

Overcoming internal audit issues with professionalism and integrity

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ABSTRACT

This case has been crafted to allow students to develop and exercise critical and analytical thinking skills while identifying and addressing audit issues within an internal auditing environment. The case also allows students to understand the importance of adhering to professional practice standards and business ethics. The case involves Lisa Gipson, a young internal auditor for New Beginnings, a non-profit agency. She finds herself at the center of controversy during a heated meeting held to discuss the audit findings of a recent audit completed by her and her supervisor. Eight significant findings are reported, all of which were discovered by Lisa. The findings do not sit well with the agency's Chief Financial Officer (CFO) whose Grants & Contracts Section was the focus of the audit. No section of the CFO's Accounting & Finance Division has ever received anything less than a clean audit report under his watch. After 35 years with the agency and his retirement imminent, he expects to continue that trend by demanding Lisa back down from her findings. And, this demand, along with other audit issues, posed challenges with profound consequences.

Keywords: internal auditing, business ethics, critical thinking, decision making, analytical skills, practice standards

Note: This is a field-researched case based upon an actual occurrence within an organization. All names, numbers, and amounts have been disguised.

THE CASE

Key Players

Lisa Gipson is 24 years old and has worked as an Internal Auditor I for New Beginnings for 2.5 years. Prior to accepting her current position, she graduated with her B.S. in accounting. Upon graduating, she didn't expect to land an auditing position. She stated, "I never ever thought I would have been an auditor." Of the several jobs she applied for, she only received offers for internal audit positions. She is also currently working on a MBA and plans to sit for the CPA exam. And, after acquiring two years experience and achieving a top score on an exam for promotion, she is now eligible for promotion to Internal Auditor II.

Carl Campbell is the agency's CFO and has occupied the position for 14 years. After 35 years with New Beginnings, he's scheduled to retire within the year. To his Accounting & Finance Division employees, he is known for getting what he wants no matter what. To gain and retain his favor, one must do things the way he likes. Although he has established layers of accounting supervisors and managers within the division, he is known as a micromanager. He's the agency's accounting, finance, and budget expert, and he wields a tremendous amount of power and influence. And, at times, that influence is known for overreaching the boundaries of his division into others, even in regards to hiring, promotion, and firing.

The Agency

New Beginnings is a non-profit agency that serves the various needs of ex-convicts in an effort to reduce recidivism rates. It provides them with the resources necessary to return to society as productive citizens. Some of the services include specialized employment-related, education-related, and social-related services such as assisting with job placement, regaining voting rights, GED preparation, and life skills development. The agency uses seven regional offices strategically dispersed throughout the state to provide the services to eligible residents. The agency oftentimes subcontracts with other organizations to provide such services. It employs more than 250 employees, and its central office is located in the capital city. Lisa states that the culture of the agency at the central office is "very laxed, very reactive," and one in which "management's perception of the audit function" is one which "nobody really understands what we're supposed to be doing," including key personnel such as the Executive Director and CFO.

In 2011, the agency operated on approximately \$28 million comprised mostly of federal sources of revenue in the form of grants. Those grants accounted for more than 75% of the agency's total revenue. And, of that federal source of revenue, \$7 million was awarded as part of the American Recovery and Reinvestment Act of 2009 (ARRA), also known as the federal stimulus package.

The Audit

Lisa Gipson and her supervisor, Eric Simpson, were charged with the responsibility of assessing internal controls over the central office's contract payments process involving 10 two-year contracts. They were to review and examine the records of payments tied to those contracts for compliance to stipulated grant award rules and guidelines. Those 10 contracts were of importance because they involved the expenditure of more than \$2 million in ARRA funds for

services provided by subcontractors of New Beginnings. Oversight over the contract payments was a function of the Grants & Contracts Section which fell under the Accounting & Finance Division.

After obtaining an understanding of the task at hand, Lisa and Eric worked to plan and coordinate the audit. They agreed to distribute the work by contracts and to audit the total population of contract payments. Of the 10 contracts, Lisa was to audit seven and Eric three. Lisa's preliminary steps for her portion of the audit began with familiarizing herself with the grant award rules and guidelines that governed how the ARRA funds were to be accounted for and used. She decided she would refer back to the grant award rules and guidelines as needed throughout the audit. After several hours of reviewing the material, she proceeded on to the next step, locating and examining contract payments.

With a payment vouchers report generated from the agency's accounting system, Lisa identified the contract payments tied to the contracts she was responsible for examining. She identified 16 (4 quarterly and 12 monthly) vouchers that were used to issue those payments to reimburse the agency's subcontractors. She then went to the Accounting & Finance Division file room, located and retrieved the vouchers in question. Upon returning to her office with the vouchers and beginning a thorough examination of them, she was alarmed by her discovery.

As Lisa examined the payment vouchers along with their supporting documentation, she noticed some payments being approved and made without sufficient documentation. The key piece of supporting documentation missing from those payments was invoices for goods or services. Paid invoices were mandatory as documentation, however, only purchase orders were included by the subcontractors. Lisa was puzzled how such payments could be made and troubled by the fact that the total amount of payments in question was approximately \$1 million. Sam Watson was the accountant responsible for issuing payments to satisfy the reimbursement requests, and part of Lisa's examination involved retracing Sam's steps. She stated, "I was doing the same thing that the accountant that issued the payments was doing. I reviewed the same documentation. We had people making payments for items of \$20,000. We issued payments for trucks, vans. I mean we're talking about very expensive equipment that's not supported by an invoice. It's supported by a purchase order." Lisa reassured herself that she properly conducted her portion of the audit by referring back to the grant award rules and guidelines. She then brought the matter to Eric's attention. She also followed-up with Sam. And, the information he shared with her only alarmed her more.

With some paid reimbursement requests in hand and a copy of the grant award guidelines, Lisa paid a visit to Sam. She inquired of him how he arrived at the conclusion that the payments made were appropriate. Lisa only assumed Sam thought they were appropriate because they left his desk to be approved for payment. She stated that Sam said he determined the requests for payment to be inadequate due to insufficient supporting documentation. He went on to tell her that he sought the advice of his supervisor, who subsequently brought it to the attention of the CFO, Carl Campbell. To Lisa's dismay, Sam produced an e-mail that he received from Mr. Campbell regarding the matter. The e-mail instructed Sam how to handle the reimbursement requests, and part of the instructions was "Just pay it!" Knowledge of Lisa's dialogue with Sam regarding the matter was immediately made known to Mr. Campbell. Lisa stated, "Then he sent out an e-mail instructing the Accounting & Finance Division to limit what information that they provide to us."

After eight months, Lisa and Eric completed the audit. Then, they met to discuss their findings as a prelude to the preparation of the audit report. As the audit supervisor, Eric was

responsible for preparing and submitting the report. Lisa stated, “My supervisor didn’t see a lot. He really didn’t have findings.” Lisa informed Eric of her findings and the audit issues encountered. Then, she prepared a formal list of her findings and gave it to Eric. Lisa presented eight findings, findings which he approved for inclusion in the audit report which only reported Lisa’s findings. She and Eric later met with the Deputy Director, who is the agency head under which the Office of Internal Audit fell, to discuss the audit and the audit report. After the meeting, the preliminary audit report was forwarded to Mr. Campbell by e-mail for his review as a standard preliminary step before arranging the audit exit conference and issuance of the final audit report.

A few days after the receipt of the audit report by the Mr. Campbell, he arranged a meeting between himself, his Grants & Contracts Section, and the Office of Internal Audit to discuss the report. Upon being informed of the meeting by the Deputy Director, Lisa assumed it would be an opportunity to set in place corrective actions to resolve the audit deficiencies before the issuance of the final audit report. However, what she experienced during the meeting left her very disturbed.

The Meeting

The meeting was held in the Executive Director’s conference room. Those in attendance were Lisa, Eric, Sam Watson’s supervisor, Mr. Campbell, the Executive Director, and Deputy Director. The Executive Director convened the meeting and yielded the floor to the Office of Internal Audit. Eric began to enumerate and expound on the findings. Lisa stated that as Eric proceeded, Mr. Campbell fiercely questioned the judgment and objectivity that led to the findings, which thrust Lisa into the discussion. Regarding her findings, Lisa stated “They weren’t received very well at all!”

Lisa interjected into the discussion how she arrived at the findings. She informed those in attendance that based on her understanding and interpretation of the guidelines pertaining to the use of the ARRA funds in question, her findings were warranted. She also stated that the paid reimbursement requests that lacked paid invoices simply violated internal controls. Lisa emphasized that the approximately \$1 million in total deficiencies could have significant consequences if not resolved. Despite her continued attempt to justify her position, Mr. Campbell was not satisfied and questioned the due care she exercised. She said she found herself quite uncomfortable being accused of such a thing by Mr. Campbell, a career employee with the agency with 35 years of experience and tremendous influence. Lisa stated she inwardly assured herself that she did a thorough job but was concerned about the weight of her justification for her findings against the accusations of the seasoned Mr. Campbell. After occasional flares of Mr. Campbell’s temper and much back-and-forth between him and Lisa, Lisa stated that he abruptly concluded the findings weren’t justified and demanded they be removed from the report. After which, a silence fell over the conference room, and the meeting was adjourned shortly thereafter.

Upon immediately returning to her office, Lisa digested what had just taken place during the meeting. She carefully weighed her options regarding the matter and pondered on possible actions she should take. And, with time ticking away, she knew she had to act soon.

Discussion Questions

1. Identify and summarize the audit issues in which Carl Campbell was involved along with the reasons as to why they were issues?
2. Explain whether or not you believe Lisa exercised professional due care during the audit?
3. Explain what actions Lisa could take.
4. Conclude what actions Lisa should take and explain the professional and ethical considerations and consequences of her actions.

CASE TEACHING NOTES FOR FACULTY

Case Overview

The Office of Internal Audit recently submitted its audit report on audit activities regarding the contract payments process of New Beginnings, a non-profit social services agency. Lisa Gipson, an early career internal auditor with the agency, finds herself at the center of controversy during a heated meeting held by her office to discuss the findings of the report with Carl Campbell, the agency's CFO. The handling of special government funds by Mr. Campbell's Grants & Contracts Section was the focus of the audit. Eight significant findings are on the audit report, and all were discovered by Lisa. Although Lisa only did what she considered to be her job, Mr. Campbell has his own thoughts regarding the matter. He has been CFO for 14 years and has never received anything less than a clean audit report on any audit of any section of the Accounting & Finance Division he oversees. Also, after serving 35 years as a career employee with the agency, he is scheduled to retire within a few months. Determined to retire with only clean audit reports under his watch as CFO, Mr. Campbell demands Lisa back down from her findings. The pressure to do so, along with other audit issues, poses challenges with profound consequences. And, Lisa must determine the appropriate course of action to take.

Purpose

This case has been crafted to allow students to develop and exercise critical and analytical thinking skills while identifying and addressing audit issues within an internal auditing environment. The case also allows students to understand the importance of adhering to professional practice standards and business ethics. It provides future accounting graduates with an opportunity to hypothetically place themselves in a case scenario position that they could realistically find themselves involved in upon securing a job after graduating. Although auditing is the context in which this case is presented, the subject matter contained in it is general enough to apply to other areas of the accounting profession.

Learning Goals

1. Students will be able to demonstrate their ability to analyze a case scenario in order to identify audit issues and dilemmas
2. Student will be able to reason critically and analytically in order to identify and determine possible courses of action to take to minimize or resolve audit issues while considering professional and ethical implications

Learning Objectives

1. To identify and summarize audit issues, and communicate them orally and/or in writing.
2. To analyze actions taken or not and communicate orally and/or in writing whether internal auditing professional practice standards were followed
3. To assess a dilemma, contemplate possible solutions, and communicate those solutions orally and/or in writing
4. To conclude and communicate orally and/or in writing a course of action to take to resolve a dilemma while considering its professional and ethical implications

Key Issues

1. Audit issues and dilemmas
2. Internal auditing practice standards and professional business ethics

Teaching Methods

This case is crafted to be incorporated in an undergraduate auditing course in which class sessions are no less than 50 minutes. The case can be presented in at least one session either at the middle or end of the course. It can be presented at either time due to the notion that many undergraduate accounting curriculums expose students early to the roles of internal and external auditors. Also, auditing material covered in the case is basic material usually covered early in undergraduate auditing courses and textbooks. Although the case is presented within an internal auditing context, the case's content is general enough to apply to auditing in general.

A flowchart of New Beginnings' Contract Payments Process of the agency's Accounting & Finance Division is included as indicated in Table 1 (Appendix). This flowchart should be used to aid in the student's obtaining an understanding of the agency's contract payment process. The diagram also allows students to see how Lisa arrived at the conclusion that internal controls over the process were violated. For further exposure and enhancement of the students' understanding of auditing practice standards and professional ethics for internal auditors, it is suggested they visit the website of the Institute of Internal Auditors (IIA), considered the premier organization and authoritative body for internal auditors around the world.

A key element to this case is that its main character, Lisa Gipson, is a young auditor who finds herself in the middle of the audit report controversy. Since it seems that key players in most publicized instances of inappropriate behavior in accounting scandals involve seasoned professionals, a preliminary point of discussion for the class could entail the fact that Lisa is a young and relatively recent college graduate. This could be pointed out to imply that even early career auditors (accountants) face job-related issues and dilemmas with profound consequences. Having that discussion could set a tone or atmosphere more conducive for learning since the students may be able to better identify with Lisa. This discussion could also be aided with some excerpts or articles involving accounting/auditing malfeasance from a newspaper or magazine.

After the lead-in discussion, the instructor may entertain any questions or comments that arose spontaneously during the preliminary discussion. Afterwards, the instructor may proceed to entertaining the student responses to the case discussion questions. It is important to keep in mind that the potential responses given for the discussion questions should not be construed as an exhaustive list. Students should be given ample time to express their responses and concerns

while leaving adequate time to properly conclude the case presentation. However, should another class session be needed to conclude, discretion in determining the best place and way to end the case presentation should be used in an effort to retain the students' interest.

Suggested Responses to Case Question 1

1. Summarize the audit issues in which Carl Campbell is involved along with the reasons as to why they are issues?
 - a. CFO's instructions to "Just pay it!"(The Audit, paragraph 5).

The Mr. Campbell's instructions to Sam Watson to pay the reimbursement requests without sufficient supporting documentation was an issue because it involved internal controls implemented to ensure ARRA are expended according to grant rules and guidelines are not overridden. Mr. Campbell, as the CFO, had a duty and obligation to ensure that the funds are expended by his Accounting & Finance Division in accordance with those rules and guidelines.
 - b. CFO's e-mail instructions to the Accounting & Finance Division to limit the information provided to the internal auditors (The Audit, paragraph 5).

This was an issue because it interfered with the scope and progress of the audit. The Accounting & Finance Division had a duty and obligation to work with the Office of Internal Audit by providing it with records, documents, information, and access deemed necessary to properly carryout the audit in an effective and efficient manner.
 - c. CFO demands audit findings be removed from the audit report (The Meeting, paragraph 2).

This was an issue because of Mr. Campbell's demand for Lisa to back down and remove the audit findings from the report simply based on his opinion of her judgment. Being the seasoned government accountant he was and person responsible for the successful implementation and maintenance of the internal controls over the contract payments process, his response was inappropriate. His response could have possibly constituted either a disregard for the internal audit function, a misunderstanding of the auditor's role in this particular audit, micromanagement, etc.

Potential Responses to Case Question 2

2. Explain whether or not you believe Lisa exercised professional due care during the audit?
 - a. Lisa exercised professional due care.

Students could respond that they believe Lisa exercised professional due care because of the following:

 - Lisa actively participated in the planning and coordinating of the audit (The Audit, paragraph 1).

- Lisa familiarized herself with the grant award rules and guidelines, obtained what she perceived to be an adequate understanding, and referred back to them as needed (The Audit, paragraph 2).
 - Lisa continued on the audit as planned (The Audit, paragraph 3).
 - Lisa continued on the audit as planned, referred back to the grant award rules and guidelines as needed, and informed Eric of her findings (The Audit, paragraph 4).
 - Lisa followed-up with Sam Watson in the Grants & Contracts Section for answers to questions regarding the payments being audited (The Audit, paragraph 5).
 - Lisa discussed the outcomes of her portion of the audit, then prepared and submitted a report of her findings to her supervisor (The Audit, paragraph 6).
- b. Lisa did not exercise professional due care.
- Students could respond that they believe Lisa did not exercise professional due care by simply not doing enough in addition to some of the items stated in the Part (a.) above.

Potential Responses to Case Question 3

3. Explain what action(s) Lisa could take.
- a. Do nothing.
- Lisa could decide to do absolutely nothing and continue on with business as usual. Students may respond that Lisa doesn't have to do anything because her line of duty is independent from the authority of Mr. Campbell. Lisa's job is within the Office of Internal Audit which falls under the direct supervision of the Deputy Director (The Audit, paragraph 6).
- b. Submit to the demand of Mr. Campbell.
- Lisa could decide to submit to the demand of Mr. Campbell and continue on with business as usual.
- c. Request Eric (her supervisor) handle the issue.
- After all, he was the audit supervisor and Lisa's immediate supervisor. After having initially discussed her findings with Eric, he approved them and incorporated them into the audit report. So, students could choose to let Eric take the lead at this point while Lisa assists him only as needed.
- d. Revisit the grant award rules and guidelines to ensure she properly interpreted and followed them, then inform management.
- Students could choose that Lisa revisit the rules and guidelines in an effort to ensure a thorough understanding was obtained to effectively perform her portion of the audit. They could respond that it's always beneficial to double-check some items, especially in situations that may have profound consequences. Management in this case could include any combination of Lisa's superiors in the Office of Internal Audit, as well as Mr. Campbell. Note: Students who put forth exceptional effort regarding this case exercise may even add another element to this possible response by raising the possibility that

Lisa or her office contact the federal agency that issued the funds for guidance on interpreting the rules and guidelines.

- e. Stand firm on her findings and convey her position to management.
Students could choose that Lisa stand firm on her findings, not submit to the demand of Mr. Campbell, and reiterate her position to management via e-mail, telephone, or an office visit. This position would be taken without having revisited the grant rules and guidelines. Students could choose to believe that Lisa obtained a sufficient understanding of the guidelines needed to effectively perform her portion of the audit.
- f. Terminate her employment with the agency.
Students could respond that Lisa simply quit her job.

Potential Responses to Case Question 4

4. Conclude what action Lisa should take and explain the professional and ethical considerations and consequences of her action(s).
 - a. Do nothing.
Students may respond that Lisa doesn't have to do anything because her line of duty is independent from the authority of Mr. Campbell (The Audit, paragraph 6). However, should Lisa not do anything, the possibility of a few cons surface. They are as follows:
 - No response perceived as unprofessional, unethical, and insubordination by management
 - Perceived behavior could lead to Lisa being fired and her reputation tarnished
 - Possible fine if the matter remains unresolved and the federal agency that awarded the grant funds uncovers the findings during an audit
 - b. Submit to the demand of Mr. Campbell.
Pros.
 - Perceived as subordination
 - Possibly improves Lisa's work environment which may currently be hostile
 - May win Lisa favor with Mr. Campbell, favor that may influence whether or not she is promotedCons.
 - Possible violation of professional internal auditing practice standards
 - Possible violation of a business ethics code or employee code of conduct
 - Possible violation of her duty and obligation to the agency and the public trust
 - Possible fine if the matter remains unresolved and the federal agency that awarded the grant funds uncovers the findings during an audit
 - c. Request Eric (her supervisor) handle the issue.
Pros.
 - May be perceived as appropriately following the chain of command
 - Possibly improves Lisa's work environment which may currently be hostile

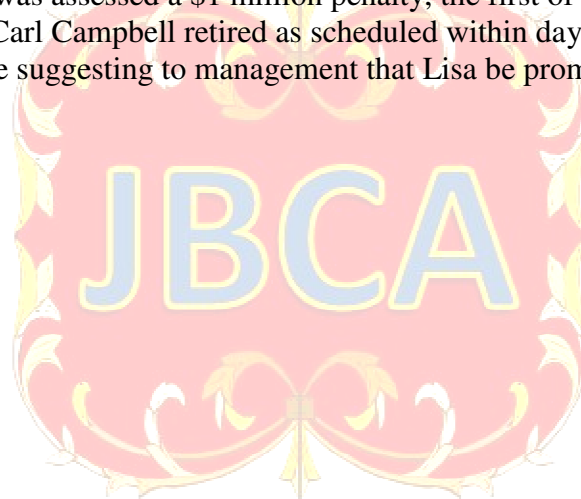
- Decision may be perceived as wise and may win Lisa favor with management
 - Eric may resolve the matter by assisting management with corrective actions
- Cons.
- May be perceived as unprofessionally shifting possible work environment hostility or her responsibility onto someone else
 - May be perceived as unethical if her motive is to shift possible hostility
- d. Revisit the grant award rules and guidelines to ensure she properly interpreted and followed them, then inform management.
- Pros.
- Decision may be perceived as wise and may win Lisa favor with management as well as persuade management regarding the need for corrective action
 - Possibly satisfies Lisa conscience regarding whether she exercised due professional care
- Cons.
- Decision may be perceived as stubbornness and an inefficient use of precious time
- e. Stand firm on her findings and convey her position to management.
- Pros.
- Decision may be perceived as wise and may win Lisa favor with management
 - Decision may persuade management regarding the need for corrective action
 - Decision may protect her in the future if the federal government uncovers the deficiencies in a subsequent audit (pending she documents her actions and those of management)
- Cons.
- Possibly perceived as stubborn and insubordinate
 - Perceive behavior could inflame possible tensions and cause the matter to go unresolved, which could possibly lead to a penalty being imposed on the agency and reduced services to the agency's clients due to funds going toward the penalty
 - Perceived behavior could lead to Lisa being fired and her reputation tarnished
- f. Terminate her employment at the Agency.
- Pros.
- Lisa removes herself from what may be a hostile work environment
 - Taking consideration other unknown factors, this may be an appropriate, professional, and ethical action to take
- Cons.
- Lisa is now without a job and income
 - New Beginnings management may provide Lisa's future prospective employers with bad references
 - Audit findings may remain unresolved, be uncovered by a federal audit, the agency possibly fined, and services to its clients reduced

- The agency and its clients loses a good employee in Lisa

Epilogue

In the end, Lisa stood firm believing that she exercised professional due care during the audit and conveyed her position once again to management, starting with her supervisor and the Deputy Director. A few days later, the Office of Internal Audit received an e-mail from the Executive Director stating he agreed with the Mr. Campbell regarding removing the findings from the audit report. Mr. Campbell's Grants & Contracts Section did not implement and carryout any corrective actions to warrant removing the findings, so the Office of Internal Audit enumerated the findings in a final report and added a disclaimer about the Executive Director's newfound position.

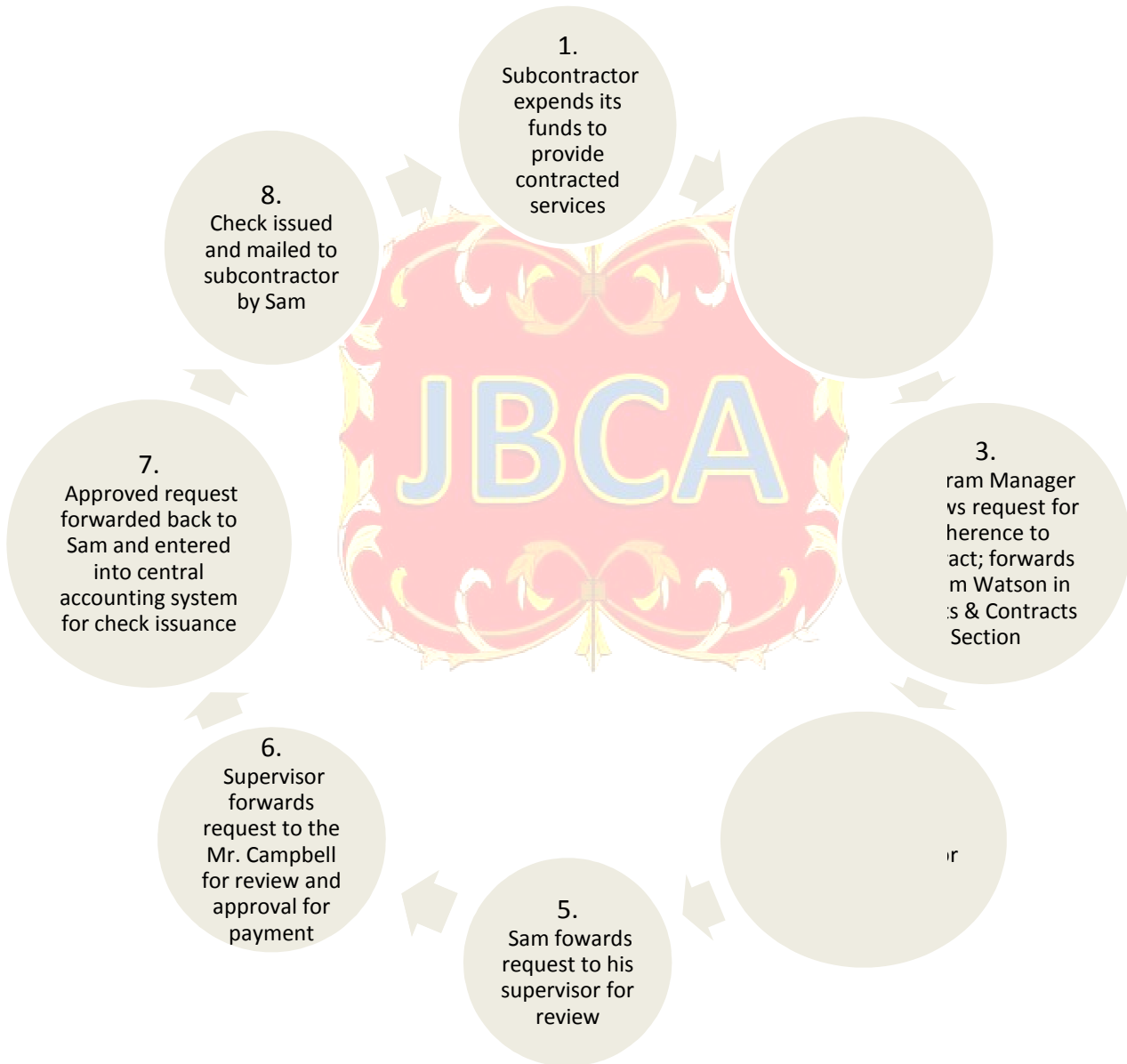
About two months after the final audit report was submitted, auditors of the federal department that awarded the ARRA funds to New Beginnings began an audit of the operations of the Accounting & Finance Division. During the audit, they discovered the findings Lisa previously discovered, and the consequences of not implementing corrective actions proved very costly. New Beginnings was assessed a \$1 million penalty, the first of its kind in the agency's history. Coincidentally, Carl Campbell retired as scheduled within days of the penalty assessment, but not before suggesting to management that Lisa be promoted to Internal Auditor II which she was.



APPENDIX

Table 1
New Beginnings
Accounting & Finance Division
Grants & Contracts Section

CONTRACT PAYMENTS PROCESS



¹Paid invoices are mandatory as part of supporting documentation.