Case 22-7c
EGF Apparel

EGF Apparel Inc. (EGF or the "Company") is a U.S. public company with a fiscal year-end of September 30, 20X9, that files quarterly and annual reports with the U.S. Securities and Exchange Commission (SEC). EGF is a leading retail chain operating more than 150 department stores across the continental United States. EGF department stores offer customers a variety of nationally advertised products, including clothing, shoes, jewelry, and other accessories. The Company's supply chain of products is managed through a single warehouse and distribution facility located in Lincoln, Nebraska.

EGF has a centralized accounting and finance structure at its corporate headquarters, where the processes and controls related to all significant account balances occur. EGF recognizes revenues from retail sales at the point of sale to its customers. Discounts provided to customers by the Company at the point of sale, including discounts provided in connection with loyalty cards, are recognized as a reduction in sales as the products are sold. Cost of goods sold for the Company primarily consist of inbound freight and costs relating to purchasing and receiving, inspection, depreciation, warehousing, internal transfer, and other costs of distribution.

Case Facts

In planning the FY20X9 audit in May 20X9, the engagement team obtained an understanding of the internal controls related to cash disbursements. This understanding was developed through the engagement team's walk-through of the cash disbursements process. As part of its walk-through procedures, the engagement team made inquiries of appropriate personnel, inspected relevant documentation, and in certain cases, observed the control performers carrying out required control procedures. As a result, the engagement team concluded that there were no significant changes to the cash disbursements process in the current year.

The engagement team identified three risks of material misstatement relating to the cash disbursements process. In addition, the team identified seven control activities within the cash disbursements process that address the identified risks of material misstatement in the excerpted worksheet.

Audit Issue

On July 1, 20X9, the Accounts Payable (AP) Manager received an e-mail inquiry about the process required for a vendor to change its bank account information. The e-mail was sent from Jane Williams at a domain address listed as "Shoe-Designers." Shoe Designers is a manufacturer that supplies EGF-branded shoes to EGF's west region department stores. In addition, Jane Williams is the primary contact at Shoe Designers with whom the Company typically interacts.

The AP Manager responded to the e-mail request on July 15, 20X9, with the procedures required of the vendor, which include completing a vendor bank account request form. On July 20, 20X9, the AP Manager received a reply e-mail from Jane Williams at "Shoe-

Designers" with a completed vendor bank account request form, which included Jane Williams' signature, new bank account information, and other related information.

Upon receiving the vendor bank account request form, the AP Manager completed a separately required Vendor Change Form for internal processing. The Vendor Change Form is completed for new vendors or changes to existing vendors' information, including bank account information. The AP Manager sent the completed Vendor Change Form to EGF's Assistant Controller, who reviewed and approved the request on July 24, 20X9. The bank account information was updated within the Vendor Master File on July 26, 20X9.

Throughout the month of August 20X9, valid Shoe Designers invoices were processed through the Company's accounts payable process, and the valid invoices were paid in accordance with the Company's process and controls for cash disbursements and wire transfers. On September 2, 20X9, the Company received an inquiry from Shoe Designers about the expected timing of the $3 million in outstanding invoices. As a result of the direct interaction with Shoe Designers' employee Jane Williams, the Company determined that the previous vendor bank account change form was received from a fraudulent domain name with the intent to defraud the Company. The e-mail domain for Shoe Designers is "Shoe Designers," with no hyphen, rather than "Shoe-Designers," with a hyphen. Both e-mails received from "Shoe-Designers" were determined to be from a fraudulent source (that also fraudulently used Jane Williams's name in the e-mail). Because the bank account information for Shoe Designers was changed (as a result of the July 1, 20X9, e-mail request) approximately $3 million in payments was wired to an incorrect bank account.

As noted above, there are two employees within the Company that were involved in processing and approving the Vendor Change Form. The Company's policy on bank account change requests was put into effect and communicated by EGF's Assistant Controller in an October 1, 20X8, e-mail that indicated that for each Vendor Change Form requesting a vendor bank account change, the accounts payable department was required to (1) obtain a previously processed and paid invoice from the vendor requesting the bank account change, (2) call the vendor using the contact information obtained from the prior invoice, (3) verify the authenticity of the requested bank account change request by directly contacting the vendor, and (4) include all relevant information obtained in steps 1 through 3 as an attachment to the Vendor Change Form. The Company's control description relating to the review of a Vendor Change Form by the Assistant Controller is not explicit regarding the specific attributes of the review. However, because the policy was distributed by the Assistant Controller, who is also the control owner (e.g., performs the review), there is a presumption that the Assistant Controller would understand that as part of her review, she should evaluate whether the AP Manager obtained sufficient information to confirm the authenticity of the bank account change request.

Other Relevant Facts

- Materiality — $9 million.

- The Company processed approximately 110 vendor requested bank account changes during FY20X9 before the realization that the request from “Shoe-Designers” was fraudulent (from October 1, 20X8, to September 2, 20X9). After the identification of the misappropriation of assets, the Company’s internal audit department obtained and reviewed all 110 Vendor Change Forms reviewed by the Assistant Controller, noting that only five Vendor Change Forms contained the information required by the policy. In addition, internal audit determined that the primary review procedure performed by the Assistant Controller related to the verification that the bank account number was appropriately included on the Vendor Change Form. This procedure was performed in all cases before the bank account information was input into the accounts payable system.
- The total wire transfer payments made to the 110 vendors that requested bank account changes in FY20X9 totaled approximately $58.2 million (based on an analysis prepared by Internal Audit of the invoices processed and paid by the Company after the processing of a Vendor Change Form for the 110 vendors).
- There are more than 30 vendors with annual purchase activity of over $30 million (12 of which have purchase activity of over $50 million); thus, the amount of payments made to any single vendor in a payables cycle could approximate $3 million, assuming a cycle of 30 days.
- The Company’s Chief Security Officer completed an internal investigation and concluded that there was no indication that the AP Manager and Assistant Controller were involved in the scheme that resulted in the $3 million misappropriation.
- After the determination on September 2, 20X9, that the Vendor Change Form was from a fraudulent source, the Company ceased processing additional Vendor Change Forms until it could understand the root cause of the deficiency. On October 1, 20X9, the Assistant Controller sent a reminder regarding the importance of following the vendor bank account request change policy. The e-mail also highlighted an enhancement to the process, which primarily included an enhancement to the Vendor Change Form. The form was revised to include the following three new, explicit sections that are required to be completed: (1) contact phone number pulled from previously processed and paid vendor invoice, (2) name of individual at the vendor (from a previous invoice) that was contacted, and (3) date discussed/contacted. The policy e-mail reiterated the requirement to include a copy of the previously processed vendor invoice with the Vendor Change Form.
- Internal Audit performed a thorough evaluation of the competency of the Assistant Controller and concluded that notwithstanding the Assistant Controller’s lack of historical performance, the Assistant Controller was suitably competent to perform the control.

Engagement Team Note

As a result of the Audit Issue described above, the engagement team identified a control deficiency in the following control:

CD5C — The Assistant Controller reviews each Vendor Change Form requesting a bank account change, including the attached supporting documentation which includes the following:

1. *A previously processed and paid invoice from the vendor requesting the bank account change.*
2. *Details regarding a phone conversation with the vendor using the contact information from the obtained invoice.*
3. *Verification of the authenticity of the requested bank account change request.*

The engagement team concluded that the Company's control description regarding the Assistant Controller's review of the Vendor Change Form is not prescriptive regarding the specific attributes of the review. However, based on the Company's policy on bank account change requests put into effect and communicated by the Assistant Controller in an October 1, 20X8, e-mail and the supporting documentation described in the control description, there is a presumption that the Assistant Controller would understand the primary objective of the control, which is to evaluate whether sufficient information was obtained by the AP Manager to confirm that the bank account change request was authentic.

Required:

1. What are the key considerations when evaluating the severity of a deficiency in a control that directly addresses a risk of material misstatement?
2. Does the Assistant Controller's failure to adequately review the Vendor Change Form represent a deficiency in the design or in the operating effectiveness of the control or both?
3. Is the failure in the vendor request change form control indicative of a material weakness in internal control over financial reporting?
4. Would the deficiency warrant disclosure in the EGF's Form 10-K, Item 9A? If so, what information would the Company be expected to disclose?
5. What implications does the deficiency have on other direct or indirect controls?