

The embezzlement was concealed by overstating assets, expenses, and cost of sales and understating liabilities and sales, through the collusion of two employees in the accounting department. At the time Ms. Sachdeva was arrested, more than 22,000 items were confiscated from her home that had been purchased using Koss Corporation funds. Below are just a few examples taken from the court complaint filed against her of purchases Ms. Sachdeva made on her American Express charge card that were later paid for by wire-transferring money from Koss Corp. to American Express as payment:

1. \$127,400 from A.C. Zuckennan Jewelers;
2. \$670,000 from Au Courant, a women's clothing store;
3. \$12,500 from Channel BTQ #16;
4. \$14,000 from Giorgio-Armani;
5. \$40,000 from Holzman's Furs;
6. \$255,000 from Karat 22 Jewelers;
7. \$1,358,322 from Valentina Boutique, a women's clothing store.

- a. Is this fraud an example of asset misappropriation or fraudulent financial reporting?
- b. Ms. Sachdeva came from a wealthy family, so the theft was not necessary for her to live comfortably. What incentive and attitude/rationalization do you believe drove Ms. Sachdeva to embezzle? Would there have been behavioral red flags that should have alerted auditors to the fraud?
- c. Koss Corporation designs, manufactures, and sells stereo headphones and related accessories. Do you think it would be normal for a manufacturing company to have recurring disbursements to American Express or more than 100 cashier's checks written per year? How could auditors have used audit software to detect these disbursements?
- d. What internal controls could Koss Corporation have had in place to prevent employee collusion in the first place or detect the fraud after it began?
- e. Ms. Sachdeva avoided using wire transfers during the month of June because she knew this was the month the auditors would review the bank records. What could the auditors have done differently to detect the fraud?
- f. Do you believe auditors should be held liable for not detecting fraud when management attempts to hide the fraud and there is employee collusion? Does it matter whether the amounts are material or immaterial to the financial statements?

Required

10-27 (OBJECTIVES 10-1, 10-4, 10-6) The following misstatements are included in the accounting records of the Joyce Manufacturing Company:

1. A material sale was recorded on the last day of the year even though the goods were not shipped until three days later.
2. Merchandise was shipped to a customer, but no bill of lading was prepared. Because billings are prepared from bills of lading, the customer was not billed.
3. The controller approved a payment to a consulting firm owned by his sister. The consulting firm did not actually perform any services for the company.
4. The shipping clerk included several additional valuable items in a shipment that were not included in the customer's order and were not invoiced to the customer. The shipping clerk has an arrangement with the customer to share the proceeds from sales of the additional items shipped.
5. Cash paid on accounts receivable was stolen by the mail clerk when the mail was opened.
6. A sales invoice was miscalculated by \$1,000 as a result of a key-entry mistake.
7. Cash paid on accounts receivable that had been prelisted by a secretary was stolen by the bookkeeper, who records cash receipts and accounts receivable. He failed to record the transactions.

- a. Identify whether each misstatement is an error or fraud.
- b. For each misstatement, list one or more procedures that could be implemented to prevent it from occurring on a continuing basis.
- c. For each misstatement, identify evidence the auditor can use to uncover it.

Required

10-28 (OBJECTIVES 10-2, 10-4, 10-6) Appliances Repair and Service Company bills all customers rather than collecting in cash when services are provided. All mail is opened by



auditor responses involving changes to the nature, timing, and extent of audit procedures related to this assessed fraud risk for inventory.

- b. What do PCAOB auditing standards say about how the auditor should assess risk related to revenue recognition?
- c. What examples of auditor responses to fraud risk related to revenue recognition are provided in PCAOB auditing standards?
- d. What kind of documentation is required for the auditor's consideration of fraud?
- e. What kinds of inquiries about fraud risks are required by PCAOB Standard No. 12?
- f. How does PCAOB Standard No. 12 define "fraud risk factors"? Do all conditions have to be present for fraud risk to exist?

10-31 (OBJECTIVE 10-5) The following audit procedures are included in the audit program of Harris Manufacturing, Inc.



1. Use audit software to examine journal entries in the sales, cash receipts, purchases, cash disbursements, payroll, and general journals for any amounts exceeding \$1 million and for any entries with unusual account codings. Review related supporting documentation for reasonableness.
2. Examine the estimate for the Allowance for Doubtful Accounts recorded in the prior year audited financial statements. Obtain information about receivable writeoffs recorded during the current fiscal year for receivables included in the prior year audited financial statements and obtain other information to perform a hindsight evaluation of the reasonableness of the allowance account included in the prior year audited financial statements.
3. Continue to observe inventories at Harris' two main distribution centers, but for this year examine inventories at its two smaller warehouses not examined in prior years. Management does not expect you to examine those additional warehouses.
4. During the current year, Harris has entered into a joint venture partnership with a company that serves similar customers, but makes an entirely different product than Harris. Inquire of management about the business rationale for this transaction.
5. Review for reasonableness any manual journal entries made by management to adjust the computer-generated accounting records.

- a. What is the overarching purpose for performing all of these procedures?
- b. How might each audit procedure in 1 through 5 help the auditor identify fraud risk?

Required

10-32 (OBJECTIVES 10-2, 10-3, 10-4, 10-6) Each year near the balance sheet date, when the president of Bargon Construction, Inc., takes a 3-week vacation to Hawaii, she signs several checks to pay major bills during the period she is absent. Jack Morgan, head bookkeeper for the company, uses this practice to his advantage. Morgan makes out a check to himself for the amount of a large vendor's invoice and, because there is no acquisitions journal, he records the amount in the cash disbursements journal as an acquisition from the supplier listed on the invoice. He holds the check until several weeks into the subsequent period to make sure that the auditors do not get an opportunity to examine an electronic copy of the cancelled check. Shortly after the first of the year when the president returns, Morgan resubmits the invoice for payment and again records the check in the cash disbursements journal. At that point, he marks the invoice "paid" and files it with all other paid invoices. Morgan has been following this practice successfully for several years and feels confident that he has developed a foolproof method.

- a. What is the auditor's responsibility for discovering this type of embezzlement?
- b. What weaknesses in Bargon's processes exist?
- c. What evidence can the auditor use to uncover the fraud?

Required

10-33 (OBJECTIVES 10-5, 10-6) The following are various potential frauds in the sales and collection cycle:

1. The company engaged in channel stuffing by shipping goods to customers that had not been ordered.
2. The allowance for doubtful accounts was understated because the company altered the aging of accounts receivable to reduce the number of days outstanding for delinquent receivables.

3. The accounts receivable clerk stole checks received in the mail and deposited them in an account that he controlled. He issued credit memos to the customers in the amount of the diverted cash receipts.
4. The company contacted a major customer and asked them to accept a major shipment of goods before year-end. The customer was told that they could return the goods without penalty if they were unable to sell the goods.
5. A cashier stole cash receipts that had been recorded in the cash register.
6. The company recorded "bill-and-hold sales" at year-end. Although the invoices were recorded as sales before year-end, the goods were stored in the warehouse and shipped after year-end.
7. The company did not record credit memos for returns received in the last month of the year. The goods received were counted as part of the company's year-end physical inventory procedures.
8. A cashier stole cash receipts by failing to record the sales in the cash register.
9. The CFO recorded fictitious credit sales at the end of the year without recording the associated cost of sales and reduction in inventory.

Required

- a. Indicate whether the fraud involves misappropriation of assets or fraudulent financial reporting.
- b. For those frauds that involve misappropriation of assets, state a control that would be effective in preventing or detecting the misappropriation.
- c. For those frauds that involve fraudulent financial reporting, state an audit procedure that would be effective in detecting the fraud.

10-34 (OBJECTIVES 10-6, 10-7) The following audit procedures are included in the audit program because of heightened risks of material misstatements due to fraud.

1. Use audit software to search cash disbursement master files for missing check numbers.
2. Search the accounts receivable master file for account balances with missing or unusual customer numbers (e.g., "99999").
3. Use audit software to create a list of all credits to the repair and maintenance expense account for follow-up testing.
4. Engage an actuarial specialist to examine management's assumptions about average length of employment and average life expectancy of retirees used in pension accounting decisions.
5. Send confirmations to customers for large sales transactions made in the fourth quarter of the year to obtain customer responses about terms related to the transfer of title and ability to return merchandise.
6. Use audit software to search purchase transactions to identify any with nonstandard vendor numbers or with vendor names reflecting related parties.
7. Search sales databases for missing bill of lading numbers.
8. Use audit software to search for journal entries posted to the sales revenue account from a nonstandard source (other than the daily sales journal).

Required

- For each audit procedure:
- a. Describe the type of fraud risk that is likely associated with the need for this audit procedure.
 - b. Identify the related accounts likely affected by the potential fraud misstatement.
 - c. Identify the related audit objective(s) that this procedure addresses.

CASE

10-35 (OBJECTIVES 10-2, 10-3, 10-4) Kent, CPA, is the engagement partner on the financial statement audit of Super Computer Services Co. (SCS) for the year ended April 30, 2016. On May 6, 2016, Smith, the senior auditor assigned to the engagement, had the following conversation with Kent concerning the planning phase of the audit:*

*Based on AICPA question paper, American Institute of Certified Public Accountants.

8. The company has developed a detailed series of accounting policy and procedures manuals to help provide detailed instructions to employees about how controls are to be performed.
9. The company has an organizational chart that establishes the formal lines of reporting and authorization protocols.
10. The compensation committee reviews compensation plans for senior executives to determine if those plans create unintended pressures that might lead to distorted financial statements.

Required Indicate which of the five COSO internal control components is best represented by each internal control.

- | | |
|------------------------|----------------------------------|
| a. Control environment | d. Information and communication |
| b. Risk assessment | e. Monitoring |
| c. Control activities | |

11-24 (OBJECTIVES 11-3, 11-4) The following are internal controls related to various cycles.

1. Sales invoices are matched with shipping documents by the computer system and an exception report is generated.
2. Receiving reports are prenumbered and accounted for on a daily basis.
3. Sales invoices are independently verified before being sent to customers.
4. Payments by check are received in the mail by the receptionist, who lists the checks and restrictively endorses them.
5. Labor hours for payroll are reviewed for reasonableness by the computer system.
6. Checks are signed by the company president, who compares the checks with the underlying supporting documents.
7. Unmatched shipping documents are accounted for on a daily basis.
8. The computer system verifies that all payroll payments have a valid employee identification number assigned by the human resources department at the time of hiring.
9. The accounts receivable master file is reconciled to the general ledger on a monthly basis.

Required

- a. For each internal control, identify the type(s) of specific control activity (or activities) to which it applies (such as proper authorization and adequate documents and records).
- b. For each internal control, identify the transaction-related management assertion(s) to which it applies.

11-25 (OBJECTIVE 11-3) The following are misstatements that have occurred in Fresh Foods Grocery Store, a retail and wholesale grocery company:

1. On the last day of the year, a truckload of beef was set aside for shipment but was not shipped. Because it was still on hand, the inventory was counted. The shipping document was dated the last day of the year, so it was also included as a current-year sale.
2. The incorrect price was used on sales invoices for billing shipments to customers because the wrong price was entered into the computer master file of prices.
3. A vendor invoice was paid even though no merchandise was ever received. The accounts payable software application does not require the input of a valid receiving report number before payment can be made.
4. Employees in the receiving department took sides of beef for their personal use. When a shipment of meat was received, the receiving department filled out a receiving report and forwarded it to the accounting department for the amount of goods actually received. At that time, two sides of beef were put in an employee's pickup truck rather than in the storage freezer.
5. An accounts payable clerk processed payments to himself by adding a fictitious vendor address to the approved vendor master file.
6. During the physical count of inventory of the retail grocery, one counter wrote down the wrong description of several products and miscounted the quantity.
7. A salesperson sold an entire carload of lamb at a price below cost because she did not know the cost of lamb had increased in the past week.

8. A vendor's invoice was paid twice for the same shipment. The second payment arose because the vendor sent a duplicate copy of the original 2 weeks after the payment was due.

- a. For each misstatement, identify one or more types of controls that were absent.
- b. For each misstatement, identify the transaction-related management assertions that have not been met.
- c. For each misstatement, suggest a control that may have prevented or detected the misstatement.

Required

11-26 (OBJECTIVE 11-3) The division of the following duties is meant to provide the best possible controls for the Meridian Paint Company, a small wholesale store:

- †1. Approve credit for customers included in the customer credit master file.
- †2. Input shipping and billing information to bill customers, record invoices in the sales journal, and update the accounts receivable master file.
- †3. Open the mail and prepare a prelisting of cash receipts.
- †4. Enter cash receipts data to prepare the cash receipts journal and update the accounts receivable master file.
- †5. Prepare daily cash deposits.
- †6. Deliver daily cash deposits to the bank.
- †7. Assemble the payroll time cards and input the data to prepare payroll checks and update the payroll journal and payroll master files.
- †8. Sign payroll checks.
- †9. Assemble supporting documents for general and payroll cash disbursements.
- †10. Sign general cash disbursement checks.
- †11. Input information to prepare checks for signature, record checks in the cash disbursements journal, and update the appropriate master files.
- †12. Mail checks to suppliers and deliver checks to employees.
- †13. Cancel supporting documents to prevent their reuse.
- †14. Update the general ledger at the end of each month and review all accounts for unexpected balances.
- †15. Reconcile the accounts receivable master file with the control account and review accounts outstanding more than 90 days.
- †16. Prepare monthly statements for customers by printing the accounts receivable master file; then mail the statements to customers.
- †17. Reconcile the monthly statements from vendors with the accounts payable master file.
- †18. Reconcile the bank account.

Required

You are to divide the accounting-related duties 1 through 18 among Robert Smith, James Cooper, and Mohini Singh. All of the responsibilities marked with a dagger (†) are assumed to take about the same amount of time and must be divided equally between Smith and Cooper. Both employees are equally competent. Singh, who is president of the company, is not willing to perform any functions designated by a dagger and will perform only a maximum of two of the other functions.*

11-27 (OBJECTIVES 11-3, 11-4) The following are misstatements that can occur in the sales and collection cycle:

1. A customer number on a sales invoice was transposed and, as a result, charged to the wrong customer. By the time the error was found, the original customer was no longer in business.
2. A former computer operator, who is now a programmer, entered information for a fictitious sales return and ran it through the computer system at night. When the money came in, he took it and deposited it in his own account.
3. A nonexistent part number was included in the description of goods on a shipping document. Therefore, no charge was made for those goods.

* Based on AICPA question paper, American Institute of Certified Public Accountants.

4. A customer order was filled and shipped to a former customer, which had already filed for bankruptcy.
5. The sales manager approved the price of goods ordered by a customer, but he wrote down the wrong price.
6. A computer operator picked up a computer-based data file for sales of the wrong week and processed them through the system a second time.
7. For a sale, a data entry operator erroneously failed to enter the information for the salesman's department. As a result, the salesman received no commission for that sale.
8. Several remittance advices were batched together for inputting. The cash receipts clerk stopped for coffee, set them on a box, and failed to deliver them to the data input personnel.

Required

- a. Identify the transaction-related management assertion(s) to which the misstatement pertains.
- b. Identify one automated control that would have likely prevented each misstatement.



11-28 (OBJECTIVES 11-3, 11-4) You are doing the audit of Phelps College, a private school with approximately 2,500 students. With your firm's consultation, they have instituted an IT system that separates the responsibilities of the computer operator, systems analyst, librarian, programmer, and data control group by having a different person do each function. Now, a budget reduction is necessary and one of the five people must be laid off. You are requested to give the college advice as to how the five functions could be done with reduced personnel and minimal negative effects on internal control. The amount of time the functions take is not relevant because all five people also do nonaccounting functions.

Required

- a. Divide the five functions among four people in such a way as to maintain the best possible control system.
- b. Assume that economic times become worse for Phelps College and it must terminate employment of another person. Divide the five functions among three people in such a way as to maintain the best possible internal control. Again, the amount of time each function takes should not be a consideration in your decision.
- c. Assume that economic times become so severe for Phelps College that only two people can be employed to do IT functions. Divide the five functions between two people in such a way as to maintain the best possible control system.
- d. If the five functions were done by one person, will internal controls be so inadequate that an audit cannot be done? Discuss.

11-29 (OBJECTIVE 11-4) During your audit of Wilcoxon Sports, Inc., a retail chain of stores, you learn that a programmer made an unauthorized change to the sales application program even though no work on that application had been approved by IT management. In order for the sales application program to work, the programmer had to make modifications to the operating software security features. The unauthorized change forced the sales program to calculate an automatic discount for a customer who happens to be the brother-in-law of the programmer. The customer and programmer split the savings from the unauthorized discount. The programmer modified the program and returned it to the librarian, who placed it into the files for live production use. No other information was forwarded to the librarian.

Required

1. What recommendation do you have for management of Wilcoxon Sports, Inc., to prevent this from recurring?
2. Explain why you believe the suggested internal control improvements will prevent problems in the future.



11-30 (OBJECTIVES 11-3, 11-4) Your new audit client, Hardwood Lumber Company, has a computerized accounting system for all financial statement cycles. During planning, you visited with the information systems vice president and learned that personnel in information systems are assigned to one of four departments: systems programming, applications programming, operations, or data control. Job tasks are specific to the individual and no

responsibilities overlap with other departments. Hardwood Lumber relies on the operating system software to restrict online access to individuals. The operating system allows an employee with "READ" capabilities to only view the contents of the program or file. "CHANGE" allows the employee to update the contents of the program or file. "RUN" allows the employee to use a program to process data. Programmers, both systems and applications, are restricted to a READ-only access to all live application software program files but have READ and CHANGE capabilities for test copies of those software program files. Operators have READ and RUN capabilities for live application programs. Data control clerks have CHANGE access to data files only and no access to software program files. The person in charge of operations maintains access to the operating software security features and is responsible for assigning access rights to individuals. The computer room is locked and requires a card-key to access the room. Only operations staff have a card-key to access the room, and security cameras monitor access. A TV screen is in the information systems vice president's office to allow periodic monitoring of access. The TV presents the live picture and no record is maintained. The librarian, who is in the operations department, is responsible for maintaining the library of program files. The librarian has READ and CHANGE access rights to program files. Backup copies of program files are stored on an external drive, and data files are maintained on a backup server. The external drive and backup server are located in a room adjacent to the computer room.

- a. Identify the strengths of Hardwood Lumber Company's computerized accounting system.
- b. What recommendations for change can you suggest to improve Hardwood's information systems function?

Required

11-31 (OBJECTIVES 11-3, 11-4) A growing number of organizations have been the target of hacking attacks, or cyberattacks, in recent years. High-profile examples in the U.S. include Target Corp., Home Depot Inc., the Internal Revenue Service, and other government agencies such as the Office of Personnel Management. Companies and governments need to consider the risks of a cyberattack, and consider backup plans in the event a cyberattack results in a loss of hardware, software, or data. The Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued a thought paper, *COSO in the Cyber Age*, to help organizations assess and mitigate risks associated with cybersecurity through the existing COSO Framework. Visit the COSO Web site (www.coso.org), and refer to the "Guidance" tab. Read the thought paper to answer the following questions:



- a. The COSO guidance acknowledges that "cyber risk is not something that can be avoided; instead it must be managed." Why is cyber risk unavoidable? Does this acknowledgement make it more or less difficult to address and mitigate cyber risk?
- b. At the control environment level (the first of the five components of internal control), what should organizations do to address cyber risk?
- c. The paper identifies five broad categories of cyberattack perpetrators and motivations. Briefly describe each group of perpetrators and their motivation.
- d. What types of control activities are recommended to address cyber risks?

Required

CASE

11-32 (OBJECTIVE 11-3) The following is the description of sales and cash receipts for the Lady's Fashion Fair, a retail store dealing in expensive women's clothing. Sales are for cash or credit, using the store's own billing rather than credit cards.

Each salesclerk has her own sales book with prenumbered, three-copy, multicolored sales slips attached, but perforated. Only a central cash register is used. It is operated by the store supervisor, who has been employed for 10 years by Alice Olson, the store owner. The cash register is at the store entrance to control theft of clothes.

Salesclerks prepare the sales invoices in triplicate. The original and the second copy are given to the cashier. The third copy is retained by the salesclerk in the sales book. When the sale is for cash, the customer pays the salesclerk, who marks all three copies "paid" and presents the money to the cashier with the invoice copies.