Ocean manufacturing

Business, Industries

The client acceptance process can be quite complex. Discuss five procedures an auditor should perform in determining whether to accept a client. Which of these five are required by auditing standards and identify the applicable standards?

1. Obtain an understanding of the client's business and operations. Consideration should be given to reading available financial information regarding the prospective client such as annual reports, registration statements, Forms 10-K, other reports to regulatory agencies and income tax returns.

2. Inquire as to the general reputation of high ranking employees, influential directors and shareholders, as well as the entity itself. Carefully consider any matters that may negatively reflect on management's integrity, ability and attitude. Such inquiries may be directed to the prospective client's bankers, legal counsel, underwriters, and others in the business community. Background checks obtained by investigative firms may also be useful.

3. Consider management's response to observations about or suggestions for improvements in internal controls made by the predecessor auditor and/or the internal auditor.

4. Consider the composition and autonomy of the Board of Directors and the Audit Committee, including the number of independent outside directors.

5. Communicate with the predecessor auditor in accordance with the provisions of Statement on Auditing Standards (SAS) No. 84 [AU315]. Inquiries should be directed to the integrity of management and the reasons for the change in auditor.

The following situations should be carefully considered in assessing whether to accept a client: o There has been a disagreement with the previous auditor over accounting principles or practices; financial statementdisclosures; auditing scope; or the Form 8-K discloses a reportable event as defined in Securities and Exchange Commission Regulation S-K. o The previous auditor resigned or declined to stand for re-election or there is no clear reason for the cessation of the client relationship. o Access to the predecessor auditor's working papers has been denied. Other CPA firms have declined to serve the prospective client. There appears to be evidence of " opinion shopping. "

2. Return on Equity (ROE= Net profit after tax /Total Shareholders' Equity * 100) 2521/35469 x100 = 7. 11% Return on Assets (ROA= Net profit after tax / Total Assets * 100)2521/66820 x 100 = 3. 77 Unfavorable Assets to Equity (Total Assets / Total Shareholders' Equity) 66821/35469 = 1. 88 favorable Accounts Receivable Turnover (Sales / Account receivable) 104026/7936 = 13. 10 favorable Average Collection Period (Account receivable / Sales * 365) 7936104026 x 365 = 27. 4 favorable Inventory Turnover (Cost of sales / Inventory) 69177/10487 = 6. 6 Unfavorable Days in Inventory (Inventory / Cost of sales * 365) 10487/69177 x365= 44. 3 Favorable Debt Ratio (Total Liabilities / Total Assets)31352/66821 = 0. 47 Not available (industry figures) Debt to Equity (Total Liabilities / Total Shareholders' Equity) 31353/35469 = 0. 88 Favorable Times Interest Earned (Profit before interest and tax / Interest expense) 6242/1474 = 4. 23 Favorable Current Ratio (Current assets / Current liabilities)27064/14118 = 1. 2 favorable Profit

Margin (Net Profit before interest and tax / Sales * 100) 6242/104026 x100 = 6. 00

Unfavorable The comparison needs to be done for the audited accounts and since the audited accounts are available for 2001 and 2000 but the industry figures are available only for 2001 and 2002 we have to select the year 2001 for comparison. The accounts show that the company is healthy and the ratios are mainly favorable except that the company is not properly leveraged and this is leading to a loss of opportunities and a lower profit margin and lower return on equity. There are no grounds of objection emanating from the ratios and the company can be accepted for auditing.

3. What non-financial matters should be considered before accepting Ocean as a client? How important are these issues to the client acceptance decision? Why? In order to minimize the likelihood of association with a client whose management lacks integrity, Statement on Quality Control Standards No. 2, System of Quality Control for a CPA Firm's Accounting and Auditing Practice, (QC Section 20. 4) (applicable to auditing and accounting and review services) provides that " policies and procedures should be established for deciding whether to accept or continue a client relationship and to perform a specific engagement for that client (QC Section 20. 14)", to minimize the likelihood of the specific policies and procedures established and the nature and extent to which they may be documented may vary significantly from firm to firm. Throughout the process, from initial consideration about accepting or continuing a client to issuance of an audit report, auditors are faced with risk.

This risk can be thought of as having three components: ? The entity's business risk - The risk that the entity will not survive or will not be profitable. ? The auditor's business risk - The risk to the auditor from association with the client, consisting of the risk of potential litigation costs and the related effect on the auditor's reputation and the risk of other costs (not related to litigation) such as the effects on fee realization. ? The auditor's audit risk - The risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated.

The following discussion highlights matters that a firm may wish to consider in connection with establishing policies and procedures for client acceptance and continuance. The extent to which a firm may choose to employ any of the following is, with the exception of certain procedures required by generally accepted auditing standards, largely a matter of professional judgment. The discussion of specific policies and procedures is intended to be thought-provoking and useful to a firm in assessing the particular client acceptance and continuance policies and procedures it may choose to employ in its practice.

4a) Ocean wants Barnes and Fischer to aid in developing and improving their IT system. What are the advantages and disadvantages of having the same audit firm provide both auditing and consulting services? Given current rules on professional independence in the Joint Code of Professional Conduct, will Barnes and Fischer be able to help Ocean with their IT system and still provide a financial statement audit?

No, given the current rules on professional independence in the Joint Code of Professional Conduct, Barnes and Fisher will not be able to help Ocean with heir IT system and still provide a financial statement audit. This appointment as an IT system consultant violates this rule: " Consider whether any financial interests or relationships exist that would impair the appearance of the firm's independence from the client and preclude its expression of an opinion on the entity's financial statements. The firm should consider Rule 101 of the AICPA Code of Professional Ethics. For clients that are public companies, the firm should also consider the requirements of the SEC ". and also, Consider any potential conflicts of interest that could result from the acceptance of a client"

4 b. As indicated in the case, one of the partners in another office has invested in a venture capital fund that owns shares of Ocean common stock. Would this situation constitute a violation of independence according to the Joint Code of Professional Conduct? Why or why not? The venture capital fund holds 50, 000 shares of Ocean stock, currently valued at approximately $18 a share. This investment represents just over a half of one percent of the value of the fund's total holdings.

The partner's total investment in the mutual fund is currently valued at about $56, 000. Since, the value of the investment represents just over one half percent of the value of the fund's total holdings, the influence of the partner is negligible, and in addition, the partner is located at a separate office so the company may go ahead with acceptance.

5a) Prepare a memo to the partner making a recommendation as to whether Barnes and Fischer should or should not accept Ocean Manufacturing, Inc as an audit client. Carefully justify your position in light of the information in the case.

Include consideration of reasons both for and against acceptance and be sure to address both financial and non-financial issues to justify your recommendation Ocean should be accepted as a client for the company. Even though: A check on the background of Ocean's management revealed that five years ago Ocean's vice president offinancewas charged with a misdemeanor involving illegal gambling on local college football games. Charges were later dropped in return for Mr. Stevens' agreeing to pay a fine of $500 and perform 100 hours ofcommunity service. There were no other integrity problems found in the company.

The various checks carried out in Ocean include:

1. Entity's Business Risk o Management:

- - Engages in activities indicative of a lack of integrity.
- - Is prone to engage in speculative ventures or accept unusually high business risks.
- - Displays a poor attitude toward compliance with outside regulatory or legislative obligations.
- - Engages in complex transactions or innovative deals that make the determination of the effects on the financial statements difficult to assess or highly subjective.
- - Lacks a proven track record. Is evasive, uncooperative or abusive to the audit team.

- - APART FROM RELUCTANCE TO INTRODUCE US TO THE PREVIOUS AUDITORS ALL THE FACTORS WERE FOUND TO BE NEGATIVE

The Entity:

- - Has products that are new and unproven.
- - Depends on a limited number of customers or suppliers.
- - Is experiencing a deteriorating financial condition or liquidity crisis.
- - Is subject to uncertainties that raise substantial doubt about its ability to continue as a going concern.
- - Operates in countries where business practices are questionable.
- - Has an inadequate capital base or is highly leveraged.
- - Is experiencing difficulty in meeting restrictive debt covenants.
- - Generates negative cash flows from operations but reports operating profits.
- - Has publicly traded debt outstanding that is below investment grade.
- - Is a low tier firm in an emerging or maturing industry where weak competitors are exiting the market.
- - Is subject to unpredictable changes in price and availability of product inputs that cause significant variance in profitability.
- - Is vulnerable to rapidly changingtechnology.
- - Is investing cash from short-term borrowings in long-term assets.

INVESTIGATIONS SHOW THAT ALL THE ABOVE FACTORS AT OCEAN ARE NEGATIVE o The Industry:

- - Is undergoing rapid change.

- - Is subject to high competition, market saturation, product obsolescence, or declining demand.
- - Has high operating leverage demonstrated by high fixed costs and low variable costs.
- - Is highly cyclical or counter cyclical.
- - Has a low entry barrier.
- - Is facing regulations that will adversely impact profitability throughout the industry.

EXAMINATION OF INDUSTRY DETAILS AT LEXIS NEXIS SHOWS THAT NONE OF THE NEGATIVE TRENDS IN THE INDUSTRY ARE PRESENT

2. Barnes and Fischer 's Business Risk o The entity is prone to a high number of lawsuits or controversies. o There are frequent changes in the entity's auditors. o The entity plans to engage in an initial public offering or use the financial statements to engage in a debt or equity offering. o The financial statements will be used in connection with an acquisition or disposal of a business or segment INVESTIGATIONS HAVE SHOWN THAT IN CASE OF THE PROSPECTIVE CLIENT NONE OF THE ABOVE MENTIONED RISKS ARE THERE FOR Barnes and Fischer .

5. b. Prepare a separate memo to the partner briefly listing and discussing the five or six most important factors or risk areas that will likely affect how the audit is conducted if the Ocean engagement is accepted. Be sure to indicate specific ways in which the audit firm should tailor its approach based on the factors you identify. The risk areas in case of Ocean include;

2. The company is under levered.

3. The company is not getting loans in the market because of disrepute not know to us.

4. There might be integrity issues related to the vice- president involved in gambling but kept underground and secret. The Barnes and Fischer should be vigilant on the activities of the main executives of Ocean.

5. The percentage of profit earned by the company is lower than the industry norm. Barnes and Fischer should keep a close watch on the profit margin of the company and in case of anomalistic behavior should mention it in the auditor's report Barnes and Fischer should follow SAS No. 47, as amended, Audit Risk and Materiality in Conducting an Audit (AU Section 312), which provides guidance on the auditor's consideration of audit risk when planning and performing an audit of financial statements.

Examples of factors that may increase audit risk include:

- o Operations that are dominated by a single individual.
- o Undue emphasis on achieving earnings per share; maintaining the market price of the company's stock; or meeting earnings projections.
- o Unreliable processes for making accounting estimates or questionable estimates by executives.
- o Unrealistic budget levels that encourage unrealistic objectives.
- o A high volume of significant year-end transactions.
- o Compensation based to a significant degree on reported earnings. o An unnecessarily complex corporate structure. Prior-year financial statements that were restated for correction of an error or irregularity.

- o Attempts by management to reduce the scope of Barnes and Fischer .
- o Substantial litigation involving the entity's business practices.
- o Material weaknesses or other reportable conditions in the internal control structure.
- o Significant and unusually complex related party transactions. o Affiliates that are unaudited or audited by others.
- o Management espouses aggressive accounting principles.
- o Understaffed accounting department or inexperienced personnel.

Financial reports not prepared on a timely basis. Please note the lacunae in the question. First, the question does not mention the weights Barnes and Fischer intend to give financial measure and non-financial measures for accepting Ocean as the client. Second, the question does not mention what influence the partner in the 'other' office has in the auditing of Barnes and Fischer. This is related to the policies of the auditors. Third, the question of there being advantages and disadvantages of appointing the same firm as auditor and consultant does not arise. Remember, the Enron scam!

Fourth, the question is not clear if Barnes and Fischer have experience of auditing accounts of firms making small home appliances. Fifth, the question mention in one place that Ocean wants to make a public issue, on the other hand the company accounts are showing that the company is under leveraged, these two things are antithetical and Barnes and Fischer should have investigated why Ocean wants to go in for equity when Ocean should actually go in for debt. Still this is an excellent question in auditing. Please use the above guidelines and write an excellent answer.