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had "probable cause" to file theft charges against O'Neil they could not be accused of "malicious prosecution."

Questions

1. Identify internal control weaknesses evident in Buranello's operations. What risks are posed by these internal control problems?
2. For each internal control weakness you listed in responding to the previous question, identify a measure that Buranello's could implement to remedy that weakness. Indicate whether these measures would be cost effective.
3. Prepare a list of internal control procedures for a restaurant other than the controls referred to in this case. For each control that you list, identify its underlying objective.
4. Do you believe that Barnes's plan to test Aaron O'Neil's honesty was appropriate? Was it ethical? What ethical responsibilities does a business's senior management or owner have when an employee is suspected of theft?

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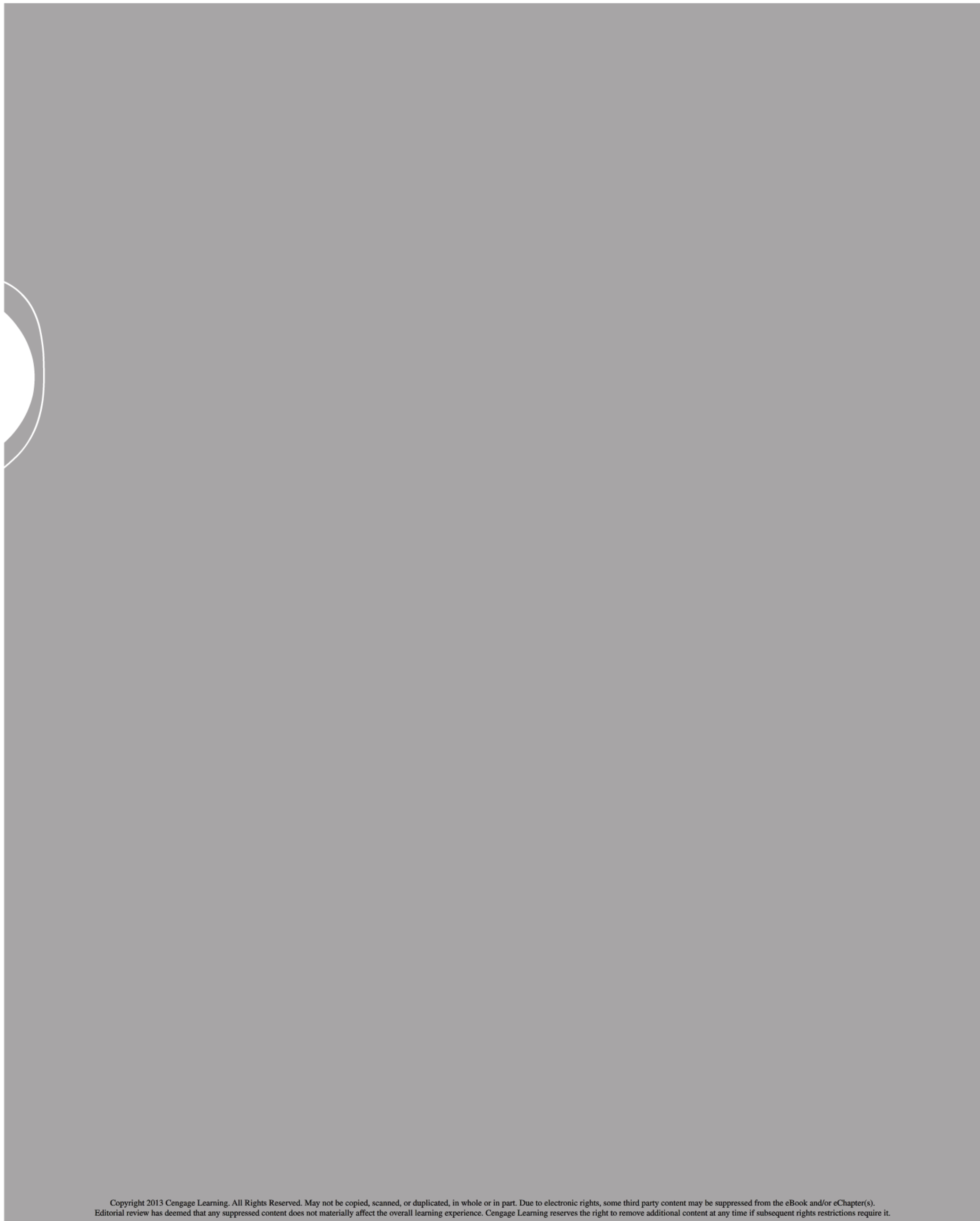

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CASE 3.4

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Goodner Brothers, Inc.

"Woody, that's $2,400 you owe me. Okay? We're straight on that?"

"Yeah, yeah. I got you."

"And you'll pay me back by next Friday?"

"Al. I said I'd pay you back by Friday, didn't I?"

"Just checkin'."

Borrowing money from a friend can strain even the strongest relationship. When the borrowed money will soon be plunked down on a blackjack table, the impact on the friendship can be devastating.

Woody Robinson and Al Hunt were sitting side by side at a blackjack table in Tunica, Mississippi. The two longtime friends and their wives were spending their summer vacation together as they had several times. After three days of loitering in the casinos that line the banks of the Mississippi River 20 miles south of Memphis, Woody found himself hitting up his friend for loans. By the end of the vacation, Woody owed Al nearly $5,000. The question facing Woody was how he would repay his friend.[1]

Two Pals Named Woody and Al

Woodrow Wilson Robinson and Albert Leroy Hunt lived and worked in Huntington, West Virginia, a city of 60,000 tucked in the westernmost corner of the state. The blue-collar city sits on the south bank of the Ohio River. Ohio is less than one mile away across the river, while Kentucky can be reached by making a 10-minute drive westward on Interstate 64. Woody and Al were born six days apart in a small hospital in eastern Kentucky, were best friends throughout grade school and high school, and roomed together for four years at college. A few months after they graduated with business management degrees, each served as the other's best man at their respective weddings.

Following graduation, Al went to work for Curcio's Auto Supply on the western outskirts of Huntington, a business owned by his future father-in-law. Curcio's sold lawnmowers, bicycles, and automotive parts and supplies, including tires and batteries, the business's two largest revenue producers. Curcio's also installed the automotive parts it sold, provided oil and lube service, and performed small engine repairs.

Within weeks of going to work for Curcio's, Al helped Woody land a job with a large tire wholesaler that was Curcio's largest supplier. Goodner Brothers, Inc., sold tires of all types and sizes from 14 locations scattered from southern New York to northwestern South Carolina and from central Ohio to the Delaware shore. Goodner concentrated its operations in midsized cities such as Huntington, West Virginia; Lynchburg, Virginia; Harrisburg, Pennsylvania; and Youngstown, Ohio, home to the company's headquarters.

Founded in 1979 by two brothers, T. J. and Ross Goodner, nearly three decades later Goodner Brothers' annual sales approached $40 million. The Goodner family dominated the company's operations. T. J. served as the company's chairman of the

1. The central facts of this case were drawn from a legal opinion. The names of the actual parties involved in the case and the relevant locations and dates have been changed. Additionally, certain of the factual circumstances reported in this case are fictionalized accounts of background material disclosed in the legal opinion.

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board and chief executive officer (CEO), while Ross was the chief operating officer (COO). Four second-generation Goodners also held key positions in the company.

Goodner purchased tires from several large manufacturers and then sold those tires at wholesale prices to auto supply stores and other retailers that had auto supply departments. Goodner's customers included Sears, Wal-Mart, Kmart, and dozens of smaller retail chains. The company also purchased discontinued tires from manufacturers, large retailers, and other wholesalers and then resold those tires at cut-rate prices to school districts, municipalities, and to companies with small fleets of automobiles.

Goodner Brothers hired Woody to work as a sales representative for its Huntington location. Woody sold tires to more than 80 customers in his sales region that stretched from the west side of Huntington into eastern Kentucky and north into Ohio. Woody, who worked strictly on a commission basis, was an effective and successful salesman. Unfortunately, a bad habit that he acquired during his college days gradually developed into a severe problem. A gambling compulsion threatened to wreck the young salesman's career and personal life.

Woody bet on any and all types of sporting events, including baseball and football games, horse races, and boxing matches. He also spent hundreds of dollars each month buying lottery tickets and lost increasingly large sums on frequent gambling excursions with his friend Al. By the summer of 2006 when Woody, Al, and their wives visited Tunica, Mississippi, Woody's financial condition was desperate. He owed more than $50,000 to the various bookies with whom he placed bets, was falling behind on his mortgage payments, and had "maxed out" several credit cards. Worst of all, two bookies to whom Woody owed several thousand dollars were demanding payment and had begun making menacing remarks that alluded to his wife, Rachelle.

Woody Finds a Solution

Upon returning to Huntington in early July 2006, Woody struck upon an idea to bail himself out of his financial problems: He decided to begin stealing from his employer, Goodner Brothers. Other than a few traffic tickets, Woody had never been in trouble with law enforcement authorities. Yet, in Woody's mind, he had no other reasonable alternatives. At this point, resorting to stealing seemed the lesser of two evils.

One reason Woody decided to steal from his employer was the ease with which it could be done. After several years with Goodner, Woody was very familiar with the company's sloppy accounting practices and lax control over its inventory and other assets. Goodner's executives preached one dominant theme to their sales staff: "Volume, volume, volume." Goodner achieved its ambitious sales goals by undercutting competitors' prices. The company's dominant market share in the geographical region it served came at a high price. Goodner's gross profit margin averaged 17.4 percent, considerably below the mean gross profit margin of 24.1 percent for comparable tire wholesalers. To compensate for its low gross profit margin, Goodner scrimped on operating expenses, including expenditures on internal control measures.

The company staffed its 14 sales outlets with skeletal crews of 10 to 12 employees. A sales manager supervised the other employees at each outlet and also worked a sales district. The remaining staff typically included two sales representatives, a receptionist who doubled as a secretary, a bookkeeper, and five to seven employees who delivered tires and worked in the unit's inventory warehouse. Goodner's Huntington location had two storage areas, a small warehouse adjacent to the sales office and a larger storage area two miles away that had previously housed a discount grocery store. Other than padlocks, Goodner provided little security for its tire inventory, which typically ranged from $300,000 to $700,000 for each sales outlet.

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Instead of an extensive system of internal controls, T. J. and Ross Goodner relied heavily on the honesty and integrity of the employees they hired. Central to the company's employment policy was never to hire someone unless that individual could provide three strong references, preferably from reputable individuals with some connection to Goodner Brothers. Besides following up on employment references, Goodner Brothers obtained thorough background checks on prospective employees from local detective agencies.

For almost three decades, Goodner's employment strategy had served the company well. Fewer than 10 of several hundred individuals employed by the company had been terminated for stealing or other misuse of company assets or facilities.

Each Goodner sales outlet maintained a computerized accounting system. These systems typically consisted of an "off-the-shelf" general ledger package intended for a small retail business and a hodgepodge of assorted accounting documents. Besides the Huntington facility's bookkeeper, the unit's sales manager and two sales representatives had unrestricted access to the accounting system.

Because the large volume of sales and purchase transactions often swamped the bookkeeper, sales representatives frequently entered transactions directly into the system. The sales reps routinely accessed, reviewed, and updated their customers' accounts. Rather than completing purchase orders, sales orders, credit memos, and other accounting documents on a timely basis, the sales reps often jotted the details of a transaction on a piece of scrap paper. The sales reps eventually passed these "source documents" on to the bookkeeper or used them to enter transaction data directly into the accounting system.

Sales reps and the sales manager jointly executed the credit function for each Goodner sales outlet. Initial sales to new customers required the approval of the sales manager, while the creditworthiness of existing clients was monitored by the appropriate sales rep. Sales reps had direct access to the inventory storage areas. During heavy sales periods, sales reps often loaded and delivered customer orders themselves.

Each sales office took a year-end physical inventory to bring its perpetual inventory records into agreement with the amount of inventory actually on hand. One concession that T. J. and Ross Goodner made to the policy of relying on their employees' honesty was mandating one intra-year inventory count for each sales office. Management used these inventories, which were taken by the company's two-person internal audit staff, to monitor inventory shrinkage at each sales outlet.

Goodner's inventory shrinkage significantly exceeded the industry norm. The company occasionally purchased large shipments of "seconds" from manufacturers; that is, tires with defects that prevented them from being sold to major retailers. The tires in these lots with major defects were taken to a tire disposal facility. A sales office's accounting records were not adjusted for these "throwaways" until the year-end physical inventory was taken.

Selling Tires on the Sly

Within a few days after Woody hatched his plan to pay off his gambling debts, he visited the remote storage site for the Huntington sales office. Woody rummaged through its dimly lit and cluttered interior searching for individual lots of tires that apparently had been collecting dust for several months. After finding several stacks of tires satisfying that requirement, Woody jotted down their specifications in a small notebook. For each lot, Woody listed customers who could potentially find some use for the given tires.

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Later that same day, Woody made his first "sale." A local plumbing supply dealer needed tires for his small fleet of vehicles. Woody convinced the business's owner that Goodner was attempting to "move" some old inventory. That inventory would be sold on a cash basis and at prices significantly below Goodner's cost. The owner agreed to purchase two dozen of the tires. After delivering the tires in his large pickup, Woody received a cash payment of $900 directly from the customer.

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Over the next several months, Woody routinely stole inventory and kept the proceeds. Woody concealed the thefts in various ways. In some cases, he would charge merchandise that he had sold for his own benefit to the accounts of large volume customers. Woody preferred this technique since it allowed him to reduce the inventory balance in the Huntington facility's accounting records. When customers complained to him for being charged for merchandise they had not purchased, Woody simply apologized and corrected their account balances. If the customers paid the improper charges, they unknowingly helped Woody sustain his fraudulent scheme.

Goodner's customers frequently returned tires for various reasons. Woody completed credit memos for sales transactions voided by his customers, but instead of returning the tires to Goodner's inventory, he often sold them and kept the proceeds. Goodner occasionally consigned tires to large retailers for promotional sales events. When the consignees returned the unsold tires to Goodner, Woody would sell some of the tires to other customers for cash. Finally, Woody began offering to take throwaways to the tire disposal facility in nearby Shoals, West Virginia, a task typically assigned to a sales outlet's delivery workers. Not surprisingly, most of the tires that Woody carted off for disposal were not defective.

The ease with which he could steal tires made Woody increasingly bold. In late 2006, Woody offered to sell Al Hunt tires he had allegedly purchased from a manufacturer (by this time, Al owned and operated Curcio's Tires). Woody told Al that he had discovered the manufacturer was disposing of its inventory of discontinued tires and decided to buy them himself. When Al asked whether such "self-dealing" violated Goodner's company policy, Woody replied, "It's none of their business what I do in my spare time. Why should I let them know about this great deal that I stumbled upon?"

At first reluctant, Al eventually agreed to purchase several dozen tires from Woody. No doubt, the cut-rate prices at which Woody was selling the tires made the decision much easier. At those prices, Al realized he would earn a sizable profit on the tires.

Over the next 12 months, Woody continued to sell "closeout" tires to his friend. After one such purchase, Al called the manufacturer from whom Woody had reportedly purchased the tires. Al had become suspicious of the frequency of the closeout sales and the bargain basement prices at which Woody supposedly purchased the tires. When he called the manufacturer, a sales rep told Al that his company had only one closeout sale each year. The sales rep also informed Al that his company sold closeout merchandise directly to wholesalers, never to individuals or retail establishments.

The next time Al spoke to Woody, he mentioned matter-of-factly that he had contacted Woody's primary supplier of closeout tires. Al then told his friend that a sales rep for the company indicated that such merchandise was only sold to wholesalers.

"So, what's the point, Al?"

"Well, I just found it kind of strange that, uh, that . . ."

"C'mon, get to the point, Al."

"Well, Woody, I was just wondering where you're getting these tires that you're selling."

"Do you want to know, Al? Do you really want to know, Buddy? I'll tell you if you want to know," Woody replied angrily.

After a lengthy pause, Al shrugged his shoulders and told his friend to "just forget it." Despite his growing uneasiness regarding the source of the cheap tires, Al continued to buy them and never again asked Woody where he was obtaining them.

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Internal Auditors Discover Inventory Shortage

On December 31, 2006, the employees of Goodner's Huntington location met to take a physical inventory. The employees treated the annual event as a prelude to their New Year's Eve party. Counting typically began around noon and was finished within three hours. The employees worked in teams of three. Two members of each team climbed and crawled over the large stacks of tires and shouted out their counts to the third member who recorded them on preformatted count sheets.

Woody arranged to work with two delivery workers who were relatively unfamiliar with Goodner's inventory since they had been hired only a few weeks earlier. He made sure that his team was one of the two count teams assigned to the remote storage facility. Most of the inventory he had stolen over the previous six months had been taken from that site. Woody estimated that he had stolen approximately $45,000 of inventory from the remote storage facility, which represented about 10 percent of the site's book inventory. By maintaining the count sheets for his team, Woody could easily inflate the quantities for the tire lots that he and his team members counted.

After the counting was completed at the remote storage facility, Woody offered to take the count sheets for both teams to the sales office where the total inventory would be compiled. On the way to the sales office, he stopped in a vacant parking lot to review the count sheets. Woody quickly determined that the apparent shortage remaining at the remote site was approximately $20,000. He reduced that shortage to less than $10,000 by altering the count sheets prepared by the other count team.

When the year-end inventory was tallied for Goodner's Huntington location, the difference between the physical inventory and the book inventory was $12,000, or 2.1 percent. That percentage exceeded the historical shrinkage rate of approximately 1.6 percent for Goodner's sales offices. But Felix Garcia, the sales manager for the Huntington sales office, did not believe that the 2006 shrinkage was excessive. As it turned out, neither did the accounting personnel and internal auditors at Goodner's corporate headquarters.

Woody continued "ripping off" Goodner throughout 2007. By midyear, Woody was selling most of the tires he stole to Al Hunt. On one occasion, Woody warned Al not to sell the tires too cheaply. Woody had become concerned that Curcio's modest prices and its increasing sales volume might spark the curiosity and envy of other Huntington tire retailers.

In October 2007, Goodner's internal audit team arrived to count the Huntington location's inventory. Although company policy dictated that the internal auditors count the inventory of each Goodner sales outlet annually, the average interval between the internal audit inventory counts typically ranged from 15 to 20 months. The internal auditors had last counted the Huntington location's inventory in May 2006, two months before Woody Robinson began stealing tires. Woody was unaware that the internal auditors periodically counted the entire inventory of each Goodner operating unit. Instead, he understood that the internal auditors only did a few test counts during their infrequent visits to the Huntington sales office.

After completing their inventory counts, the two internal auditors arrived at an inventory value of $498,000. A quick check of the accounting records revealed a book inventory of $639,000. The auditors had never encountered such a large difference between the physical and book inventory totals. Unsure what to do at this point, the auditors eventually decided to take the matter directly to Felix Garcia, the Huntington sales manager.

The size of the inventory shortage shocked Garcia. He insisted that the auditors must have overlooked some inventory. Garcia, the two internal auditors, and three delivery workers spent the following day recounting the entire inventory. The resulting

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physical inventory value was $496,000, $2,000 less than the original value arrived at by the auditors.

Following the second physical inventory, the two internal auditors and Garcia met at a local restaurant to review the Huntington unit's inventory records. No glaring trends were evident in those records to either Garcia or the auditors. Garcia admitted to the auditors that the long hours required "just to keep the tires coming and going" left him little time to monitor his unit's accounting records. When pressed by the auditors to provide possible explanations for the inventory shortage, Garcia erupted. "Listen. Like I just said, my job is simple. My job is selling tires. I sell as many tires as I can, as quickly as I can. I let you guys and those other suits up in Youngstown track the numbers."

The following day, the senior internal auditor called his immediate superior, Goodner's chief financial officer (CFO). The size of the inventory shortage alarmed the CFO. Immediately, the CFO suspected that the inventory shortage was linked to the Huntington unit's downward trend in monthly profits over the past two years.

Through 2005, the Huntington sales office had consistently ranked as Goodner's second or third most profitable sales outlet. Over the past 18 months, the unit's slumping profits had caused it to fall to the bottom one-third of the company's sales outlets in terms of profit margin percentage. Tacking on the large inventory shortage would cause the Huntington location to be Goodner's least profitable sales office over the previous year and one-half.

After discussing the matter with T. J. and Ross Goodner, the CFO contacted the company's independent audit firm and arranged for the firm to investigate the inventory shortage. The Goodners agreed with the CFO that Felix Garcia should be suspended with pay until the investigation was concluded. Garcia's lack of a reasonable explanation for the missing inventory and the anger he had directed at the internal auditors caused Goodner's executives to conclude that he was likely responsible for the inventory shortage.

Within a few days, four auditors from Goodner's independent audit firm arrived at the Huntington sales office. Goodner's audit firm was a regional CPA firm with six offices, all in Ohio. Goodner obtained an annual audit of its financial statements because one was demanded by the New York bank that provided the company with a line of credit. Goodner's independent auditors had never paid much attention to the internal controls of the client's sales offices. Instead, they performed a "balance sheet" audit that emphasized corroborating Goodner's year-end assets and liabilities.

During their investigation of the missing inventory, the auditors were appalled by the Huntington unit's lax and often nonexistent controls. The extensive control weaknesses complicated their efforts to identify the source of the inventory shortage. Nevertheless, after several days, the auditors' suspicions began settling on Woody Robinson.

A file of customer complaints that Felix Garcia kept in his desk revealed that over the past year an unusually large number of customer complaints had been filed against Woody. During that time, 14 of his customers had protested charges included on their monthly statements. Only two customers serviced by the other sales rep had filed similar complaints during that time frame.

When questioned by the auditors, Garcia conceded that he had not discussed the customer complaints with Woody or the other sales rep. In fact, Garcia was unaware that a disproportionate number of the complaints had been filed against Woody. When Garcia received a customer complaint, he simply passed it on to the appropriate sales rep and allowed that individual to deal with the matter. He maintained a file of the customer complaints only because he had been told to do so by the previous sales manager whom he had replaced three years earlier.

After the independent auditors collected other incriminating evidence against Woody, they arranged for a meeting with him. Also attending that meeting were Goodner's CFO and Felix Garcia. When the auditors produced the incriminating

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evidence, Woody disclaimed any knowledge of, or responsibility for, the inventory shortage. Woody's denial provoked an immediate and indignant response from Goodner's CFO. "Listen, Robinson, you may have fooled the people you've been working with, but you're not fooling me. You'd better spill the beans right now, or else." At this point, Woody stood, announced that he was retaining an attorney, and walked out of the meeting.

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EPILOGUE

Goodner Brothers filed a criminal complaint against Woody Robinson two weeks after he refused to discuss the inventory shortage at the Huntington sales office. A few weeks later, Woody's attorney reached a plea bargain agreement with the local district attorney. Woody received a five-year sentence for grand larceny, four years of which were suspended. He eventually served seven months of that sentence in a minimum-security prison. A condition of the plea bargain agreement required Woody to provide a full and candid written summary of the fraudulent scheme that he had perpetrated on his employer.

Woody's confession implicated Al Hunt in his theft scheme. Over the 15 months that Woody had stolen from Goodner, he had "fenced" most of the stolen inventory through Curcio's Tires. Although the district attorney questioned Al Hunt extensively, he decided not to file criminal charges against him.[2]

Goodner Brothers filed a $185,000 insurance claim to recoup the losses resulting from Woody's thefts. The company's insurer eventually paid Goodner $130,000, which equaled the theft losses that Goodner could document. After settling the claim, the insurance company sued Curcio's Tires and Al Hunt to recover the $98,000 windfall that Curcio's allegedly realized due to Al Hunt's involvement in the theft ring. The case went to federal district court where a judge ordered Hunt to pay $64,000 to Goodner's insurer. Al Hunt then sued Woody Robinson to recover that judgment. The judge, who had presided over the earlier case, quickly dismissed Al Hunt's lawsuit. According to the judge, Al Hunt's complicity in the fraudulent scheme voided his right to recover the $64,000 judgment from his former friend.

Questions

1. List what you believe should have been the three to five key internal control objectives of Goodner's Huntington sales office.
2. List the key internal control weaknesses that were evident in the Huntington unit's operations.
3. Develop one or more control policies or procedures to alleviate the control weaknesses you identified in responding to Question 2.
4. Besides Woody Robinson, what other parties were at least partially responsible for the inventory losses Goodner suffered? Defend your answer.

2. Ironically, Woody's confession also implicated his wife, Rachelle. After Woody revealed that Rachelle had typically deposited the large checks written to him by Al Hunt, the district attorney reasoned that Rachelle must have been aware of Woody's fraudulent scheme and was thus an accessory to his crime. However, Woody insisted that he had told his wife the checks were for gambling losses owed to him by Al. After interrogating Rachelle at length, the district attorney decided not to prosecute her.

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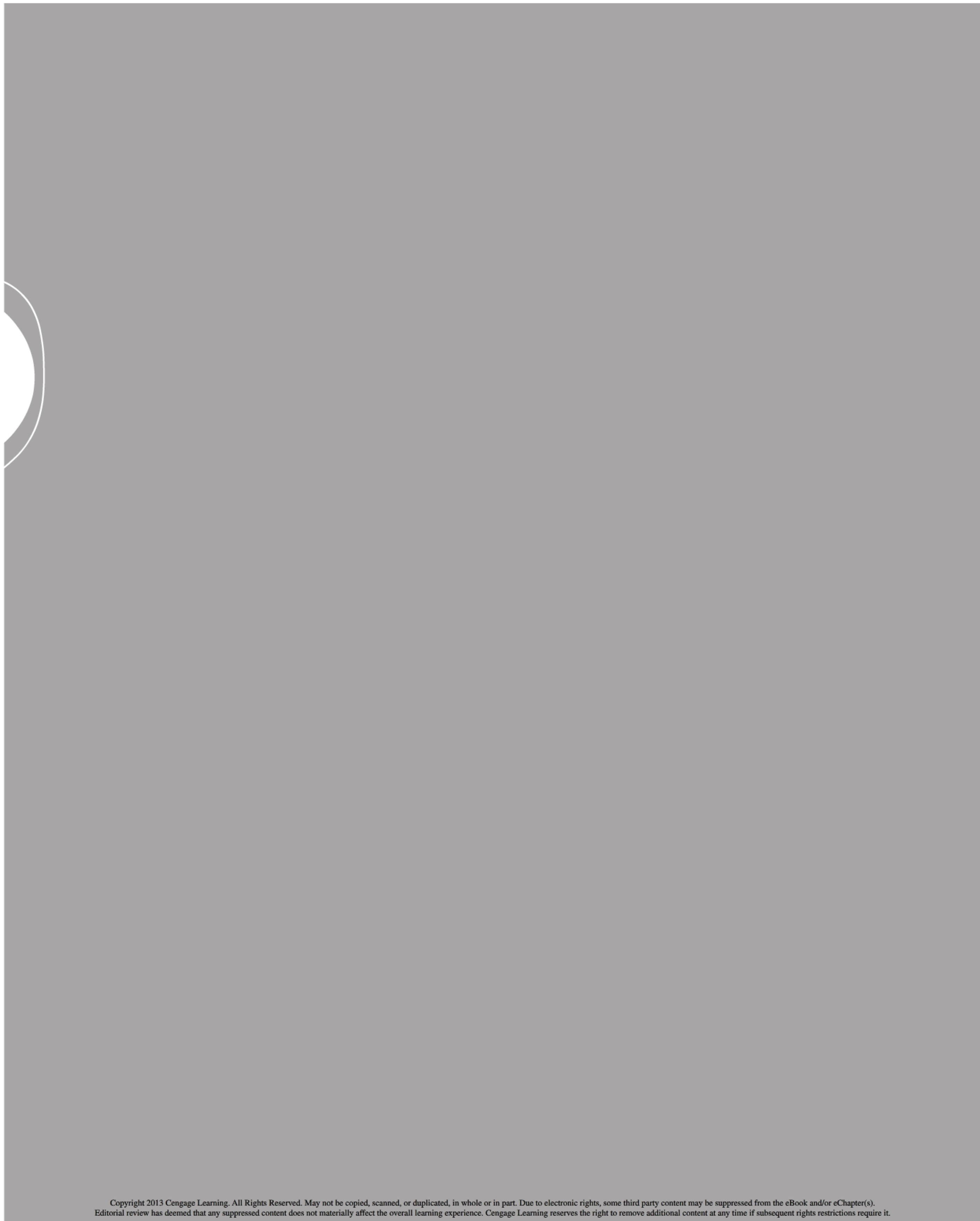

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