The Chocolate Utopia LLC – An Enterprise Risk Assessment Case

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Case Description

The primary subject matter of this case is risk assessment. Students are asked to perform a risk assessment of a potential audit client to help the audit partners determine if it should be accepted as one of the firm's clients. The case is appropriate for an undergraduate or graduate auditing course. The case is designed to be taught in one class hour and is expected to require approximately three hours of outside preparation by students. The events described in this case are based on real world experiences, but all names have been disguised.

Case Synopsis

The case is about The Chocolate Utopia LLC (the company), a New Jersey small business that specializes in the manufacturing of plastic chocolate molds. The business is owned by a couple, the Tullens. The couple has been married for a number of years and has five children. While Ms. Tullen has a college degree, Mr. Tullen only has a high school diploma. The wife focuses on the business operations while the husband repairs any broken plant machinery.

The company has been in business for a number of years and saw sales increase from $150,000 in 2007 to $5 million in 2009. This increase was primarily due to the change in customer focus from small retail chocolate shops to large national retailers such as Target. As a result, the company is forced to move from a cash only business to credit sales, with most receivable outstanding for 30 days or more. This has affected the company's cash flow and its ability to pay its vendors on time. Meanwhile, the company needs to obtain additional outside financing but is unable to do so without audited financial statements. The financing is critical since the company must replace its chocolate mold machines which are approaching the end of their useful life. The current financial reporting process is antiquated and the company has never been audited or reviewed by an outside entity. Chocolate Utopia has contacted an audit firm to request an audit of its financial statements.

Introduction

The Chocolate Utopia LLC is a small business that is incorporated in New Jersey and began operations in 2006. It specializes in the manufacturing of plastic chocolate molds and is owned by a couple, Mary and Allen Tullen. Allen is responsible for the manufacturing activities while Mary handles sales and marketing. The final users of the chocolate molds are usually home crafters who melt chocolate disks and then pour the melted chocolate into the molds to set. After an hour the filled molds are turned over and the formed chocolate pieces fall out. The company produces 2,000 molds per day. Its major competitor, which is based in Oklahoma, is also the market leader with a 75% market share.

History and Organization

The Tullens have been married for 15 years and have five children, none of whom are involved in the business. Mr. Tullen's formal education ended in high school; however, he is a master electrician and is capable of fixing any piece of machinery. Ms Tullen is an exceptional marketer with a college degree in that area. Over the last fifteen years, Allen has been the main breadwinner for the family. Mary has always been involved in sole proprietary forms of business. She made money doing many home parties in order to maintain flexibility while raising their children. Through these home parties she sold Tupperware, lingerie, toys and chocolate molds. After selling chocolate molds for another manufacturing company, she decided to open a retail chocolate store. This store offered not only chocolate molds but chocolate, decorations, paper products, and other craft type items. After one year she opened another retail store but at the end of that year sold both of the retail businesses.

In 2006, the Tullens decided to lease a large manufacturing facility in Northern New Jersey for the sole purpose of manufacturing and selling chocolate molds to retail chains. The facility is rented under a five year renewable lease for approximately $5,000 per month. The company maintains only the minimum liability insurance required by the lease agreement to protect against building damage. However, it has no insurance to protect against theft or other negative impact on its inventory.

The Tullens started Chocolate Utopia on very little money. For the first year Allen kept his government job as an electrician. They did not have a great deal of outside financing. However they were able to attract bank financing from the United Bank. The outstanding loan balance is $250,000. There are no other investors in the business. The bank requires quarterly information but this information is self-reported.

Company Operations

Sales and Manufacturing

The Tullens started the business by hiring several neighborhood friends who handled the sales calls, accepted incoming materials, packaged sales to customers and kept the plant clean. The company currently has four employees exclusive of the owners. The typical worker is female with a high school diploma and no previous work experience. The Tullens are generous in that they provide employees with new cars every three years. However, the company does not offer any other employee benefits such as health, retirement or worker's compensation.

There is very little overtime demanded of the employees except during peak wholesale business seasons of January (for Easter), December (for Valentine's Day) and September (for Christmas). Although the Tullens have considered training programs for their small staff, they have never initiated such programs nor do they have any performance evaluation standards.

Most of Chocolate Utopia's equipment is used. The two chocolate mold manufacturing machines are at least 15 years old and were acquired for a modest $10,000. However, the machines break down frequently due to their age. New machines would cost $625,000 each. The tools and dies used in the machines for producing the molds are well used and have a tendency to produce molds that lacked the crisp definition that would result from using newer tools and dies. Allen works diligently to keep the machines in good running order.

There are no formal quality control procedures in place, and so less than crisp molds are regularly shipped to customers. Customers can return any item without a hassle and the company has experienced an uptick in such returns. New replacement tools and dies would cost approximately $75,000.

Common in this industry is the use of images and trademarks (i.e. Mickey Mouse, Tweedy Bird, etc.) without paying royalties. Many of these old tools and dies contain such images. Company procedures are not formally documented and much reliance is placed on the owners' collective memories to ensure the consistency and continuation of operations.

Ms. Tullen is responsible for contacting potential customers and working with current customers' needs. The customer base initially consisted of small retail chocolate shops. However, Mary was able to solicit several major large retail chains that agreed to buy Chocolate Utopia's products provided they were sold on credit terms.

All Mary's past business endeavors were operated on a cash basis. Chocolate Utopia was also started on a cash basis. The company paid its vendors in cash and customers always prepaid for their orders. As Mary started dealing with larger customers, the customers paid their invoices within 30 days. Since the company is minority-owned, Mary was able to secure large sales contracts with Sears and Target which has resulted in an increase in revenue. For instance, the company reported sales of $150,000 in 2007 which grew to $5 million in 2009. As a result of these national contracts, the company was forced to move from a cash only business to credit sales, with most receivables outstanding for 30 days or more. This has affected the company's cash flow and its ability to pay its vendors on time.

Mary is also responsible for working with the company's vendors mainly the United Postal Service (UPS), Pacific Plastics Company (PPC), and United Bank. All wholesale sales are shipped out on a daily basis via UPS. Due to its cash flow problems, the company must prepay UPS before it will pick up a delivery. PPC supplies all materials used to produce the molds and has demanded that payment be made within five working days of the company's plastics' deliveries. The company is also chronically late with the loan payments to United Bank.

Financial Operations

The company does not have an accounting department and the financial statements and tax returns are prepared by a bookkeeper (a close relative) on a pro bono basis. Also, it does not use formal budgets or other planning tools since company activities or plans are developed based on Ms. Tullen's intuition.

Customer payments are processed by any employee based on their work load (i.e., no one employee has this responsibility). The employee opens the mail, records the payment in a manual ledger, and transfers the funds to Ms Tullen. Ms Tullen deposits the funds in the bank account at her convenience. The Tullens are the only ones with access to the bank account and each can authorize cash disbursements from the bank account.

The company's bank account is not reconciled on a monthly basis. Instead, the bank statements are received and accumulated, and two or three are reviewed and reconciled at the same time by Ms Tullen. Therefore, the identification and recovery of funds due to bank errors or misappropriation could go unnoticed for a few months. Ms Tullen provides the bookkeeper with the bank statements and other source documents to facilitate the financial and tax reporting process.

The company (with the bookkeeper's assistance) provided you with a balance sheet as of the end of the most recent quarter. The information is provided below.

The Chocolate Utopia Inc
Balance Sheet
June 30, 20xx

Assets	
Cash	5,000
Accounts receivable (net)	50,000
Inventory	150,000
Leasehold Improvements (net)	50,000
Machinery(net)	-
	255,000
Liabilities and Equity	
Liabilities	
Accounts payable	50,000
Loans payable	250,000
Total liabilities	300,000
Owner's Equity	(45,000)
Total liabilities and equity	255,000

The Tullens have continuously taken out profits from the business in the form of salaries and for personal expenses such as paying the mortgage on their home. No extra money has been retained in the company for future working capital. With the failure to build-up capital invested in the business, the bank is reluctant to advance any additional funds without an independent evaluation of the business.

Call to Action

The bank requires audited financial statements from the company before it considers any additional loan requests. Chocolate Utopia has contacted your firm to request that it performs a financial statement audit to satisfy the bank's requirements.

Assume you have been asked to perform a risk assessment to help the audit partners determine whether they should accept Chocolate Utopia as a new audit client as part of the firm's due diligence process. You are ask to perform the following tasks and then to make an accept/reject recommendation to the partners.

1. Use the Business Risk Framework (Appendix A) to help formulate your risks. Using this framework, identify 12 business risks from the above case. Place the identified risks in Appendix B (Identify Business Risks.)
2. Take each identified risk in No. 1 above, and rank the likelihood of that risk occurring. Rank 10 for 'High Likelihood' and 1 for 'Low Likelihood'. Some risks may have the same ranking. Place rankings in Appendix C.
3. Take each identified risk in No. 1 above, and rank the impact of that risk on meeting business and financial objectives. Rank 10 for 'High Impact' and Rank 1 for 'Low Impact'. Place rankings in Appendix D.
4. Using results from No. 2 and No. 3 above, (Appendix C and Appendix D), transfer information to Appendix E.
5. Rank-order the risks from Appendix E from high to low. For example, if an identified risk has 10 for Likelihood, and 9 for Impact, (and there are no higher risks identified) then this is the most important risk associated with this client. Do this for each of the 12 Risks. Use Appendix F.
6. Take the prioritized risks from Appendix F and position in the Impact / Likelihood Matrix (Appendix G). For example, if Risk No. 1 is the risk of using very old machinery to manufacture molds and is ranked 10, 8, place No. 1 in the upper right quadrant. Do this for all risks identified.
7. Create an audit memorandum, addressed to the partners, outlining the significant business and financial risks associated with The Chocolate Utopia LLC. Concentrate on the risks in the upper right hand corner of Appendix G (the highest likelihood/impact risks). Use Appendix G to make a recommendation on whether to accept or reject The Chocolate Utopia LLC as a new client. Use Appendix H.

Appendix A

Business Risk Framework[1]

Objectives:			
Strategic (risks that relate to doing the wrong things)	**Operating (risks that relate to doing the right things the wrong way)**	**Reporting (risks that relate to losing financial resources or incurring unacceptable liabilities)**	**Compliance (risks that relate to inaccurate or non-relevant information, unreliable systems, and inaccurate or misleading reports)**
Political/Cultural	Hiring	Availability of capital	Laws and regulations
Natural and man-made disasters	Knowledge and skills of work force	Interest rates for capital	Regulatory reporting
Sufficiency of systems	Development and training of work force	Creditworthiness of client	Securities law
Industry	Size/Safety of work force	Cash availability for investing	Transfer Pricing Tax Issues
Competitors	Reliability/Protection of systems	Securities held	Environmental
Financial Markets	Procurement Practices	Receivables	Antitrust law
Outsourcing	Technology/Obsolescence	Inventory	
Organizational Planning	Physical plant and other tangible assets	Derivatives	
Resource allocation by the organization	Development, Quality, Pricing, Cost, and Delivery of products	Accounting issues	
Monitoring by the organization	Knowledge and intellectual property	Budgets	
Credit Granting Policies	Consumer protection	Accrual Tax Issues	

[1] Framework was developed by the authors using the objectives from the COSO/ERM framework

Business Risk Framework (continued)

Objectives:			
Strategic (risks that relate to doing the wrong things)	**Operating (risks that relate to doing the right things the wrong way)**	**Reporting (risks that relate to losing financial resources or incurring unacceptable liabilities)**	**Compliance (risks that relate to inaccurate or non-relevant information, unreliable systems, and inaccurate or misleading reports)**
Mergers, acquisitions, and divestitures	Customer Satisfaction	Financial reporting	
Joint ventures and alliance of the organization			
Leadership Vision and Judgment			
Relevance and accuracy of measurements of financial information			
Succession Planning			
Tone at the Top			
Management - Accountability, Authority, Responsibility			
Ethics			
Reputation			
Company Values			
Fraud and illegal acts			
Investor/Creditor Relations			
Performance rewards for employees			
Employee Benefits			
Workplace environment			
Diversity in work place			

Appendix B

Identify Business Risks

Identified Risks:

1. ____
2. ____
3. ____
4. ____
5. ____
6. ____
7. ____
8. ____
9. ____
10. ____
11. ____
12. ____

Appendix C

Analyze Likelihood of Business Risks

Analyze identified business risks by the likelihood of occurrence. Rank 10 for High Likelihood of Occurrence. Rank 1 for Low Likelihood of Occurrence.

Identified Risks:	Likelihood:
1. ____	_______
2. ____	_______
3. ____	_______
4. ____	_______
5. ____	_______
6. ____	_______
7. ____	_______
8. ____	_______
9. ____	_______
10. ____	_______
11. ____	_______
12. ____	_______

Appendix D

Analyze Impact of Business Risks

Analyze identified business risks by the Impact of the risk on meeting business objectives. Rank 10 for High Impact. Rank 1 for Low Impact.

	Identified Risks:	Impact:
1.	________________________________	_____
2.	________________________________	_____
3.	________________________________	_____
4.	________________________________	_____
5.	________________________________	_____
6.	________________________________	_____
7.	________________________________	_____
8.	________________________________	_____
9.	________________________________	_____
10.	________________________________	_____
11.	________________________________	_____
12.	________________________________	_____

Appendix E

Analyze Business Risks for Likelihood and Impact

Analyze identified business risks by the likelihood of occurrence and the potential impact on achieving the company's objectives. [Likelihood rankings should come from Appendix C. Impact rankings should come from Appendix D.)

	Identified Risks:	Likelihood:	Impact:
1.	______________________________	______	______
2.	______________________________	______	______
3.	______________________________	______	______
4.	______________________________	______	______
5.	______________________________	______	______
6.	______________________________	______	______
7.	______________________________	______	______
8.	______________________________	______	______
9.	______________________________	______	______
10.	______________________________	______	______
11.	______________________________	______	______
12.	______________________________	______	______

Appendix F

Prioritize Business Risks for Likelihood and Impact

Prioritize identified business risks from Appendix E, by risks that have a 10 ranking for likelihood of occurrence and a 10 ranking for potential impact on achieving the company's objectives.

	Identified Risks:	Likelihood:	Impact:
1.	________________	______	______
2.	________________	______	______
3.	________________	______	______
4.	________________	______	______
5.	________________	______	______
6.	________________	______	______
7.	________________	______	______
8.	________________	______	______
9.	________________	______	______
10.	________________	______	______
11.	________________	______	______
12.	________________	______	______

Appendix G

Business Risk Matrix – Likelihood / Impact

High Impact

Impact of risk on Achievement of Objective		
	Likelihood of Occurrence	

Low Impact **Low** **High**

Appendix H

Audit Memorandum

Date: (use the assignment completion date)
To: Audit Partner
From: Student Group (List Names)

Re: Potential Client: The Chocolate Utopia LLC

Based on our analysis of the above client, we've identified the following business risks that should be considered as part of the firm's due diligence process:

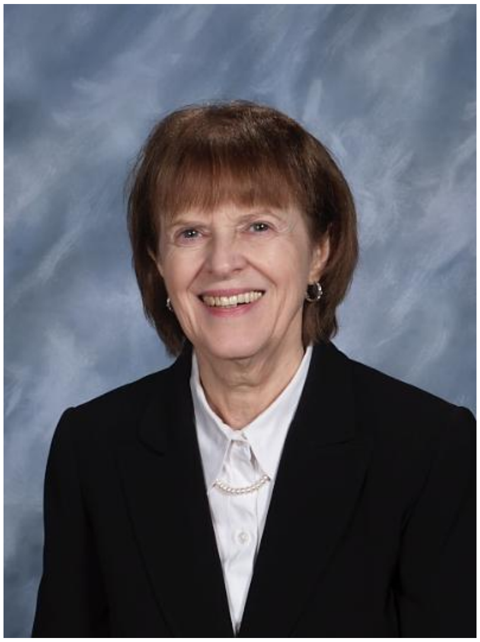
(Identify and discuss the major business risks)

Recommendation

(The group's accept or reject recommendation goes here.)

Teaching Note/Instructor Manual available from the authors.

Biographies



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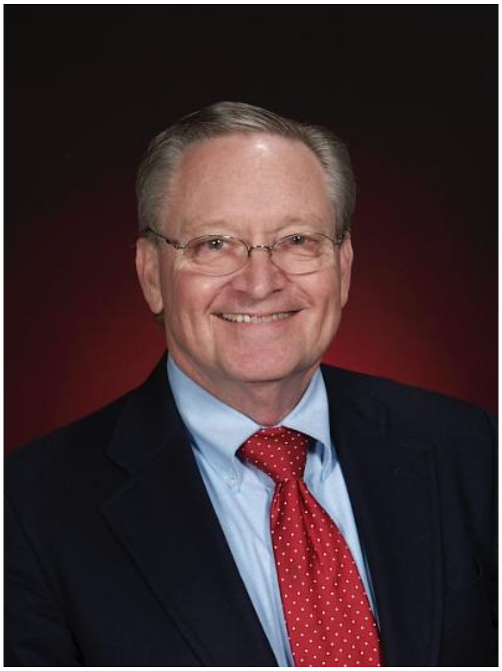

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