SUPERIOR FOODS: A CASE STUDY IN COSO RISK ASSESSMENT

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CASE DESCRIPTION

This case addresses the risk assessment process in the internal audit function. The level of difficulty is four. The case should require about three hours of classroom time for coverage and students should expect to spend another three to four hours in preparation time outside class. This case is designed to be used in an accounting information systems or auditing course, graduate or undergraduate. In order for students to learn how to audit a client's risk assessment process, they must first gain a detailed understanding of that process. This case has been developed to provide exposure to an actual company's risk assessment process and thereby provide guidance for this understanding.

CASE SYNOPSIS

This case describes the development, implementation, and results of a Fortune 500 company's risk assessment process. Some information about the company has been altered due to the company's request for anonymity. However, the detailed descriptions of the risk assessment process and the risks identified by management are factual.

The newly hired Director of Internal Audit Services in this case already had seven years of experience managing external audits for a major international public accounting firm. The company had been one of his audit clients, so he was very familiar with their internal controls and financial reporting procedures. He was hired to develop a comprehensive internal control program to comply with the COSO Report (1992). His first step was to develop a process of risk assessment. This case describes the design and implementation of that risk assessment process.

"I've done over fifty audits...evaluation of internal control systems, tests of controls, substantive tests, etc... now COSO requires management to have a risk assessment process. How do we design, implement, and then audit this new 'process?'"

-- Greg Johnson, CPA
Director of Internal Audit
Superior Foods, Inc.

INSTRUCTORS' NOTES

1. **List additional "general" risks that would pertain to a company that owns and operates grocery stores.**

GENERAL RISKS:

Business acquisitions	Negative media exposure
Changes in competition	Noncompliance with benefit plan regulations
Changes in sales policies	Noncompliance with business license laws
Civil unrest - riots	Noncompliance with debt covenants
Concentration of senior mgmt	Noncompliance with EPA regulations
Discontinuity of increase in earnings	Noncompliance with pharmaceutical regs
Discontinuity of increase in sales	Noncompliance with union contracts
Discontinuity of store expansion	Noncompliance with GAAP
Disruption of supply of product	Noncompliance with SEC regulations
Embezzlement of cash	Noncompliance with tax regulations
Fraudulent financial reporting	Poor quality products
Employee turnover	Poor quality service
General business liabilities	Product liability (customer harm, lawsuits)
Hostile takeover	Theft of cash
Human errors	Theft of inventory
Inability to meet daily cash needs	Unavailability of capital
Inflation	Unreliable financial reporting
Labor strikes	Untrained work force
Market decline in stock price	Vandalism
Misuse of information	Workplace violence

2. **List additional "technical" risks that would pertain to a company that owns and operates grocery stores. The locations of such risks would include corporate office, division offices, distribution centers, and retail operations.**

Telecommunications

Computer equipment failure
Software failure
Technology changes
Loss of data integrity & security
Equipment failure
Power loss

3. **List additional "natural" risks that would pertain to a company that owns and operates grocery stores. The locations of such risks would include corporate office, division offices, distribution centers, and retail operations.**

Earthquakes
Winds/hurricanes
Dam failure
Fire
Gas leak
Water leak
Hazardous material incident

4. **List additional control objectives, risks, and controls in the "purchasing activity" at the retail operations level that would pertain to a company that owns and operates grocery stores.**

Control Objectives	Risks	Controls
Proper quantities are ordered.	Overbuying results in excess inventory carrying costs and/or spoiled products. Under buying results in lost sales and lost customers.	Weekly excess inventory report. Weekly out-of-stock report.
Acceptable quality and vendor performance.	Poor quality reflects upon company image, and results in lost customers, lost sales.	Approved vendor list. POs are issued by Purchasing Dept.
Product prices in the system are correct and marked at competitive prices.	Pricing errors. Overpricing results in lost sales/customers.	Price lists are reviewed periodically in the PO Dept. Bids are routinely received.
Purchase orders are authorized and filed correctly.	Wrong products ordered. Unauthorized products ordered.	Purchase orders must be approved by user supervisor.
Vendor invoices are filed correctly.	Lost cash discounts. Payment errors.	Invoices are mailed to Accounts Payable Dept. by vendors.
Payment terms are advantageous.	No cash discounts.	POs are issued by Purchasing Dept.

5. How is the "monitoring" component related to the "risk assessment" component?

In addition to the identification of risks, the risk assessment process provides a means of organizing and integrating professional judgments for the "monitoring" of internal controls through the development of the annual internal audit work schedule. Based on prior risk assessments, highest audit priorities can be assigned to activities with the highest risk.

The risk assessment process should be conducted annually as a basis for the annual internal audit plan that is part of the "monitoring" process. Conditions may change that would affect the risk assessment. Changes in the risk assessment may necessitate revisions to the annual audit plan.

6. List "monitoring" activities that could be implemented by Superior Foods.

Management review of operating and financial reports.

Internal auditors' periodic evaluation of internal controls by reviewing the controls, evaluating their effectiveness, reporting their results, and providing recommendations for improvement

Annual performance evaluations.
Physical inventory reconciled with recorded inventory periodically.

Review of complaints by customers or suppliers about billings or payments.

Supervisory reviews that identify deficiencies.

Reviews by various governmental agencies.

External auditors' evaluation of internal controls as part of the annual audit.

7. List "information & communication" activities that could be implemented by Superior Foods.

Accounting and financial reporting manuals
Organization chart with defined responsibilities
Written personnel procedures
Training programs (i.e., explanation of controls)
Code of conduct

Ethics program (i.e., encourage employees to report irregularities, rewards for information)
Open communication channels

8. SAS 78 (AICPA 1995) requires external auditors to understand all the components of the internal controls of the auditee. What audit procedures should be performed to understand and evaluate a company's "risk assessment" process?

Discussions with management
Questionnaires

The following questions should be addressed in the discussions and questionnaires:

Have company objectives been established?
Have the objectives been prioritized?
Were all employee levels represented in establishing the objectives?
Have risks to each of the objectives been identified?
Were risks from internal sources adequately considered?
Were risks from external sources adequately considered?
Have risks been prioritized?
Was there an evaluation of the likelihood of occurrence for each risk?
Has the potential monetary impact been estimated for each risk?
Have the risks been evaluated, i.e., are there adequate controls or insurance to mitigate or transfer each risk?
Were appropriate levels of management involved in analyzing the risks?

9. What audit procedures should be performed to understand and evaluate a company's "monitoring" component of internal control?

Discussions with management
Discussions with the internal auditor
Questionnaires

The following questions should be addressed in the discussions and questionnaires:

Does management routinely evaluate the overall effectiveness of the internal control system?
How does management monitor the control environment?
Does management periodically evaluate the risk assessment process?
Does management monitor the effectiveness of key control activities?

Are the information & communication systems periodically evaluated for accuracy, timeliness, and relevance?

10. What audit procedures should be performed to understand and evaluate a company's "information & communication" component of internal control?

To understand and document the design of the accounting information system (the information component), the auditor would describe the system either by a narrative description or a flowchart.

The auditor would perform a transaction walk-through by tracing several transactions through the system.

Discussions with management
Questionnaires

The following questions should be addressed in the discussions and questionnaires:

Does the company receive relevant information regarding legislation, regulatory changes, economic changes, and other external factors?

Is key information about your organization's operations identified and regularly reported?

Are plans for the effective use of information technology developed and linked with strategic objectives?

Are training, seminars, and on-the-job supervision sufficient to communicate to employees their duties and responsibilities?

Are employees encouraged to provide recommendations for improvement?

Is there a procedure to communicate suspected improprieties?

Is the complainant protected from retaliation?

Are client complaints taken seriously, investigated, and acted upon?