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Green Tech Manufacturing Company: Fraud and the Independent Auditor

Diane Matson
Lawrence Chui*

Background

Assume that you are an audit senior for Andrew and Andrew, CPAs, LLP. Your client is Green Tech Manufacturing Company. The client, a privately held company, is involved in the production and sales of solar panels. Its primary customers are builders and home supply stores. You are reviewing the income statement accounts. Your audit staff person, Jessica Kirner, has done some preliminary audit work in this area, as indicated by her comments and tick marks. Jessica has been called to another client, and you are taking over this audit area. You have some work papers relevant for the audit of income statement accounts. These are **W/Ps I-1 through I-4**. *Note:* Identifying information has been altered and removed; any resemblance to actual companies or individuals is coincidental.

Questions

The questions are organized in five parts (**Parts I – V**). These are presented next.

Part I: Initial Analysis

Please refer to the Planning Comments and Internal Control Questionnaire (**W/P I-1**) and the Income Statement with Common-Size information (**W/P I-2**) to answer these questions in **Part I**.

* The authors are Associate Professors at University of St. Thomas. Solutions may be obtained from authors.

Consider the income statement and the related common-size accounts.

- A. What trends and patterns do you see?
- B. What account(s), in particular, should be investigated more? Please be specific, and discuss your concerns.

Part II: Additional Information

Consider your findings in **Part I**.

- A. What additional information would you like to obtain? Where could you get this information?
- B. What are the costs of obtaining this information? What are the benefits of obtaining this information?

Part III: Analysis of Information

You have the Selling, General and Administrative (S, G and A) Expense Detail (**W/P I-3**) and Sample of Cancelled Checks (**W/P I-4**). Please consider your findings in **Part I**, and **Part II**, and also use **W/P I-3** and **W/P I-4** to answer the questions in **Part III**.

- A. The client has a problem. What is the problem?
- B. Who could have done this? Why do you think this?
- C. Consider the fraud triangle. Identify and define each part of the fraud triangle. Apply the fraud triangle to this situation. Try to speculate on motive, opportunity and rationalization.

Part IV: Recommendations

- A. Consider what recommendations you could make to help the client prevent future frauds. Try to think of at least three recommendations.
- B. Discuss how your recommendations would affect the parties involved.

Part V: Select One Recommendation

- A. Assume you have to select one recommendation. What would it be?
- B. Explain the advantages and disadvantages of this recommendation.

Green Tech Manufacturing Company
12/31/2015
Planning Comments

Workpaper I-1
Initials J. A. K.
Date 1-15-16

Memo from Jessica Kirner January 15, 2016

There has not been turnover in the top four client people: Marvin Green, Owner; Jacob Merriweather, Treasurer; Maeve Rehnhart, accountant; and Lucinda Washburn, factory manager. While talking at various times with these client people, I learned that a small piece of land was purchased from a nearby landowner, and the factory was expanded. In addition, some new equipment was purchased. This expansion is to allow a new product—Solar Panel Plus (Model X-4) to be produced. Builders are requesting this new solar panel as it is easier to install than the other models.

Marvin thinks the new products will be a great seller. Marvin has a new office; he is in the corner office now. Jacob just got back from a 3-month paternity leave to take care of his new baby. He was able to work from home, so he said he is just about up-to-date. Maeve is getting a divorce and has missed some work to attend attorney meetings and court dates. Lucinda recently completed the second level factory manager/computer certification, so that she can run the new software related to the expansion.

In addition to reading Jessica's memo, you can talk briefly with four individuals. Here are a few of their comments.

Comments from primary individuals:

Owner, Marvin Green: I'm not really into all of the accounting, but we seem to have less cash than I would expect. Sales are up, but I'm not sure why we are not generating more cash.

Treasurer, Jacob Merriweather: We took a loan of about \$600,000 from the bank in the beginning of 2015. This notes payable is for the factory expansion.

Accountant, Maeve Rehnhart: Where did the cash go? Well, we bought new equipment, added to our factory, and bought some land. These acquisitions reduced our cash. I can show you the contracts for the PPE.

Factory Manager, Lucinda Washburn: We have added to our building and added productive capacity. I can give you a tour and show you the new area and items.

Green Tech Manufacturing Company
12/31/2015
Internal Control Questionnaire

Workpaper: I-1
Initials: J. A. K.
Date: 1-10-16

Internal Control Activity	Response	Comments
1. Does client have an internal control manual?	Yes.	Manual updated in May 2015.
2. Does client have independent checks on performance?	No.	Because of Jacob Merriweather's paternity leave, as well as the factory addition and the new product line, everyone has been too busy to check the work of others.
3. Does client have adequate documents and records?	Yes.	The accounting system is computerized. All paper and electronic documents are pre-numbered.
4. Does client have physical control over assets and records?	Yes.	File cabinets, storage rooms, and vault are locked. Passwords are required to access all critical computer programs and applications.
5. Does client have proper authorization of transactions and activities?	No.	An individual tends to authorize transactions in his or her area. Lucinda Washburn authorizes all factory activities. Maeve Rehnhart authorizes cash disbursements. Jacob Merriweather authorizes banking relationships and investment strategies.
6. Does client have adequate separation of duties?	No.	Accountant Maeve Rehnhart authorizes cash disbursements and prepares checks. Treasurer Jacob Merriweather handles deposits and authorizes banking activities.

Green Tech Manufacturing Company			Workpaper I-2	
12/31/2015			Initials <u>J.A.K.</u>	
Income Statement with Common-Size Information			Date <u>1-15-16</u>	
Income Statement	For Year Ending	Common-Size	For Year Ending	Common-Size
	12/31/2015	12/31/2015	12/31/2014	12/31/2014
	Unaudited		Audited	
Sales Revenue	\$ 11,000,000	100%	\$ 8,000,000	100%
Cost of Goods Sold Expense	\$ 8,250,000	75%	\$ 5,920,000	74%
Gross Profit	\$ 2,750,000	25%	\$ 2,080,000	26%
S,G and A Expenses	\$ 2,420,000	22%	\$ 1,520,000	19%
Operating Income	\$ 330,000	3%	\$ 560,000	7%
Interest Expense	\$ 121,000	1%	\$ 80,000	1%
Income before Taxes	\$ 209,000	2%	\$ 480,000	6%
Income Tax Expense	\$ 62,700	1%	\$ 144,000	2%
Net Income	\$ 146,300	1%	\$ 336,000	4%

Green Tech Manufacturing Company		Workpaper I-3	
12/31/2015		Initials <u>J. A. K.</u>	
S G & A Expense Detail		Date <u>1-15-16</u>	
Selling, General and Administrative Detail			
Account Descriptions	Detail Amounts	Subtotal	Subtotal
	12/31/2015	12/31/2015	12/31/2014
Corporate Headquarters	Unaudited	Unaudited	Audited
<u>Depreciation</u>			
Office Building	\$ 100,000.00	\$ 100,000.00	\$ 100,000.00
<u>Utilities</u>			
Heating and Cooling	\$ 121,000.00		
Electricity	\$ 47,000.00		
Water	\$ 15,000.00	\$ 183,000.00	\$ 125,000.00
<u>Repairs and Maintenance</u>			
Ace Supplies	¥ \$ 16,000.00		
XYZ Furnace and Air	\$ 50,000.00		
Fred's Painting	\$ 35,000.00		
Norstein Electrical	\$ 32,000.00	\$ 133,000.00	\$ 45,000.00
<u>Administrative</u>			
<u>Salaries and Benefits</u>			
Executive	\$ 550,000.00		
Managers	\$ 282,000.00		
Customer Reps	\$ 300,000.00		
Support	\$ 90,000.00	\$ 1,222,000.00	\$ 928,000.00
<u>Training</u>			
Enhanced Communications	\$ 40,000.00		
M and R Motivation	¥ \$ 50,000.00		
Computer Strategies	\$ 30,000.00		
Diversity Plus	¥ \$ 18,000.00	\$ 138,000.00	\$ 47,000.00
<u>Travel</u>			
Executive	\$ 60,000.00		
Customer Reps	\$ 75,000.00	\$ 135,000.00	\$ 102,000.00
<u>Entertainment</u>			
Customer Meetings	\$ 37,000.00		
Holiday Party	\$ 9,000.00	\$ 46,000.00	\$ 36,000.00
<u>Professional Services</u>			
<u>Auditing</u>			
Andrews and Andrews	\$ 42,000.00	\$ 42,000.00	\$ 37,000.00
<u>Tax</u>			
Andrews and Andrews	\$ 16,000.00	\$ 16,000.00	\$ 14,000.00
<u>Legal</u>			
Norris and Morris	¥ \$ 33,000.00		
Claremont and Cirrus	\$ 2,000.00	\$ 35,000.00	\$ 17,000.00
<u>Consulting</u>			
Acme Consulting	¥ \$ 38,000.00		
Environo Consultants	\$ 65,000.00		
ProProfits Business Power	\$ 4,000.00		
MAR Software Consulting	¥ \$ 50,000.00	\$ 157,000.00	\$ 37,000.00
<u>Engineering</u>			
Factory Synergy	\$ 68,000.00		
Chemstart Performance	¥ \$ 45,000.00		
High Power Engineering	¥ \$ 47,000.00		
Mechanix Water Tech	\$ 53,000.00	\$ 213,000.00	\$ 32,000.00
Totals		\$ 2,420,000.00	\$ 1,520,000.00
<u>Tickmark Legend</u>			
¥ Selected expenses as <u>sample</u> items to test. Traced vendor name and check amount to scanned copy of check paid by and received from the bank. (See Workpaper series I-4).			

Green Tech Manufacturing Company
Sample of Cancelled Checks
For Year Ending 12/31/2015

Workpaper I-4
Initial J.A.K.
Date 1-15-16

(1) Front and Back of Check #2001

Green Tech Manufacturing Company 1117 Industrial Road Bloomington, MN 55422	2-402/710 #2001
	Date: <u>February 2, 2015</u>
Payee: <u>ACE Supplies, Inc.</u>	\$ <u>16,000.00</u>
<u>Sixteen thousand and no/100s-----</u> ¥	
<u>Water pipe repair</u>	Signed <u>Maeve Rehnhart</u>
Second state bank 31-0041 1967 5607198002 2001	

Pay to Order of Prime Bank Farmington, MN For Deposit Only #100-376-0871 Ace Supplies, Inc. 2-6-15
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(2) Front of Check and Back of Check #2007

Green Tech Manufacturing Company 1117 Industrial Road Bloomington, MN 55422	2-402/710 #2007
	Date: <u>March 19, 2015</u>
Payee: <u>Acme Consulting</u>	\$ <u>38,000.00</u>
<u>Thirty-eight thousand and no/100s-----</u> ¥	
<u>Installation Assistance for New Computers</u>	Signed <u>Maeve Rehnhart</u>
Second state bank 31-0041 1967 5607198002 2007	

Deposit Only 3/24/15 Capitol View Bank St. Paul, MN #179-675

MAR Software Consulting
Capitol View Bank
St. Paul, MN
#179-675
July 5, 2015
Deposit Only

(5) Front and Back of Check #2035

I-4

Green Tech Manufacturing Company	2-402/710	#2035
1117 Industrial Road		
Bloomington, MN 55422		
Payee: <u>Norris and Morris Law Firm</u>	Date: <u>July 30, 2015</u>	<u>\$ 33,000.00</u>
<u>Thirty- three thousand and no/100s-----</u>		¥
<u>Tax Advice for Potential Acquisition</u>	Signed <u>Maeve Rehnhart</u>	
Second state bank		
31-0041 1967 5607198002 2035		

Pay to Order of
Big First Bank
Minneapolis, MN
Norris and Morris
Deposit Only
#417-22-0954
August 5, 2015

(6) Front and Back of Check #2045

Green Tech Manufacturing Company	2-402/710	#2045
1117 Industrial Road		
Bloomington, MN 55422		
Payee: <u>M and R Motivation</u>	Date: <u>September 22, 2015</u>	<u>\$ 50,000.00</u>
<u>Fifty- thousand and no/100s-----</u>		¥
<u>Training for Executives</u>	Signed <u>Maeve Rehnhart</u>	
Second state bank		
31-0041 1967 5607198002 2045		

High Power Engineering
Deposit Only
November 7, 2015
Capital View Bank
St. Paul, MN
Deposit Only
ACCT# 179-675

¥ Traced vendor name and check amount to S G & A Expense Detail (See **W/P I-3**).