

University of Missouri – St. Louis
College of Business Administration
Department of Accounting
ACCTNG 4435 – Auditing
Spring Semester 2021

Writing Assignment II
Case - The Assessment of Risk at Great Gifts, Inc.

Please carefully read the following information about Great Gifts, Inc., and then carefully read the assignment instructions and guidance.

As noted below, imagine for the purposes of the case writing assignment that the current date is 5 December 2017. The covid pandemic has no impact or role in this case.

Company Background Great Gifts, Inc., (“the Company” or “GGI”) designs and markets a variety of relatively inexpensive gift items for all occasions. Gifts sold by the Company include items of jewelry, desk accessories, clocks, calendars, pen and pencil sets, lapel pins, and the Company is planning a new line of offerings in the home décor area. The Company outsources some of its manufacturing functions to Asian manufacturers, and conducts some manufacturing operations itself. Gift items are sold to national retailers like Target, to large and small gift shop chains, and independent individual gift store owners. Although the Company is a gift business, there are few seasonal effects on sales, since the Company supplies gifts to almost all religious and secular holidays and special occasions throughout the year.

GGI is a small public company. GGI was engaged as a client of your firm in early 2016 for the audit of their 31 December 2016 financial statements. That audit was completed in early 2017, and as of now (**the current date is 5 December 2017**), you are preparing to execute the year-end phase of the audit of the 31 December 2017 financial statements in mid-January 2018. Interim testing (primarily tests of controls) was accomplished in November 2017. You were assigned to this audit as the audit senior toward the end of calendar year 2017, after initial planning and interim tests of controls had taken place. (Due to staff turnover, the previous audit senior on the audit, as well as the three of the four staff auditors that had been assigned to the audit last year, have all left the accounting firm.)

As a public company, GGI requires an audit of both their year-end financial statements, as well as internal control. Your firm will complete an integrated audit of the financial

statements and internal control. Your firm also provides tax services to GGI. Again, you are preparing to lead the year-end phase of the audit beginning in January 2018. The last day of fieldwork is scheduled for mid-February, and the issuance of the audit report will likely take place at the end of February.

GGI organizes their products into three product lines. Their two historical and traditional lines have been personal gifts like jewelry and watches, and office gifts such as desk accessories and pen and pencil sets. Due to the sluggish or non-existent growth in the two traditional lines, management planned the addition of a third line: home décor items, which it intends to sell to home décor retailers across the country. The expansion of products was planned in 2016, with research and roll-out scheduled for 2017.

You are now reviewing working paper documentation relating to the background of the Company (in the permanent files), as well as working paper documentation relating to last year's audit (in last year's current files), and this year's interim audit work (in this year's current files).

Please review the following excerpts from relevant documents involving the planning and execution of the current year audit. Then review the academic and administrative requirements of this assignment at the end of the case materials.

Excerpts from the document...

"Notes and observations from my review of the GGI Permanent File, the GGI current year files relating to the 31 December 2016 audit, and the GGI current year files relating to planning and interim testing for the 31 December 2017 audit"

**(These notes were written by YOU, the newly appointed senior auditor,
as you reviewed the files noted above...)**

- During 2017, the CEO who had led the Company for 7 years resigned. According to news reports, the resignation was submitted in order to spend more time with his family. Shortly thereafter, the Chief Financial Officer and the Controller also left the Company. A new CEO and CFO were hired before mid-year (after an "acting" CEO and CFO had been appointed and served for a couple months) but the Controller position had not been filled as of November 2017. In their first "conference call" with analysts who follow the company and issue earnings estimates, both the CEO and the CFO guaranteed the Company would meet its earnings targets. Coincidentally, the new CEO is the owner of the building that the Company rents as its corporate headquarters.
- The previous senior auditor on the engagement noted during interim testing that the roll-out of the new product line has not been going smoothly. In the early months of 2017, the Company was engaged in research relating to a new

procedure to make their pottery products in the new home décor line unbreakable, making the products desirable to families with small children. The Company indicated that the result of that research was successful, and the new technology was scheduled to be incorporated into the manufacturing process. However, implementing the new process took longer than expected. Shipments of product to retailers relating to products in the new home décor line did not commence before the holiday period of late 2017, and the roll-out was deferred until 2018. Because of the success of the research and long-term benefits that the research was going to provide to the Company, management has capitalized \$175,000 of research costs as a deferred asset on this year's (2017) balance sheet, and intends to amortize those costs over 20 years.

- Sales trends of product from the old, traditional product lines continued to be flat or negative during 2017. Management was hopeful that the last weeks of the holiday ordering period in 2017 would bring increases in sales sufficient to equal the previous year.
- During 2017, management of the Company installed a new software package to improve accounting and processing surrounding the purchases and payables process at the company. When the audit team was developing an understanding of internal control in this area (in July 2017), significant problems were noted, including the presence of two material control weaknesses in the system. Based on this finding, the previous senior auditor decided to test controls over payables and purchases at interim (November 2017) to be sure they were working. The work performed by the audit team has not yet been reviewed.
- In October 2017, GGI entered into an arrangement with a new customer retail chain to provide gift products for the following Valentine's Day. Manufacturing of these products began in late 2017, manufacturing was scheduled to end in early January, and shipment of the product was scheduled for mid-January. Management believes that shipment and delivery is assured, and recognized \$250,000 of revenue in October 2017.
- Under terms of their employment contracts, the new CEO and CFO will receive a bonus of 50% of their base salary if net income for 2017 exceeds \$12,000,000. Interim financial statements for 31 October 2017 indicated net income of \$10,500,000, with a forecasted amount of \$12,100,000 for the end of December.
- Because of the robust economy, the Company has reduced the amount reported in the Allowance for Doubtful Accounts on the balance sheet. The Company uses the allowance method (income statement approach) and reduced the estimated percentage of sales deemed uncollectible from 3.0% to 1.5%.
- In 2016, management adjusted the inventory balance for an impairment due to holding approximately \$150,000 of what appeared to be obsolete inventory. The Company continues to hold the inventory, but believes, due to the strength of the economy in 2017, that the product will be sold by the end of the year, and the write-off was unnecessary. Therefore, management has reversed the impairment write-off from last year into income this year. The previous senior auditor noted

that controls over this area were particularly strong, as the CEO herself initiated and recorded this entry.

- After the Company Board Meeting in September 2017, the Audit Committee met with the auditor for 30 minutes before the members had to leave to catch their planes. The next meeting of the Audit Committee is scheduled for mid-March 2018. A Board member who is a brother-in-law of the new CFO sits on the Audit Committee. The Internal Audit Department manager was laid off in 2016 in a cost-cutting measure. The Company is seeking to hire another manager, at a lower salary, to report to the Controller regarding internal audit matters.
- Over recent years, labor relations at the Company have deteriorated. Employees consider themselves underpaid, as flat profitability in recent years has prevented the granting of raises. Although negotiations are continuing, the union representing warehouse and transportation workers has threatened to walk out prior to the end of the year if wages are not increased. Administrative and financial office workers, who are not unionized, are also upset about the lack of raises.

Requirements: Using as reference material your textbook and other written materials posted to the Canvas site, as well as material discussed in lecture and Zoom sessions, please address the following requirements:

1. Create a **bullet point** list of risks present at GGI, using a sentence or two to describe the risk factor. After each risk you identify, please **briefly** note where each risk might be classified according to the components of the engagement risk model. If you believe that an identified risk could be classified in the various intersections of the model, **associating a particular risk with just one of the risk areas is sufficient**. (Remember, there are often many ways to think about how identified risks “fit in” to the engagement risk model, and many can be classified at the areas of intersection between ABR, CBR, and AR.) It should be very easy to identify at least 10 different risk factors in the case, as there actually many more than 10.
2. Based on your identification of risk factors, please assess the overall level of ABR, CBR, and the risk of material misstatement (RMM also known as IR+CR) separately, each on a scale of *very low, low, medium, high, and very high*. **Briefly** (as in a couple sentences) explain your assessments.
3. The facts presented above indicate that management has departed, or plans to depart, from generally accepted accounting principles in a number of situations (each of which is an indicator or evidence of risk). Identify **one** of those cases (it may also be on your bullet point list of risks above), **briefly** describe what management is doing wrong, and **briefly** describe what they should have done instead. In order to do this, you will need to assess the reasonableness of the accounting or proposed accounting for the particular issue you choose. If you don't recall the particulars of how to account for certain issues, **you may need to**

- engage in a brief bit of accounting review/research to assess whether the accounting or proposed accounting is in conformity with GAAP.**
4. Then identify, for one of the misstated or likely-to-be misstated **accounts**, one **management assertion** relating to that account that management is likely misstating. (Each possible or probable misstatement will misstate at least one account and at least one assertion. Identify a misstated account, and a particular management assertion relating to it that is or will likely be misstated.)
 5. **Briefly**, what is the implication of the material weaknesses noted in the purchases and payables process for the integrated audit and the audit report(s)?
 6. **Bonus** - The **previous senior auditor** who supervised the interim audit work and testing of controls made an illogical and incorrect decision. Briefly identify that mistake and explain why it was a mistake.

Administration: In order to organize your paper and facilitate my review, please attend to the following instructions regarding the format and style of your paper. **PAY VERY CLOSE ATTENTION TO THE FOLLOWING GUIDANCE.** Failure to follow these instructions may result in point deductions from your mark on this writing assignment.

- **You MUST complete this writing assignment, submit it to me, and earn at least 50% as a grade on the paper in order to fulfill course requirements.** If you do not submit a writing assignment, I will submit an deferred grade for the course, which will remain until this requirement is completed, or when the deferred grade expires and reverts to an "F" grade. If you earn less than 50% on this assignment, I will return it to you for re-writing and improvement before I submit a final grade. Remember, this assignment is weighted with 10% of your overall grade in the course, so do your best work!
- Please prepare your paper in **MS Word**, and email it to me at kozloskit@umsl.edu prior to Thursday, 6 May at 11:59 PM. **This is a short extension of the due date, and provides three weeks to fit this into your schedule and work on this assignment. Please DO NOT send your paper to me through Canvas. Send it to my email address above.** Please include a separate cover page that includes your name and student number.
- There are five distinct requirements noted above (or six if you address the bonus question). **Please address all five (maybe six) requirements in the order they are presented above. You should number the requirements in your paper. Please be sure to READ CAREFULLY what you are being asked, and please respond fully and completely to that "ask".**
- You may write the case utilizing bullet points where appropriate or required, but bullet points should be written in complete sentences, not phrases. Make sure I can understand the point you are trying to make.
- Please use a **single-spaced, block paragraph format** (left and right justification), with one space between paragraphs or headings (similar to the presentation of

the first page of the case above). Use a **12 point font and standard margins**. I believe you can address the requirements above in 3 pages. Please don't exceed 4 pages.

- **Please do not re-type the questions/requirements from above and include them in your paper.** You can simply use the numbers of the questions (1 through 5 or 6) to divide your paper into sections. You may use a short description of the requirement for a heading or section title if you choose, but please do not re-type the entire requirement.
- **Please see the “Important Information about Course Requirements” page of the course website to view a document presenting guidance and tips for writing assignments.**
- Please do NOT spend significant portions of your write-up recounting the facts of the case, or presenting a summary of the case. **Assume I have read the case information, am familiar with GGI, and most importantly, am familiar with auditing terminology, theory, and practice. You do NOT need to define auditing terminology in your case write-up.** Doing so is unnecessary, and will detract from the quality of your paper.
- **Be careful about the dates of events in the case.** You may benefit from drawing a timeline of events to make sure you are clear about what happened when. (Don't include a timeline in your write-up.)
- **This is an individual assignment.** Although you may discuss the case you're your classmates, please be VERY CAREFUL to ensure that what you submit is your work and yours alone. Please refer to the ACCTNG 4435 course syllabus for guidance and information about academic integrity/misconduct.
- Your paper should be well-written and professionally presented. **I will evaluate both the content and the style of the document.** Content will account for approximately 70% of the points relating to the paper, and style (grammar, punctuation, presentation, etc.) will account for approximately 30% of the points. Pervasively poor writing and presentation may cause you to lose all the points relating to style, so please invest the effort you need to improve your paper before submission. **PLEASE PROOFREAD YOUR PAPER, AND PERFORM A FINAL REVIEW TO BE SURE YOU HAVE FOLLOWED THE DIRECTIONS AND GUIDANCE ABOVE.**
- **Early submissions are welcome and appreciated!**
- **If you have any questions, I am very happy to answer them for you.**