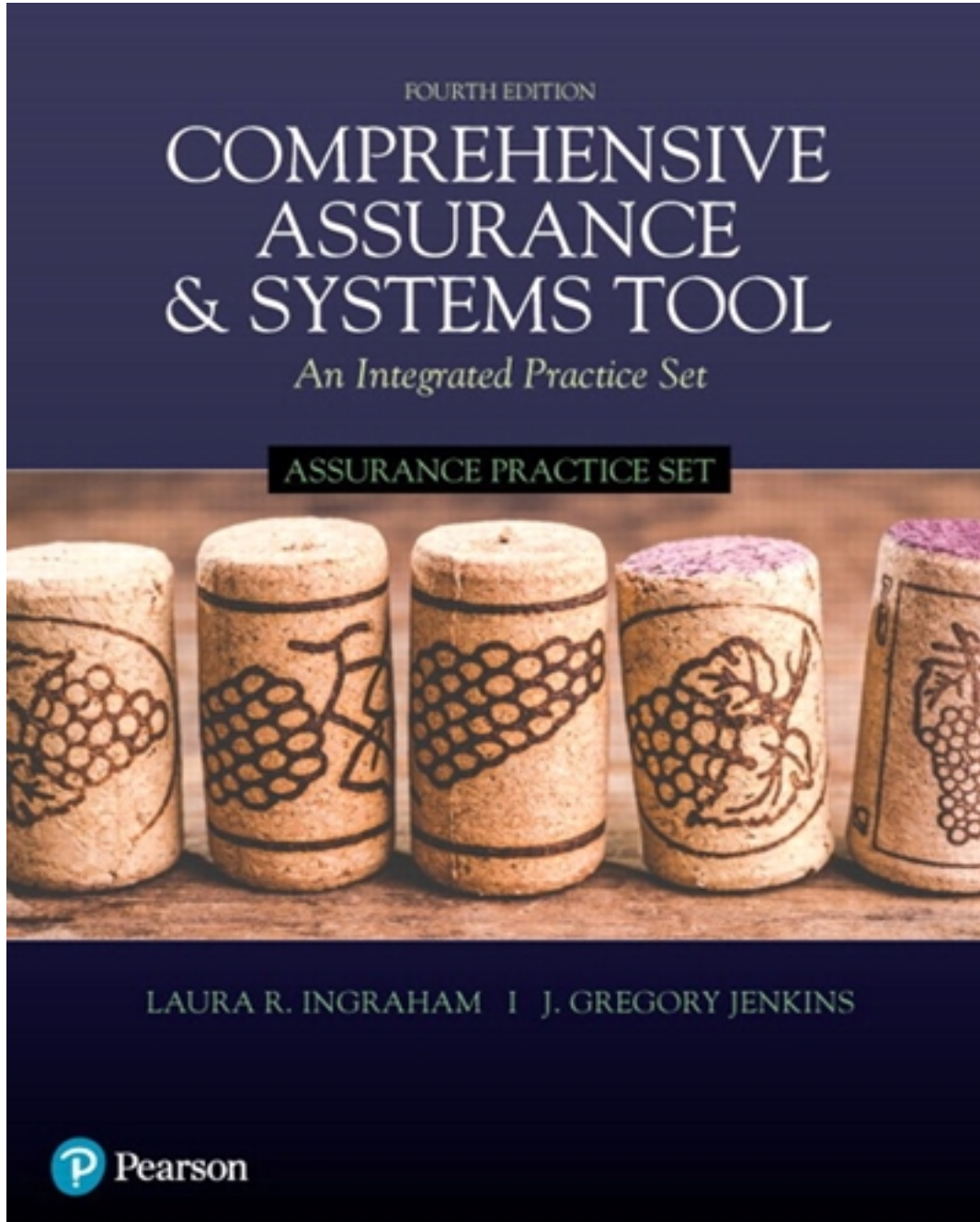


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## **INSTRUCTIONAL NOTES**

### **UNDERSTANDING THE BUSINESS ENVIRONMENT: The Winery at Chateau Americana**

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#### **INSTRUCTIONAL OBJECTIVES**

- Describe and document information related to the evaluation of a client's business environment
- Describe sources of business risks and understand the relationship between business risk and the risk of material misstatements in the financial statements
- Describe the types of information that should be used in assessing the risk of material misstatements in the financial statements
- Articulate the types of questions that may be used to conduct interviews of client personnel

#### **KEY FACTS**

- The winery is a family business with most management positions held by family members.
- The wine business is highly competitive with almost 8,000 wineries in the U.S.
- The winery has a relatively stable workforce of 250 permanent employees and is currently operating below capacity.
- The company's products are sold in more than 20 states.
- The company is planning to expand its sales force and increase sales to a level slightly below capacity over the next three to five years.
- There is an active board of directors comprised of seven individuals – three employees and four non-employees. There are no sub-committees.
- There is an incentive plan that is available to all employees. Bonuses are based upon company performance (e.g., sales, profits, and various production efficiency measures).
- The company just completed its first full year after implementing a fully integrated accounting information system. The chief financial officer believes the system provides accurate and useful information.

## SUGGESTED SOLUTIONS

1. ***Document your assessment of Chateau Americana on each of the following criteria: business and industry, operations, management and corporate governance system, objectives and strategies, and performance measurement system.***

Many students will tend to want to focus on an evaluation of the company's accounting system and will fail to understand the importance of understanding the company's business environment. Instructors may wish to motivate this particular requirement by asking students to discuss the means by which a company might respond to various external business forces (e.g., competition, labor shortages, general economic conditions, investor expectations) and the impact that such actions can have on accounting decisions and choices. These criteria are based upon those discussed included in "AU-C 315: Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement."

The following is a partial list of issues that students may discuss for each of the dimensions:

### Industry, regulatory and other external factors

- a. The winery is a typical family business with many management positions held by family members.
- b. Edward Summerfield, the winery's president, founded the winery in 1980 following a long career in the wine industry.
- c. The wine business is highly competitive with some 8,000 wineries in the U.S.
- d. The company is located in California, home to almost half of all domestic wineries. This location gives the company reasonable access to a talented labor pool.
- e. While there is a trend toward consolidation, the Summerfield family does not intend to sell the company.

### Nature of the entity

- a. The winery has a stable work force of 250 permanent employees. Temporary employees are hired as needed to assist with the harvest each year.
- b. The winery's current production level is below capacity such that unexpected demand can be accommodated given sufficient lead time.
- c. The company currently sells its wine in more than 20 states.
- d. The board of directors (BOD) has seven total members - three employees and four non-employees. Employee members are Taylor Summerfield and Rob Breeden. The non-employee members are Edward Summerfield's wife Charlotte, Bill Jameson, and Susan Martinez, and Terrence Dillard. Bill and Susan are local business owners and Terrence is an attorney.
- e. The BOD generally meets for two to three hours four times a year. There are no subcommittees (e.g., audit committee, compensation committee, etc.).
- f. Management appears to be competent and each individual has relevant and substantial outside business experience.
- g. Management has no intentions of selling the company. The owners/managers rely on the company for their livelihood.

### Objectives and Strategies

- a. The winery plans to increase its sales force and to increase and sustain production at a level slightly below capacity within the next three to five years. Planned annual sales growth is eight to ten percent.

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- b. The company currently has several exclusive agreements with distributors in several large metropolitan areas. Management plans to pursue similar agreements with distributors in other areas in the near future.
- c. The advertising and marketing budget appear to be sufficient. The vice president of marketing expects to increase the budget by 10 to 20 percent in the near future.
- d. The company is very conscious of its reliance on single customers. Consequently, no single customer represents more than five percent of annual sales.
- e. The company's president noted that the company has excess production capacity of 80,000 cases per year, but the company's vice-president of winery operations stated that excess capacity was just 20,000 to 30,000 cases. This difference should be resolved and its implications understood.

Measurement and review of the entity's financial performance

- a. The winery recently implemented a new, fully integrated accounting information system. The chief financial officer believes that the new accounting information system provides higher quality information than the old system.
- b. The sales force is compensated through a salary and sales-based commission plan. All other company employees receive annual bonuses based on the company's overall performance.
- c. The company considers operating effectiveness and efficiency measures to determine the bonus amounts.

**2. Document your assessment of Chateau Americana's control environment.**

Students should document their assessment based upon the control environments outlined in "AU-C 315: Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement." These factors are integrity and ethical values, commitment to competence, participation by those charged with governance, management's philosophy and operating style, organizational structure, assignment of authority and responsibility, and human resource policies and practices.

Chateau Americana measures-up reasonably well on each of these factors. Based on the interviews the management group appears to be committed to honesty and hard work and also to rewarding these attributes. Employees are encouraged to maintain their competence levels and the company has a reimbursement policy which allows employees to continue to maintain their education and skill levels. The company has a board of directors comprised of three employee directors and four non-employee directors (although one of these individuals, Charlotte Summerfield, is the wife of the president). The company does not have an audit committee, but does appear to be reasonably active. Based on the available evidence the board appears to be filled with competent directors.

The management group is committed to open communications with employees and maintains an "open door" policy. There has been little employee turnover over the years which suggests that this approach is successful at maintaining employee morale. The company's organizational structure is typical of a small, privately-owned business. The president appears to respect the opinions of other members of management and there does not appear to be a great deal of domination by a single person. While there is no explicit description of the company's policies regarding assignment of authority and responsibility, the interview transcripts suggest that management employees understand their functions and are vested with the appropriate authority. The company seems to be committed to its employees and takes actions to reduce turnover and maintain their skills.

The final requirement asks students to make an overall assessment of the control environment. There is no single answer to the question; rather, students' memos should support their assessments which

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should be generally favorable. Instructors may wish to slightly modify this requirement by asking students to weight the seven underlying factors so that they gain an appreciation for the relative importance among the factors.

3. ***Identify and discuss factors affecting Chateau Americana's business risk. For each of the factors, indicate the client's business objective that is put at risk.***

Student responses will likely differ as students may be less confident in their ability to identify business risks and the related at-risk business objectives. The following is a partial list of factors and the related at-risk business objectives:

- a. Wine consumption (i.e., sales) may decrease due to a deterioration in general economic conditions – Increasing sales and profits
- b. A poor-quality or lower than expected harvest could have negative consequences for the winery's production and reputation – Future sales growth
- c. Consolidation within the industry could put pressure on the company's ability to competitively price its wines – Growth in market share and sustained sales and profits
- d. General economic conditions could lead to higher than expected bad debts – Cash management strategies may be ineffective at maintaining necessary liquidity
- e. Unforeseen events (fire, flooding, freezing, etc.) may destroy or severely damage the winery's vineyard or their suppliers' vineyards – Sustained production
- f. The company's new accounting information system may provide erroneous data to management – Numerous business objectives may be put at risk including cash management, accounts receivable collection activities, inventory management, and vendor payments
- g. A limited number of interested and qualified family members may give rise to management succession problems – Management succession is a significant issue in many companies, but especially in family owned businesses. If management succession and transition are not properly addressed a company can suffer from a host of operational and strategic difficulties.

4. ***Based on your knowledge of Chateau American, what accounts are likely to have a lower risk of material misstatement and what accounts are likely to have higher risk of material misstatement?***

NOTE: You may wish to ask students to begin by explaining the relationship between business risk and the risk of material misstatement in the financial statements. Responses may follow along these lines: Business risk represents the risk that a company will fail to achieve its objectives due to internal and/or external factors. The auditor should be concerned that management will respond to increased business risks by pursuing operational plans that might be ineffective or utilizing accounting practices that may be inappropriate. If management is unsuccessful in responding to business risks, there may be increased incentives to select accounting treatments that provide a desired outcome. Such pressures are greatest when the company reports results to outside parties such as stockholders and creditors.

Students may have difficulty with this question. Nonetheless, the question is intended to encourage students to think carefully about how an auditor goes about making such an assessment. The suggested solution is based upon a typical audit environment with reasonably strong controls. Changes in the auditor's assessment of the components of the audit risk model would influence the following discussion. Accounts that are likely to have a lower risk of material misstatement include: Cash, Investments, Notes payable, and Long-term debt. Cash is generally considered to have high inherent risk; however, because the year-end balance can be confirmed with an outside party, there is a lower risk of material misstatement. The Investments, Notes payable and Long term debt accounts

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are also easy to confirm with outside parties and so there is a lower risk of material misstatement for these accounts as well. Accounts that may have a higher risk of material misstatement include: Accounts receivable, Inventories, and Accounts payable and accrued expenses. Accounts receivable and Inventories require management to exercise considerable judgment in estimating bad debts and assessing inventory obsolescence. These types of judgments are subjective and may result in misstatements to either account. Accounts payable and accrued expenses also have a higher risk of material misstatement due to their nature and the volume of transactions. Of particular concern with liability accounts is the issue of “completeness.”