The Lakeside Company: Analysis of a Potential Audit Client

Benjamin M. Rogers is the president of the Lakeside Company, a retailer and distributor of consumer electronics (such as televisions) based in Richmond, Virginia. Although King and Company CPAs, a Richmond firm, had previously audited Lakeside, Rogers has recently become aware of the CPA firm of Abernethy and Chapman from reading several advertisements. His interest in the firm was heightened when he discovered that Abernethy and Chapman audit the primary bank with which he does business. During March of 2012, Rogers contacted his banker who arranged for Rogers to have lunch with one of the CPA firm’s partners. At that time, a wide-ranging conversation was held concerning Lakeside as well as Abernethy and Chapman. Rogers discussed the history of the consumer electronics company along with his hopes for the future. The partner, in turn, described many of the attributes possessed by his public accounting firm. Subsequently, Rogers requested a formal appointment with Richard Abernethy, the managing partner of Abernethy and Chapman, in hopes of arriving at a final conclusion concerning Lakeside’s 2012 audit engagement.

A June1 meeting was held at the accounting firm’s Richmond office and was attended by Abernethy, Rogers, and Wallace Andrews, an audit manager with the CPA firm who would be assisting in the investigation of this prospective client. Both auditors were quite interested in learning as much as possible about the consumer electronics business. Although a number of similar operations are located in the Richmond area, Abernethy and Chapman has never had a client in this field. Thus, the Lakeside engagement would offer an excellent opportunity to break into new market.

During a rather lengthy conversation with Rogers, Abernethy and Andrew were able to obtain a significant quantity of data about the Lakeside Company and the possible audit engagement. Included in this information were the following facts:

* Rogers originally began Lakeside in 1993 as a single store that sold bargain-priced televisions and stereo equipment. This business did well and the company expanded thereafter at the rate of one new store every two or three years. Presently six stores are in operation, three in Richmond with one in each of three nearby cities: Charlottesville, Fredericksburg, and Petersburg. The first five were set up in rented space within small shopping centers. However, the most recent store was located in a building constructed by Lakeside itself, adjacent to a new shopping mall on the east side of Richmond. In addition, Lakeside owns a warehouse that also provides office space for the company’s administrative staff. The growth to date has been slow and has not produced the benefits and profitability that Rogers has expected. He is looking for a new way to increase the growth rate and taking the company public is beginning to look like the only way that sufficient resources can be amassed.
* In 2005, Lakeside reduced the marketing of bargain-priced electronics in a move to concentrate on the sale of high-end audio and video equipment. Several years later, Lakeside became the sole distributor of Cypress Products for the states of Virginia and North Carolina. Cypress is the manufacturer of a quality line of audio and video equipment. Shortly thereafter, the Lakeside stores began to carry Cypress products almost exclusively. Despite the quality of Cypress equipment, the brand was not well known in the Richmond area and store revenues (retail sales”) began to decline. Sales did rebound somewhat in 2010 and 2011, although Rogers admitted to Abernethy that all of the stores had suffered from intense competition and a poor economy with the local market
* To market the Cypress brand across the states of Virginia and North Carolina, Lakeside had hired a staff of six sales representatives who visit audio, electronics, and appliance stores in their geographic region. These other retailers could then order merchandise from Lakeside by telephoning the Richmond headquarters/warehouse. After a credit check, requested inventory in shipped to these customers and billed at 2/10; n/45. Up to 20% of the merchandise can be returned to Lakeside within four months as long as the good have not been damaged. In the past, returns have been low. Rogers indicated that these “distributorship sales” had initially been disappointing but had risen materially in the last two years as the Cypress reputation began to spread
* Audio and video equipment inventory is purchased weekly from Cypress. Regional distributors such as Lakeside are allowed 90-day terms, but Cypress encourages quick payment by offering large cash discounts. In hopes of maintaining a high profit margin, Rogers has chosen to take all available discounts. To meet the payment terms, Lakeside holds bank credit lines with two Richmond banks totaling$1,500,000. Interest on this debt is based on the floating prime rate of the respective banks and has averaged around 5% to 8% during recent years. Both banks require that cash in an amount equal to 5% of the outstanding credit line remain on deposit.
* The company’s warehouse and the sixth store were constructed with funds provided by loans from the National Insurance Company of Virginia. The first of these obligations was obtained at a 6.5% annual interest rate while the second holds a rate of 8%.
* Rogers stated that he was quite unhappy with the services of his present CPA firm, King and Company. He enumerated three grievances that he had with that organization. First, he felt the firm had provided little assistance in updating Lakeside’s accounting systems. Lakeside was simply outgrowing the control features of its current systems, and Rogers asserted that King and Company had not provided the needed input for upgrading them. Second, Rogers believed that King and Company was charging an excessive fee for its annual audit. He stated that he was no longer willing to pay that much money for what he termed were inferior services.
* Rogers’ final problem with King and Company revolved around the audit opinion that was rendered on Lakeside’s financial statements for the year ending December 31, 2011. The auditors issued a qualified opinion. King and Company believed that the value of Lakeside’s $186,000 investment in its latest store had been impaired based on guidelines established by the FASB. However, Rogers disagreed and refused to write down the reported value of the property. The sixth store, which opened in November of 2010, was constructed adjacent to a shopping center that had proven to be very unsuccessful. To date, the shopping center has leased less than 40 percent of its available space. The Lakeside store has, consequently, never been able to generate the customer traffic necessary to even come close to its break-even point. The continuing failures of the shopping center made the fate of the Lakeside store appear quite uncertain to King and Company. Furthermore, the CPA firm felt that Lakeside would have considerable trouble in disposing of the store if that become necessary. Because Rogers continued to report this asset based on historical cost, the firm felt that a material misstatement existed and issued a qualified opinion. Rogers expressed annoyance with a firm that would stifle his growth plans and wondered what it would be like if his expansion plans were to become a reality.
* Lakeside Company is owned by a group of eight investors. Rogers (who is 46 years old) owns 30% of the outstanding stock while the remaining seven stockholders individually possess between 6% and 22% of the company’s shares. Although all of the investors live in the Richmond area, only Rogers is involve actively in the day-to-day operations of the business. The Board of Directors is comprised of Rogers, two other owners, and two other local residents who are not owners. Three board members, including the two non-owners, comprise the audit committee. When the company was first organized, all eight shareholders agreed that an audit by an independent CPA firm would be held annually. This same requirement was also a stipulation made by the banks participating in Lakeside’s financing.
* A manager and an assistant manager operate each of the six stores. Normally, three to six sales clerks also work at each outlet on a part-time basis. In hopes of stimulating lagging stores sales, Rogers initiated a bonus system during 2011, which already appears to be boosting revenues. Under this plan, every manager and assistant manager will receive a cash bonus each January based on the income earned by his or her store during the previous year. The bonus figure is a percentage of the gross profit of the store less any directly allocable expenses.
* Lakeside Company is in the process of opening a new (seventh) store, which will begin operations by December of 2012. Earlier this year Rogers formed his own separate corporation to construct this latest facility. Upon completion, the building will be leased to Lakeside for its entire life. Although Rogers was confident that this new store would do well, he wanted to avoid any further accounting problems associated with the uncertainty of success. He is also investigating land purchases in at least four other locations in the Southeast.
* To finance its growth, the company is considering a public offering of stock.
* The company is strongly contemplating the addition of computer equipment to its product line.
1. Why would the owner of Lakeside as well as the company’s banks require that an independent CPA firm perform an annual audit?
2. This case implies that no auditor with the firm of Abernethy and Chapman has an in-depth understanding of the consumer electronics industry. Is a CPA firm allowed to accept an engagement without having established the necessary expertise to oversee the audit? Would the knowledge required to audit a consumer electronics company differ significantly from that needed in the examination of a car dealership? Does the auditor have an obligation to discuss his lack of expertise, or his plans to obtain the expertise with the client?
3. Rogers wants Abernethy and Chapman to assist his company in developing new accounting systems. Does a CPA firm face an independence problem in auditing the output of systems that the same firm designed and installed? Does your answer depend on if the client is publicly traded or not? How so?
4. Bases upon the discussion, prepare the auditor’s report that King and Company rendered at the end of the year 2011 engagement. How does this opinion differ from a standard auditor’s report?