

Peach blossom
cologne company
essay sample



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After analyzing the financial statements of Peach Blossom Cologne Company, we have concluded through the change analysis the following accounts contain some measure of audit risk. In analyzing the change analysis we concluded on threshold amounts of any change exceeding 15% and above the amount of \$5000. If both criteria were met, a business reason and possible client error reason were provided. The following accounts provide the possibility for audit risk:

Cash- Business reason: Acquired a loan during the period to obtain cash;

Client error: Not properly recording all expenses paid in cash Accounts

Receivable- Business reason: Increase in sales; Client error: recording sales in the wrong period (cutoff error) Allowance for Bad debts- Business reason:

changed percentage of sales used to record; Client error- Used incorrect

percentage to calculate to raise revenue amounts Inventory- Business

reason: Reduced inventory through selling goods at a rate faster than produced at current level of production; Client error: were misclassifying

goods as inventory instead of sales or WIP (cutoff error) Machine and

Equipment- Business reason: purchased more equipment during the year

(forklift and storage machine); client error- Overstated by not writing off

machines when fully depreciated Acc Dep. Machine and Equip- Business

reason: had more machines and thus higher depreciation; client error: Not using the correct depreciation rates (too high for purchases)

Auto Equip- Business reason: Purchased company car (sedan); Client error:

classified personal automotive expenses to the company Acc Dep. Auto

Equip- Business reason: More cars increased the depreciation amount; client

error: not using the correct depreciation rates (too high to justify purchase)

Accounts Payable- Business reason: Purchased more items with cash or purchased fewer items; Client error- not recorded all liability payments due

Note Payable Short term- Business reason: Paid off the note with its increased sales during 2009; Client error: misrepresented the note to change company outlook

Note payable long term- Business reason: Acquired loan during year from bank (in minutes); Client error- used short term note and moved to long term

Retained Earnings- Business reason: rose because net income went up; Client error: Did not raise to the same amount as net income so something else could be affecting the number

COGS- Business reason: more items are being produced so the costs rise; Client error: used items not factorable into COGS to reduce amount and thus raise gross margin

Professional Expense- Business reason: Hired consultants to help when the business;

Client error- Could have classified personnel on payroll's expenses and thus increased the expense amount

Insurance- Business reason: Costs increased for the current insurance plan (for new machines/ cars); Client error: Employees are submitting expenses not covered and are paid by the company

Interest Expense- Business reason: Paid off a loan so lower payments due on long term note; client error- Did not factor the new interest payments into interest expense (ie added it to the asset)

Sale of Fixed Assets- Business reason: Sold a damaged good at a loss for the company to acquire new piece of equipment (forklift); client error- recorded as AR instead of the correct account

Tax Expense- Business reason: Should be charged more tax due to increased income; Client error- Used incorrect percentage to reduce level of tax for the company

Net Income- Business

reason: Higher sales resulted in more income; Client error: Did not properly classify all expenses

Analysis of Questionable Accounts:

Peach Blossom Cologne Company had questionable accounts that did not change when a change was expected. These accounts are discussed below:

Allowance for Bad Debts- This account is calculated using a percentage of accounts receivable. This was a major problem account because with accounts receivable being almost 90% higher than last year, the allowance for doubtful accounts was actually lower. There are some items that could affect the account (more reliable suppliers lowering the percentage calculated), but this seems to go against the increase in accounts receivable. It will be important for the audit team to find the underlying cause for the decrease in the percentage estimated. Depreciation expense- Depreciation did increase from the prior year, but not to the extent which would have been expected. Peach Blossom made many equipment purchases in office, auto, and machines all increasing from the prior period. It would be expected to have increased at a higher rate. The audit team must figure out which method of depreciation Peach Blossom is using and make sure first year depreciation on assets is being calculated.

Assessment of Risk of Financial Failure:

After analyzing the financial ratios of Peach Blossom Cologne Company, we place the company at a low risk of client financial failure. The amount in sales, net income, and debt the company has incurred show the company does not have an issue paying its liabilities. The ratios are analyzed below in order to show the reasoning behind our distinction of the risk of financial

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failure. Current and quick ratios- The current ratio shows the companies' ability to pay off its debt obligations in a timely manner. The ratios for Peach Blossom for the past two years are well above the industry averages of both of the ratios.. It is therefore unlikely the current ratio would contribute to the risk of Peach Blossom failing. The quick ratio shows how much of current assets are made up of inventory to show another financial picture. Both of the firms have almost doubled last year's ratios showing it is a stable firm. As auditors we must make sure they are properly classifying the accounts used to calculate the ratios as to not try and persuade investors with the promising financials.

Accounts Receivable turnover- The AR turnover calculates the ability of Peach Blossom to extend and receive credit from purchasers. The AR turnover is above the industry average, but fell significantly from last year. This shows they are collecting slower than last year, and could show less AR amounts being collected compared to last year. Inventory turnover- This ratio shows how quickly Peach Blossom is selling and producing more inventory. Peach Blossom has been well below the industry average for the past two years. However, last year they increased the number to closer to the average showing improvement in that ratio category. Asset turnover- This ratio shows how well Peach Blossom is using its assets to produce revenue for the company. The asset turnover is lower than the industry average, but like the inventory turnover has increased the past two years. We hope to also see some improvement during the next year in this ratio category. Times Interest Earned- This ratio shows Peach Blossom's ability to

honor its debt payments. This ratio is over seven times the industry average. This ratio shows great potential for Peach Blossom and a low risk of failure.

Overall Appraisal of Audit Risk:

At the conclusion of analytical procedures and risk analysis, we place the overall assessment of audit risk at between a low and moderate level.

Reason for low audit risk:

Should easily meet its debt obligations

High management integrity and no management changes

Strong internal controls developed and implemented

Firm familiar with Peach Blossom should lower audit failure risk Most accounts increased as would have been expected due to sales numbers

Litigation risk low with mutual communication between parties Many familiar employees in complying with audit

Possible concerns:

Peach Blossom is familiar with us as auditors

Some accounts had questionable balances

New lead auditor for the audit

Litigation risk could rise with them not being familiar with new auditor policies New employee may be asked to perform tasks for other without knowing it is breaking procedure