

AIS (Prof O'Haver) – Mini Case Study

As noted in the Syllabus, this is a short assignment (it should take you 60-90 minutes or so to complete) to practice your internal control skills with a factual description that is longer than the paragraph or so examples we have used in class. Please plan to turn in a one to two page, or so, write-up of your findings to the questions to the case. You may work along or in a group of two people only. The grade will be based on 25 points each for the content (completeness, reference to in-class control examples, insightfulness, ...) in the answers to the three questions at the bottom of the case and 25 points for the general quality of the writing. I have underlined some key facts; you should keep in mind certain elements of the Protiviti presentation as well as frameworks and examples we have discussed in class.

AAA Jewelry Fraud Case (0049)

Jannie's Jewelry Stores is a large corporation founded in 1998 that operates 23 retail jewelry stores located throughout the Southeastern United States. Jannie's tailors its product line to middle-class shoppers, and specializes in engagement and wedding rings. Each store offers a large variety of jewelry (approximately 1,200 different items) with a fairly narrow price range (\$50 to \$3,500). Although sales increased rapidly during the first years of Jannie's operations, sales during the last three years were flat. In an effort to increase sales, Jannie's recently initiated its own credit card program.

The credit card program required new manual and new IT systems. Among other things, a credit department was established and an accounts receivable (AR) IT program was installed. The credit department's responsibilities include approving customers for the company's credit cards, following up on past-due receivables, and determining when customer accounts should be written off. The credit department has two employees: a credit manager and an AR clerk.

Customers' credit card requests are initiated by the customer completing an online application in any of Jannie's 23 retail locations. The online application requests the customer's name, address, current monthly income, and Social Security number, among other information. Once the credit application is completed, the IT system automatically interfaces with an independent credit bureau. If the information included in the customer's application matches the information in the credit bureau's database, and if the customer has a credit score of in excess of a predetermined minimum score, the customer is extended a credit limit equal to 10 percent of his/her current monthly income. Higher credit limits require the approval of the credit manager.

The AR IT system interfaces with the company's point-of-sale system, automatically posting sales transactions that occur at the company's stores to the AR trial balance. Customers' payments are received at a lockbox, posted to the company's bank accounts daily by the bank. Copies of customer checks and remittance advices are received by the Credit Department, where the AR clerk posts them to customers' accounts. Monthly customer statements are automatically generated by the IT system. Each month-end, a report of all customers with past-due balances is generated by the IT system. The credit manager reviews the report and instructs the AR clerk to follow-up on specific customer accounts.

Based on the results of the AR clerk's follow-up activities, the credit manager determines which accounts should be written off, and processes any necessary adjustments through the IT system. The credit manager meets quarterly with Jannie's CFO to discuss any particularly problematic accounts or unusual write-offs of customer accounts.

The Fraud

Before accepting a position with Jannie's Jewelry, the credit manager was employed by Fred's Fashions in a similar position. Fred's owner decided to discontinue Fred's credit card program and eliminated the credit manager's position. The credit manager purchased a new home just prior to being laid off. The night prior to being laid off, the credit manager got engaged, promising that he and his new fiancée would soon shop for an engagement ring. Even though the position at Jannie's paid \$20,000 less than the position at Fred's, the credit manager was assured by Jannie's president that as long as the company's credit card program went well, the credit manager was sure to receive raises that would soon make the salary comparable to his former salary. In addition, the credit manager was looking forward to taking advantage of Jannie's employee discount program when purchasing his fiancée's engagement ring.

The credit manager selected a \$3,500 ring for his fiancée, which with his employee discount cost \$2,900. The purchase was financed on a Jannie's credit card, by the credit manager overriding the company policy of granting a credit limit of 10 percent of a customer's current monthly salary. The credit manager quickly fell behind in his required credit card payments. Although his account began to show up on the AR past-due report, the credit manager avoided directing the AR clerk to perform follow-up procedures for several months. When he learned that the company's auditors would be visiting his department soon, he wrote his remaining account balance off using the IT system, fully intending to repay the balance when he receives his promised raise.

Questions to Consider

- A. What are the red flags present that suggest the possibility of fraud? Are there conditions present suggested by the fraud triangle that may facilitate fraud? Are there IT-related issues that could facilitate fraud?
- B. How would the fraud impact the financial statements? What accounts would be misstated?
- C. How might the fraud be detected? What audit tests might be performed on the processes and IT systems to detect the fraud?