Background
Seaside Memorial (Seaside) is a non-profit, 100 bed community hospital located in Southern New Jersey. It has operated for 20 years providing inpatient and outpatient care. Seaside also operates three Urgent Care Centers (UCCs) that are located within a 30 mile radius of the hospital. These UCCs are staffed primarily by Nurse Practitioners providing services to patients throughout the region. If the patient is triaged and the level of care requires additional resources the patient is transferred by ambulance to Seaside’s Emergency Department.

You (Ed Lauer) have recently joined Seaside’s Internal Audit Department as a staff auditor. The Internal Audit Department was established three years ago and is comprised of an Audit Director (Steve McAninch) and one other staff auditor (Paula Dalton). Your initial assignment is to perform an audit of the Storeroom inventory. This audit has been added to the approved Internal Audit Plan based on a concern raised by the Accounting Manager. This audit has not been previously performed by Internal Audit since the external auditors have observed the physical inventory of the Storeroom in conjunction with the financial audit in prior years. The Audit Director recommends that you set up a meeting with Matt Burns, Accounting Manager, to obtain an understanding of his concern as well as to understand the inventory valuation process. He also recommends that you then meet with the Storeroom Manager to obtain an understanding of the scope of the Storeroom’s operations.

The following week you meet with Mr. Burns in his office. Matt Burns welcomes you and lets you know that he is also relatively new to Seaside since he joined Seaside about one year ago. Matt indicated that since he is relatively new in his position, he does not have a sufficient historical perspective on supplies inventory and welcomes any knowledge share that may be gained by this audit. He proceeds to elaborate on the inventory accounting process as well as his concern regarding the inventory. You note the following based on your discussion:

Inventory Accounting

- The current general ledger balance for the inventory is $400,000. The balance has decreased from $450,000 as of last fiscal year end. He indicated that total storeroom supplies expense is about $10 million this year, which is about $2 million higher than the prior year.
- When the supplies are received they are added to the perpetual inventory value and when they are delivered to the departmental area, perpetual inventory is reduced and the item is recorded as expense to the department operating budget. Any special order items received are immediately expensed.
- The general ledger balance for storeroom inventory is adjusted monthly based upon a transmission from the perpetual inventory system of accumulated inventory receipts, cycle count adjustments, and inventory release (i.e., “pick”) transactions.
- All disbursements to vendors for storeroom supplies inventory require a three-way match between the invoice, purchase order, and receiving report information. When the invoice is received in accounts
payable (AP), the AP clerk matches the information (quantity and price) to the information maintained in the system. Any variances are referred back to the Storeroom purchasing clerk for investigation and resolution.

**Inventory Concern**

Matt noted that adjustment transactions have totaled over $600,000 (inventory reduction) during the year. Despite his requests, he has not received any specific explanations from Michael Barton, Storeroom Manager, regarding these adjustments. Matt also noted that he has heard complaints from several of the hospital departments that they do not understand why their supplies expense is exceeding the budgeted amount since their patient volumes have not significantly changed.

**Storeroom**

Your next meeting is with the Storeroom Manager, Michael Barton, who has been the Storeroom Manager since Seaside first opened. Upon your arrival, Michael gives you a quick tour of the Storeroom, which is located on the first floor at the back of the hospital. You observe and take note of the following based on your tour and discussion with Michael Barton.

- The storeroom is comprised of an open area containing a series of shelves, bins, and several locked cabinets.
- Hospital and storeroom personnel access the Storeroom through a single door at the front of the Storeroom area. Delivery personnel and vendors can also access the Storeroom through a back door from the loading dock. Access is controlled and restricted through a badge card and reader system. The loading dock also has an automated large overhead door into the Storeroom that can accommodate a forklift and pallets.
- The inventory maintained in the Storeroom is comprised of medical supplies, surgical supplies, as well as surgical implantable devices. There are over 500 items within this inventory.
- All ordering of supplies is performed by two Storeroom purchasing clerks. Ordering of stock supplies is based on system-established replenishment levels that, once met, trigger a purchase order. Special orders (i.e., non-stock items) can also be processed based on purchasing requests. Any supplies required by the UCCs are requested by the UCC Managers and are delivered directly to those locations.
- Supplies are delivered from the Storeroom to various hospital departmental areas on a daily basis, as needed. The need is determined by either department management or Storeroom personnel (Requisitioner) who are assigned to ensure adequate supplies are on hand within the department. Orders are placed in the system by either the department managers or the Requisitioners, which triggers the selection of the requested number of the item from the Storeroom inventory location by one designated individual (Picker) for delivery to the hospital department by the Requisitioner. All delivered supplies are signed for by the designated department managers.
- All Storeroom supplies are received through the loading dock. There are generally two Receivers on the day shift and one Receiver on the evening shift. The Receivers are responsible for counting the supplies received, matching it to the packing slips as well as the purchase order quantity, and
recording the amount received in the system. Any variances between the amount received and ordered are recorded in a log book for follow-up by the Storeroom purchasing clerks with the vendor.

• Any Special Order items received through the loading dock are not recorded in the perpetual inventory system and are immediately forwarded to the requesting hospital department.

• Cycle counts of 10 randomly selected items are performed on a monthly basis. The number in the perpetual inventory system is adjusted to the counted amount. A year end physical count is also performed by the Storeroom staff and observed by the external auditors.

Mr. Barton indicated that the Storeroom operated very efficiently due primarily to his long tenure and knowledge of Seaside. He further pointed out that he has a very experienced staff on which he places great reliance, he was exceeding his key performance metric (i.e., less than 10 Stockout situations per year), and that the external auditors have never mentioned any control deficiencies to him during the prior year end physical inventories.

In response to your inquiries about the inventory variances, Mr. Barton makes the following comments:

• Variances are normal and as long as the shrinkage is no more than the current 6% he is not concerned.

• The root cause for the shrinkage is due to a combination of factors, therefore he does not consider it a good use of resources to investigate the specific reasons why just to give an explanation to Accounting.

He suggested that any follow-up questions regarding the inventory system should be directed to Barbara Swanson in the Information System (IS) department and any follow-up questions regarding vendor pricing should be directed to Kimberly Adams, the Purchasing Department Director. As recommended, you follow-up by phone with the Purchasing Director and the Systems Analyst and learn the following:

**Purchasing Department**

The Purchasing Department is responsible for vendor selection and pricing negotiation. Pricing is negotiated at a percentage discount off of list price with vendors for the 500 stock items. The discount percentage varies by vendor and is based on volume. Notifications of changes in list pricing by the vendors are often delayed. Since pricing for non-stock items is not negotiated, they are purchased at list price. Purchasing Department personnel are responsible for recording all pricing in the perpetual inventory system for use by the Storeroom purchasing clerks in issuing purchase orders and valuing the inventory.

Purchasing works with the hospital departments to evaluate medical supplies to ensure supplies represent the optimal combination of quality and price. Based on these ongoing evaluations, new vendors or products are competitively bid. Based on data analytics performed by the Purchasing Department, it has continued to achieve its key metric (i.e., Special Orders < 20% of total supplies expense).

**System Access**
Role-based system access authorities are managed by the IS Department. The associated policy requires that any changes (e.g., new, revised, termed) to the access authorities assigned to employees must be submitted within 30 days of the status change by the requesting hospital department managers, including the Storeroom manager. The roles include Purchasing, Receiving, Requisitioning, Pricing, and Administrator.

- The Purchasing role can order stock and non-stock items. The pricing for stock items is maintained in the system and populates the purchase order. The delivery location can be designated as either Storeroom or “Other”. The “Other” location is for special order non-stock purchases and UCC purchases. The specific location must be manually recorded. Only the Storeroom Purchasing clerks have this role. Purchases over $100,000 require a secondary approval by the Storeroom Manager.
- The Receiving role can record the receipt of goods. The quantity is either manually recorded or can be automatically recorded at the full purchase order quantity by using a special “Receive All” function. Only the Receivers and UCC Managers have this role.
- The Requisitioning role can place orders for stock and non-stock items. Orders do not require a secondary approval. This role is limited to the Requisitioners, Purchasing clerks, Hospital department managers, and UCC Managers.
- The Pricing role can update the system for vendor pricing. This role is limited to Purchasing Department personnel.
- The Administrator role can perform all functions and is assigned only to the Storeroom Manager and the Systems Analyst.

The Systems Analyst requests hospital department managers to confirm that their employees continue to require their assigned level of system access on an annual basis.

Physical Inventory

Based upon the information obtained to date, you recommend and the Audit Director agrees that you should observe the upcoming year end physical inventory. In a prior conversation with the external audit firm, they have agreed to rely on Internal Audit’s observation of the inventory count. On the day of the inventory count, you arrive early and observe the following:

- As the Storeroom staff prepare to start the count, one member requests the Storeroom manager for his keys to open up the locked cabinets where the high-value surgical supplies and implants are stored.
- One of the Day Shift Receivers complains that the Evening Shift Receiver had once again utilized the “Receive All” function even though the packing slips noted that the last shipment included some backordered surgical supply and implant items that were not received. These items were also not included in the back order log for follow-up by the Purchasing clerks.
- Variances are found on many of the initial counts of the medical supply items because of unit of measure issues (e.g., 10 boxes per the system versus a physical count of 120 – 12 items per box)
• During the lunch break, you overhear one of the Purchasing clerks talking to the BMW car dealership about when she can pick up her new Bimmer.
• You observe only Storeroom personnel in the Storeroom except for one vendor who accessed the Storeroom through the back door by using their assigned badge. You also notice that throughout the day the overhead door to the loading dock remains closed.
• During the afternoon break, you overhear one of the Requisitioners making final arrangements for their upcoming vacation to the South Pacific island of Bora Bora with the travel agency.

At the end of the day, the perpetual inventory is adjusted to the actual count and the Storeroom Manager determines that the inventory value must be adjusted downward by $100,000 primarily related to surgical supplies and implants. The variance is communicated to the Accounting Manager.
You have a scheduled audit status meeting with your Audit Director. As you prepare for this meeting, please incorporate the key points in response to the questions below into your status report presentation.

1. What was the primary objective of your audit?

2. What are the key controls established to mitigate the inherent risks in the following processes:
   - Storeroom – Requisitioning, Ordering, Receiving, Picking, Physical Security
   - Accounting
   - Purchasing/Pricing
   - System Access
   - Key Metrics / Monitoring

3. What are the identified control deficiencies in the processes noted above?

4. What process changes would you recommend to improve the inventory controls and who should be responsible for implementing the corrective actions?

5. What additional information or testing, if any, would you want to obtain or perform, respectively, to determine the root causes for the variance?

6. Based on the initial results of your review, do you believe that the inventory variances are the result of poor control techniques or the result of fraud? If fraud is suspected, who is most likely to have committed the fraud and how was the fraud potentially perpetrated?

7. What recommended actions should be taken to reduce the risk of fraud within the storeroom process? What entity-level controls should be considered to reduce the risk of fraud?

8. What are the recommended next steps to complete your audit and communicate the results?