
INSTRUCTIONAL NOTES

CLIENT ACCEPTANCE: The Winery At Chateau Americana

INSTRUCTIONAL OBJECTIVES

- Understand types of information used to evaluate a prospective audit client
- Evaluate background information about an entity and key members of management
- Brainstorm relevant financial and non-financial factors related to client acceptance
- Perform and evaluate preliminary analytical procedures
- Make and justify a client acceptance decision
- Describe matters that should be included in an engagement letter

KEY FACTS

- Chateau Americana (CA) is a family-owned winery that is currently considering whether to hire a new public accounting firm.
- Current year sales - \$21,945,000; net income - \$1,997,000; total assets - \$42,029,000.
- CA operates a 125-acre vineyard which yields one-fourth of the winery's production needs. CA is a modest winery with annual production of 385,000 cases of wine.
- The wine industry is a fragmented industry with more than 1,800 wineries in the United States.
- Most key management positions are held by members of the Summerfield family. The exception to this rule is Rob Breeden, the CFO.
- The winery implemented a new accounting information system some fourteen months ago. There has been some employee turnover as a result of the new system.
- Discussions with the predecessor auditor, Harry Lawson, revealed no significant disagreements with management; however, Mr. Lawson indicated that Rob Breeden was "more aggressive" than the winery's former CFO.

SUGGESTED SOLUTIONS

1. ***Identify four to six procedures auditors may perform as part of the client acceptance process. Are any of the procedures identified by you required by generally accepted auditing standards?***

Auditors perform a wide variety of procedures prior to accepting a new audit client. The following are examples of procedures that may be performed as part of the client acceptance process (Required procedures are indicated by an asterisk). Please note that these procedures are not listed in a specific order.

- a. Determine the reason for the audit (e.g., compliance with debt covenants, regulatory requirements, etc.).
- b. Conduct a background investigation of the client and key personnel.
- c. Determine whether the firm personnel have sufficient training and expertise to perform an audit of the client in accordance with GAAS. *
- d. Review available financial statements, minutes of board of directors' meetings prior, tax returns and other documents pertinent to the client's operations.
- e. Perform preliminary analytical review procedures to identify areas of high risk and to understand the nature of the client's financial statements.
- f. Determine whether the firm is independent with respect to the client. *
- g. Request the prospective client's permission to communicate with the predecessor auditor. *
- h. Communicate with the predecessor auditor and inquire about matters such as information that might bear on the integrity of management, disagreements as to accounting principles, audit procedures, or other significant matters, communications to the audit committee regarding fraud, illegal acts and internal control related matters, and the predecessor auditor's understanding as to the reason for the change of auditors. *
- i. Tour the client facilities to learn of the nature and scope of operations.
- j. Evaluate the need for and availability of specialists. *
- k. Obtain an understanding with the client regarding the services to be performed in the engagement and document that understanding in written communication with the client. *
- l. Assess the business risks of the CPA firm's association with the prospective client.

The following solutions relate to steps from the audit program that students were asked to complete.

2. ***Brainstorm about and briefly describe financial and non-financial factors that are relevant to the decision to accept the potential client.***

Student responses to this requirement will vary. The following is a partial list of the factors that are likely to be relevant to the firm's decision.

Financial Factors:

- a. CA has strong and upwardly trending sales and has been profitable for the last three years and beyond as evidenced by the retained earnings balance.
- b. Although CA's current ratio is below the industry average, its AR and Inventory turnover compare favorably.
- c. The company's debt load is lower than the industry average (debt-to-equity ratio for the company is 0.52 [calculation shown in solution to question 3 below] compared to the industry average of 0.99 in the most recent year). The company's strong sales and earnings have provided sufficient cash to cover debt and interest payments and produce a Times Interest Earned measure above the

industry average (9.41 [calculation shown in solution to question 3 below] compared to 6.91 in the most recent year).

- d. CA's balance sheet appears to be strong with increasing current assets. Much of the increase in the last year is in the company's Investments and Production Inventories balances. In addition, the company has invested more than \$2,000,000 in productive assets in the last year.
- e. Accounts payable have increased by more than 35% since the prior year and long term debt has increased slightly.

Non-financial Factors:

- a. The company is considering an initial public offering in the near future.
- b. The wine industry is a highly fragmented industry that is dominated by a small number of large companies such as Ernest & Julio Gallo and Constellation Brands.
- c. Wine distribution is primarily achieved through supermarket chains and mass merchandisers. Other distribution outlets offer substantially less growth opportunity.
- d. The wine industry appears to have a bright future and the industry, as a whole, has significant growth opportunities in the US. Wine consumption is highest among adults 35-64 years of age, the generation that tends to have the greatest amount of disposable income.
- e. Significant consolidation has taken place in the wine industry and the trend is likely to continue.
- f. CA has entered into exclusive distribution agreements with outlets in several large metropolitan areas and is seeking similar opportunities in other areas.
- g. The Summerfield family owns the winery and members of the family hold most management positions.
- h. Rob Breeden became the winery's CFO just two years ago after the company's CFO of more than 15 years resigned. There are rumors that the resignation was in response to disagreements between the CFO and the president, Edward Summerfield, regarding the need for a new IS.
- i. The vice-president of winery operations, Jacques Dupuis, was accused of theft of trade secrets from a former employer, but the charges were ultimately dropped due to insufficient evidence.
- j. CA implemented a new IS some fourteen months ago. The new system is fully integrated with modules for purchasing and accounts payable, sales and accounts receivable, production and inventory, payroll, and the general ledger. Each of these modules provides data that are critical to the company's operations. There has been some employee turnover due to continuing problems with the AP and AR modules.
- k. Discussions with the predecessor auditor indicate that there were no significant disagreements, but the former partner-in-charge made the comment that Rob Breeden was "more aggressive than CA's former CFO."

3. ***Perform preliminary analytical procedures using the financial statements provided by the client. Calculate ratios for comparison to the industry averages provided.***

	Company Ratios	Industry Ratio	
	20XX	20XX	20XW
Current Ratio $27,076 \div 7,082 = 3.82$	3.82	4.9	4.7
Accounts Receivable Turnover $21,945 \div [(5,241 + 4,816) \div 2] = 4.36$	4.36	4.42	4.30
Average Days to Collect Accounts Receivable $365 \div 4.36 = 83.72$	83.72	82.58	84.88
Inventory Turnover $11,543 \div [(15,593* + 14,309) \div 2] = .77$ * Includes production and finished goods	0.77	0.67	0.80

Days in Inventory $365 \div 0.77 = 474$	474	545		456
Assets to Equity $42,029 \div 27,718 = 1.52$	1.52	1.99		2.14
Debt to Equity Ratio $14,311 \div 27,718 = 0.52$	0.52	0.99		1.14
Times Interest Earned $3,386 \div 360 = 9.41$	9.41	6.91		7.29
Return on Assets $(1,997 + 360) \div [(42,029 + 38,322) \div 2] = 5.9\%$	5.9 %	5.56 %		7.61 %
Return on Equity $1,997 \div [(27,718 + 25,721) \div 2] = 7.5 \%$	7.5 %	5.92 %		10.76 %

4. ***Discuss the overall results of the preliminary analytical procedures. Identify relationships or areas that may be of concern during the audit.***

Ratios for CA generally compare favorably to industry averages. Certainly the company's current ratio is below the industry average, but it's AR and inventory turnover measures compare favorably. In addition, the asset to equity ratio is below the industry average and debt to equity is lower than the industry average. The company is generating a higher return on profits and equity than the industry. This also bears investigation. Notwithstanding the results from the analytical procedures, areas that would generally be treated as significant and requiring more audit effort include accounts receivable, investments, inventory, accounts payable, and long term debt.

5. ***Based on the information obtained do you recommend that the firm accept or not accept the potential client? Briefly explain the basis for your recommendation.***

Although there is no correct answer, most CPA firms would accept CA as a client. Student responses should include discussion of the financial and non-financial factors identified in response to question #2 above. It may also be useful to have a discussion of whether a CPA firm can accept a client such as CA if they do not possess experience in that client's industry. Students often believe that CPA firms cannot accept engagements when they have no related experience, but such is not the case.

6. ***Identify matters that should be included in an engagement letter for this client.***

Auditors are required to obtain an understanding with their client which should be documented in an audit engagement letter or other written agreement. The following are matters that should generally be included in an engagement letter (Refer to "AU 210: Terms of Engagement" for more discussion of obtaining an understanding with a client.):

- The objective and scope of the audit of the financial statements
- The responsibilities of the auditor
- The responsibilities of management
- A statement that because of the inherent limitations of an audit, together with the inherent limitations of internal control, an unavoidable risk exists that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with GAAS
- Identification of the applicable financial reporting framework for the preparation of the financial statements

- Reference to the expected form and content of any reports to be issued by the auditor and a statement that circumstances may arise in which a report may differ from its expected form and content

Engagement letters may include other matters such as:

- Elaboration of the scope of the audit, including reference to applicable legislation, regulations, GAAS, and ethical and other pronouncements of professional bodies to which the auditor adheres
- The form of any other communication of results of the audit engagement
- Arrangements regarding the planning and performance of the audit, including the composition of the audit team
- The expectation that management will provide written representations
- The agreement of management to make available to the auditor draft financial statements and any accompanying other information in time to allow the auditor to complete the audit in accordance with the proposed timetable
- The agreement of management to inform the auditor of events occurring or facts discovered subsequent to the date of the financial statements, of which management may become aware, that may affect the financial statements
- The basis on which fees are computed and any billing arrangements
- A request for management to acknowledge receipt of the audit engagement letter and to agree to the terms of the engagement outlined therein, as may be evidenced by their signature on the engagement letter
- Arrangements concerning the involvement of other auditors and specialists in some aspects of the audit
- Arrangements concerning the involvement of internal auditors and other staff of the entity
- Arrangements to be made with the predecessor auditor, if any, in the case of an initial audit
- Any restriction of the auditor's liability when not prohibited
- Any obligations of the auditor to provide audit documentation to other parties
- Additional services to be provided, such as those relating to regulatory requirements
- A reference to any further agreements between the auditor and the entity