuss this position.**

Well-designed controls should not be viewed as “red tape” because they can actually improve both efficiency and effectiveness. The benefits of business controls are evident if one considers the losses that frequently occur due to the absence of controls.

Consider a control procedure mandating weekly backup of critical files. Regular performance of this control prevents the need to spend a huge amount of time and money recreating files that are lost when the system crashes, if it is even possible to recreate the files at all. Similarly, control procedures that require workers to design structured spreadsheets can help ensure that the spreadsheet decision aids are auditable and that they are documented well enough so that other workers can use them.

It is probably impossible to eliminate resentment or loss of morale among all employees, but these factors may be minimized if controls are administered fairly and courteously.

Of course, there is a cost-benefit tradeoff in implementing internal controls. If an organization has too many controls, this may justifiably generate resentment and loss of morale among employees. Controls having only marginal economic benefit may be rejected for this reason.

Another factor is the obtrusiveness of the controls. When the user sees no clear need or purpose to a control it can appear to be there only to control them and little more than that. When the user does not understand their purpose, controls can often provoke resentment.

**7.4** **In recent years, Supersmurf’s external auditors have given clean opinions on its financial statements and favorable evaluations of its internal control systems. Discuss whether it is necessary for this corporation to take any further action to comply with the Sarbanes–Oxley Act.**

The Sarbanes-Oxley Act of 2002 (SOX) applies to publicly held companies and their auditors and was intended to prevent financial statement fraud, make financial reports more transparent, provide protection to investors, strengthen the internal controls at public companies, and punish executives who perpetrate fraud.

SOX has had a material impact on the way boards of directors, management, and accountants of publicly held companies operate. It has also had a dramatic impact on CPAs of publicly held companies and the audits of those companies.

As a result of SOX, Supersmurf’s management and their audit committee must take a more active role in the financial disclosure process. Some of the more prominent roles include:

**Audit Committee**

* Audit committee members must be on the company’s board of directors and be independent of the company. One member of the audit committee must be a financial expert.
* Audit committees hire, compensate, and oversee any registered public accounting firm that is employed
* Auditors report to the audit committee and not management
* Audit committees must pre-approve all audit and non-audit services provided by its auditor

**Management**

* The CEO and CFO at companies with more than $1.2 billion in revenue must prepare a statement certifying that their quarterly and annual financial statements and disclosures are fairly presented, were reviewed by management, and are not misleading.
* Management must prepare an annual internal control report that states
  + Management is responsible for establishing and maintaining an adequate internal control structure
  + Management assessed the company’s internal controls and attests to their accuracy, including notations of significant defects or material noncompliance found during their internal control tests.
  + Auditors were told about all material internal control weaknesses and fraud
  + Significant changes to controls after management’s evaluation were disclosed and corrected
* Management must base its evaluation on a recognized control framework, developed using a due-process procedure that allows for public comment. The report must contain a statement identifying the framework used by management to evaluate internal control effectiveness. The most likely framework is one of those formulated by COSO and discussed in the chapter.
* SOX also specifies that a company’s auditor must attest to as well as report on management’s internal control assessment.
  1. **When you go to a movie theater, you buy a prenumbered ticket from the cashier. This ticket is handed to another person at the entrance to the movie. What kinds of irregularities is the theater trying to prevent? What controls is it using to prevent these irregularities? What remaining risks or exposures can you identify?**

There are two reasons for using tickets.

1. The theater is trying to prevent cashiers from stealing cash by providing greater control over cash receipts. You cannot get into the theater without a ticket so you never give cash to a cashier without insisting on a ticket. That makes it much harder for a cashier to pocket cash.
2. Prenumbered tickets are also used so cashiers cannot give tickets to their friends. The number of tickets sold at the cashier counter can be reconciled with the number of tickets taken by the usher letting patrons into the theater.

Reconciling the cash in the register to the tickets sold and then reconciling the number of tickets sold to the number collected by the ticket-taker helps prevent the theft of cash and giving tickets away to friends.

Despite these controls, the following risks still exist:

* The ticket-taker can let friends into the theater without tickets.
* The ticket-taker may take money from theater patrons, pocketing the cash and letting them enter without a ticket.
* The cashier and the ticket-taker may collude in selling admittances without issuing tickets and then split the proceeds.

**7.6 Some restaurants use customer checks with prenumbered sequence codes. Each food server uses these checks to write up customer orders. Food servers are told not to destroy any customer checks; if a mistake is made, they are to void that check and write a new one. All voided checks are to be turned in to the manager daily. How does this policy help the restaurant control cash receipts?**

The fact that all documents are prenumbered provides a means for accounting for their use and for detecting unrecorded transactions. Thus, a missing check indicates a meal for which a customer did not pay. Since each server has his or her own set of checks, it is easy to identify which server was responsible for that customer.

This policy may help to deter theft (e.g., serving friends and not requiring them to pay for the meal, or pocketing the customer’s payment and destroying the check) because a reconciliation of all checks will reveal that one or more are missing.

* 1. **Compare and contrast the following three frameworks: COBIT, COSO Integrated Control, and ERM.**

The COBIT Framework consolidates systems security and control standards into a single framework. This allows management to benchmark security and control practices of IT environments, users to be assured that adequate IT security and control exist, and auditors to substantiate their internal control opinions and to advise on IT security and control matters. The framework addresses control from three vantage points:

1. Business objectives, to ensure information conforms to and maps into business objectives.
2. IT resources, including people, application systems, technology, facilities, and data.
3. IT processes, including </planning and organization, acquisition and implementation, delivery and support, and monitoring and evaluation.

COSO’s Internal Control Framework is widely accepted as the authority on internal controls and is incorporated into policies and regulations that control business activities. However, it examines controls without looking at the purposes and risks of business processes and provides little context for evaluating the results. It makes it hard to know which control systems are most important, whether they adequately deal with risk, and whether important controls are missing. In addition, it does not adequately address Information Technology issues.

It has five components:

1. Control environment, which are the individual attributes, (integrity, ethical values, competence, etc.) of the people in the organization and and the environment in which they operate.
2. Control activities, which are control policies and procedures that help ensure that the organization addresses risks and effectively achieves its objectives.
3. Risk assessment, which is the process of identifying, analyzing, and managing organizational risk
4. Information and communication, which is the system that captures and exchanges the information needed to conduct, manage, and control organizational operations.
5. Monitoring company processes and controls, so modifications and changes can be made as conditions warrant.

COSO’s Enterprise Risk Management Framework is a new and improved version of the Integrated Control Framework. It is the process the board of directors and management use to set strategy, identify events that may affect the entity, assess and manage risk, and provide reasonable assurance that the company achieves its objectives and goals. The basic principles behind ERM are:

•Companies are formed to create value for their owners.

•Management must decide how much uncertainty it will accept as it creates value.

•Uncertainty results in risk and opportunity, which are the possibilities that something negatively or positively affects the company’s ability to create or preserve value.

•The ERM framework can manage uncertainty as well as create and preserve value.

TERM adds three additional elements to COSO’s IC framework:

1. Setting objectives
2. Identifying events that may affect the company
3. Developing a response to assessed risk.

The ERM framework takes a risk-based rather than a controls-based approach. As a result, controls are flexible and relevant because they are linked to current organizational objectives. The ERM model also recognizes that risk, in addition to being controlled, can be accepted, avoided, diversified, shared, or transferred.

Because the ERM model is more comprehensive than the Internal Control framework, it will likely become the most widely adopted of the two models.

**7.8** **Explain what an event is. Using the Internet as a resource, create a list of some of the many internal and external factors that COSO indicated could influence events and affect a company’s ability to implement its strategy and achieve its objectives.**

An event is “an incident or occurrence emanating from internal or external sources that affects implementation of strategy or achievement of objectives.” An event can have a positive or a negative impact.

By their nature, events represent uncertainty. An event may or may not occur. If it does occur, it is hard to know when it will occur. Until it occurs, it may be difficult to determine its impact on the company. When it occurs, it may trigger another event.

Events may occur individually or concurrently. Therefore, management must anticipate all possible events, whether positive or negative, that might affect the company. It must also determine which events are most and least likely to occur, and it must understand the interrelationship of events.

The following table lists some of the many internal and external factors that COSO indicated could influence events and affect a company’s ability to implement its strategy and achieve its objectives. Lists like these help management identify factors, evaluate their importance, and examine those that can affect objectives. Identifying events at the activity and entity levels allows companies to focus their risk assessment on major business units or functions and helps align the company’s risk tolerance and risk appetite.

**COSO’s Nine ERM Event Categories**

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| --- | --- |
| **Event Categories** | |
| **External Factors** | **Internal Factors** |
| **Economic** | **Infrastructure** |
| • Availability of capital; lower or higher costs of capital | • Inadequate access to or poor allocation of capital |
| • Rising or declining unemployment rates | • Availability and capability of company assets |
| • Price movements upward or downward | • Complexity of systems |
| • Ability to issue credit and possibility of default |  |
| • Concentration of competitors, customers, or vendors |  |
| • Presence or absence of liquidity |  |
| • Movements in the financial markets or currency fluctuations |  |
| • Lower barriers to competitive entry, resulting in new competitors |  |
| • Mergers or acquisitions |  |
| • Potential regulatory, contractual, or criminal legal liability |  |
| **Natural Environment** | **Personnel** |
| • Natural disasters such as fires, floods, or earthquakes | • Workplace accidents, health or safety concerns |
| • Emissions and waste | • Employees acting dishonestly or unethically |
| • Energy restrictions or shortages | • Employee skills and capability |
| • Restrictions limiting development | • Strikes or expiration of labor agreements |
| **Political** | **Process** |
| • Election of government officials with new political agendas | • Process modification without proper change management procedures |
| • New laws and regulations | • Process execution errors |
| • Public policy, including higher or lower taxes | • Poorly designed processes |
| • Regulation affecting the company’s ability to compete | • Suppliers cannot deliver quality goods on time |
|  |  |
| **Social** | **Technology** |
| • Privacy | • Insufficient capacity to handle peak IT usages |
| • Terrorism | • Data or system unavailability |
| • Corporate citizenship | • Poor systems selection/development |
| • Human resource issues causing production shortages or stoppages | • Inadequately maintained systems |
| • Changing demographics, social mores, family structures, and work/life priorities | • Security breaches |
| • Consumer behavior that changes products and services demand or creates buying opportunity | • Inadequate data integrity |
| **Technological** |  |
| • New e-business technologies that lower infrastructure costs or increase demand for IT-based services |  |
| • Emerging technology |  |
| • Increased or decreased availability of data |  |
| • Interruptions or downtime caused by external parties |  |

**7.9 Explain what is meant by objective setting and describe the four types of objectives used in ERM.**

Objective setting, the second ERM component, is determining what the company hopes to achieve. It is often referred to as the corporate vision or mission. The four types of objectives used in ERM are:

1. **Strategic objectives** are high-level goals that align with the company’s mission, support it, and create shareholder value. Management should identify alternative ways of accomplishing the strategic objectives, identify and assess the risks and implications of each alternative, and formulate a corporate strategy.
2. **Operations objectives** deal with the effectiveness and efficiency of company operations and determine how to allocate resources. They reflect management preferences, judgments, and style and are a key factor in corporate success. They vary significantly - one company decides to be an early adopter of technology, another adopts technology when it is proven, and a third adopts it only after it is generally accepted.
3. **Reporting objectives** help ensure the accuracy, completeness, and reliability of company reports; improve decision-making; and monitor company activities and performance.
4. **Compliance objectives** help the company comply with all applicable laws and regulations.

Most compliance and many reporting objectives are imposed by external entities due to laws or regulations. ERM provides reasonable assurance that reporting and compliance objectives are achieved because companies have control over them. However, the only reasonable assurance ERM can provide about strategic and operations objectives is that management and directors are informed on a timely basis of the progress the company is making in achieving them.

**7.10 Discuss several ways that ERM processes can be continuously monitored and modified so that deficiencies are reported to management.**

1. Have a special team or internal auditing perform a formal or a self-assessment ERM evaluation.
2. Supervise effectively, including training and assisting employees, correcting errors, and overseeing employees who have access to assets.
3. Use Responsibility Accounting Systems such as budgets, quotas, schedules, standard costs, and quality standards; reports comparing actual and planned performance; and procedures for investigating and correcting significant variances.
4. Use risk analysis and management software packages to review computer and network security measures, detect illegal access, test for weaknesses and vulnerabilities, report weaknesses found, and suggest improvements.
5. Track purchased software to comply with copyrights and protect against software piracy lawsuits. Companies should periodically conduct software audits. Employees should be informed of the consequences of using unlicensed software. Track and monitor mobile devices, as their loss could represent a substantial exposure. Also, track who has them, what tasks they perform, the security features installed, and what software is needed to maintain adequate system and network security.
6. Have periodic external, internal, and network security audits to assess and monitor risk as well as detect fraud and errors.
7. Have a chief security officer (CSO), who is independent of the information system function, be in charge of system security and report to the chief operating officer (COO) or the CEO. Have a chief compliance officer (CCO), who reports to the same people, be responsible for all compliance issues
8. Use forensic investigatorss, who specialize in fraud detection and investigation, help with the financial reporting and corporate governance process. Most forensic investigators received specialized training with the FBI, IRS, or other law enforcement agencies. Investigators with the computer skills to ferret out fraud perpetrators are in great demand.
9. Install fraud detection software to help ferret out fraud, such as illegal credit card use, and notify forensic investigators when it is found.
10. Use a fraud hotline so people witnessing fraudulent behavior can report it anonymously.

**SUGGESTED SOLUTIONS TO THE PROBLEMS**

**7.1** **You are an audit supervisor assigned to a new client, Go-Go Corporation, which is listed on the New York Stock Exchange. You visited Go-Go’s corporate headquarters to become acquainted with key personnel and to conduct a preliminary review of the company’s accounting policies, controls, and systems. During this visit, the following events occurred:**

1. **You met with Go-Go’s audit committee, which consists of the corporate controller, treasurer, financial vice president, and budget director.**
2. **You recognized the treasurer as a former aide to Ernie Eggers, who was convicted of fraud several years ago.**
3. **Management explained its plans to change accounting methods for depreciation from the accelerated to the straight-line method. Management implied that if your firm does not concur with this change, Go-Go will employ other auditors.**
4. **You learned that the financial vice president manages a staff of five internal auditors.**
5. **You noted that all management authority seems to reside with three brothers, who serve as chief executive officer, president, and financial vice president.**
6. **You were told that the performance of division and department managers is evaluated on a subjective basis, because Go-Go’s management believes that formal performance evaluation procedures are counterproductive.**
7. **You learned that the company has reported increases in earnings per share for each of the past 25 quarters; however, earnings during the current quarter have leveled off and may decline.**
8. **You reviewed the company’s policy and procedures manual, which listed policies for dealing with customers, vendors, and employees.**
9. **Your preliminary assessment is that the accounting systems are well designed and that they employ effective internal control procedures.**
10. **Some employees complained that some managers occasionally contradict the instructions of other managers regarding proper data security procedures.**
11. **After a careful review of the budget for data security enhancement projects, you feel the budget appears to be adequate.**
12. **The enhanced network firewall project appeared to be on a very aggressive implementation schedule. The IT manager mentioned that even if he put all of his personnel on the project for the next five weeks, he still would not complete the project in time. The manager has mentioned this to company management, which seems unwilling to modify the schedule.**
13. **Several new employees have had trouble completing some of their duties, and they do not appear to know who to ask for help.**
14. **Go-Go’s strategy is to achieve consistent growth for its shareholders. However, its policy is not to invest in any project unless its payback period is no more than 48 months and yields an internal rate of return that exceeds its cost of capital by 3%.**
15. **You observe that company purchasing agents wear clothing and exhibit other paraphernalia from major vendors. The purchasing department manager proudly displays a picture of himself holding a big fish on the deck of a luxury fishing boat that has the logo of a major Go-Go vendor painted on its wheelhouse.**

**The information you have obtained suggests potential problems relating to Go-Go’s internal environment. Identify the problems, and explain them in relation to the internal environment concepts discussed in this chapter**

The underlined items correspond to one of the 7 elements of the internal environment covered in the text.

1. **You met with Go-Go’s audit committee, which consists of the corporate controller, treasurer, financial vice president, and budget director.**

**PROBLEM:** Section 301 of the Sarbanes-Oxley Act of 2002 (SOX) applies to publicly held companies and their auditors. It requires audit committee members to be on the company’s board of directors and to be independent of the company. That is not the case at Go-Go Corporation.

**SOLUTION:** All members of the audit committee should be members of the Board of Directors. They must also be independent of the company – meaning none of the audit committee can be employees. The audit committee is responsible for overseeing the corporation’s internal control structure, its financial reporting process, and its compliance with related laws, regulations, and standards. The committee works closely with the corporation’s external and internal auditors. SOX requires audit committees to be responsible for hiring, compensating, and overseeing the auditors and for auditors to report all critical accounting policies and practices to the audit committee.

b. **You recognized the treasurer as a former aide to Ernie Eggers, who was convicted of fraud several years ago.**

**PROBLEM:** Because the position of corporate treasurer involves managing cash and other financial assets, it is critical that the position be filled with someone of unquestioned commitment to integrity and ethical values. This question presents somewhat of a dilemma. Here are the two sides of that dilemma.

On the one hand, just because the treasurer worked for someone that turned out to be dishonest does NOT mean the treasurer is dishonest as well. Everyone should be judged on his or her own merits, not those of someone else. Therefore, you need to be careful not to assume automatically that the treasurer is dishonest.

On the other hand, the fact that the treasurer has been an aide to someone convicted of fraud should raise questions in your mind. You should approach all audits with the requisite skeptical attitude. That skeptical attitude should be heightened due to his past associations.

**SOLUTION:** Though you may not have specific information linking the corporate treasurer to the prior fraud, this information should indicate a need to examine carefully the corporation's human resource standards and personnel policies and practices with respect to hiring.

1. **Management explained its plans to change accounting methods for depreciation from the accelerated to the straight-line method. Management implied that if your firm does not concur with this change, Go-Go will employ other auditors.**

**PROBLEM:** Why would a company want to move from an accelerated depreciation method to one with a lower depreciation write-off? One reason is that it reduces depreciation expense, thereby increasing net income and, potentially, the company’s stock price. Alternatively, they may be looking for a way to mask, or hide, other company problems that will affect net income.

**SOLUTION:** The company should have a logical and defensible reason for changing accounting methods, other than just to increase net income and the stock price. The company may be willing to go to great lengths to "get their own way" with respect to an important financial reporting matter. The commitment to ethics issue involves questionable practices, desire to make the numbers, etc. If management does not have a good reason for the desired change, company management’s commitment to integrity and ethical values should be carefully evaluated.

It is also possible that there is a problem with management's philosophy and operating style. Management’s philosophy and operating style relates to risk-taking propensity and problems with philosophy and operating style are similar to carelessnessn or recklessness.

It is important to note that management can be careless, yet ethical; they can also be careful, yet unethical.

d. **You learned that the financial vice president manages a staff of five internal auditors.**

**PROBLEM:** The internal audit function is not organizationally independent of the accounting and finance functions.

**SOLUTION:** Organization structure and board of director requirements dictates that internal audit should report directly to the audit committee of the board of directors rather than the financial vice president.

e. **You noted that all management authority seems to reside with three brothers, who serve as chief executive officer, president, and financial vice president.**

**PROBLEM:** The dominance of an organization's management by one or a few individuals is an aspect of management's philosophy and operating style that might indicate a problem with the internal environment, in that there may be a potential for this small group to override the internal control system. Just because a family is run by family members does not indicate there is a problem such as fraud – but it does make it easier to commit and that should be take into consideration.

**SOLUTION:**  It is important to evaluate carefully this situation to determine if it indeed presents an internal control weakness.

f. **You were told that the performance of division and department managers is evaluated on a subjective basis, because Go-Go’s management believes that formal performance evaluation procedures are counterproductive.**

**PROBLEM:** This indicates a possible problem with management's human resource standards and their methods of monitoring performance. Subjective evaluation methods are often not be as effective in detecting problems or in identifying good performance as objective measures, such as formal performance evaluation procedures, that have been communicated to employees.

**SOLUTION:** It is important to evaluate carefully this situation to determine if it indeed presents an internal control weakness.

g. **You learned that the company has reported increases in earnings per share for each of the past 25 quarters; however, earnings during the current quarter have leveled off and may decline.**

**PROBLEM:** Management's philosophy and operating style, as well as their commitment to integrity and ethical values, can be tested when a company faces declining earnings. When earnings per share decrease or when they do not meet expectations, company stock can take a dive, sometimes a significant one. As a result, a company may try and avoid earnings decreases when possible. The problem comes when management uses questionable or even illegal means to prop up their earnings.

**SOLUTION:** Because many frauds have been perpetrated to prop up earnings, this significant fraud “red flag” must be investigated.

h. **You reviewed the company’s policy and procedures manual, which listed policies for dealing with customers, vendors, and employees.**

**PROBLEM:** One of the methods of assigning authority and responsibility is a written and comprehensive policies and procedures manual. Go-Go has a written policy and procedures manual, but it is incomplete. It is limited to only three areas: policies for dealing with customers, vendors, and employees.

**SOLUTION:** A policies and procedures manual should contain much more than what is indicated. The manual should explain proper business practices, describe the knowledge and experience needed by key personnel, and list the resources provided to carry out specific duties. It should spell out management policy with respect to handling specific transactions and documents and the systems and procedures employed to process those transactions. It includes the organization’s chart of accounts and sample copies of forms and documents. The manual should be a helpful on-the-job reference for employees and a useful tool in training new employees.

i. **Your preliminary assessment is that the accounting systems are well designed and that they employ effective internal control procedures.**

**PROBLEM:** Even though you believe that the accounting systems are well designed, and that they employ effective internal control procedures, you cannot rely on that belief. The most effective internal control systems and procedures can be negated by a weak internal control environment, such as top management overriding the internal controls. In other words, there is no evidence that the controls are effective or that employees use and follow them.

**SOLUTION:** You cannot rely on the internal controls procedures being effective until you test the controls.

j. **Some employees complained that some managers occasionally contradict the instructions of other managers regarding proper data security procedures.**

**PROBLEM:** It does not appear that there is a clear line of authority and responsibility for data security policies and procedures.

**SOLUTION:** Achieving adequate security and control over an organization’s data should be a top management priority. A company’s organizational structure defines its lines of authority, responsibility, and reporting and provides the overall framework for controlling and monitoring its operations.

Management should assign authority and responsibility for business objectives, such as data security, to specific departments and individuals and then hold them accountable for achieving those objectives. Authority and responsibility are assigned through formal job descriptions; employee training; and operating plans, schedules, and budgets. A written policy and procedures manual can be an important tool for assigning authority and responsibility.

k. **After a careful review of the budget for data security enhancement projects, you feel the budget appears to be adequate.**

**PROBLEM:** This item does not appear to be a problem.Your careful review indicates that the company appears to be allocating sufficient budget dollars to fund the data security enhancement projects.

l. **The enhanced network firewall project appeared to be on a very aggressive implementation schedule. The IT manager mentioned that even if he put all of his personnel on the project for the next five weeks, he still would not complete the project in time. The manager has mentioned this to company management, which seems unwilling to modify the schedule.**

**PROBLEM:** The firewall implementation schedule is not feasible.

**SOLUTION:** Management’s philosophy and operating style should be carefully evaluated. Is management taking undue business risks to achieve its objectives? Is management pressuring employees to achieve the desired results regardless of the methods used to achieve them?

m. **Several new employees have had trouble completing some of their duties, and they do not appear to know who to ask for help.**

**PROBLEM:** Employee training and support appear to be rather weak. Companies that shortchange training are more likely to have more fraud and more security breaches.

If the employees do not know who to turn to for help, the company’s organizational structure and methods of assigning authority and responsibility appear to be lacking or unexplained.

**SOLUTION:** Good human resource standards require that training programs familiarize new employees with their responsibilities; expected levels of performance and behavior; and the company's policies and procedures, history, culture, and operating style. On going training is needed to help employees tackle new challenges, stay ahead of the competition, adapt to changing technologies, and deal effectively with the evolving environment.

n. **Go-Go’s strategy is to achieve consistent growth for its shareholders. It also has a policy not to invest in any project unless its payback period is no more than 48 months and yields an internal rate of return that exceeds its cost of capital by 3%.**

**PROBLEM:** Go-Go's risk appetite, although aggressive, appears to be grounded in solid capital budgeting principles. This item, therefore, does not appear to be a problem

o. **You observe that company purchasing agents wear clothing and exhibit other paraphernalia from major vendors. The purchasing department manager proudly displays a picture of himself holding a big fish on the deck of a luxury fishing boat that has the logo of a major Go-Go vendor painted on its wheelhouse.**

**PROBLEM**: Gifts from vendors can unduly influence purchasing agents to buy more goods from the gifting vendors. Purchasing decision should be free of this sort of bias.

**SOLUTION:** Part of management’s philosophy and operating style should be the creation of an organizational culture that stresses integrity and commitment to ethical values and competence. In doing so, management should develop clearly stated human resource standards and policies that explicitly describe honest and dishonest behaviors, often in the form of a written code of conduct (methods of assigning authority and responsibility), and communicate them to employees.

These policies should especially cover issues that are uncertain or unclear, such as conflicts of interest and the acceptance of gifts. For example, most purchasing agents would agree that accepting a $5,000 bribe from a supplier is dishonest, but a weekend fishing trip or clothing is not as clear-cut. The observations in the purchasing department indicated that there could be a problem with favoring certain vendors.

**7.2** **Explain how the principle of separation of duties is violated in each of the following situations. Also, suggest one or more procedures to reduce the risk and exposure highlighted in each example.**

a. **A payroll clerk recorded a 40-hour workweek for an employee who had quit the previous week. He then prepared a paycheck for this employee, forged her signature, and cashed the check.**

**PROBLEM:** Segregation of duties is violated here because the payroll clerk had the ability to record time worked and to prepare the payroll check (custody). This allowed the payroll clerk to both commit and conceal the fraud. The payroll clerk ignored the authorization process or had the authority to authorize the payment.

**SOLUTION:** These three functions should be segregated. One person should authorize payments, another should record the payments, a third should prepare the check, and a fourth should sign it.

b. **While opening the mail, a cashier set aside, and subsequently cashed, two checks payable to the company on account.**

**PROBLEM:** The cashier who opened the mail had custody of the cash. The cashier opening the mail can pocket the checks and forge a signature, never giving the authorized endorser a chance to be involved. For this reason, many companies have the mail opened by two people or have those opening the mail videotaped.

**SOLUTION:** While the cashier can get away with this fraud for a few weeks or months, the missing checks will eventually be noticed – usually when the customer complains – because the cashier has no way to conceal the fraud (recording function). An investigation would include an examination of the stolen checks and that could lead to the cashier as the person cashing the checks. To be successful in the long term, the cashier needs access to the recording function to indicate that customer accounts are paid so that their complaints do not start an investigation.

c. **A cashier prepared a fictitious invoice from a company using his brother-in-law’s name. He wrote a check in payment of the invoice, which the brother-in-law later cashed.**

**PROBLEM:** Segregation of duties is violated here because the cashier had the ability to both write the check (custody) and approve the invoice for payment (authorization).

**SOLUTION:** The functions of authorizing invoices for payment and preparing checks for signature should be organizationally independent.

1. **An employee of the finishing department walked off with several parts from the storeroom and recorded the items in the inventory ledger as having been issued to the assembly department.**

**PROBLEM:** Employees can commit and conceal fraud when they have access to physical inventory (custody) and to inventory records (recording).

**SOLUTION:** This can be prevented by restricting storeroom access to authorized employees. Likewise, access to inventory records should be limited to authorized employees. Where possible, no storeroom employee should have access to both the physical inventory and the inventory records.

1. **A cashier cashed a check from a customer in payment of an account receivable, pocketed the cash, and concealed the theft by properly posting the receipt to the customer’s account in the accounts receivable ledger.**

**PROBLEM:** The cashier had custody of the checks and was responsible for posting (recording) to the accounts receivable ledger.

**SOLUTION:** Custody of the checks and posting to the Accounts Receivable Ledger should be organizationally independent. In addition, there should be an independent reconciliation of the three items:

1. dollar amounts of the checks received
2. dollar amounts of the checks deposited in the bank
3. dollar amounts credited to customer accounts.
4. **Several customers returned clothing purchases. Instead of putting the clothes into a return bin to be put back on the rack, a clerk put the clothing in a separate bin under some cleaning rags. After her shift, she transferred the clothes to a gym bag and took them home.**

**PROBLEM:** The clerk was authorized to accept the return, grant credit, and had custody of the inventory. It is also possible that the clerk may have had responsibility to record the returns, but did not do so to cover the theft.

**SOLUTION:** All purchase returns should be documented by preparing a customer receipt and recording the return in a purchase returns journal. No cash or credit can be given without the return being authorized by a supervisor and recorded in the data files recorded in the cash register.

The purchase returns area should be kept clean and orderly so that returns cannot be "hid" among excess returns. Employees should not be allowed to have gym bags or other personal items that could conceal stolen items in work areas.

1. **A receiving clerk noticed that four cases of MP3 players were included in a shipment when only three were ordered. The clerk put the extra case aside and took it home after his shift ended.**

**PROBLEM:** The receiving clerk had custody of arriving goods, counted the goods, and compared the count to a purchase order. The problem is that, while the receiving clerk did not record the purchase order, she did have access to a document that showed the amount ordered. This allows her to steal any excess items shipped without having to record anything to conceal it.

**SOLUTION:** Purchase orders sent to the receiving area should not indicate how many items or cases were ordered, thus helping ensure that all shipments are counted and recorded. The purchasing department should reconcile items received against items ordered.

1. **An insurance claims adjuster had check signing authority of up to $6,000. The adjuster created three businesses that billed the insurance company for work not performed on valid claims. The adjuster wrote and signed checks to pay for the invoices, none of which exceeded $6,000.**

**PROBLEM:** The adjuster had authorization to add vendors to vendor master file, authorization to write checks up to $6,000, and had custody of the signed the checks. Apparently, the adjuster also had some recording duties (maintaining the vendor master file).

**SOLUTION:** The functions of signing checks for invoices, approving vendors, and maintaining the vendor master file should be organizationally independent. Payments should not be made to anyone that is not on the approved vendor list. Controls should be put into place to endure that employees cannot add an unauthorized or unapproved vendor to the vendor master file.

i. **An accounts payable clerk recorded invoices received from a company that he and his wife owned and authorized their payment.**

**PROBLEM:** The accounts payable clerk had recording duties and he authorized payments.

**SOLUTION:** The functions of recording invoices and authorizing payments should be organizationally independent.

In addition, vendors should only be allowed to purchase goods and services from approved vendors. Controls should be put into place to endure that employees cannot add an unauthorized or unapproved vendor to the vendor master file. The company needs to establish policies and a code of conduct that prohibits conflicts of interest and related party transactions, such as buying goods from a company in which you have ownership interest.

j. **A cashier created false purchase return vouchers to hide his theft of several thousand dollars from his cash register.**

**PROBLEM:** The cashier had recording (creating return vouchers), custody (cash in the cash register), and authorization (authorize the return of goods) duties.

**SOLUTION:** These three duties should be performed by three separate people. A cashier should only have custody duties. Cashiers and others with access to cash should not be allowed to have recording or authorization duties. Cashiers should not pay out on cash on purchase return vouchers until they are authorized by a supervisor.

k. **A purchasing agent received a 10% kickback of the invoice amount for all purchases made from a specific vendor.**

**PROBLEM:** The purchasing agent has both recording (prepare the purchase order) and authorization (select a vendor from a list of authorized vendors) duties. The purchasing agent gets custody to cash when the vendor gives her the kickback.

**SOLUTION:** Purchasing agents should only be allowed to purchase goods and services from approved vendors. Controls should be put into place to ensure that employees cannot add an unauthorized or unapproved vendor to the vendor master file.

Vendor performance with respect to reliability, quality of goods, and prices charged should be tracked and periodically reviewed. Prices should periodically be compared to those charged by other vendors to make sure they are fair, competitive, and reasonable. Analytical procedures can be performed to track the percentage of business a purchasing agent gives to vendors.

The company needs to establish policies and a code of conduct that prohibits conflicts of interest, related party transactions, and kickbacks.

**7.3 The following description represents the policies and procedures for agent expense reimbursements at Excel Insurance Company.**

**Agents submit a completed expense reimbursement form to their branch manager at the end of each week. The branch manager reviews the expense report to determine whether the claimed expenses are reimbursable based on the company’s expense reimbursement policy and reasonableness of amount. The company’s policymanual states that agents are to document any questionable expense item and that the branch manager must approve in advance expenditures exceeding $500.**

**After the expenses are approved, the branch manager sends the expense report to the home office. There, accounting records the transaction, and cash disbursements prepares the expense reimbursement check. Cash disbursements sends the expense reimbursement checks to the branch manager, who distributes them to the agents.**

**To receive cash advances for anticipated expenses, agents must complete a Cash Advance Approval form. The branch manager reviews and approves the Cash Advance Approval form and sends a copy to accounting and another to the agent. The agent submits the copy of the Cash Advance Approval form to the branch office cashier to obtain the cash advance.**

**At the end of each month, internal audit at the home office reconciles the expense reimbursements. It adds the total dollar amounts on the expense reports from each branch, subtracts the sum of the dollar totals on each branch’s Cash Advance Approval form, and compares the net amount to the sum of the expense reimbursement checks issued to agents. Internal audit investigates any differences.**

**Identify the internal control strengths and weaknesses in Excel’s expense reimbursement process. Look for authorization, recording, safeguarding, and reconciliation strengths and weaknesses.** (CMA Examination adapted)

|  |  |  |  |
| --- | --- | --- | --- |
| **Strengths** | | | **Weaknesses** |
| ***Authorization*** | | | |
| Excel has a formal statement of policies and procedures for agent reimbursements. | There is no limit on the agent’s total weekly expenditures or cash advances. | | |
| Expense reports must be approved by the Branch Manager prior to payment. | Expense reimbursement checks are sent to the Branch Manager for distribution rather than to the agent. This allows the Branch Manager to submit a fictitious expense reimbursement for a former agent or one on vacation and then cash the check. | | |
| ***Recording*** | | | |
| Accounting receives approved expense reports and cash advance forms. This facilitates the correct recording of all authorized transactions. | The Branch Manager does not retain a copy of expense reports or cash advances for audit purposes. | | |
|  | The expense report is not checked for mathematical accuracy. | | |
| ***Safeguarding*** | | | |
| Expense reimbursement checks are issued by the cash disbursements department. | A copy of the Cash Advance Approval form should be sent to the Branch Office Cashier so it can compare it with the one submitted by the agent. | | |
| Cash disbursements are made only after receipt of an approved expense report or Cash Advance Approval form. | Supporting documentation is not required for all expenditures. | | |
| ***Reconciliation*** | | | |
| Internal Audit compares reimbursement checks with expense report totals less cash advances in the home office.  Reconciliation differences are investigated. | | There is no reconciliation of Branch Office Cashier disbursements with Cash Advance Approval forms. | |

* 1. **The Gardner Company, a client of your firm, has come to you with the following problem. It has three clerical employees who must perform the following functions:**
  2. **Maintain the general ledger**
  3. **Maintain the accounts payable ledger**
  4. **Maintain the accounts receivable ledger**
  5. **Prepare checks for signature**
  6. **Maintain the cash disbursements journal**
  7. **Issue credits on returns and allowances**
  8. **Reconcile the bank account**
  9. **Handle and deposit cash receipts**

**Assuming equal abilities among the three employees, the company asks you to assign the eight functions to them to maximize internal control. Assume that these employees will perform no accounting functions other than the ones listed.**

a. **List four possible unsatisfactory pairings of the functions**

All five of the unsatisfactory pairings below involve custody of cash and a recording function that would allow a fraud perpetrator to conceal a theft.

1. **General ledger - cash receipts**. With custody to cash, this person could steal cash receipts and conceal the theft by recording a fictitious entry in the General Ledger to credit (reduce) the balance of the cash account by the amount stolen.

2. **Accounts receivable ledger - cash receipts**. With custody to cash, this person could steal cash receipts and conceal the theft by recording a fictitious entry in the Accounts Receivable Subsidiary Ledger to reduce a customer’s accounts receivable balance by the amount stolen.

3. **Bank reconciliation - cash receipts**. With custody to cash, this person could steal cash receipts and conceal the theft by falsifying (recording) the bank reconciliation.

4. **Credits on returns and allowances - cash receipts**. This person could authorize (authorization) or record false credit memos (recording) to customers who are making a payment and steal the customer payments (custody).

5. **Accounts payable ledger - prepare checks for signature**. A person with both of these responsibilities could create fictitious payables (recording) and then write and cash checks to pay them (custody).

1. **Maintain accounts receivable - issue credit memos** – this combines authorization and recording. A person with both of these responsibilities could write off accounts for friends.
2. **State how you would distribute the functions among the three employees. Assume that with the exception of the nominal jobs of the bank reconciliation and the issuance of credits on returns and allowances, all functions require an equal amount of time.**

Any distribution that avoids all of the above unsatisfactory combinations and spreads the workload evenly is acceptable. The key is not to have anyone with both custody and a recording function that could be used to conceal a theft. One such combination is:

First employee accounts payable ledger, accounts receivable ledger, bank reconciliations

Second employee general ledger, disbursements journal, credits on returns and allowances

Third employee prepare checks for signature, cash receipts

**7.5 During a recent review, ABC Corporation discovered that it has a serious internal control problem. It is estimated that the impact associated with this problem is $1 million and that the likelihood is currently 5%. Two internal control procedures have been proposed to deal with this problem. Procedure A would cost $25,000 and reduce likelihood to 2%; procedure B would cost $30,000 and reduce likelihood to 1%. If both procedures were implemented, likelihood would be reduced to 0.1%.**

**a.** **What is the estimated expected loss associated with ABC Corporation’s internal control problem before any new internal control procedures are implemented?**

Expected Loss = Risk \* Exposure = 0.05 \* $1,000,000 = $50,000

1. **Compute the revised estimate of expected loss if procedure A were implemented, if procedure B were implemented, and if both procedures were implemented.**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Control Procedure | Risk | Exposure | Revised Expected Loss | Reduction in Expected Loss | Cost of Control(s) | Net Benefit (Cost) |
| A | 0.02 | $1,000,000 | $20,000 | $30,000 | $25,000 | $ 5,000 |
| B | 0.01 | $1,000,000 | $10,000 | $40,000 | $30,000 | $10,000 |
| Both | 0.001 | $1,000,000 | $ 1,000 | $49,000 | $55,000 | $(6,000) |

1. **Compare the estimated costs and benefits of procedure A, procedure B, and both procedures combined. If you consider only the estimates of cost and benefit, which procedure(s) should be implemented?**

Considering only the estimated costs and benefits, procedure B should be implemented because its net benefit is greater than A; it is also greater than both A and B together. Care must be taken with these discussions, however, because the numbers used are estimates. The net benefit figures are only as good as the estimates used to produce them.

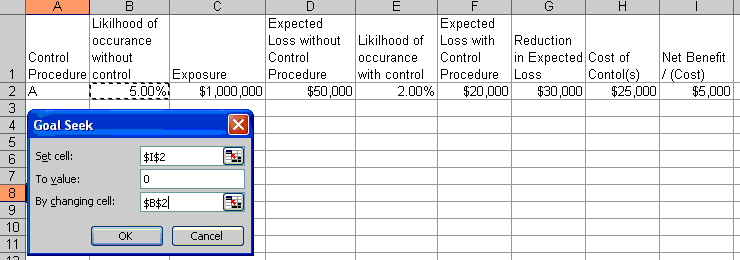
1. **What other factors might be relevant to the decision**

Another important factor to consider is how critical the $1,000,000 loss would be to ABC Corporation.

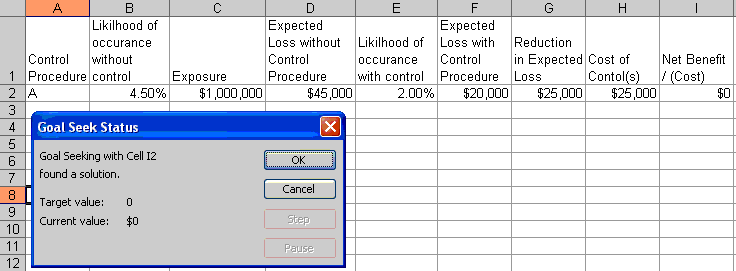
* If ABC is a multi-billion dollar corporation, then they can afford to evaluate this matter strictly on the basis of estimated costs and benefits.
* However, if ABC is a small corporation then a loss of this magnitude could threaten their continued existence, and it may be worthwhile to incur extra costs (as a form of insurance premium) to reduce the risk of loss to the smallest possible level.

1. Use the Goal Seek function in Microsoft Excel to determine the likelihood of occurrence without the control and the reduction in expected loss if the net benefit/cost is 0. Do this for procedure A, procedure B, and both procedures together

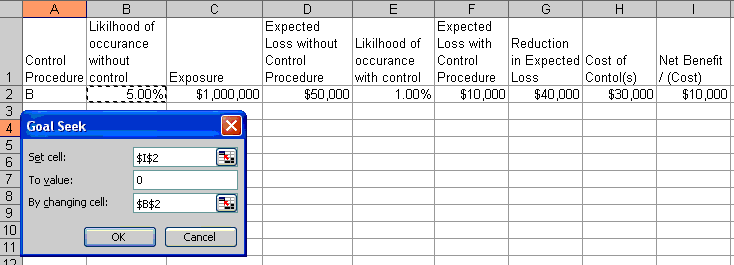
Control Procedure A - Goal Seek-setup.



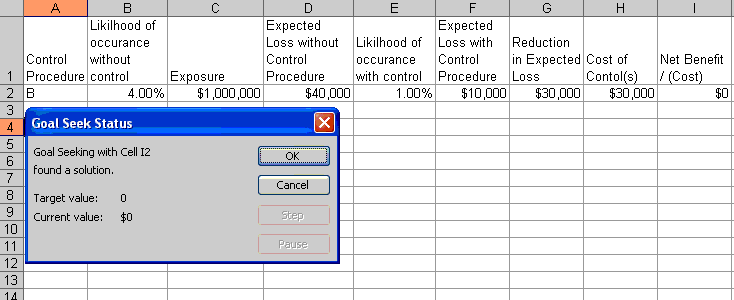
Control Procedure A - Goal Seek - solved.



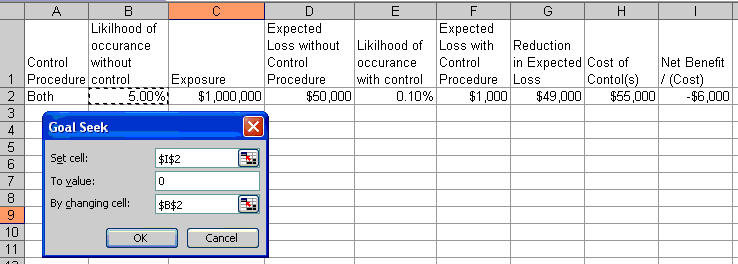
Control Procedure B - Goal Seek-setup.



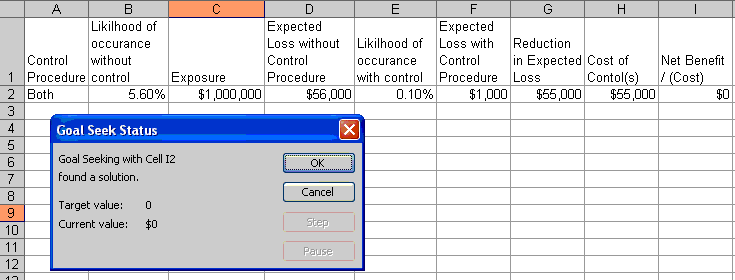
Control Procedure B - Goal Seek - solved.



Control Procedure Both - Goal Seek-setup.



Control Procedure Both - Goal Seek - solved.



**7.6 The management at Covington, Inc., recognizes that a well-designed internal control system provides many benefits. Among the benefits are reliable financial records that facilitate decision making and a greater probability of preventing or detecting errors and fraud. Covington’s internal auditing department periodically reviews the company’s accounting records to determine the effectiveness of internal controls. In its latest review, the internal audit staff found the following eight conditions:**

* 1. **Daily bank deposits do not always correspond with cash receipts.**
  2. **Bad debt write-offs are prepared and approved by the same employee.**
  3. **There are occasional discrepancies between physical inventory counts and perpetual inventory records.**
  4. **Alterations have been made to physical inventory counts and to perpetual inventory records.**
  5. **There are many customer refunds and credits.**
  6. **Many original documents are missing or lost. However, there are substitute copies of all missing originals.**
  7. **An unexplained decrease in the gross profit percentage has occurred.**
  8. **Many documents are not approved.**

**For each of the eight conditions detected by the Covington internal audit staff:**

<**a.** **Describe a possible cause of the condition.**

**b. Recommend actions to be taken and/or controls to be implemented that would correct the condition.** Adapted from the CMA Examination

|  |  |  |  |
| --- | --- | --- | --- |
| **#** | | 1. **Possible Cause** | **b. Recommendation to Correct Condition** |
| 1 | **Daily bank deposits do not always correspond with cash receipts.**  Timing difference between when cash is received and when deposited in the bank   * + - Cash is received after the day’s bank deposit is prepared and sent to the bank.     - Bank credits bank deposits received after a certain hour on the next day.   Cash receipts are being stolen | | Make two deposits for each day’s receipts.  An employee who does not handle cash receipts daily reconciles each day’s cash receipts per book with deposits per bank  List cash received each day; compare it to daily cash deposits.  Have 2 people involved in cash receipts if practical. If only one can be involved, video tape the receipts process.  Have an employee who does not handle receipts do all reconciliations. |
| 2 | | **Bad debt write-offs are prepared and approved by the same employee.**  Collusion between customers and the employee writing off the bad debts. | Require all bad debt write-offs to be approved by a second employee. |
| 3 | | **Occasional discrepancies between physical inventory counts and perpetual inventory records.**  Unauthorized access to physical inventory and/or inventory records.  Inventory theft by employees | Limit physical and logical access to the inventory records to authorized employees.  Require that all adjustments to inventory records be approved by a responsible official.  Count all inventory when received at the warehouse and at the storeroom; reconcile the counts.  Count inventory to be shipped before it is removed from the storeroom, when received by shipping, and when shipped; reconcile counts.  Bar codes and RFID tags to facilitate counts  Hold storeroom employees responsible for all inventory losses. |
| 4 | | **Alterations to physical inventory counts and perpetual inventory records**  Unauthorized access to inventory records.  Fraud | Limit physical and logical access to the inventory records to authorized employees.  Require that all adjustments to inventory records be approved by a responsible official.  Examine physical inventory counts and perpetual inventory records for evidence of fraud  Terminate any employees that commit fraud |
| 5 | | **Many customer refunds and credits.**  Collusion among customers, salespersons, common carriers, and the shipping and accounting departments of Covington.  Poor product quality | Segregate duties so refunds and credits are authorized by responsible employees not otherwise involved in sales, shipping, or maintaining accounts receivable.  Fix production problems |
| 6 | | **Many original documents are missing or lost. However, there are substitute copies of all missing originals**.  Failure to use pre-numbered documents.  Fraud was perpetrated, original copies of the documents were destroyed, and they were replaced by photocopies. | Use pre-numbered documents to facilitate the control and identification of documents.  Investigate all instances where originals are missing and photocopies are used. |
| 7 | | **An unexplained decrease in the gross profit percentage has occurred**.  Granting unauthorized discounts or credits to customers.  Theft of inventory  Customers given lower, preferential sales prices  Unrecorded sales | Require the approval of a responsible party before granting customer discounts or credits.  Count all inventory when received at the warehouse and at the storeroom; reconcile the counts.   * + - Count inventory to be shipped before it is removed from the storeroom, when received by shipping, and when shipped; reconcile counts.   Bar codes and RFID tags to facilitate counts  Hold storeroom employees responsible for all inventory losses.  Require the approval of a responsible party before granting preferential sales prices  Require the use of pre-numbered sales documents and do not allow inventory to leave the warehouse without an accompanying sales document. |
| 8 | | **Many documents are not approved.**  Lack of, misunderstanding of, or failure to comply with written procedures.  Fraud committed by bypassing the approval process | Prepare or update written procedures and train employees using the procedures  Hold employees responsible for not approving documents  Examine unapproved documents for evidence of fraud  Terminate any employees that commit fraud |

**7.7 Consider the following two situations:**

**For the situations presented, dDescribe the recommendations the internal auditors should make to prevent the following problems.** Adapted from the CMA Examination

**Situation 1: Many employees of a firm that manufactures small tools pocket some of the tools for their personal use. Since the quantities taken by any one employee are immaterial, the individual employees do not consider the act as fraudulent or detrimental to the company. The company is now large enough to hire an internal auditor. One of the first things she did was to compare the gross profit rates for industrial tools to the gross profit for personal tools. Noting a significant difference, she investigated and uncovered the employee theft.**

* Implement and communicate through proper training a policy regarding the theft of company goods and services and the repercussions associated with theft.
* Allow employees to purchase tools at cost from the company.
* Continue to compare the gross profit rates for industrial tools to the gross profit for personal tools until the problem is resolved.
* Discipline or terminate any employees not following the new policy
* Institute better physical access controls over the tools to prevent theft

**Situation 2: A manufacturing firm’s controller created a fake subsidiary. He then ordered goods from the firm’s suppliers, told them to ship the goods to a warehouse he rented, and approved the vendor invoices for payment when they arrived. The controller later sold the diverted inventory items, and the proceeds were deposited to the controller’s personal bank account. Auditors suspected something was wrong when they could not find any entries regarding this fake subsidiary office in the property, plant, and equipment ledgers or a title or lease for the office in the real-estate records of the firm**

* Implement a better segregation of duties. The company controller should not be able to order goods, specify shipment locations, and authorize payment for inventory.
* Require all inventory purchases to be initiated by the purchasing department.
* Require all inventory payments to be supported by proper supporting documents such as receiving reports signed by authorized personnel.
* Require special authorization for shipments to locations not typically used.

**7.8 Tralor Corporation manufactures and sells several different lines of small electric components. Its internal audit department completed an audit of its expenditure processes. Part of the audit involved a review of the internal accounting controls for payables, including the controls over the authorization of transactions, accounting for transactions, and the protection of assets. The auditors noted the following items:**

* 1. **Routine purchases are initiated by inventory control notifying the purchasing department of the need to buy goods. The purchasing department fills out a prenumbered purchase order and gets it approved by the purchasing manager. The original of the five-part purchase order goes to the vendor. The other four copies are for purchasing, the user department, receiving for use as a receiving report, and accounts payable.**
  2. **For efficiency and effectiveness, purchases of specialized goods and services are negotiated directly between the user department and the vendor. Company procedures require that the user department and the purchasing department approve invoices for any specialized goods and services before making payment.**
  3. **Accounts payable maintains a list of employees who have purchase order approval authority. The list was updated two years ago and is seldom used by accounts payable clerks.**
  4. **Prenumbered vendor invoices are recorded in an invoice register that indicates the receipt date, whether it is a special order, when a special order is sent to the requesting department for approval, and when it is returned. A review of the register indicated that there were seven open invoices for special purchases, which had been forwarded to operating departments for approval over 30 days previously and had not yet been returned.**
  5. **Prior to making entries in accounting records, the accounts payable clerk checks the mathematical accuracy of the transaction, makes sure that all transactions are properly documented (the purchase order matches the signed receiving report and the vendor’s invoice), and obtains departmental approval for special purchase invoices.**
  6. **All approved invoices are filed alphabetically. Invoices are paid on the 5th and 20th of each month, and all cash discounts are taken regardless of the terms.**
  7. **The treasurer signs the checks and cancels the supporting documents. An original document is required for a payment to be processed.**
  8. **Prenumbered blank checks are kept in a locked safe accessible only to the cash disbursements department. Other documents and records maintained by the accounts payable section are readily accessible to all persons assigned to the section and to others in the accounting function.**

**RRReview the eight items listed and decide whether they represent an internal control strength or weakness**

1. **For each internal control strength you identified, explain how the procedure helps achieve good authorization, accounting, or asset protection control.**
2. **For each internal control weakness you identified, explain why it is a weakness and recommend a way to correct the weakness** Adapted from the CMA Examination

|  |  |  |  |
| --- | --- | --- | --- |
| **#** | **a. Why it is a strength** | **b. Why it is a weakness** | **b. Recommendation to correct weakness** |
| 1 | User authorization means the right materials and quantities will be ordered.  The use of pre-numbered purchase orders allows all POs to be accounted for. | A purchase order copy should not be used as a receiving report unless the quantities have been blanked out. | The receiving report is prepared after an independent count and identification. |
| 2 |  | The user/purchaser may not be trained in purchasing techniques and could be overcharged in the transaction. | Both the user and the purchasing agent should be involved in negotiating with the company. |
| 2 |  | It increases the potential for collusive agreements. | The purchasing department should approve orders before the purchase, not before payment is made. |
| 3 |  | Failure to properly maintain the list of authorized signatories renders it useless | Update the list as soon as a change in purchase authorization occurs.  Payables clerk should be required to use the list. |
| 4 | Numbering and recording process establishes good control over invoices and helps ensure their recording in accounting records. | Failure to follow-up on open invoices indicates an ineffective control due to a lack of follow-up. | A periodic review and follow-up of all open items. |
| 5 | The transaction audit helps minimize errors and helps ensure that only properly authorized transactions are recorded. |  |  |
| 6 |  | Paying monthly on only the 5th or 20th prevents payment of any invoice due on another date. | Approved, unpaid invoices should be filed by payment due date first, and then alphabetically. |
| 6 |  | Taking unearned cash discounts causes additional paperwork when disputed by suppliers and creates animosity. This policy may lead to fewer discounts being offered. | Pay suppliers on or before the discount date.  Lost discounts should be analyzed for cause and future avoidance. |
| 7 | Proper separation of duties exists  Requiring original documents and cancelling them after payment reduces duplicate payments. |  |  |
| 8 | Proper protection of blank checks (locked safe only accessible to cash disbursements department | Unlimited access to cash disbursement documents (other than blank checks) permits unauthorized alteration of payables documents. This could result in a loss of control, a loss of accountability, or a loss of assets - as well as improper or inaccurate accounting or destruction of records. | A policy limiting access to and physical protection of accounts payable documents and records should be established and monitored. |

* 1. **Lancaster Company makes electrical parts for contractors and home improvement retail stores. After their annual audit, Lancaster’s auditors commented on the following items regarding internal controls over equipment:**

1. **The operations department that needs the equipment normally initiates a purchase requisition for equipment. The operations department supervisor discusses the proposed purchase with the plant manager. If there are sufficient funds in the requesting department’s equipment budget, a purchase requisition is submitted to the purchasing department once the plant manager is satisfied that the request is reasonable.**
2. **When the purchasing department receives either an inventory or an equipment purchase requisition, the purchasing agent selects an appropriate supplier and sends them a purchase order.**
3. **When equipment arrives, the user department installs it. The property, plant, and equipment control accounts are supported by schedules organized by year of acquisition. The schedules are used to record depreciation using standard rates, depreciation methods, and salvage values for each type of fixed asset. These rates, methods, and salvage values were set 10 years ago during the company’s initial year of operation.**
4. **When equipment is retired, the plant manager notifies the accounting department so the appropriate accounting entries can be made.**
5. **There has been no reconciliation since the company began operations between the accounting records and the equipment on hand.**

**Identify the internal control weaknesses in Lancaster’s system, and recommend ways to correct them.** Adapted from the CMA Examination

|  |  |
| --- | --- |
| **Weakness** | **Recommendation** |
| 1. No authorization form describing the item to be acquired, why it is needed, expected costs, and benefits. 2. Equipment purchases over a certain amount are not reviewed and approved by top management. | The purchase requisition should include an item description, why the item is needed, estimated costs and benefits, account code, useful life, depreciation method, and management approval.  Large sums of money can be spent on equipment. Large purchases should be approved by top management |
| 1. Purchase requisitions for fixed assets are intermingled with requisitions for inventory, even though they are very different purchases. This results in a lack of control over the much more expensive equipment acquisitions. 2. No mention of pre-numbered purchase requisitions or purchase orders. | Authorized equipment acquisitions should be processed using special procedures and purchase orders.  Copies of equipment purchase orders should be distributed to all appropriate departments so they can be monitored.  Pre-numbered purchase requisitions and purchase orders should be used so that all documents can be accounted for. |
| 1. Plant engineering is not inspecting machinery and equipment upon receipt. 2. Equipment is not tagged and controlled to prevent theft. 3. Plant engineering is not helping with the equipment installations. 4. Machinery and equipment accounting policies, including depreciation, have not been updated to make certain that the most desirable methods are being used. | Machinery and equipment should be subject to normal receiving routines. In addition, plant engineering should inspect the machines to make certain the correct item was delivered and that it was not damaged in transit.  All new machinery and equipment should be assigned a control number and tagged at the time of receipt.  Plant engineering should help with the equipment installations to ensure expensive equipment is not damaged.  Machinery and equipment accounting procedures, including depreciation, must be updated periodically to reflect actual experience, changes in accounting pronouncements, and income tax legislation. |
| 1. Equipment retirement schedules are not reconciled periodically to general ledger control accounts. | Equipment retirement schedules, which provide information on asset cost and accumulated depreciation, should be reconciled to general ledger control accounts at least yearly.  Periodically, a physical inventory of fixed assets should be taken and reconciled to the equipment retirement schedule and the general ledger control account. |

**7.10**

**The Langston Recreational Company (LRC) manufactures ice skates for racing, figure skating, and hockey. The company is located in Kearns, Utah, so it can be close to the Olympic Ice Shield, where many Olympic speed skaters train.**

**Given the precision required to make skates, tracking manufacturing costs is very important to management so it can price the skates appropriately. To capture and collect manufacturing costs, the company acquired an automated cost accounting system from a national vendor. The vendor provides support, maintenance, and data and program backup service for LRC’s system.**

**LRC operates one shift, five days a week. All manufacturing data are collected and recorded by Saturday evening so that the prior week’s production data can be processed. One of management’s primary concerns is how the actual manufacturing process costs compare with planned or standard manufacturing process costs. As a result, the cost accounting system produces a report that compares actual costs with standards costs and provides the difference, or variance. Management focuses on significant variances as one means of controlling the manufacturing processes and calculating bonuses.**

**Occasionally, errors occur in processing a week’s production cost data, which requires the entire week’s cost data to be reprocessed at a cost of $34,500. The current risk of error without any control procedures is 8%. LRC’s management is currently considering a set of cost accounting control procedures that is estimated to reduce the risk of the data errors from 8% to 3%. This data validation control procedure is projected to cost $1,000 per week.**

**a.** **Perform a cost/benefit analysis of the data-validation control procedures.**

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  | Without Control Process |  | With Control Process |  | Net Difference Expected |
|  |  |  |  |  |  |  |  |  |
| Cost of Production Data Reprocessing | | | | $34,500 |  | $34,500 |  |  |
|  |  |  |  |  |  |  |  |  |
| Risk of Data Errors | |  |  | 8% |  | 3% |  |  |
|  |  |  |  |  |  |  |  |  |
| Expected Reprocessing Costs | | |  | $2,760 |  | $1,035 |  | $1,725 |
| (Cost of Process \* Risk) | | |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |
| Cost of Control Process | | |  |  |  | $1,000 |  | -$1,000 |
|  |  |  |  |  |  |  |  |  |
| Net estimated benefit/(loss) | |  |  |  |  |  |  | $725 |

**b.** **Based on your analysis, make a recommendation to management regarding the control procedure.**

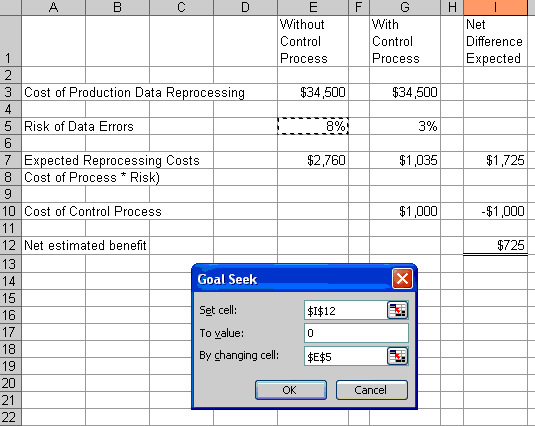
Since the process yields an estimated net weekly benefit of $725, LRC should implement the control process.

1. **The current risk of data errors without any control procedures is estimated to be 8%. The data control validation procedure costs $1,000 and reduces the risk to 3%. At some point between 8% and 3% is a point of indifference—that is, Cost of reprocessing the data without controls = Cost of processing the data with the controls + Cost of controls. Use a spreadsheet application such as Excel Goal Seek to find the solution**

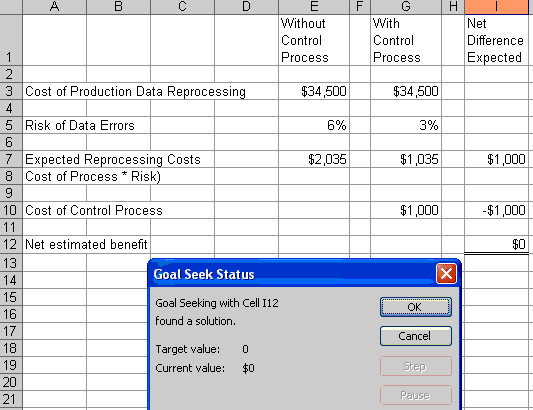
Solution: 6%

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  | Without Control Process |  | With Control Process |  | Net Difference Expected |
|  |  |  |  |  |  |  |  |  |
| Cost of Production Data Reprocessing | | | | $34,500 |  | $34,500 |  |  |
|  |  |  |  |  |  |  |  |  |
| Risk of Data Errors | |  |  | 6% |  | 3% |  |  |
|  |  |  |  |  |  |  |  |  |
| Expected Reprocessing Costs | | |  | $2,035 |  | $1,035 |  | $1,000 |
| (Cost of Process \* Risk) | | |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |
| Cost of Control Process | | |  |  |  | $1,000 |  | -$1,000 |
|  |  |  |  |  |  |  |  |  |
| Net estimated benefit | |  |  |  |  |  |  | $0 |

Goal Seek Setup:



Goal Seek Solved:



**7.11 Spring Water Spa Company is a 15-store chain in the Midwest that sells hot tubs, supplies, and accessories. Each store has a full-time, salaried manager and an assistant manager. The sales personnel are paid an hourly wage and a commission based on sales volume.**

**The company uses electronic cash registers to record each transaction. The salesperson enters his or her employee number at the beginning of his/her shift. For each sale, the salesperson rings up the order by scanning the item’s bar code, which then displays the item’s description, unit price, and quantity (each item must be scanned). The cash register automatically assigns a consecutive number to each transaction. The cash register prints a sales receipt that shows the total, any discounts, the sales tax, and the grand total.**

**The salesperson collects payment from the customer, gives the receipt to the customer, and either directs the customer to the warehouse to obtain the items purchased or makes arrangements with the shipping department for delivery. The salesperson is responsible for using the system to determine whether credit card sales are approved and for approving both credit sales and sales paid by check. Sales returns are handled in exactly the reverse manner, with the salesperson issuing a return slip when necessary.**

**At the end of each day, the cash registers print a sequentially ordered list of sales receipts and provide totals for cash, credit card, and check sales, as well as cash and credit card returns. The assistant manager reconciles these totals to the cash register tapes, cash in the cash register, the total of the consecutively numbered sales invoices, and the return slips. The assistant manager prepares a daily reconciled report for the store manager’s review.**

**Cash sales, check sales, and credit card sales are reviewed by the manager, who prepares the daily bank deposit. The manager physically makes the deposit at the bank and files the validated deposit slip. At the end of the month, the manager performs the bank reconciliation. The cash register tapes, sales invoices, return slips, and reconciled report are mailed daily to corporate headquarters to be processed with files from all the other stores. Corporate headquarters returns a weekly Sales and Commission Activity Report to each store manager for review.**

**Please respond to the following questions about Spring Water Spa Company’s operations:** (CMA exam adapted)

**a. The fourth component of the COSO ERM framework is risk assessment. What risk(s) does Spring Water face?**

Spring Water faces the risk of fraud and employee theft of merchandise and cash. Spring Water also faces the risk of unintentional employee errors.

|  |  |  |
| --- | --- | --- |
| 1. **Control strengths in Spring Water’s sales/cash receipts** | 1. **Type of control activity** | 1. **Problems avoided/Risks mitigated by the controls** |
| 1. All 15 stores use the same electronic, bar-code based system for recording and controlling sales transactions. | Proper authorization of transactions and activities. | -Difficulty in managing and auditing all stores and in making system changes.  -Barcodes automatically identifies item description, unit price, quantity.  - Ensures mechanical accuracy of all transactions and recording processes.  -Automatic receipt generation helps ensure all transactions are entered into system. |
| 1. Transactions are sequentially numbered by the cash register. | Design and use of documents and records. | -Minimizes employee error and theft.  -Minimizes undetected or lost invoices.  -Provides an audit trail for invoices. |
| 1. The cash receipts, checks, credit cards, sales returns, and cash register tapes are reconciled. | Independent check. | -Reduces the risk of theft or fraud and employee error. |
| 1. The bank deposit is prepared and deposited by the manager. | Segregation of duties. | -Reduces the risk of theft or fraud and employee error. |
| 1. Segregating the sale of goods from the delivery of goods. | Segregation of duties. | -Customers not having access to goods reduces shoplifting, customer/clerk collusion, and other theft. |

**e. How might Spring Water improve its system of controls?**

* The bank reconciliation should be performed by someone other than the manager who makes the deposits.
* Sales people should never be allowed to authorize credit sales. At Spring Water, the sales person authorizes credit purchases and approves payments made by check. They also approve sales returns. This lack of separation of duties facilitates fraud. In addition, since the sales person is paid a commission based on sales without taking into account returns and collections, they have incentive to approve all credit sales and accept all payments made by check without checking whether a customer is credit worthy and/or whether the have sufficient funds available to cover their check. They can also talk customers into buying more than they need and then returning the items not needed.
* Warehouse personnel should have electronic read-only access to daily sales orders to control and facilitate customer order pick-up and/or delivery.
* Warehouse personnel should scan-in the bar codes of all sales-return merchandise. The manager or assistant manager should reconcile a sales return report from the warehouse to the sales return report from the cash registers on the sales floor.

**7.12 PriceRight Electronics (PEI) is a small wholesale discount supplier of electronic instruments and parts. PEI’s competitive advantage is its deep-discount, three-day delivery guarantee, which allows retailers to order materials often to minimize in-store inventories. PEI processes its records with stand-alone, incompatible computer systems except for integrated enterprise resource planning (ERP) inventory and accounts receivable modules. PEI decided to finish integrating its operations with more ERP modules, but because of cash flow considerations, this needs to be accomplished on a step-by-step basis.**

**It was decided that the next function to be integrated should be sales order processing to enhance quick response to customer needs. PEI implemented and modified a commercially available software package to meet PEI’s operations. In an effort to reduce the number of slow-paying or delinquent customers, PEI installed Web-based software that links to the Web site of a commercial credit rating agency to check customer credit at the time of purchase. The following are the new sales order processing system modules:**

* + ***Sales*. Sales orders are received by telephone, fax, e-mail, Web site entry, or standard mail. They are entered into the sales order system by the Sales department. If the order does not cause a customer to exceed his credit limit, the system generates multiple copies of the sales order.**
  + ***Credit*. When orders are received from new customers, the system automatically accesses the credit rating Web site and suggests an initial credit limit. On a daily basis, the credit manager reviews new customer applications for creditworthiness, reviews the suggested credit limits, and accepts or changes the credit limits in the customer database. On a monthly basis, the credit manager reviews the accounts receivable aging report to identify slow-paying or delinquent accounts for potential revisions to or discontinuance of credit. As needed, the credit manager issues credit memos for merchandise returns based on requests from customers and forwards copies of the credit memos to Accounting for appropriate account receivable handling.**
  + ***Warehousing*. Warehouse personnel update the inventory master file for inventory purchases and sales, confirm availability of materials to fill sales orders, and establish back orders for sales orders that cannot be completed from stock on hand. Warehouse personnel gather and forward inventory to Shipping and Receiving along with the corresponding sales orders. They also update the inventory master file for merchandise returned to Receiving.**
  + ***Shipping and receiving*. Shipping and Receiving accepts inventory and sales orders from Warehousing, packs and ships the orders with a copy of the sales order as a packing slip, and forwards a copy of the sales order to Billing. Customer inventory returns are unpacked, sorted, inspected, and sent to Warehousing.**
  + ***Accounting*. Billing prices all sales orders received, which is done approximately 5 days after the order ships. To spread the work effort throughout the month, customers are placed in one of six 30-day billing cycles. Monthly statements, prepared by Billing, are sent to customers during the cycle billing period. Outstanding carry forward balances reported by Accounts Receivable and credit memos prepared by the credit manager are included on the monthly statement. Billing also prepares electronic sales and credit memos for each cycle. Electronic copies of invoices and credit memos are forwarded to Accounts Receivable for entry into the accounts receivable master file by customer account. An aging report is prepared at the end of each month and forwarded to the credit manager. The general accounting office staff access the accounts receivable master file that reflects total charges and credits processed through the accounts receivable system for each cycle. General accounting runs a query to compare this information to the electronic sales and credit memo and posts the changes to the general ledger master file.**

(CMA exam adapted)

a.  **Identify the internal control strengths in PEI’s system**

* The automated customer credit limit system suggests a new customer's credit limit on a real-time basis. The Credit Manager establishes credit limits for new customers on a daily basis so that new credit-worthy customers can have their orders filled in a timely manner.
* Real-time customer credit checks before orders are processed.
* Monthly aging reports allow the credit manager to detect overdue and near overdue accounts so that corrective action can be taken.
* The credit manager creates credit memos that authorize returned merchandise but has no recording responsibility.
* Customers are not billed until an order has shipped.
* Shipping and Receiving accept and inspect returned materials to assure the receipt and identification of damaged materials and to limit credit returns.
* Warehouse personnel confirm the availability of materials to fill orders and prepare back-orders for sales orders that cannot be filled with current stock.
* General Accounting posts changes to the general ledger master file after accessing the accounts receivable master file, electronic sales, and credit memo files.

b **Identify the internal control weaknesses in PEI’s system, and suggest ways to correct them.**

**Weakness 1:** The Credit Department only checks the accounts receivable aging report at month-end, which delays the identification of slow or non-paying customers for potential credit status changes.

**Correction:** Revise the aging report process to produce an exception report whenever a customer account is overdue. The exception report should automatically be sent to the credit manager by email so that corrective action can be taken in a timely manner.

**Weakness 2**: Customer credit requests for sales returns are not compared to materials received, which might result in credits to customer accounts for goods not returned or for returned goods that are damaged.

**Correction:** Require the credit manager to receive an acknowledgement from Shipping and Receiving that the goods were returned in good condition before issuing a credit memo. In addition, Accounting should not process any credit memos without receiving a report of goods received from Shipping and Receiving.

**Weakness 3:** Warehouse personnel have responsibility for updating inventory records for purchases and sales that can lead to inventory shrinkage.

**Correction:** Create a purchasing function to update the inventory master file for purchases. The update should not take place until Shipping and Receiving notify them that the goods have been received.

**Weakness 4:** Receiving does not prepare a Returned Goods report.

**Correction:** Receiving should record all purchase returns and prepare a Returned Goods report. This record should be used to create a daily report that should be sent to General Accounting to compare with the purchase returns put back into the warehouse.

**Weakness 5:** Warehouse personnel have responsibility for updating inventory records for purchase returns, which can lead to inventory shrinkage.

**Correction:** Have the warehouse create a daily purchases returned report for all returned goods they receive from Receiving. This report should be sent to General Accounting for comparison with a purchase return report prepared by Receiving.

**Weakness 6:** Inventory is not counted when received and then counted again when received by the warehouse to prevent theft after items are received. In similar fashion, inventory is not counted before leaving the warehouse, when received by shipping, and when shipped. Those counts should be the same to ensure that inventory is not stolen before it is shipped to the customer.

**Correction:** Count and compare inventory counts as inventory enters the company and as it arrives in warehousing; likewise count and compare inventory counts as it leaves warehousing and arrives at shipping.

**Weakness 7:** Billing is not done until 5 days after shipping.

**Correction:** Billing should be more prompt in billing for goods shipped. This gives customers more time to put the bill through their bill paying process and pay for the goods on time.

**SUGGESTED SOLUTIONS TO THE CASES**

**7.1 Nino Moscardi, president of Greater Providence Deposit & Trust (GPD&T), received an anonymous note in his mail stating that a bank employee was making bogus loans. Moscardi asked the bank’s internal auditors to investigate the transactions detailed in the note. The investigation led to James Guisti, manager of a North Providence branch office and a trusted 14-year employee who had once worked as one of the bank’s internal auditors. Guisti was charged with embezzling $1.83 million from the bank using 67 phony loans taken out over a three-year period.**

**Court documents revealed that the bogus loans were 90-day notes requiring no collateral and ranging in amount from $10,000 to $63,500. Guisti originated the loans; when each one matured, he would take out a new loan, or rewrite the old one, to pay the principal and interest due. Some loans had been rewritten five or six times.**

**The 67 loans were taken out by Guisti in five names, including his wife’s maiden name, his father’s name, and the names of two friends. These people denied receiving stolen funds or knowing anything about the embezzlement. The fifth name was James Vanesse, who police said did not exist. The Social Security number on Vanesse’s loan application was issued to a female, and the phone number belonged to a North Providence auto dealer.**

**Lucy Fraioli, a customer service representative who cosigned the checks, said Guisti was her supervisor and she thought nothing was wrong with the checks, though she did not know any of the people. Marcia Perfetto, head teller, told police she cashed checks for Guisti made out to four of the five persons. Asked whether she gave the money to Guisti when he gave her checks to cash, she answered, “Not all of the time,” though she could not recall ever having given the money directly to any of the four, whom she did not know.**

**Guisti was authorized to make consumer loans up to a certain dollar limit without loan committee approvals, which is a standard industry practice. Guisti’s original lending limit was $10,000, the amount of his first fraudulent loan. The dollar limit was later increased to $15,000 and then increased again to $25,000. Some of the loans, including the one for $63,500, far exceeded his lending limit. In addition, all loan applications should have been accompanied by the applicant’s credit history report, purchased from an independent credit rating firm. The loan taken out in the fictitious name would not have had a credit report and should have been flagged by a loan review clerk at the bank’s headquarters.**

**News reports raised questions about why the fraud was not detected earlier. State regulators and the bank’s internal auditors failed to detect the fraud. Several reasons were given for the failure to find the fraud earlier. First, in checking for bad loans, bank auditors do not examine all loans and generally focus on loans much larger than the ones in question. Second, Greater Providence had recently dropped its computer services arrangement with a local bank in favor of an out-of-state bank. This changeover may have reduced the effectiveness of the bank’s control procedures. Third, the bank’s loan review clerks were rotated frequently, making follow-up on questionable loans more difficult.**

**Guisti was a frequent gambler and used the embezzled money to pay gambling debts. The bank’s losses totaled $624,000, which was less than the $1.83 million in bogus loans, because Guisti used a portion of the borrowed money to repay loans as they came due. The bank’s bonding company covered the loss.**

**The bank experienced other adverse publicity prior to the fraud’s discovery. First, the bank was fined $50,000 after pleading guilty to failure to report cash transactions exceeding $10,000, which is a felony. Second, bank owners took the bank private after a lengthy public battle with the State Attorney General, who alleged that the bank inflated its assets and overestimated its capital surplus to make its balance sheet look stronger. The bank denied this charge.**

**1.** **How did Guisti commit the fraud, conceal it, and convert the fraudulent actions to personal gain?**

**Commit:** James Guisti, a trusted 14-year employee and manager of a Greater Providence Deposit & Trust’ branch office, was authorized to make consumer loans up to a certain dollar limit without loan committee approvals. He used this authority to create 67 fraudulent 90-day notes requiring no collateral. As the scheme progressed, he was able to bypass the loan committee approval as some of his loans exceed his loan limit. Guisti was charged with embezzling $1.83 million from the bank.

**Conceal:** He made the loans out to five people: his wife using her maiden name, his father, two friends, and a non-existent person. To avoid detection, he made sure the loans were performing and that they were never examined for non-payment. That is, when the loans matured, he would take out a new loan, or rewrite the old one, to pay the principal and interest due. He also kept the loans small to avoid the attention of auditors, who examined loans much larger than those he was fraudulently originating.

**Convert**: He had a subordinate, customer service representative Lucy Fraioli, cosign the checks. He then had another subordinate, head teller Marcia Perfetto, cash the checks, and give him the money.

* 1. **Good internal controls require that the custody, recording, and authorization functions be separated. Explain which of those functions Guisti had and how the failure to segregate them facilitated the fraud.**

**Authorization**: Guisti was authorized to make consumer loans up to $10,000 (later $15,000 and then $25,000) without loan committee approval. This authorization is standard industry practice. He used this authority to create fraudulent loans.

As the scheme progressed, he was able to bypass loan committee approval for loans that exceeded his loan limit. This is not standard industry practice and represents a failure of bank internal controls.

**Custody**: Guisti was able to commit the fraud because he was able to obtain custody of the checks used to extend the loans. He used his position as branch manager to get his subordinates to cosign the checks and cash them.

**Recording**: Nothing in the case write-up indicates that Guisti had any recording responsibilities. It appears that he used the bank’s normal recording processes: the bank recorded the loans when created and the payments were appropriately recorded when Guisti repaid them

* 1. **Identify the preventive, detective, and corrective controls at GPD&T and discuss whether they were effective.**

**Preventive**: All bank loans exceeding Guist’s limit ($10,000, then $15,000 and then $25,000) were supposed to be approved by a loan committee. This control was not enforced or was not effective as Guisti was able to bypass it.

GPD&T segregated the functions of loan origination, authorization (a co-signer needed on loans), and custody of cash (tellers). Guisti used his position of branch manager to override the controls over co-signatures and check cashing.

Loan applications were to be accompanied by the applicant’s credit history report, purchased from an independent credit rating firm. The loan taken out in the fictitious name did not have that credit report and it should have been flagged by a loan review clerk at the bank’s headquarters. This control was not enforced or was not effective as Guisti was able to bypass it.

Greater Providence dropped its computer services arrangement with a local bank in favor of an out-of-state bank. This may have reduced the effectiveness of the bank’s control procedures.

**Detective**: State regulators and the bank’s internal auditors failed to detect the fraud. Bank auditors do not examine all loans and focus on much larger loans than Guisti’s.

The bank’s loan review clerks were rotated frequently, making follow-up on questionable loans more difficult.

**Corrective:** The bank bonded (an insurance policy on an employee’s honesty) its employees. When the bank was defrauded, the bank’s bonding company covered the loss. This control was effective in restoring the financial losses the bank experienced.

* 1. **Explain the pressures, opportunities, and rationalizations that were present in the Guisti fraud.**

**Pressures:** Guisti was a frequent gambler and needed the money to pay gambling debts.

**Opportunities**: As the Branch Manager, Guisti could override some internal controls and unduly influence his subordinates not to comply with others.

**Rationalization**: No information is given on how or why Guisti rationalized his fraud

* 1. **Discuss how Greater Providence Deposit & Trust might improve its control procedures over the disbursement of loan funds to minimize the risk of this type of fraud. In what way does this case indicate a lack of proper segregation of duties?**

Loan funds should generally not be disbursed in cash. Better control would be established by depositing the funds in a checking account in the borrower's name or by issuing a bank check to the borrower.

When cashing such a check, bank personnel should require identification containing the borrower's photograph, and the borrower's signature on the check, and should scan both the photograph and the signature to verify the borrower's identity.

In no case should one bank employee disburse cash to another for a loan to a third party borrower without first verifying the existence and identity of the borrower.

Customer service representatives generally should not co-sign checks to borrowers without first verifying their existence.

* 1. **Discuss how Greater Providence might improve its loan review procedures at bank headquarters to minimize its fraud risk. Was it a good idea to rotate the assignments of loan review clerks? Why or why not?**

A system should be in place at the bank's headquarters to maintain data on all outstanding bank loans. This system should flag all loans that have been made in excess of the loan officer's lending limit. The authenticity of these loans should be scrutinized by internal auditors or other bank officials independent of the loan officer.

Disciplinary action should be taken when a loan officer extends a loan that is greater than his loan limit.

Approved loans for which there is no credit report should be flagged and scrutinized.

Bank headquarters could send a letter to each new borrower thanking them for their business. Individuals whose names had been used on loan documents without their permission would be likely to question why they had received such a letter, while letters mailed to fictitious borrowers would be returned as undeliverable. Either event should trigger an investigation.

Rotating the assignments of loan review clerks may have made it more difficult for the bank to detect this fraud. After it discovered the embezzlement, Greater Providence changed its policy to require its loan review clerks to track a problem loan until it is resolved.

**7. Discuss whether Greater Providence’s auditors should have been able to detect this fraud.**

Audits are not guaranteed to detect fraud. It is too costly for auditors to examine every loan, so they generally examine a systematically selected sample. It makes sense for auditors to focus on larger loans, since that is where the greatest exposure is.

The case notes that Guisti was a former auditor. Therefore, he would have been very familiar with the bank's control system and its audit procedures. He undoubtedly made use of this knowledge in planning and carrying out his embezzlement scheme.

On the other hand, since the bank's central records were computerized, it should have been a simple matter for auditors to find and examine every outstanding loan record with questionable characteristics, such as:

* Loan amounts in excess of the loan officer's lending limit
* Short-term loans that had been rewritten several times.

If auditors had any indication that Guisti was heavily involved in gambling activities, they should have examined his accounts very carefully. However, the case gives no indication that the auditors were ever aware of Guisti's penchant for gambling.

8. **Are there any indications that the internal environment at Greater Providence may have been deficient? If so, how could it have contributed to this embezzlement?**

There are three indications of potential deficiencies in the bank's control environment.

* + - Controls may have been deficient during the computer services changeover. However, the fraud took place over a three-year period, and any problems relating to the computer changeover should have taken much less than three years to resolve.
    - The bank pled guilty to a felony three years prior to discovery of the fraud, which was about the time the fraud began.
    - The state's charges of an inflated balance sheet suggest the possibility that the integrity of the bank's management may be flawed, though there is certainly no proof of this.

While one indicator of a deficient internal environment may be tolerable, three begins to look like a pattern. Deficiencies in the bank's internal environment certainly could have contributed to the embezzlement by enhancing the opportunity for fraud and by fostering an attitude that dishonest behavior is somehow acceptable.