Case 1.1
Instructional Notes

Ocean Manufacturing, Inc.:
The New-Client Acceptance Decision

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INSTRUCTIONAL OBJECTIVES

- To help students understand the process of considering a new prospective audit client and the types of factors that auditors commonly consider in making the acceptance decision.
- To give students experience in computing and interpreting preliminary analytical procedures commonly used in obtaining an understanding of a prospective client during the client acceptance decision process.
- To raise issues relating to auditor independence in the context of client acceptance, both in terms of financial interests and the provision of non-audit services.
- To illustrate the subjective and sometimes difficult nature of the judgments involved in the client acceptance decision, and to give students the opportunity to justify a recommendation on client acceptance in the presence of both significant positive and negative factors.
- To help students understand how information gathered in the client acceptance process can help the auditor in planning the audit if the client is accepted.

KEY FACTS

- The student takes on the roll of a newly promoted audit manager recently given the task of considering factors and making a recommendation with respect to the acceptance of a new prospective client. The request to consider the engagement was received two weeks past the client's fiscal year-end.
- The accounting firm, Barnes and Fischer, LLP, is a fairly large national firm. The firm mainly provides auditing and tax services, but has been trying with some success to build the information systems consulting side of the business over the past few years. Most of the clients in the local office that is considering the acceptance of Ocean Manufacturing, Inc. are in the healthcare services industry.
- The prospective client, Ocean Manufacturing, is a medium-sized manufacturer of small home appliances, and is planning an initial public offering (IPO) in the next two years. The company has recently decided to terminate the relationship with its current auditor. The partner is intrigued with the idea of having a client in the home appliance industry. She believes the engagement may present an excellent opportunity for Barnes and Fischer to enter a new market.

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- The case gives brief background information on the home appliances industry and Ocean's business environment, management team, selected financial statement accounts, and internal controls. Summary information is also provided on the predecessor auditor, independence issues, and client background checks. Ocean's financial statements are also included, as are some industry ratios.
- Ocean's management reluctantly gives Fischer and Barnes permission to contact the predecessor auditor. The predecessor auditor indicates he had problems dealing with Ocean's new IT system and management's tendency to become aggressive with financial reporting issues (year-end accruals and revenue recognition) to meet creditor requirements for relatively favorable interest rates. He also indicates there had been some disagreement over the proposed audit fee.
- Two independence issues are raised for research or discussion. These involve consulting services and an immaterial indirect financial interest by a partner in another office.
- Ocean has recently implemented a new IT system, and the transition has not gone smoothly. As a result, some audit trails have not been successfully maintained. Risk of material misstatement is high in 1) inventory tracking and cost accumulation, 2) receivables billing and aging, 3) payroll deductions, 4) payables balances, and 5) balance sheet account classifications.
- There has been significant management turnover in the past year. A client background check reveals the V.P. of finance was previously charged with illegal gambling five years ago, raising a management integrity issue.

USE OF CASE

This case is designed to expose students to a client acceptance decision that includes consideration of both significant positive and negative client acceptance issues. The case has been designed to present a non-trivial acceptance decision, making class discussion more rich and interesting. The case is intended to go beyond the standard textbook treatment of the client acceptance decision by illustrating the subjective nature of the process and stimulating discussion of the issues affecting this important decision. The case can be used in either an introductory or an advanced financial statement auditing course. The case is short enough to be used as a stimulating in-class learning exercise, but involved enough to be used as an out-of-class written assignment, including computation of preliminary analytical procedures and preparation of recommendation and pre-planning memos.

If the case is going to be used for an in-class discussion, we recommend having students read the case as an out-of-class reading assignment prior to the in-class discussion. A useful cooperative learning technique to use for the in-class discussion is "Roundtable." The basic process for the Roundtable activity is to have students meet in small groups to state aloud and write down on a single sheet of paper ideas for each question. Once all students have had an opportunity to state their ideas and arrive at a group consensus, the instructor can randomly call on individual students to share their group's answers with the class. The class time allocated to the group discussion can be shortened by assigning groups responsibility for different case questions. Randomly calling on individual students to share their group's answers with the class helps to ensure that all students take responsibility for learning the material.

If the case is going to be used as an out-of-class writing assignment, we recommend discussing the case requirements with the students prior to having them complete the assignment. A useful cooperative learning technique to use for the out-of-class writing assignment is "peer editing." With this approach students first meet in pairs to develop an outline for each memo. Once the outlines are developed, one student individually drafts the recommendations memo while the other student drafts the pre-planning memo based on the outlines. When the drafts are completed, students exchange draft responses and prepare written suggestions on the grammar, organization, and accuracy of the composition. Students then meet to discuss revisions for each draft. Finally, students revise their responses based on the suggestions provided. To ensure the process is followed, students should attach their final drafts to the outlines and critiqued drafts. The out-of-class activity can be reviewed by having

student pairs compare their answers with another student pair. Students can then be selected to share their answers with the whole class. Again, randomly selecting students to share their answers with the class helps to maintain individual student accountability for the learning task.

PROFESSIONAL STANDARDS

Relevant professional standards for this assignment include AU Section 311, "Planning and Supervision," AU Section 315, "Communications Between Predecessor and Successor Auditors," ET Section 191.069-070, "Ethics Rulings on Independence, Integrity, and Objectivity," Et Section 301, "Confidential Client Information," and QC Section 20, "System of Quality Control for a CPA Firm's Accounting and Audit Practice."

SUGGESTED SOLUTION

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

There are many activities that are reasonable for an auditor to perform in making the client acceptance decision. Thus, students' answers will vary greatly. Relevant standards (see prior listing) require that the audit firm establish quality control procedures to determine whether a client should be accepted. The audit firm also must determine its independence with respect to the prospective client, evaluate its ability to adequately service the prospective client, evaluate the integrity of management, and attempt to communicate with the predecessor auditor after obtaining permission from the prospective client to discuss confidential matters. Once these steps are taken the client and auditor must come to an agreement on various issues such as the nature and limitations of the specific services to be rendered, the expected cooperation of client personnel, the anticipated audit start and end dates, and an estimated audit fee. Below are some of the more common and important activities (those activities that are ***specifically*** required by relevant standards begin with an asterisk):

a) Obtain and review client financial information such as annual reports and income tax returns.
b) *Evaluate the integrity of client management.
c) *Communicate with the predecessor auditor after receiving permission from the client, as SAS No. 84 requires. Topics discussed should include management integrity and any disagreements about accounting or auditing issues.
d) *Determine the independence of your firm with respect to the client.
e) Inquire of third parties about the client (banks, attorneys, credit agencies, etc.).
f) *Take various steps to obtain an understanding of the client and its industry (e.g., on-site tour, reviewing industry publications), and determine if your firm has or can reasonably expect to obtain the technical skills and industry knowledge needed to perform the audit properly.
g) Consider whether the client has any unusual or special circumstances that will require special attention by your firm. Also consider whether issues such as litigation or going-concern problems exist for the client.
h) Perform preliminary analytical procedures to obtain an understanding of the prospective client and its industry.
i) Evaluate the opportunities and business risks posed by the client to your auditing firm.

2. Using Ocean's financial information, calculate relevant preliminary analytical procedures to obtain a better understanding of the prospective client and to determine how Ocean is doing financially. Compare Ocean's ratios to the industry ratios provided. Identify any major differences.

The following are various ratios computed from Ocean's financial statements. This question is intentionally vague so that students will have to refer to their auditing textbook for guidance on the types of analytical procedures useful for gaining an understanding of the client. The instructor can make the assignment more specific by requiring specific ratios to be computed. The instructor could also require preparation of horizontal and vertical analyses on the financial statements.

Several interesting trends should be noted in the ratios. Return ratios are improving, as is inventory turnover (which is poor relative to the industry), but accounts receivable turnover, while relatively good, is deteriorating.

	200W	200V	200U
ROE	8.94%	7.11%	6.28%
ROA	4.54%	3.77%	3.39%
Asset to equity	1.97	1.88	1.85
Accounts Receivable Turnover	11.69	13.11	14.02
Average Collection Period	31.23	27.85	26.03
Inventory Turnover	6.08	4.51	3.48
Days in Inventory	59.98	80.89	104.99
Debt Ratio	0.49	0.47	0.46
Debt to Equity	0.97	0.88	0.85
Times interest earned	4.70	4.24	6.23
Current ratio	1.85	1.92	1.69
Profit Margin	5.5%	6.0%	4.7%

Industry Ratios for Comparison:

	200W	200V
ROE	22.1%	28.5%
ROA	7.2%	8.8%
Asset to equity	3.59	3.06
Accounts Receivable Turnover	8.14	7.57
Average Collection Period	44.84	48.21
Inventory Turnover	8.80	7.50
Days in Inventory	41.48	47.67
Debt to Equity	2.58	2.06
Times interest earned	1.50	2.20
Current ratio	1.20	1.30
Profit Margin	9.8%	10.0%

Major Differences to be noted:

a) Ocean has a low return on equity relative to the industry.
b) Ocean has a low return on assets relative to the industry.
c) Ocean's accounts receivable turnover is high relative to the industry.
d) Ocean's inventory turnover is low relative to the industry.
e) Ocean's profit margin is low relative to the industry.

3. What nonfinancial matters should be considered before accepting Ocean as a client? How important are these issues to the client acceptance decision? Why?

Relevant non-financial matters include the following:

a) Recent management turnover. This matter may or may not pose a potential problem to the audit, but may be a sign of other problems that should be investigated. The controller is very new and has little relevant experience, which may make audit work slower and more difficult.
b) High auditor turnover rate. This should be a red flag to the auditors. The auditors should look into why Ocean has employed so many different auditors in such a few years.
c) Complicated new computer system. The complicated system poses a couple of problems for the auditors. First, the auditors may have a hard time getting the information they need from the system, and a question arises as to auditability. Second, inadequate controls over the new system may increase the amount of substantive testing required.
d) Client hesitant to allow the new auditor to speak with the previous auditor. Anytime a client is hesitant or unwilling to allow new auditors to communicate with the previous auditor, a red flag should be raised in the mind of the successor auditor, and a careful examination of the issue, including careful consideration of management integrity, should ensue.
e) Illegal gambling incident. This is a matter of concern because it raises the management integrity issue. What the V.P. of finance did was definitely wrong, but the impact on the overall integrity of management is a matter of judgment. This issue can be debated among the students. Some will come down on one side saying that if a key member of management is dishonest in one thing, he is likely to be dishonest in others. Other students will argue that the incident has little to do with the business and its management, especially since there are no other known incidents. At a minimum, this factor creates an opportunity to raise and discuss the central role of management integrity in the client acceptance decision.
f) Initial public offering. Ocean has plans to go public and aggressively expand into the national market. If successful, these plans will make Ocean a more attractive client for Barnes and Fischer, but they also serve to increase the auditor's business risk (increased reliance on the statements, increased litigation risk, etc.) and should be considered.
g) Management's aggressiveness. There are some indications in the case that management is willing to manipulate the financial statements via year-end accruals and revenue recognition to achieve relatively low interest rates from creditors. This raises a potential management integrity issue, and should be heavily weighted in view of the fact that the upcoming IPO may give management even greater incentive to manipulate the financial statements.
h) Relationship with predecessor auditor. This issue is left intentionally debatable in the case, but is certainly a concern that should be raised. The relationship with the predecessor auditor has been negative, and this is cause for concern. On the other hand, the poor relations may be present because the auditor did not have a sound understanding of Ocean's business and was not competent in helping Ocean with its new IT system. Personality issues can also play a role. Further, the apparent differences over the current year's audit fee should be a concern to Barnes and Fischer.
i) Students should also raise *positive* non-financial issues, such as the opportunity to expand into a new industry and the opportunity to provide significant consulting services relating to Ocean's new IT system as well as to Ocean's internal controls. The company has a relatively long and stable history in the small appliances industry. Further, Ocean is well positioned in the small appliances market. With its plans for going public and expanding nationally, the company may become an even larger and more attractive client. Some students will think the case represents a clear non-acceptance situation due to the negative factors listed above. The instructor can provide some perspective by pointing out that no prospective client comes without some concerns and problems. Ocean certainly presents some issues and concerns, but would likely be accepted

by most auditing firms.

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

The issue of providing both systems consulting and auditing services to the same client has been a topic of considerable debate in the profession. Some parties, including some individuals in the SEC, argue that providing both consulting and auditing services to the same client may impair auditor objectivity. On the other hand, many in the profession argue that a great deal of efficiency is gained by the same firm providing both kinds of services because the firm can leverage the auditor's deep understanding of the client and its information system in providing additional services. For public companies, which are subject to the Sarbanes-Oxley Act, the auditor is not permitted to provide certain types of consulting services for clients. Financial information systems design and implementation is not an approved consulting service under Sarbanes-Oxley. Until it executes its planned initial public offering, Ocean is a privately-held company and is subject to AICPA independence requirements. The AICPA Code of Professional Conduct indicates that systems implementation is an acceptable nonattest service to provide to audit clients under certain conditions. For example, while a CPA firm may assist an audit client in implementing a computer software package, it may not "design" the financial information system by creating or changing the computer source code underlying the system. Students typically have strong views on this issue. Some argue that objectivity would likely be impaired, and others argue that the objectivity issue can be dealt with and that the efficiencies gained outweigh the potential costs.

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 AICPA Code of Professional Conduct. Why or why not?

According to Rule 101 of the AICPA *Code of Professional Conduct* (see ET 191.069-070), materiality is not to be considered in the case of a direct financial interest—no direct financial interests on the part of the auditor are tolerated. However, if the financial interest is indirect, as in the case of a mutual fund or venture capital fund investment, materiality is considered. It is fairly clear from the case that the partner's indirect financial interest is immaterial and thus does not constitute a violation of Rule 101. The instructor may wish to point out that no individual who is on the engagement team, who is a partner or manager not on the attest engagement team but who provides nonattest services to that client, who is a partner who works in the same office as the attest engagement's lead partner, or who is a position to influence the engagement, can hold a direct financial interest in the client. However, even the partner in charge of the Ocean audit *would* be permitted to hold an immaterial indirect financial interest in Ocean.

5. a. 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 nonfinancial issues to justify your recommendation.

The memo should be professional in appearance and in substance, and should be well written. The memo should include the points brought out in the preceding questions, which are designed to help prepare the students to make reasoned and informed recommendations. The memo should also include a clear recommendation as to whether the client should be accepted. There is no right or

wrong recommendation as long as a student demonstrates s/he weighed the issues and made a reasonable decision based on the information provided. However, in our experience, students tend to be much more negative about the prospect of accepting Ocean as an audit client than are auditing professionals. Most of our students tend to reject Ocean as a client; audit partners visiting our classrooms, especially those partners from non-big 4 firms, often indicate that Ocean is similar to many of their own clients. Students tend to want an ideal client; audit professionals have to make a living in the real world, which includes dealing with clients that have some issues and that present some risks. Emphasize that the client acceptance decision is a very subjective one that is ultimately determined by professional judgment.

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.

This pre-planning memo should include many of the same issues considered in the acceptance decision. However, this memo should then consider the implications of these issues for how the audit will be conducted assuming the client is accepted. The case discusses many issues that would have potentially important implications for conducting the audit. Some of the more important implications are listed below.

a) As a result of Ocean's recent IT implementation, some audit trails have not been successfully maintained. The auditor will need to determine how to gain comfort on the items for which traditional audit trails were not maintained. Depending on the nature of the items, the auditor may be able to gather evidence by backing in to the missing periods using the data from before and after the breakdown of the trails. Additionally, analytical procedures to test for reasonableness may become more important due to the audit trail breakdowns.
b) Also as a result of Ocean's recent IT implementation, risk of material misstatement is high in inventory tracking and cost accumulation, receivables billing and aging, payroll deductions, payables balances, and balance sheet account classifications. Substantive procedures with relatively large sample sizes will likely play an important role in these areas, with particular emphasis on tests of details of balances.
c) Internal controls appear to be lacking. Thus, the auditor will likely have to rely heavily on substantive procedures. This will in turn have implications for staffing budgets and the cost of the audit.
d) Accounts Receivable turnover, while good, is deteriorating. This suggests that the auditor may want to pay special attention to the valuation of receivables.
e) Inventory turnover, while still poor relative to the industry, has improved rather dramatically over the past three years. This could be due to more effective inventory management, but may also be due to misstatements in the inventory account. This suggests the auditor may want to emphasize the completeness, valuation, and accuracy objectives for inventory. Also, since the client is a manufacturer with relatively large inventory balances, the audit of inventory will be a major focus of the audit.
f) Ocean's profit margin percentage and return on equity are low relative to the industry. The auditor should identify and corroborate a viable explanation. These factors are likely related to Ocean's cost structure or the competitiveness of Ocean's region or product set. However, the issue is worth investigating as these ratios may be seen as red flags for fraud risk.
g) The predecessor auditor indicated that Ocean's management tended to become aggressive in the treatment of accruals and revenue recognition toward the year-end. This is clearly an area where

the auditors will want to focus a great deal of attention, increasing the extent of cut-off tests, reasonableness of accruals, etc. Frequent material fourth-quarter adjustments are also considered a red flag for fraud, so the audit program should probably take into account a heightened risk of fraud, in accordance with SAS 82.

h) Since the successor auditor will take on the audit subsequent to year-end, some cut-off and inventory issues arise. For ending inventory in particular, the successor will either have to rely on the work of the predecessor auditor (if the predecessor observed the client's ending inventory procedures) or gain comfort by "backing into" the ending inventory balance via alternative procedures, such as roll-backs and tests of transactions.