

# Prefab sprout company essay



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The Prefab Sprout Company is a construction company which develops and constructs modular home enclosures in South Florida. Though being listed on the New York Stock Exchange (NYSE), it is still a family-run business with about 40% of the shares resting with the Warner family.

This working paper provides a thorough analysis of Prefab's internal structure and its external business relations from an auditor's viewpoint. In particular, the potential business and audit risks that could possibly evolve from an audit engagement are central to this study. Before coming to a decision whether or not accepting an audit engagement at Prefab Sprout Company, the auditor should obtain business-related background information and evaluate the risk factors associated with the potential client on which a well-grounded judgment can be made (Knechel et al. , 2007). In this respect, the auditor especially needs to become aware of the wide-ranging family ties between executives of Prefab and closely related business partners. With the president, the vice president and the treasurer being members of the Warner family, it is doubtful whether the objectivity and the reliability of Prefab's internal control system can be guaranteed.

Moreover, family members are financially involved in the Sun Atlantic Bank which provides Prefab with loans, as well as in JRW Realty, Prefab's most important purchaser of modular home developments. Consequently, there is a risk that transactions between these more or less affiliated parties are not carried out at arm's length (Knechel et al. , 2007). A further problem that should already be detected in the pre-engagement risk evaluation process is the composition of the audit committee. The Sarbanes-Oxley Act of 2002 and the accompanying SEC standards prescribe that publicly-traded companies

in the United States establish an audit committee that consists of at least three members, with all of them being outsiders to the company (SEC, 2003). At Prefab however, the audit committee is composed of the vice-president, the treasurer and a local college professor.

Thus, only one member can be regarded as not being directly associated with the company. This situation is a serious weakness in Prefab's accounting and internal control system, thereby increasing the risk of fraudulent activities in regard of the financial statements. A similar problem arises with the compensation committee, which comprises Prefab's lawyer and an employee who is selected on a rotating basis. As there are no explicit conditions for compensation committee membership, Prefab does not infringe upon any law. However, it is commonly agreed that the compensation committee should be representative of the company's shareholders. Even if the Warner family still has a 40% stake in Prefab, it is problematic that the top executive is part of the committee.

Moreover, the lawyer and the employee can be expected to be biased in their decisions as both are financially dependent on the company. Neither of them would probably risk their financial stakes by for instance lowering top management's salaries. Auditors that are new to an engagement are obliged by law to get in touch with the predecessor auditor of the prospective client. This regulation facilitates the information gathering process of new auditors and can already give first indications about where problems could possibly emerge during the audit. Unfortunately, the predecessor auditor to be contacted in this case has been appointed to become the controller of Prefab. As this appointment imposes restrictions on the unconfined

impartiality of the predecessor auditor, his assertions should be handled with care.

Whether an auditor should accept the engagement with Prefab Sprout Company depends on the one hand on factors under the control of the auditor, like expertise, staffing and being independent of the client. These factors will probably not cause any problems at Prefab as they can be influenced by the auditor. On the other hand, certain factors are not under the influence of the auditor and therefore should be carefully examined. Integrity might cause problems in this case as the main persons in this organization are family members and there are also family members with high functions in the bank and JRW Realty with which Prefab has close business relations. Moreover, the members of the audit and compensation committee are not all independent of the firm and therefore, the likelihood of fraud or material misstatements in the financial statements is quite high. The profitability of the engagement to the auditor should be considered as well.

Due to the extensive investigation the auditor has to do, especially due to the relationships between the people at the top management and the independence of the audit and compensation committee, the profitability might be a concern. Furthermore, from the analysis of the business risks of accepting the audit it can be concluded that there are several severe problem areas in which fraud or material misstatements in the financial statements can take place. At the Prefab Sprout Company the risk of fraud or material misstatements is considered to be very high and therefore, the engagement should not be accepted. Assuming that the auditor would,

despite the concerns uttered above, accept the engagement at Prefab, another kind of risk would emerge: Audit risk.

This is the risk that the financial statements contain material misstatements without those being detected by the auditor. There are several possible audit risks at Prefab Sprout Company. First of all, the auditor would have to examine the internal controls that are in place at Prefab very detailed, especially as the president, vice president and treasurer are family members. The internal controls in place can provide the auditor with information about the likelihood that material misstatements take place anywhere in the financial statements. As the auditor has access to confidential internal documents and processes when accepting an engagement, he can analyze the problem areas detected during the business risk analysis more thoroughly now to mitigate the audit risk. In addition, he can suggest improvements to the internal control mechanisms at the client, thereby also protecting himself from overlooking any misstatements.

As already mentioned above, the audit committee consists of the vice president of the company, the treasurer, and a college professor. The vice president and the treasurer have a financial interest in Prefab and might have the incentive to manipulate the financial statements. The chance that the financial statements contain material misstatements is high and, as the vice president and the treasurer have an interest in favorable financial statements, they cannot judge the financial statements objectively. It is required by law that the audit committee consists of three members which do not have a financial interest in the firm.

Therefore, the auditor should ask the vice president and the treasurer to resign from the audit committee and to replace them by impartial outsiders. The compensation committee consists of the president of the firm, the company's lawyer and an employee and is responsible for establishing the executive compensation philosophy and strategy. All members of the compensation committee have a financial interest in the firm. The president can determine his own compensation.

Management might not report financial information in a reliable way. It has a tendency to boost earnings, so the compensation that could be paid would rise. Again, the auditor should try to induce a change of personnel in the compensation committee in order to assure objectivity. 0 percent of Prefab's sales are to JRW Realty, which is owned by the younger brother of Prefab's president. This can be a concern to the auditor, as both parties could engage in fraudulent transfer pricing policies with prices not reflecting the fair value of the properties being exchanged. As the modular home enclosures are finally transferred to limited partnerships which are set up as tax shelters (and with JRW Realty being a general partner in these partnerships), pricing policies could be established to dilute tax duties.

Another possibility is that Prefab may increase its prices to boost earnings. If the transactions between Prefab and JRW Realty do not represent fair market values, the financial statements will not be correct. If a related party transaction is detected, the auditor must investigate the transactions, examine supporting documentation, and verify the accuracy of the required disclosures. In this way, the auditor can check whether the transactions have

taken place at arm's length. Prefab pays salaries to the Warner family totalling 350. 000.

The salaries are recorded as part of costs of construction for individual projects. There is a large risk that the salaries which have been paid are higher than what someone would receive if he did not belong to the family. The auditor must check whether the salaries represent fair amounts. He can do this by checking for each family member and for each project separately and determine how much each family member has cost for each project. A further problem arises from the wages being recorded as part of construction costs.

This way of conduct does not necessarily point at fraudulent misstatements. However, it would be more appropriate to separate wage costs according to functions, for example. Jim Warner, the owner of JRW Property Management, is a leading shareholder of Sun Atlantic Bank and is also member of the board of directors of this bank. Prefab finances most of its construction costs through this bank. JWR Realty periodically advances funds to the construction company to help meet required pay-down provisions of Prefab's bank loans.

The auditor needs to investigate whether the bank loan conditions are corresponding to market conditions and that funds are only forwarded after a thorough analysis of Prefab's creditworthiness. The bank's loans are central to the Warner family's business model as Prefab is highly dependend on receivables and therefore needs loans to safeguard its liquidity. References Knechel, W. R. , Salterio, S.

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