

**6.5** 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 presently 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 one-tenth of 1%.

#### Required

- What is the estimated expected loss associated with ABC Corporation's internal control problem before any new internal control procedures are implemented?
- Compute the revised estimate of expected loss if procedure A were implemented, if procedure B were implemented, and if both procedures were implemented.
- Compare the estimated costs and benefits of procedure A, procedure B, and both procedures combined.
- Considering only the estimates of cost and benefit, which procedure(s) should be implemented? What other factors might be relevant to the decision?

**6.6** 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 internal control effectiveness. In its latest review, the internal audit staff found the following eight conditions:

- Daily bank deposits do not always correspond with cash receipts.
- Bad debt write-offs are prepared and approved by the same employee.
- There are occasional discrepancies between physical inventory counts and the perpetual inventory records.
- The auditor noticed alterations to physical inventory counts and perpetual inventory records.
- There is a high percentage of customer refunds and credits.
- Many original documents are missing or lost. However, there are substitute copies of all missing originals.
- An unexplained decrease in the gross profit percentage has occurred.
- Many documents are not approved.

#### Required

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

- Describe a possible cause of the condition.
- Recommend actions to be taken and/or controls to be implemented that would correct the condition.

(CMA, adapted)

**6.7** Consider the following two situations:

- 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 nor 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.
- 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.

### Required

For the situations presented, describe the recommendations the internal auditors should make to prevent similar problems in the future.

(CMA, adapted)

**6.8** Tralor Corporation manufactures and sells several different lines of small electric components. Its internal audit department completed an audit of the expenditure cycle for the company. 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, a copy is retained in purchasing, a copy is sent to the user department, a copy is sent to receiving to be used as a receiving report, and a copy is sent to accounts payable in the accounting department.
- 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 last updated two years ago and is seldom used by accounts payable clerks.
- 4** All vendor invoices are recorded in an invoice register. The register indicates the receipt date, any invoices dealing with special orders, when those special orders are sent to the requesting department for approval, and when they are returned. 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 ago 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 any departmental approval of invoices for special purchases.
- 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 after they are paid. 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.

### Required

Review the eight items listed and decide whether they represent an internal control strength or weakness.

- a.** For each internal control strength identified, explain how the described procedure helps achieve good authorization, accounting, or asset protection control.
- b.** For each internal control weakness identified, explain why it is a weakness and recommend a way to correct the weakness.

(CMA, adapted)