Chapter 5

Merchandise Accounting and Internal Control

Key Concepts:
- How does a retailer earn revenue?
- What is cost of goods sold?
- How does a company control inventory?
- What constitutes good internal control?
Net Sales of Merchandise

**Net sales** = sales less sales returns and allowances and sales discounts (Exhibit 5-2)

**Income statement accounts:**
- Sales
- Sales returns and allowances
- Sales discounts

**Balance sheet accounts:**
- Cash
- Accounts receivable

**Sales returns and allowances:**
- Return of unsatisfactory merchandise by customer
  - cash refund
  - credit against future purchase
- Price reduction granted to customer for spoiled or damaged merchandise
- *Contra-revenue* account
- Separate account for better control of these items

**Discounts:**
- **Trade discount**: offered to special customers
- **Quantity discount**: offered to customers who buy in large volume
  - these are not recorded in accounts, but the sales are recorded at net
- **Sales discount**: offered for early payment at terms specified on the invoice
  - account for by *gross* method: record sale at full amount, debit *contra-revenue* account called *sales discounts* if the customer takes the discount
  - account for by *net* method: record sale at net of discount
  - text focuses on the *gross* method

**Cost of goods sold:**
- **Cost of goods sold** is the cost to the merchandiser of items sold during the period
  - does not include the cost of *all* the merchandise *purchased* during the period

\[
\text{Beginning inventory} + \text{purchases} = \text{cost of goods available for sale} - \text{ending inventory} = \text{cost of goods sold}
\]

- example of matching principle: match expense (cost of goods sold) to the period of revenue (sales)
Inventory Systems: Perpetual and Periodic

**Perpetual system:** inventory account is updated constantly, after every purchase or sale
- More costly to maintain
- More record keeping in a large volume operation
- Point-of-sale terminals now make this feasible for large volume merchandisers
- Most retailers use a perpetual system for units of inventory, but use a periodic system for cost of inventory

**Periodic system:** inventory account updated only at the end of each accounting period, not each time a sale of purchase is made
- Inventory account contains amount from beginning of year
- Ending inventory determined by counting, and the inventory account is updated when count is done (Inventory must also be counted when the perpetual system is used)
- Some loss of control results from not knowing how much inventory may have been stolen, damaged, or otherwise lost
- Counting is time consuming, so interim statements are generally prepared using estimates

Accounting for the Cost of Goods Sold

**Cost of goods purchased = purchases less purchase returns and allowances less purchase discounts plus transportation in** (Exhibit 5-3 and Exhibit 5-6)
- Assumes a periodic system
- **Purchases** is a temporary account, not an asset; closed at the end of the period
- **Purchase returns and allowances** is a contra account to purchases, with a credit balance
  - opposite number to sales returns and allowances
- **Purchase discounts**, another contra account, accounted for the same way as sales discounts
- **Transportation** charges and **sales tax** are part of the cost of merchandise
  - transportation in is an adjunct account, added to net purchases, as opposed to a contra account, which is subtracted
- If seller pays transportation, it is part of selling expense
- At period end, who owns inventory in transit?
  - FOB shipping point, buyer owns as soon as carrier takes the merchandise
  - FOB destination, seller owns until buyer receives the shipment

Periodic system has an extra step, counting inventory, in the accounting cycle at the end of the period before cost of goods sold can be calculated

An Introduction to Internal Control

**Internal control:** policies and procedures necessary to safeguard assets, ensure reliability of accounting records, and reach overall goals
- **Report of management** in annual report spells out responsibility, including internal control
- Extent of system varies from company to company
  - larger companies have an internal audit staff
- Outside auditors cannot check everything, so they rely to some degree on internal audit staff and internal control system
Board of directors is made up of a majority of outsiders, plus representatives of company management
- audit committee of the board of directors is contact between outside auditors and stockholders

Internal control system:
- Control environment: management operating style, personnel policies, board of directors
- Accounting system: capable of handling company's volume and complexity
- Control procedures

Internal Control Procedures
Administrative controls: efficient operation of business
Accounting controls: safeguard assets and ensure reliability of statements

Internal control procedures:
- Proper authorizations: authority and responsibility
- Segregation of duties: fundamental procedure requiring that physical custody be separated from accounting for assets
- Independent verification: one person's or department's duties act as a check on the work of another
- Safeguarding assets and records: basic security, including safes, lock boxes, secured areas, limited access, passwords
- Independent review and appraisal: internal audit and independent accountants
- Design and use of business documents: capture all necessary information
  - serial numbering, multiple copies

Limitations:
- Larger firm has more resources to devote to control
  - rotation of duties can help in a smaller company
- Errors can override any system, problems don't result only from deliberate fraud
Appendix 5A

Merchandise firm's internal control:

- Cash receipts
  - deposit daily, intact, with no deductions for any reason
    - all disbursements except for petty cash are made by check
  - over the counter
    - cash register displays sale rung up to customer
    - tape record of sales
    - customer receipts
  - collections by mail on credit sales
    - generally checks rather than cash
    - two people should open the mail, with an itemized list of receipts
    - these people should be rotated
    - monthly customer statements
  - cash over and short reconciles the register tape to cash in register
    - investigate material or recurring amounts from the same clerk

The Role of Computerized Business Documents in Controlling Cash Disbursements

Purchases of goods for resale (Exhibit 5-9):

- Purchase requisition from department needing item to purchasing
- Purchase order from purchasing department to vendor
  - offer to purchase, not basis for recording liability
- Invoice from vendor to company
  - practically speaking, this is what the company uses as a cue to record accounts payable
- Receiving report by receiving department lists materials received
  - often blind, that is, receivers don't check items off against the purchase order copy; they fill in the quantity column from the actual goods received
- Invoice approval form
  - check off that requisition, purchase order, invoice, and receiving report all received and coordinated in accounting
  - invoice is footed, payment date noted
- Check written by a separate department and signed according to company's approval policy


**Lecture Suggestions**

**LO 1**
Ask your students how often they return items they have purchased, and why they return them. Should the store be interested in the reason for the return? Do they ask?

The cost of goods sold model will be used frequently in the topics to come. Prepare a handout with a number of exercises that show how the mechanics of the calculation work. Reproduce it more than once on a sheet, then have students fill in the numbers under a variety of scenarios. Don't always make cost of goods sold the “missing” number students are required to calculate.

**LO 2**
Ask your class if anyone has ever taken part in counting inventory. Practical experience demonstrates vividly what a tedious job it is. Ask local merchandisers when they take their inventory and whether they hire “casual help” for it, and then inform students so they can learn about inventories firsthand, and earn a little spending money in the process.

Discuss reasons for taking a physical inventory for both the perpetual and periodic inventory systems.

**LO 3**
Stress to students that the purchases account is a temporary account, not an asset (permanent) account. Its purpose is to account for inventory purchased during a period, and it will ultimately be closed. Have students use the cost of goods sold model to determine where the account will be closed.

Another point worth addressing is the nature of purchase discounts, pointing out that they are not income, but simply a reduction in the amount paid for inventory. Some instructors may wish to point out the net method of recording purchases and accounts payable, so that the accounting system identifies purchases discounts lost. The net method can be presented in the context of structuring accounting systems to provide better information to managers.

**LO 5**
Internal control always comes across to students as a very dry topic. Involve them by suggesting hypothetical situations with limited employees and resources, and let students devise ways to maintain adequate controls without investing in more people. They could work in teams on this, and then compare the solutions the different teams arrive at. Postulate that they cannot simply “throw money at the problem.”

Students can talk about internal control procedures at places they have worked. Many have worked as cashiers and have worked with procedures to safeguard cash. Employment at movie theatres, grocery stores, department stores and banks provide excellent examples.
CHAPTER 5 — MERCHANDISE ACCOUNTING AND INTERNAL CONTROL

Projects and Activities

Accounting for Net Sales

In-class discussion: Why offer discounts at such high rates?

You are newly employed at a hardware wholesaler, with many area retail outlets as customers. As you look over the billing system, you notice that your company’s standard terms to customers are “2/10, n/30.” You calculate that your company is paying customers interest at an annualized rate of 36% to encourage them to pay 20 days earlier than they ordinarily might.

• Is this correct? Show a calculation to prove or disprove the example.

• If the example were correct, why would the company want to pay so high a premium? Wouldn’t it be wiser to wait the 20 days and collect a greater amount of money?

Solution

• This problem addresses the questions of sales discounts, and the business, or cash-to-cash, cycle. If the customer is receiving a discount of 2% for 20 days, and there are approximately eighteen 20-day periods in a year, this is a 36% annual rate.

• Sales discounts shorten this cycle, providing the company cash to begin a new cycle sooner. The company may not have to borrow, and they may purchase additional inventory and increase sales, generating additional profit. Also, accounts are not often collected in 30 days, but instead extend to 45 or even 60 days. If this incentive can shorten that to 10 days, the effective interest rate being paid is actually much lower than the 36% calculated. If the average collection period is 45 days, for example, the rate is closer to 20.5%. If collections extend to 60 days, the rate is reduced to around 14%. Customers may also be attracted by the better price this discount gives them on the merchandise they buy.

Outside assignment: Will a retailer accept returns for any reason at all?

You are working as a sales assistant in the men’s sportswear department of a store in a large department store chain. A young man comes in one evening and buys a few hundred dollars’ worth of clothing. The next evening he returns most of them. “What’s wrong with them?” you ask. He answers that there is nothing at all wrong with the clothing. He hates trying on clothes at stores, so he picks out what he might want, buys it on his charge card, tries it all on at home, and returns what he doesn’t want. He proceeds to pick out and buy another batch. You know that many of those will be back the next evening. Maybe you’ll take a day off tomorrow. In the meantime, you decide to discuss the return policy with the buyer, who supervises the department.

• What is your opinion of this situation? Assemble a team of four to five people. Assign each member a role, including the customer, the sales clerk, the department’s buyer/supervisor, the store manager, another customer in the same department. Argue the question among yourselves in these roles

• Why do stores have liberal sales return policies? Are they a good idea? What about the possibility of abuse? Does this make you think the stores should not be so liberal?

• Write a brief memorandum to the store’s home office detailing your team’s conclusions about the pros and cons of liberal return policies. Suggest a store policy for returns.

Solution

• The story sounds farfetched, but it really happened. With logging in each returned item and gathering the proper signed approvals, the clerk needed over half an hour to process...
that return, and that did not include restocking the merchandise. If students become truly engaged in their roles, a lively exchange of views results. Opinions will change and become more broad-based.

- Stores offer liberal terms on returns to make customers comfortable with buying merchandise from them. Nothing puts off customers more than trying to return truly unsatisfactory merchandise and being "grilled" as though they'd stolen it. Thus the majority good is served, even if that occasionally inconveniences the individual, when the store assumes "the customer is always right."

- Most customers do not abuse the policy. There is some inconvenience involved in returning to the store and waiting in line to make the return. Stores find that the benefits outweigh the disadvantages. The extra expense of returns is included in prices.

- Students might be surprised to know that at least this particular department store accepted merchandise that wasn't even purchased in their store, for example a hand-knit blanket that was received as a gift in one of the store's boxes. Another customer returned merchandise that was obviously damaged by sheer carelessness. Her son tore a hole in an athletic shirt trying to remove a decorative logo tag. "It shouldn't have been attached with all those stitches!" The clerk did not argue, but wrote down the reason for each return for store records, even when that reason was, "She didn't like the way the quilt smelled." The customer is always right.

**Inventory Systems: Perpetual and Periodic**

**Food for thought: The accounting system as a sales tool**

In an article in the *Wall Street Journal* about the faltering chain of Zayre's stores, a number of interesting items came to light, among them the following:

“To attract customers, Zayre cut prices on everyday items like disposable diapers, paper towels and toothpaste. Once in the stores, it figured, customers would splurge on higher-priced—and higher-profit—goods.”

“Half of the strategy worked. Customers snapped up the ‘super discount specials’ all right. But they didn't buy much else.”

“Poor merchandising decisions filled its 382 stores with many items—such as out-of-fashion women's blouses—that few customers wanted.”

“…distribution mistakes often left the shelves empty of goods that shoppers did want…. In the all-important Christmas selling season … were out of basics, like men's dress shirts, underwear, brand-name toothpaste, aspirin.”

Is an accounting system more than a way to track dollars and report past results? Can an accounting system also offer help in marketing, and be a planning tool? You are an accountant for Zayre. Write a memo to the Zayre management suggesting how the accounting department's resources can be used to help the company solve merchandising problems.

**Solution**

The accounting system, used properly and in time to make a difference, could have told the company a number of things about their merchandise. Cost records could have helped make buying decisions on the potential “super bargain” items, to minimize losses on these items by obtaining the best purchase prices. Sales records reveal which products sold and how fast. Sales totals by department show which departments have the best performance, and when. Sales records by department can be compared to determine if actual proximity of departments made a difference in profits by monitoring performance after changing some locations.

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The accounting department must be informed of management’s information needs, to allow quick turnaround of information to make all these things possible. Better tracking of inventory predicts stock-outs before they occur. Better coordination between department heads, central purchasing, and accounting also improves inventory management. Noting buying patterns (again through inventory observation) could give clues to “complementary items” to stock when certain “bargain items” are on sale, and where to place merchandise so that the shoppers will notice. Timely monitoring of profit margins differentiates discounting that increases profits from discounting that simply multiplies losses.

**Accounting for the Cost of Goods Sold**

**In-class discussion: Reporting purchase discounts missed**

Why would “purchase discounts missed” be reported by a company as a part of interest expense? Independent auditors consider the taking of purchase discounts to be important to good cash management. Many argue in favor of using the net method. The invoice is booked net of the discount, and if the discount is missed the company debits the expense “discounts missed.” Managers, on the other hand, prefer the gross method, where the invoice is booked at the full amount, then a credit, or contra account to purchases, is recorded for “discounts earned.” This discloses only discounts the company took, not what they might have taken. Why do you think such opposing views exist? From the point of view of a stockholder, which would you prefer?

**Solution**

A purchase discount offers the customer a “payment” for the earlier use of money. This fits within the definition of interest, as the “rent” charged for the use of money. On the other hand, if the customer does not take advantage of the offer, they are paying to use the money a bit longer themselves, that is, they are paying interest by paying more for the purchases.

From the point of view of disclosure, the net method is preferable. The gross method makes great show of how many dollars of discounts the company earned, but could well hide many more dollars that they could have earned but didn’t. The net method discloses the amount foregone, and lets the stockholders know how well they manage cash. Auditors also believe that accumulating the amount, publishing it notwithstanding, will make companies more aware of its size, and attentive to the possibilities of discounts. They might be encouraged to develop systems to ensure that the due dates are known and met. The company, on the other hand, prefers not to disclose “negatively charged” items. The amount may not be material so the method of disclosure could be academic.

Stockholders generally prefer more disclosure if they know the choices available.

**In-class discussion: Transportation and taxes as inventory costs**

Although the accounting rules require companies to include inbound transportation and sales taxes as part of the cost of merchandise purchased for reporting purposes, in actual practice many retailers do not actually “inventory” these costs when calculating the cost of their merchandise for resale. For example, let’s say the A La Mode Dress Shop receives a shipment of 12 wool skirts with a total cost of $1,200. They also are billed for sales tax of $72 and shipping of $30. The next day they receive 12 similar skirts from another supplier. The cost is again $1,200, tax this time is $60 and transportation $40. On the inventory record for this item, each of the 24 skirts is listed at a cost of $100. Sixteen of the skirts were sold during the month. On this month’s income statement A La Mode will include sales tax of $132 and shipping of $70.

- Does A La Mode’s method of accounting for these skirts violate the rule as you understood it?
- Why do you suppose a company would prefer this method to that of adding the tax and transportation to the cost of each item in the inventory?
Solution

- The first question is one of timing. The retailer does include the transportation and taxes in cost of goods sold, but too soon, some might argue. As costs of the merchandise these charges should be inventoried until the items are sold, and only expensed at that time. However, the reporting error caused is probably not material in most cases.

- The argument the company makes against inventorying these items is that two identical items, bought at the same time, can have different costs just because of their origin. This adds to accounting complexity without material benefit. The company inventories the invoice cost of the item, but expenses the incidental costs as incurred.

**Internal Control Procedures**

**Food for thought: Who is responsible for internal control?**


- The report repeatedly refers to “management.” Do you think all this is done at the corporate headquarters level, with representatives sent to individual outlets? Is some of the responsibility for internal control delegated?

- How do you think the system works? If authority is delegated, how does top management ensure that the system is properly maintained?

- How might it actually cause a control problem, in and of itself, if all the control did rest “at the top?”

**Solution**

- In an organization as large and widespread as The Gap, internal control could not rest solely with corporate headquarters. They might formulate policies, and the internal audit staff reside there, but responsibility must be delegated for the system to be managed successfully.

- The organization chart gives not only operating responsibility, but control responsibility. Note the comment on selection and training of qualified personnel. Well-qualified managers hire well-qualified subordinates. Throughout management, everyone has specific responsibilities, in both operations and internal control, and a system of checks and balances not only ensures the goals of internal control (asset preservation, accounting integrity, etc.) but also ensures the process of control itself. Responsibility reverts to the individual store managers, who are trained by headquarters.

- Students can surmise that all this must be true in any large organization. No one can hold too many strings successfully. If too much control rests in one place, the company is violating one of the basic internal control procedures, division of responsibility.

**In-class discussion: The Gap Board of Directors**

The Board of Directors of The Gap Inc. has eleven members, of whom seven are not employees of the company. The occupations of the “outside directors” include: Chairman of a number of specialty retailers, General Partner of venture capital investment firm, College President, Chief Judge of a Juvenile Court, and Chairman/CEO of a discount brokerage firm.²

- Is it important that all the directors are not employees? Why or why not? What control function do non-employee directors serve? How many, and what per cent, are employees?

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• Comment on the distribution of occupations. What is the value of such a wide variety? Would you as a shareholder prefer to see the directors all tied in some way to the retail clothing industry?

Solution

• Directors who are not employees provide an independent view of operations. They represent stockholders, not management. Note in the Management Report that none of the Audit Committee are managers of Gap. This minimizes potential conflicts of interest, as well as providing separation of duties.

• Four directors, or about 36%, are employees.

• The board represents academe, finance, and consumer retailing. They bring a valuable mix of experience and expertise in business. The variety allows them to view issues of concern to the company from enough sides to avoid the pitfalls of always proceeding in the same way in a changing environment.

Food for thought: Stockholder involvement in operations

Your text says that “In most large corporations, it is impossible for the owners—the stockholders—to be actively involved in the daily affairs of the business”. What do you think the authors mean by “impossible”? Is active involvement by stockholders impossible because the conditions of ownership prohibit it? Is it something about the stockholders themselves that prohibits active involvement?

• The Gap has 7,967 shareholders as of March 12, 1999. What do you think would happen if 10% of them suddenly decided they wanted a voice in running the company?

• What options are open for a stockholder to have a say in the affairs of a company? Why is it not necessary for shareholders to step in actively in day-to-day affairs?

Solution

• Stockholders are given certain rights, but helping to run the company's everyday affairs is not one of them.

• The Gap certainly hopes that not even 1% of the shareholders ever decide they want to move into corporate headquarters all at once and help run the company because that would create chaos. Managers are carefully chosen for their skills, experience, and ability to work within the existing management team. Random unplanned additions would not help the company.

• Stockholders finance the operation and reap the benefits. Management is hired to do the day-to-day work. Most stockholders would probably not be qualified to run a corporation even if they wanted to, which most emphatically do not. Stockholders vote on various issues including elections to the board of directors, and can certainly write letters, which the majority of management do answer, on issues of concern to them. They can learn all they can about the business and keep up to date so that they can vote wisely when asked. Professional managers are hired to make the ongoing daily decisions.

Internal Control Procedures

Outside assignment: Asset control

Sid and Harry, brothers, ran an auto parts store located in a somewhat run-down neighborhood of a large city. They had owned the store for over 20 years, since they both finished business school. They employed two bookkeepers, an inventory control clerk with an assistant, a mechanic, two counter people, and two pick-up/delivery drivers.

The two counter people, with the mechanic to help if necessary, served also as receivers for inventory. Sometimes a delivery truck from a supplier would leave items on the loading dock, walk forward through the storeroom to have the counter people sign his drop-off sheet, and exit the way he came. Only later, when business was slack, would someone shelve the items delivered, checking off what they found against the receiving document. The counter clerks also packed orders for the drivers to deliver to distant customers, based on messages radioed in by the drivers. Often when the drivers came in for these supplies and the clerks were busy, the drivers would pick their own inventory, and fill out the shipping form, leaving a copy for the inventory clerks and the bookkeeper. It was also accepted practice for long-standing commercial customers to go out back and look for an item if the salespeople were busy, bringing it forward to be “written up.”

The store was rectangular in shape. The front was the retail area, with the inventory control area in one corner. Inventory records were kept on cards by quantity only, and updated daily from the shipping copies of sales invoices and receiving documents. The largest area, in the middle of the building, was the inventory area consisting of floor to ceiling steel shelving on which most parts were kept by number and grouped by type. Some inventory was in the retail area. Near the back was a receiving dock, which was never locked until the store closed at night. This loading dock was left open in the summer, with the door not even closed, let alone locked, for air circulation.

At the very back was a small office for Sid, Harry, and the bookkeepers, and a work area for the mechanic. There was a wall between the retail and inventory area with an opening (no door) at either end for salespeople to walk back and forth for items for customers. The office had a door, unlocked, just to keep out some of the noise of the mechanic’s machinery. The entire office area had glass walls for the upper 2/3 of its height, affording a view of the receiving dock and inventory and mechanic’s area, and even a limited view of the sales area. Since Sid and Harry acted as outside salesmen to commercial customers, they were not in the office very often, or for very long. The inventory area was completely open and accessible from all other areas.

A physical inventory count was taken once a year, and checked against the cards.

One summer Harry became convinced that inventory was disappearing. Too many times an item that should have been in stock wasn't there. He suspected someone working in the store was removing stock. The suspicions and resulting questions turned what had been a very congenial working crew into a tense, unhappy group. It was the view among employees that someone from the outside was the culprit. One employee resigned after feeling that he was under suspicion without cause, and two others threatened to follow.

- What possibilities do you see for the source of the disappearances?
- What features of the business, given the limited amount you have been told, can be viewed as positive factors in asset control?
- What changes could you suggest to Harry in the way of internal controls that would improve control?

**Solution**

The business survived the crisis, but not without losing some employees. People left because they thought the owner was jumping to conclusions without trying to approach the problem logically and impartially. They felt uncomfortable with what appeared to be random suspicions. This was certainly a legitimate criticism. Internal control was loose, making any investigation difficult.

- Needless to say, too many people could and did go into the inventory area. Most were probably unquestionably honest and had legitimate reasons to be there, but still presented a serious control problem. A customer could move an item to the wrong shelf, a driver could fill an order and not leave the copy that deducted the items from the inventory cards. Errors could too easily occur.
- The glass office seemed like a good way to keep an eye on the stock, but in reality the brothers were generally out making sales calls, and the office people were too busy to notice everything that went on, as was the mechanic. Everyone was accustomed to
seeing different people, not necessarily employees, in the inventory area, so that no one questioned a stranger. The card file, updated daily, was a good system, but if inventory was only counted once a year, no one really knew if the cards were right or wrong unless they actually checked a specific item on the shelf against the card record. This often happened, but differences were usually explained by some ordinary business reason—someone bought three an hour ago—and thus no one worried too much when this occurred. If the inventory clerks left their area, it was readily accessible to customers, since it was in the retail area and not walled off.

- The loading door should have been at least closed, if not locked, to keep passers-by outside where they belonged. Customers should have been tactfully kept forward of the counter. More frequent inventory counts should have been made, if not of everything then on a rotating basis so every category got counted at least twice a year. All incoming shipments should have been checked immediately, signed for, and removed from outside to inside, even if that meant having an occasional “jam-up” at the front counter. Perhaps an office person or an inventory clerk could come out and handle some routine sales for the ten minutes time an average incoming shipment took. The store's drivers should not have been under such time constraints that they could not wait ten minutes for one of the counter people to pull their order and write the proper documents, so that inventory withdrawals were properly recorded. The owner might also have determined who had keys to the store. Although this is not mentioned in the case, many students will be familiar enough with this type of business to realize that over 20 years a lot of stray keys end up in the pockets of former employees who have been long forgotten. Perhaps it was time to change locks. Students will think of a variety of possible controls. Some may even want to lock up the inventory. They have to keep in mind the size of the business and the staff. Many will also suggest a computerized system to speed up record keeping, which would possibly allow the store to change one inventory clerk to a physical control clerk. Then it might actually be possible to secure the area.

Ethical decision: What's right and what's wrong?

Many things are accepted nowadays as “all right,” just because they are done often, by a lot of people. But are they really all right? For each of the following situations state and explain your opinion on whether or not the action is ethically correct.

- Employees of a manufacturer all receive a discount on company merchandise, paying well below what any outside customer pays. Even larger discounts are offered on so-called seconds.

- A company has a paper recycling box next to the copy machine for defective copies, or other paper that for some reason (for example, a wrinkle) is not usable for business purposes. Many employees routinely help themselves to some of this paper to take home and use for scrap paper, or for the children to draw on.

- Employees, when they go to the office supply cabinet for paper, pencils, pens, staples, tape, and so on for office use, also help themselves to an item or two for personal use.

- Employees of a restaurant (who are allowed to eat a meal at the restaurant if their shift coincides with a normal mealtime) often “nibble” during slack times.

- The bartender at a restaurant routinely brings in a bottle of whiskey he's purchased on his own, and pours drinks for customers out of it, pocketing the money paid (at the bar's standard charge for the drink) for those drinks.

- An employee of a department store, who receives a 20% employee discount on all store merchandise, buys items on her store discount for her friends and family.

- A public employee responsible for, among other things, procuring department vehicles, orders a car for himself in an order for town vehicles. Both he and the dealership, who
gives the town a discount not available to other customers, know it is a personal car. The employee pays for the car (discounted) with a personal check. The car for the employee was not included on the town purchase order.

**Solution**

- The employee discount is perfectly legitimate. Most companies give their employees discounts on company products, and many even let them have “seconds” for free. No one is doing anything wrong here.

- The paper for recycling is being recycled, even if not to where it might ordinarily go. The company would be discarding it one way or the other, and here it is being put to good use, most likely with the full knowledge and consent of management. The only ethical problem for employees might be if a package or two of good, new sheets slips through.

- Office supplies are an “everybody does it” item. Frequent abuse doesn't make it right, just common. Companies often turn a blind eye as long as the practice does not appear to be getting out of hand. But taking office supplies isn't ethical unless the company tells you to help yourself. Some companies have tried doing just that, with an interesting result: they found they gave away fewer rather than more supplies.

- A meal is an employee benefit. Eating all day long is quite another issue, and poor practice for a number of reasons. First, it is unauthorized and thus unethical. Second, the employees are bound to eat in front of customers eventually. This is very unprofessional, and a disservice to the employer. Third, the number of people handling food increases and poses health risks, which management wants to avoid.

- The story of the bartender's extra income was told to me by a student who was a restaurant owner, who returned to school for a management degree. On the surface it looks O.K. to some students. They say that since the bartender bought the whiskey, the owner doesn't lose anything. They forget about the drinks the owner should have sold out of his own stock. If the bartender wants to go into business, he must do so at his own expense, on his own time and premises, not someone else's.

- Again, technically, this is unethical. The discount is for the employee, and perhaps her immediate family, not her wide circle of acquaintances. However the problem again is one of volume, and many large stores, concluding that a sale is a sale, allow employees to make all their purchases, no matter for whom, at a discount. They will perhaps offer a slightly higher discount on “clothing and accessories you can wear to work,” which mitigates abuse.

- This is another real case, and clearly unethical. The discounts are offered to the town, not to town employees. If there are discounts for employees, they have to be made available to everyone, not just a few select people who happen to know where to get them. A hint of coercion and collusion could arise here: give me a discount on my car or the town contract goes to another dealer. This would turn the case into a far more serious one.

**LO 5**

**Internal Control Procedures**

**In-class discussion: Franking privileges**

An article in *The Wall Street Journal* discussed an audit of the United States House of Representatives’ operations by Price, Waterhouse. Consider the following quote from Price Waterhouse’s findings:

Prior to 1995, the Folding Room often did not ask staff if a mailing received Franking Commission approval or was exempt. When they did ask, they did not document the staff’s reply. . . . We found that 70 Members who incurred official
mail costs in 1994 had no printing expenses, including 13 Members with official mail costs of over $100,000 each.\(^4\)

- Explain the incorrect or unethical practice, and why it is wrong. You may have to research “franking privileges.”

**Solution**

A Senator or Congressman has the ability, his/her franking privilege, to send official mail at no charge. Certain conditions, known to the participants, must be met. The auditors found that the privilege was being abused. Controls over whether or not mailings were authorized were weak, with no documentation. For example, in the absence of printing expenses, what was being mailed for $100,000?

**Food (no pun intended) for thought: Burger King**

As you stand in line at a Burger King one night a shift supervisor across the counter glances at her watch, removes about 6 hamburgers from the heat shelf, throws them away, and notes on a log sheet the time, shift, what she threw away, and her initials.

- What might the reasons for her actions be? Do you see any internal control procedures at work here?

**Solution**

Fast food restaurants keep prepared food for a limited time, beyond which the food no longer meets company criteria for freshness. The log accounts for the merchandise. Managers also record what is prepared, and reconcile food prepared with food sold. A number of internal control procedures are thus being carried out by this one simple action.

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