

## 9. KICKBACK FRAUD

The kickback is a form of fraud often associated with purchasing. Most organizations expect their purchasing agents to select the vendor that provides the best products at the lowest price. To influence the purchasing agent in his or her decision, vendors may grant the agent financial favors (cash, presents, football tickets, and so on). This activity can result in orders being placed with vendors that supply inferior products or charge excessive prices.

### Required

Describe the controls that an organization can employ to deal with kickbacks. Classify each control as preventive, detective, or corrective.

## 10. ASSESSING INTERNAL CONTROL

The following describes the cash receipts procedures for a medium-sized online and catalogue-based retailer.

Customer payments come directly to the general mail room along with other mail items. The customer payments mail constitutes about 20 percent of the total mail received each day. The mailroom clerks sort through the mail, open the customer payment envelopes, remove the customer checks and remittance advices, and reconcile the two documents. The mailroom supervisor then sends the reconciled checks and remittance advices to the Accounts Receivable clerk, who posts the amounts received to the customer AR subsidiary ledger and the cash receipts journal from her computer terminal. The AR clerk then manually prepares a remittance list of all checks received, endorses the checks "for deposit only" and sends the checks and remittance list to the Treasurer. Finally, the clerk files the remittance advices in the AR department.

Once the checks and remittance list arrive at the Treasury department, the treasurer reconciles the documents, and manually prepares three hard copies of the deposit slip. Next, he sends the checks and two copies of the deposit slip to the bank. Finally, he files the third copy of the deposit slip and the remittance in the department.

### Required

- Identify the internal control weaknesses in the cash receipts process.
- For each weakness, describe the associated risks.
- For each weakness provide a possible control activity.

## 11. ASSESSING INTERNAL CONTROL

The following describes the cash disbursement procedures for a wholesale building supply company.

When the accounts payable clerk receives the supplier's invoice she records the purchase in the purchases journal, records the liability in the AP subsidiary ledger, and sets a due date based on the terms specified on the invoice. The clerk then updates the inventory control and accounts payable control accounts in the general ledger. The invoice is then filed in the department.

Each day, the clerk visually searches the AP subsidiary ledger from her terminal for invoices that are due to be paid. From her computer terminal, the clerk prepares the check and records it in the check register. The negotiable portion of the check is mailed to the vendor and a check copy is filed. The clerk then closes the liability in the AP subsidiary ledger and updates the accounts payable control and cash accounts in the general ledger.

### Required

- Identify the internal control weaknesses in the cash receipts process.
- For each weakness, describe the associated risks.
- For each weakness provide a possible control activity.

## 12. EVALUATION OF INTERNAL CONTROLS

The Never Sink Canoe (NSC) Company is a small manufacturer of high-quality canoes, pontoons, and fishing craft. It sells its products to sporting good stores throughout the northeast United States and parts of Canada. NSC began as a small family owned company that served a local market. Over the years it expanded its market through the use of seasonal sales force employees. The sales staff work on straight commission and travel extensively while taking orders from customers at sporting outlets and trade shows during the water sports and fishing season. All sales are on credit and payment is due within 30 days after being billed. In late fall when the season ends, the temporary sales personnel are laid off until the following spring. Employee turnover is high with approximately 50 percent of the laid-off sales staff returning the following year.

NSC's revenue and expense procedures associated with their sales force activities are as follows:

The salesperson takes an order, reviews the customer's credit worthiness, and submits the approved order to the accounting clerk at the main office who calculates the sales commission to be remitted and promptly writes a check to the salesperson. The clerk then sets up an account receivable for the customer. The clerk also receives cash in payment of customer accounts and updates the related customer AR records.

The order is then sent to the billing department, where the sale is recorded and the customer is billed. Finally, the order is sent to the warehouse where the items are selected, packaged and shipped to the customer. The warehouse clerk then updates the inventory subsidiary ledger to reflect the shipment.

Sales staff periodically submit travel expense reimbursement claims on hard copy forms to the accounting clerk. NSC policy requires sales staff to keep receipts, but they are not required to submit them with the reimbursement forms. The clerk prepares an account payable for each salesperson based on their reimbursement form and twice each month writes checks them for the amount indicated in their individual AP account.

After the end of the past season, and after the temporary employees had been laid off, NSC financials showed a substantial rise in sales compared to previous years. These increases were, however, offset to a great extent by a high rate of product returns. Furthermore, travel expenses were disproportionately high compared with previous years.

#### Required

- Using the COSO internal control model for control activities (e.g., transaction authorization, segregation of duties) identify any potential internal control weaknesses in the NSC system.
- For each weakness discuss the potential for fraud in the system
- Make recommendations for correcting each identified control weakness.

### 13. DOCUMENTING SYSTEM AND EVALUATING CONTROLS

The following section describes the warehouse and shipping procedures for a company:

The warehouse clerk receives two copies of a stock release document from the sales department. The stock release document describes the items that

were sold, the quantities to be picked from the shelves, and the warehouse locations of the items. The clerk then picks the items and sends them with one copy of the stock release document to the shipping department. Using the second copy of the stock release, the clerk accesses the inventory subsidiary ledger from the PC in the warehouse and updates the inventory to reflect the items shipped. The clerk also looks for items that have fallen below their reorder points, selects a vendor, prepares a purchase order, and sends it to the vendor.

Upon receipt of the goods and a copy of the stock release document the shipping clerk prepares the items for shipment, records the shipment in the hard copy shipping log, and sends the items sold along with the stock release document to the carrier.

- Prepare a systems flowchart of the procedures previously described.
- Identify any control problems in the system.
- What sorts of fraud are possible in this system?

### 14. ANALYSIS OF FLOWCHART, INTERNAL CONTROLS

The flowchart labeled Problem 14 depicts the responsibilities of an accounting clerk in a small company.

#### Required

- Identify any control problems in the system.
- What sorts of fraud are possible in this system?

### 15. EVALUATING INTERNAL CONTROLS

Gaurav Mirchandaniis is the warehouse manager for a large office supply wholesaler. Mirchandaniis receives two copies of the customer sales order from the sales department. He picks the goods from the shelves and sends them and one copy of the sales order to the shipping department. He then files the second copy in a temporary file. At the end of the day, Mirchandaniis retrieves the sales orders from the temporary file and updates the inventory subsidiary ledger from a terminal in his office. At that time, he identifies items that have fallen to low levels, selects a supplier, and prepares three copies of a purchase order. One copy is sent to the supplier, one is sent to the accounts payable clerk, and one is filed in the warehouse. When the goods arrive from the supplier, Mirchandaniis reviews the attached packing slip, counts and inspects the goods, places

**Required**

Advise Iris as to which business modules you think her organization could find beneficial. Discuss advantages, disadvantages, and internal control issues.

**10. INTERNAL CONTROL**

You are a consultant who has been hired to design a point-of-sale (POS) system with appropriate controls for a restaurant that accepts cash and credit cards including Visa, MC, and AMEX. The restaurant also issues coupons through the mail and in local newspapers, which it accepts as cash from customers. The system will employ computer terminals with cash drawers that are connected to a central computer. Servers take orders and receive payments from customers. At the end of the shift, servers reconcile their cash drawers with the manager. The system automatically updates the journals and GL accounts.

**Required**

- Prepare a flowchart for the new system.
- Describe the risks inherent in the system and the physical and computer controls needed to mitigate the risks.

**11. CONTROL WEAKNESSES AND RELATED RISKS**

Refer to the system flowchart in the figure labeled Problem 11.

**Required**

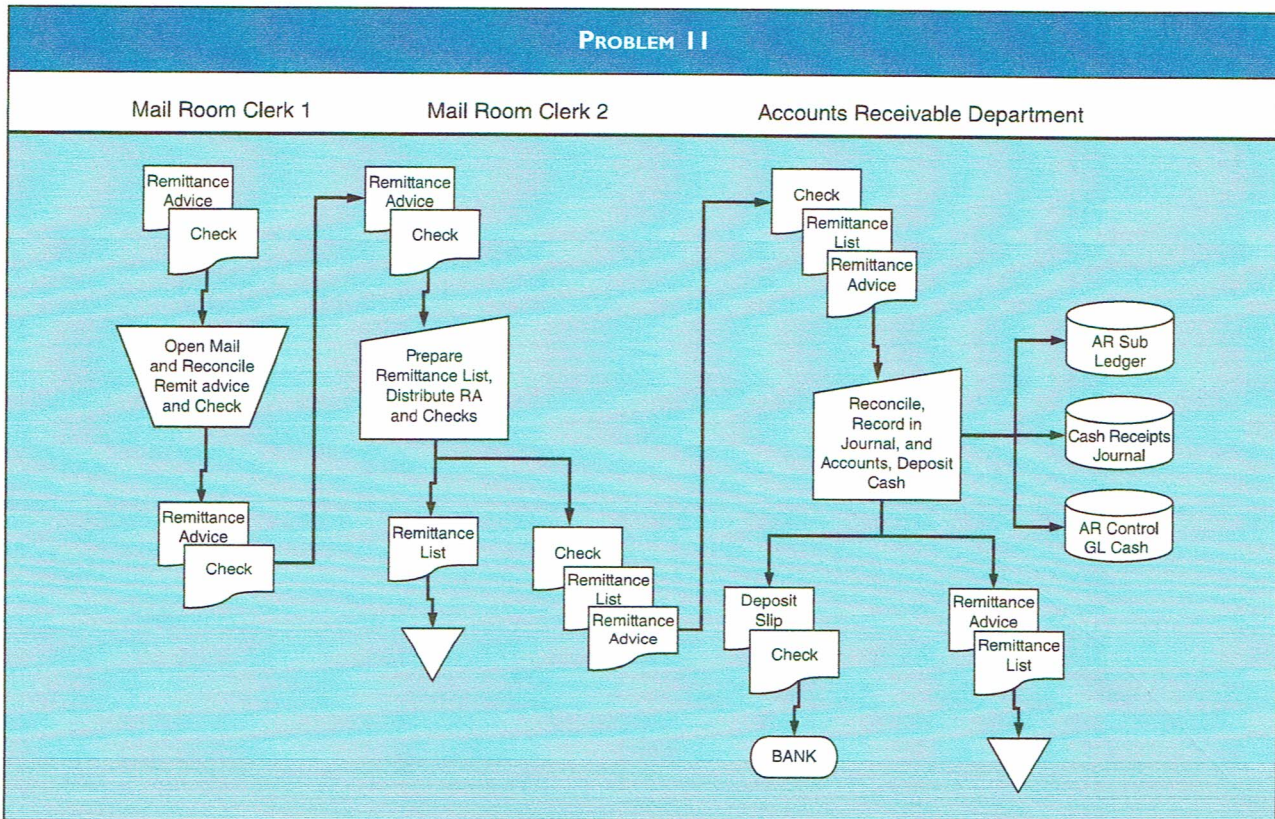
- Discuss the uncontrolled risks associated with the systems as currently configured.
- Describe the controls that need to be implemented into the system to mitigate the risks in (a) above.

**12. CONTROL WEAKNESSES AND RELATED RISKS**

Refer to the system flowchart in the figure labeled Problem 12.

**Required**

- Describe the control weaknesses depicted in the system flowchart.
- Discuss the risks associated with the control weaknesses in identified (a) above.



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from the large online discount stores such as Harbor Freight and Northern Supply. In addition, the company is suffering from operational inefficiencies related to its archaic information system. ABE's revenue cycle procedures are described in the following paragraphs.

### Revenue Cycle

ABE's sales department consists of 17 full-time and part-time employees. The company receives orders via traditional mail, e-mail, telephone, and the occasional walk-in customer. Because ABE is a wholesaler, the vast majority of its business is conducted on a credit basis. The process begins in the sales department, where the sales clerk enters the customer's order into the centralized computer sales order system. The computer and file server are housed in ABE's small data processing department.

If the customer has done business with ABE in the past, his or her data are already on file. If the customer is a first-time buyer, however, the clerk creates a new record in the customer file. The system then creates a record of the transaction in the open sales order file. When the order is entered, an electronic copy of it is sent to the customer's e-mail address as confirmation.

A clerk in the warehouse department periodically reviews the open sales order file from a terminal and prints two copies of a stock release document for each new sale, which he uses to pick the items sold from the shelves. The warehouse clerk sends one copy of the stock release to the sales department and the second copy, along with the goods, to the shipping department. The warehouse clerk then updates the inventory subsidiary file to reflect the items and quantities shipped. Upon receipt of the stock release document, the sales clerk accesses the open sales order file from a terminal, closes the sales order, and files the stock release document in the sales department. The sales order system automatically posts these transactions to the sales, inventory control, and cost-of-goods-sold accounts in the general ledger file.

Upon receipt of the goods and the stock release, the shipping department clerk prepares the goods for shipment to the customer. The clerk prepares three copies of the bill of lading. Two of these go with the goods to the carrier and the third, along with the stock release document, is filed in the shipping department.

The billing department clerk reviews the closed sales orders from a terminal and prepares two copies

of the sales invoice. One copy is mailed to the customer and the other is filed in the billing department. The clerk then creates a new record in the account receivable subsidiary file. The sales order system automatically updates the account receivable control account in the general ledger file.

ABE has hired your public accounting firm to review its sales order procedures for internal control compliance and to make recommendations for changes.

### Required

- Create a data flow diagram of the current system.
- Create a system flowchart of the existing system.
- Analyze the physical internal control weaknesses in the system.
- (Optional) Prepare a system flowchart of a redesigned computer-based system that resolves the control weaknesses that you identified. Explain your solution.

## 6. GREEN PRODUCTS GARDEN SUPPLY (STAND-ALONE PC-BASED ACCOUNTING SYSTEM)

Green Products Garden (GPG) Supply sells and distributes a wide range of garden products and equipment including organic fertilizers, premium flower and grass seeds, organic pesticides, and garden spreaders. GPG's headquarters and warehouse is located in Hopewell, Virginia. Their customers are primarily small garden centers and landscape companies in the Mid-Atlantic States. Sales are on credit.

GPG's current information system includes manual procedures supported by independent (non-networked) PCs in each department. Communications between departments is entirely through hard-copy documents. Recently, GPG has been receiving complaints from customers and suppliers about billing, shipping, and payment errors. Management believes that these complaints stem, in part, from their antiquated computer system. You have been hired to assess GPG's procedures and internal controls. The following is a description of GPG's revenue cycle.

### Sales Procedures

The revenue cycle begins when a customer places an order with a sales representative by phone or fax. A sales department employee enters the customer order

into a standard sales order format using a word processor installed on a PC to produce: three sales order copies, a stock release document, a shipping notice, and a packing slip. The accounting department receives a copy of the sales order, the warehouse receives the stock release and a copy of the sales order, and the shipping department receives a shipping notice and packing slip. The sales clerk files a copy of the sales order in the department.

Upon receipt of the sales order, the accounting department clerk manually prepares an invoice and sends it to the customer. Using data from the sales order, the clerk then enters the sale in the department PC and records the sale in the sales journal and in the AR subsidiary ledger. At the end of the day the clerk prepares a hard-copy sales journal voucher, which is sent to the general ledger department.

Upon receipt of the sales order and stock release the warehouse clerk picks the products and sends them to the shipping department, along with the stock release. The warehouse clerk then updates the inventory records on the warehouse PC and files the sales order in the warehouse. At the end of the day the clerk prepares a hard-copy inventory account summary and sends it to the general ledger department.

The shipping department clerk receives a shipping notice and packing slip from the sales department. The clerk files the shipping notice and holds open the packing slip until he receives the stock release and products from the warehouse. Upon receipt of the stock release, the shipping clerk prepares the two copies of a bill of lading using a word processor. The bills of lading and the packing slip are sent with the product to the carrier. The clerk then files the stock release in the department.

The general ledger clerk posts the journal voucher and inventory summary to the general ledger, which is stored on the department PC, and the clerk then files these documents in the general ledger department.

### Cash Receipts Procedure

Mail room employees open cash receipts from customers and reconcile the amounts on the checks and remittance advices. The remittance advices are sent to the accounting department, where a clerk records each remittance advice on a remittance list. The remittance list is then sent to the cash receipts department. Using the remittance advices, the accounting clerk updates the customer accounts receivable on the department PC and files the advice

in the department. At the end of the day the clerk prepares an AR summary on the PC. A hard copy of the summary is sent to the general ledger department.

The mail room clerk sends the checks to the cash receipts department, where a clerk endorses each check with the words "For Deposit Only." Next, the clerk reconciles the checks with the remittance list and records the cash receipts in the cash receipts journal on the department PC. Finally, the clerk prepares a deposit slip and sends it and the checks to the bank.

The general ledger clerk posts the accounts receivable summary to general ledger and files it in the general ledger department.

### Required

- Create a data flow diagram of the current system.
- Create a system flowchart of the existing system.
- Analyze the physical internal control weaknesses in the system.
- (Optional) Prepare a system flowchart of a redesigned computer-based system that resolves the control weaknesses that you identified. Explain your solution.

## ~~7. CUSTOM FABRICATIONS (STAND ALONE PC BASED ACCOUNTING SYSTEM)~~

*(Prepared by Will Richens and Michael Catchpole, Lehigh University)*

~~CUSTOM FABRICATIONS Inc., is a bicycle manufacturing firm founded in 2000 that currently employs 126 people. The company produces custom bicycles in its factory located near Los Angeles, CA. Each bicycle is tailored to a rider based on a number of different measurements, including height, weight, inseam, and arm length. These measurements are taken at 30 professional bicycle shops around Southern California, which are certified to size CUSTOM FABRICATIONS cycles. By accepting orders only through licensed dealers, CUSTOM FABRICATIONS ensures that each bike matches its rider precisely. CUSTOM FABRICATIONS custom bikes are considered extremely high quality, and the company takes pride in using only the best components sourced from around the world. Accordingly, CUSTOM FABRICATIONS purchases from a cast of hundreds of suppliers, chosen for their commitment to quality and reliability.~~