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Assessing Audit and Business Risks at Toy Central Corporation

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ABSTRACT: This case requires you to evaluate business risks and accounting issues facing a toy manufacturer, and determine how these matters will translate into assertion-specific audit risks. When performing your analyses, you will need to draw on your general knowledge of toys and possibly research some of the issues facing the toy industry. Through these analyses, you should begin to see a need for auditors to consider broad management issues relating to supply chain management and marketing, as well as more traditional matters pertaining to accounting and auditing.

INTRODUCTION

As a senior in a professional services firm, you have been assigned to plan the financial statement audit of a private company named Toy Central Corporation (TCC). In addition, the partner on the engagement has asked you to identify business risks that could adversely affect TCC's sustained profitability, so that they can be brought to the attention of the company's board of directors. These tasks will require you to draw on your knowledge of supply chain management, marketing, internal controls, audit assertions, and financial accounting.

COMPANY BACKGROUND

Toy Central Corporation (TCC) designs, manufactures, and markets a variety of toys, which are sold primarily to large national retailers like Wal-Mart, Toys R Us, Kmart, and Target. TCC is a small company compared to competitors Mattel and Hasbro; nevertheless, TCC's managers believe its toys are among the best in the world. Unlike the larger toy makers, which bring thousands of toys to market each year but experience success with only a fraction of them, TCC has enjoyed success with a small portfolio of brands and products, representing three categories: (1) soft toys, consisting primarily of its Cuddle Monsters® stuffed animals; (2) hard toys, including metal-cast and plastic-cast toys like Fast Racers® cars and Acto® action figures; and (3) digital toys, consisting of video game software under development. Like most toy makers, 60 percent of TCC's sales revenues are generated in October and November, with the last two weeks of November driving half of those sales.

Your firm, KDOK, has been TCC's professional services firm since 2001, providing audit and tax services for the company. The primary external user of TCC's audited financial

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statements is its bank. Assume it is now October 28, 2007. You have taken over audit senior responsibilities for the company's October 31, 2007 year-end financial statement audit, because the original audit senior has left the firm. As a private company, TCC is not directly affected by the Sarbanes-Oxley Act (SOX). However, the partner in charge of the engagement has advised you that, ever since the financial scandals at the turn of the century, TCC has become interested in strengthening its corporate governance. Two years ago, following the release of the AICPA's Audit Committees Toolkit for public and private corporations, TCC has asked your firm to consider not only financial reporting issues, but also significant business risks that could affect the sustainability of TCC's success in the toy industry. Although TCC's board of directors believes it is aware of strategic issues facing the company, it has been considering spinning off its digital toy division into a separate company and, subsequently, merging it with an upstart software company. Before embarking on a change in organizational structure, the board wants a "second set of eyes" to ensure it has considered all significant business risks that currently exist and could adversely affect TCC in the foreseeable future. TCC's audit committee is meeting in two weeks and would like the partner to explain significant business risks identified during KDOK's interim audit tests and the year-end audit planning.

The partner would like you to prepare an audit planning memorandum that addresses significant engagement issues, and specifically identifies matters relevant to the audit committee. To prepare the memo, you have consulted last year's audit file (Exhibit 1), findings of interim audit procedures (Exhibit 2), and a memo prepared by the engagement partner (Exhibit 3).

REQUIREMENTS

Develop a planning memo for the TCC engagement based on the information provided in the case. The planning memo should address the following issues:

(1) Business risks.
(2) Audit risk factors.
(3) Accounting issues, related management assertions impacted by these issues, and planned audit approach to address these issues.

Bear in mind that the partner on this engagement is also responsible for many other client engagements. Consequently, while you should endeavor to be direct and succinct in your memo (limiting it to no more than four single-spaced pages), you should avoid assuming that the partner will fully recall all relevant facts, or that she will immediately recognize all important implications of those facts. In short, be sure to describe the specific facts that you consider relevant and explain the implications for the TCC engagement. In addition, you are not expected to outline all audit procedures that would be performed on the engagement. Instead, just provide a general overview of how KDOK might approach the audit for each accounting issue identified.

EXHIBIT 1
Observations Noted in Last Year's 2006 Audit File

1. TCC's management advised KDOK that retailers dramatically reduced the quantity of toys they were willing to carry in 2006, and were expected to continue this trend in 2007. This reduction in available retail shelf and warehouse space has intensified competition among all manufacturers of consumer products, particularly those in the toy industry. The change did not reduce the volume of toys sold through retailers. It did, however, require that manufacturers be able to fill a retailer's order with only 1–2 days of advanced notice rather than the 2–3 weeks that they enjoyed in previous years.
2. By and large, 2006 was a successful year for TCC. Sales picked up from 2005—a result largely attributable to introducing the Cuddle Monsters® stuffed animals during the year. As compared to 2005, production costs in 2006 fell slightly because differences in foreign currency exchange rates allowed TCC to purchase toy parts from foreign suppliers at lower U.S.-dollar-equivalent prices. The only negatives for TCC in 2006 were substantial write-offs taken to increase reserves for receivables and inventories. Despite these charges, TCC exceeded its earnings target for fiscal 2006, reporting operating income of $1,008,700 and net income before tax of $857,600.
3. The Cuddle Monsters® stuffed animals were introduced on October 15, 2006, in time for the Christmas holiday selling season. By blending electronics-based facial gestures with the warm comfort of a teddy bear, the products instantly struck a chord with kids, selling out within only three weeks. Unfortunately, because TCC had not anticipated the wild popularity of the toys, the company had not placed sufficient orders with the supplier of the electronics components, whose manufacturing facilities are located in the Philippines and Taiwan. As soon as TCC realized the toy's popularity, it placed a large order for electronics components. Unfortunately, the components were not delivered in time for TCC to make more Cuddle Monsters® for the 2006 holiday selling season.
4. TCC's October 31, 2006 allowance for doubtful accounts included a reserve to cover amounts owed by Kmart that TCC was concerned would not be collectible. According to TCC's CFO, Kmart has struggled ever since it emerged from bankruptcy protection and merged with Sears in 2005, but was expected to receive a significant future infusion of cash from Sears Holdings Corporation. To be safe, though, an extra $100,000 was added to the receivables reserve specifically for Kmart.
5. Ever since 2004, TCC's executives have shared in a bonus pool that is created through TCC contributions of 10 percent of the first $250,000 of operating income, plus 20 percent on the next $250,000, and an additional 30 percent of the next $500,000. TCC's total contributions to the bonus pool are capped at a yearly maximum of $225,000.

EXHIBIT 2
Findings from Interim Audit Procedures Conducted in July and August 2007

1. Based on a sample of 75 cash disbursements, KDOK concluded that controls over the purchase/payables/payments system were operating effectively. Most disbursements were made for purchases of raw materials from suppliers in Taiwan, and were properly converted to U.S. dollars and classified to appropriate accounts. Only one item seemed unusual in comparison to the sample; it involved a $10,000 payment to the International Workers Transport Union. The payment was requisitioned by TCC's VP-Operations and was approved by the CFO. According to the VP, this payment was "a gesture of support for U.S. transport workers—a gesture we believe is important these days, as transport workers believe they are significantly underpaid and are talking about organizing work stoppages and strikes in 2007 in the late fall or early winter. Our hope is that this payment will make it possible for the union executives to discuss and resolve this matter with their members before things get out of hand." KDOK's audit staff member noted

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EXHIBIT 2 (continued)

that because the transaction was approved and was appropriately classified as an "other non-operating expense," a control deviation did not exist.

2. One of the control tests for the receivables system involved determining whether bad debt write-offs and recoveries were properly authorized. KDOK's staff member concluded, based on a sample of five transactions selected randomly from transactions during the first three quarters of fiscal 2007, that TCC's authorization controls over bad debts and recoveries were effective. The staff member further noted that "even the CFO should be commended for his diligence of over-sight, having approved the recording of a recovery on July 31, 2007 for $100,000 owed by Kmart that had been previously allowed for." The staff member noted that the CFO not only approved the recording of the recovery, but that he also initiated the journal entry for the transaction.
3. KDOK also performed interim substantive tests of inventory. The audit staff member noted that TCC counted its inventory of Acto® action figures on July 31, 2007. The staff member concluded that she was "satisfied that everything that TCC had produced was included in the inventory records." Further, the staff member mentioned in passing that this was her first enjoyable inventory count, because "there was something pleasing about seeing all those cute little stuffed animal faces everywhere throughout the warehouse."

EXHIBIT 3
Audit Partner Memo to File

1. Although TCC was unable to produce enough Cuddle Monsters® to satisfy the enormous demand for them during the 2006 holiday selling season, it was able to produce significant quantities during the second week of January 2007. Although not ideal, this timing allowed TCC to sell a fair quantity of this product for Valentine's Day 2007. Soon after, at the insistence of the national retailers, all unsold Cuddle Monsters® were returned to TCC for a full refund. In addition to freeing-up shelf space in the short-term, the retailers claimed that this action would be beneficial in the long-run, as it would help TCC to build-up demand for Cuddle Monsters® over the summer—increasing the chances that a holiday season selling frenzy could again be created in November 2007.
2. TCC's executives have been working hard to boost sales in September—a month that traditionally has been "the quiet before the storm" of October, November, and December sales. After several months of negotiations, TCC has worked out a partnering agreement with Fathom Studios—a movie company that has been created to produce and distribute its first animated movie called *Delgo*. The movie is scheduled for release in theatres on October 31, 2007. The partnering agreement states that, in exchange for a $300,000 licensing fee, TCC obtains the right to produce plastic-cast *Delgo* character toys, which are expected to be sold through TCC's regular retail customers. TCC is contemplating deferring and amortizing this fee over the 7-year period of the agreement. The agreement further states that Fathom Studios will compensate TCC if sales of *Delgo* toys fail to reach $500,000 during the first two months following the movie's release. On the basis of this guarantee, TCC has accrued $500,000 of sales revenue in September 2007, when the contract was signed. The delay in reaching a final licensing agreement somewhat delayed final completion of the character toys, which are now expected to be ready for retailers on October 30, 2007.
3. TCC's executives claim that they carefully reviewed their inventory pricing during October 2007 and determined that the inventory valuation reserve established in 2006 is no longer required. A journal entry was made on October 15, 2007, to reverse the entry that originally established the reserve.

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EXHIBIT 3 (continued)

4. The company with which TCC's digital toys division might be merged is named Open Game Inc. This company started its operations in 2006 by hiring a staff of programmers who were enticed to leave other software companies and join Open Game for its competitive salaries and attractive stock option program. Open Game's staff is working solely on developing a Linux-based videogame console. Linux is an easily modifiable computer operating system that is attempting to provide an alternative to much more dominant operating systems such as Microsoft's Windows. Linux has a small but devoted following, which Open Game hopes to tap. Open Game believes that its Linux-based console will attract high-end Linux users who dabble in videogames. When Open Game's work on its first-generation console is complete in Spring 2008, the console is expected to run videogames that TCC has begun developing. Open Game's console is expected to be priced at 15 percent above other game consoles. Currently, TCC has guaranteed one of Open Game's operating loans, and has been asked by Open Game's bank for a copy of TCC's audited financial statements. The precise terms of the merger agreement are still being worked-out, but current plans are for TCC to contribute financing and video game rights to the merged entity and for Open Game to contribute manufacturing equipment and game console rights.
5. To date, TCC's digital division has hired a small staff of employees, invested nearly $150,000 in creating state-of-the-art software tools that are hoped to be useful in developing Linux games, and inquired with the companies that hold the intellectual property rights to produce popular games, which currently are produced only for consoles and computers that run on Windows-based software.
6. On October 1, 2007, TCC's compensation committee agreed to double the company's contributions to the bonus pool, resulting in a yearly maximum contribution of $450,000, which will be effective for the 2007 year-end.
7. For the year ended October 31, 2007, TCC forecasts operating income of $979,980 and net income before tax of $275,000.

CASE LEARNING OBJECTIVES AND IMPLEMENTATION GUIDANCE

Learning Objectives

The TCC case has four main learning objectives:

1. To develop students' ability to identify business risks;
2. To develop students' ability to identify audit risks;
3. To develop students' ability to identify accounting issues and consider the impact of the identified issues on management assertions and on the planned audit approach; and
4. To develop students' ability to communicate the results of their analyses in writing.

Implementation Experience and Instructional Guidance

Although this case introduces TCC as a hypothetical company, it is based on issues actually encountered by companies operating primarily in the toy industry. If desired, instructors and students can heighten their familiarity with the industry, beyond the pertinent issues presented in the case, by reading the 10-Ks of Mattel, Inc. and Hasbro, Inc., and an article describing many of the supply chain management and marketing issues existing in the toy industry (Johnson 2001). The issues confronting the toy industry are similar to those affecting other industries, such as high-tech products and fashion apparel.

The TCC case is designed for use in undergraduate or graduate courses in auditing and assurance. The case can be used in at least three different ways, as has been done by the authors at the graduate level at two different institutions. First, it was used as a midterm examination question, administered after students had reviewed topics relating to business risks and the audit risk model. In this format, students were given 60 minutes to read, analyze, and write their responses. Second, the TCC case was used as a basis for class discussion, being assigned as advance reading. In this format, students prepared reference notes and engaged in class discussion during a 75-minute session. Third, the case was used as an out-of-class group project for which pairs of students researched additional aspects of the case outside of class and provided a written research paper. Students' responses to all three forms of case use were positive (as described below). They particularly appreciated how the case extended beyond the traditional scope of financial accounting and auditing in order to demonstrate the relevance of supply chain management and marketing to the delivery of professional accounting services. Based on the student responses and our own experiences using the case, we have created a list of discussion prompts that other instructors can use to guide classroom discussion (presented in the Appendix to the Teaching Notes).

When used in one of the author team's graduate auditing course as an in-class exam, the case requirements simply asked students to prepare the memo. These students had been exposed to several cases earlier in the term and were familiar with the expected structure of their memo, so this short instruction tested their ability to recall the presentation of a typical planning memo as well as their ability to identify and express points relevant to the engagement. When used in a different author's graduate auditing course as a take-home class project, the case requirements were modified to include additional directions for conducting outside research, as presented in Table 1. These directions aided students in organizing their written responses, but because they had little prior experience with preparing an audit-planning memo, some students asked for additional guidance about the structure of the memo. Table 2 provides a template for the memo that can be used if students require more structure in the assignment.

To assist instructors in assessing student responses (in written and/or oral form), an evaluation guide is provided in the Teaching Notes. The evaluation guide was initially

TABLE 1
Instructions Used to Incorporate Outside Research

You are required to develop a planning memo for the TCC engagement based on the information provided in the case and information you encounter from outside research. You should research the toy industry and look at the annual reports of other toy companies to get a sense of the issues that are faced by that industry. Newspaper articles, particularly from business-specific news sources, such as *BusinessWeek* or *Wall Street Journal,* will aid you in compiling facts about specific companies and the toy manufacturing industry in general. The planning memo should cover the following:

(1) *Business Risks of TCC*: Be sure to address risks affecting toy companies in general, including *external risk factors* (e.g., supply and demand for products, target customers, supplier issues, retailer issues) and *internal risk factors* (e.g., inventory obsolescence, allowance for bad debts, earnings management pressures).
(2) *Audit Risk Factors*: Using the audit risk model as a guide, be sure to address the inherent risk factors and internal control risk factors on the TCC engagement, as well as the fraud risk factors that are present. Be sure to provide a preliminary assessment of each type of risk as High, Moderate, or Low. Note that some of the Audit Risk factors may have been addressed as Business Risk Factors above, but here they should be addressed in the context of the specific type of risk they represent for audit planning purposes.
(3) *Accounting Issues and Audit Assertions Affected*: Identify the accounting issues being faced by TCC and discuss how these issues relate to the audit work you are likely to perform and the specific management assertions to which they relate. Be sure to identify the significant issues separately from the minor issues.

developed for use in the graduate-level midterm exam, and has been revised based on subsequent use of the case in classroom discussions and grading of group projects. The evaluation objectives identified in the guide provide flexibility to accommodate varied student responses, while providing a structure that ensures consistency in evaluation. These evaluation objectives should help discriminate among varying levels of student performance.

Student Evaluation of the Case

As noted above, student reaction to the case has been positive. For students who were assigned the case as a group research project in one graduate auditing course, we administered a survey asking students to use Likert-scale ratings to assess the case in terms of the learning objectives. The students also indicated times to complete the case, and perceptions about the case's clarity and difficulty, as well as their level of interest in the case. These students worked on the case in pairs and reported taking ten total hours to complete the case (five hours per group member). This time requirement met our expectations because, unlike students who completed the case in an exam or discussion format, students completing the take-home case were required to conduct some industry analysis, outside research, and additional reading beyond the case itself.[1]

With respect to students' perceptions of and interest in the case, the mean response of the surveyed graduate auditing students was that the case was easy to understand, moderately challenging, and generated above average interest among students. In terms of the first two learning objectives, students found the case above average in terms of helping

[1] A formal survey was not administered when the case was used as an exam question or as a basis for in-class discussion. Anecdotal student reports suggest that it was perceived as a fair and challenging exam question, but felt time pressured because only 60 minutes were allocated to the question (consistent with other case questions included in the exam). When assigned as an in-class discussion case, most students indicated it required a "typical" amount of time to prepare, which is estimated to be one or two hours of reading and analysis time.

TABLE 2
Template to be Used for Structuring Memo

NOTE: You have been asked to prepare a memo outlining the business risks faced by your client, Toy Central Corporation (TCC), as well as audit risks, accounting issues identified, and management assertions affected. Because this document has to be reviewed quickly by a partner, it should be succinct and easy to read, while still addressing all of the necessary issues. The template below provides you with a guide for completing the memo.

KDOK

Client	Period-end	W/P Reference
(i.e., Toy Central Corporation)	(i.e., 10-31-07)	

Purpose
The purpose of this memo is to document…

Business Risks Facing TCC
(Overview paragraph here)
(Bullet-point descriptions of individual risks here)

Audit Risk Factors to be Considered by KDOK
(Overview paragraph here)
(Bullet-point descriptions here)

Accounting Issues Identified and Related Assertions Affected
(Overview paragraph here)
(Bullet-point descriptions here)
For the bullet-point descriptions of each accounting issue, include sub-headings as follows:

Accounting Issue:

Assertion(s) Affected:

Steps to consider in audit of related accounts:

Concluding Remarks

them learn to identify business risks and above average in terms of helping them to learn to identify audit risks. At the time of the survey, we had framed the third learning objective as developing an audit plan responsive to identified risks. Students rated the case as only moderately above average on this dimension, and explained that their ratings were tempered by the fact that the risk assessment process and resulting audit memo was only one stage in planning an audit, and that there were other aspects of planning that the case does not aim to address. We have since refined the third learning objective to better reflect its focus on the identification of high-risk assertions at the level of transactions and account balances. In terms of the fourth learning objective, students felt that the case was above average in developing their ability to communicate in writing. Consistent with students' perceptions, the instructor (one of the authors) found the resulting written projects to be very well written. The main challenge that students faced was keeping the memos concise, given that so much information is available to them when case requirements are extended to include outside research.[2]

TEACHING NOTES

Teaching Notes are available only to full-member subscribers to *Issues in Accounting Education* through the American Accounting Association's electronic publications system at http://www.atypon-link.com/action/showPublisherJournals?code=AAA. Full-member subscribers should use their personalized usernames and passwords for entry into the system where the Teaching Notes can be reviewed and printed.

If you are a full member of AAA with a subscription to *Issues in Accounting Education* and have any trouble accessing this material, then please contact the AAA headquarters office at office@aaahq.org or (941) 921-7747.

REFERENCE

Johnson, M. Eric. 2001. Learning from toys: Lessons in managing supply chain risk from the toy industry. *California Management Review* 43 (Spring): 106–124.

[2] Descriptive statistics summarizing the numerical assessments are available from the authors upon request.