Week 3, Just for FEET, Inc.

1) Prepare common-sized balance sheets and income statements for Just for Feet for the period 1996-1998. Also compute key liquidity, solvency, activity, and profitability ratios for 1997 and 1998. Given these data, comment on what you believe were the high-risk financial statement items for the 1998 Just for Feet audit.

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| **Just for Feet, Inc** | **1998** | **1997** | **1996** | **1998** | **1997** | **1996** |
| Cash & Cash Equivalent | $12,412 | $82,490 | $138,785 | 1.8% | 18.4% | 36.9% |
| Marketable Securities |  |  | $33,961 |  |  | 9.0% |
| Accounts Receivable | $18,875 | $15,840 | $6,553 | 2.7% | 3.5% | 1.7% |
| Inventory | $399,901 | $206,128 | $133,323 | 58.0% | 46.0% | 35.5% |
| Other Current Assets | $18,302 | $6,709 | $2,121 | 2.7% | 1.5% | 0.6% |
| Total Current Assets | $449,490 | $311,167 | $314,743 | 65.2% | 69.4% | 83.7% |
| Plant, Property & Equipment | $160,592 | $94,529 | $54,922 | 23.3% | 21.1% | 14.6% |
| Goodwill | $71,084 | $36,106 |  | 10.3% | 8.1% | 0.0% |
| Other | $8,230 | $6,550 | $6,169 | 1.2% | 1.5% | 1.6% |
| **Total Assets** | $689,396 | $448,352 | $375,834 | 100.0% | 100.0% | 100.0% |
|  | | | | | | |
| Short-Term Debt |  | $90,667 | $100,000 |  | 20.2% | 26.6% |
| Accounts Payable | $100,322 | $51,162 | $38,897 | 14.6% | 11.4% | 10.3% |
| Accrued Expenses | $24,829 | $9,292 | $5,487 | 3.6% | 2.1% | 1.5% |
| Income Tax Payable | $902 | $1,363 | $425 | 0.1% | 0.3% | 0.1% |
| Current Long Term Debt | $6,639 | $3,222 | $2,105 | 1.0% | 0.7% | 0.6% |
| Total Current Liabilities | $132,692 | $155,706 | $146,914 | 19.2% | 34.7% | 39.1% |
| Long-Term Debt | $230,998 | $24,562 | $10,364 | 33.5% | 5.5% | 2.8% |
| **Total Liabilities** | $363,690 | $180,268 | $157,278 | 52.8% | 40.2% | 41.8% |
| Common Stock | $3 | $3 | $3 | 0.0% | 0.0% | 0.0% |
| Paid-In Capital | $249,590 | $218,616 | $190,492 | 36.2% | 48.8% | 50.7% |
| Retained Earnings | $76,113 | $49,465 | $28,061 | 11.0% | 11.0% | 7.5% |
| **Total Equity** | $325,706 | $268,084 | $218,556 | 47.2% | 59.8% | 58.2% |
| **Total Liabilities & Equity** | $689,396 | $448,352 | $375,834 | 100.0% | 100.0% | 100.0% |

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| **Just for Feet, Inc** | **1998** | **1997** | **1996** | **1998** | **1997** | **1996** |
| Sales | $774,863 | $478,638 | $256,397 | 100.0% | 100.0% | 100.0% |
| COGS | $452,330 | $279,816 | $147,526 | 58.4% | 58.5% | 57.5% |
| Gross Profit | $322,533 | $198,822 | $108,871 | 41.6% | 41.5% | 42.5% |
| Other Revenues | $1,299 | $1,101 | $581 | 0.2% | 0.2% | 0.2% |
| **Operating Expenses** |  | | | | | |
| Store Operating | $232,505 | $139,659 | $69,329 | 30.0% | 29.2% | 27.0% |
| Store Opening | $13,669 | $6,728 | $11,240 | 1.8% | 1.4% | 4.4% |
| Amortization | $2,072 | $1,200 | $180 | 0.3% | 0.3% | 0.1% |
| General & Administrative | $24,341 | $18,040 | $7,878 | 3.1% | 3.8% | 3.1% |
| Operating Income | $51,245 | $34,296 | $20,825 | 6.6% | 7.2% | 8.1% |
| Interest Expense | $(8,059) | $(1,446) | $(832) | -1.0% | -0.3% | -0.3 |
| Interest Income | $143 | $1,370 | $4,750 | 0.0% | 0.3% | 1.9% |
| Earnings before tax & extra items | $43,329 | $34,220 | $24,743 | 5.6% | 7.1% | 9.7% |
| Income Taxes | $16,681 | $12,817 | $8,783 | 2.2% | 2.7% | 3.4% |
| Extraordinary Item |  |  | $(2,041) |  |  | -0.8% |
| Net Income | $26,648 | $21,403 | $13,919 | 3.4% | 4.5% | 5.4% |

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| **Liquidity & Solvency** | **1998** | **1997** | **1996** |
| Current Ratio=Current Assets / Current Liabilities | $449,490/$132,692 =  3.39 | $311,167/$155,706=  2.00 | $314,743/$146,914=  2.14 |
| Debt to Equity=Debt / Equity | $363,690/$325,706=  1.12 | $180,268/$268,084=  .67 | $157,278/$218,556=  .72 |
| Times Interest Earned=  (Net income + taxes + interest) / interest expense | (26648+16681+$8059)/8059  51388/8059=6.38 | (21403+12817+1446)/1446  35666/1446=24.67 | (13919+8783+832)/832  23534/832 |
| **Activity** |  | | |
| Account Rec Turnover =  Sales / Average Account Rec | 774863/(18875+15840/2)  774863/17357.5=44.64 | 478638/(15840+6553/2)  478638/11196.5=42.75 | 256397/6553=  39.13 |
| Inventory Turnover = COGS / Avg Inventory | 452330/(399901+206128/2)  452330/303014.5=1.49 | 279816/(206128+133323/2)  279816/169725.5=1.65 | 147526/133323=  1.11 |
| **Profitability Ratios** |  | | |
| Operating Margin= Operating Inc / Sales | 51245/774863= 6.61% | 34296/478638= 7.17% | 20825/256397=8.12% |
| Net Margin=Net Income / Sales | 26648/774863=3.44% | 21403/478638=4.47% | 13919/256397=5.43% |
| Return on Assets=Net Income / Avg Assets | 26648/689396=3.87% | 21403/448352=4.77% | 13919/375834=3.70% |
| Return on Equity=Net Income / Avg Equity | 26648/325706=8.18% | 21403/268084=7.98% | 13919/218556=6.37% |

The inventory turnover seems to be low, leaving the total inventory as the majority of the total assets. It also seems that the negative cash flow from operations would give cause for suspicion from auditors. Another cause for concern for auditors would be the accounts payable/debt increase.

2) Just for Feet operated large, high-volume retail stores. Identify internal control risks common to such businesses. How should these risks affect the audit planning decisions for such a client?

Some internal controls common to high-volume retail stores include inventory control such as counting and rotation and also methods of valuation. Another internal control is a clear separation of duties. This will help prevent theft and false documentations. Most retail stores have a high employee turnover rate and if there is no separation of duties there is a higher risk of theft and other fraudulent activities. The auditor has the responsibility to access these risks when they are assessing if the company is considered a high risk.

3) Just for Feet operated in an extremely competitive industry, or sub-industry. Identify inherent risk factors common to business facing such competitive conditions. How should these risks affect the audit planning decisions for such a client?

The main inherent risk that competitive industries face comes from the pricing of their merchandise. Many times, larger chain type businesses will go out of their way to play "cut throat" games with their competition. Larger chains can get away with this because where they may lose money on a competitive product, they may gain on a specialty product. Larger chains also have more room for error because they generally have a higher product turnover. They feel if they price their merchandise lower they will generate higher sales. However, this creates a problem because in cutting prices lower than the competition, the cost of goods sold may exceed the income received from the sales. Eventually these numbers should even out, at least to the point of break even.

4) Prepare a comprehensive list, in a bullet format, of the audit risk factors present for the 1998 Just for Feet Audit. Identify the five audit risk factors that you believe were more critical to the successful completion of that audit. Rank these risk factors from least to most important and be prepared to defend your rankings. Briefly explain whether or not your believe that Deloitte auditors responded appropriately to the five critical audit risk factors that you identified.

Audit risks from least to most important

* The integrity of management and the significance placed on earnings.
* Inventory size is extremely large while the turnover rate is extremely low
* Monthly booth income and booth asset confirmations
* Negative operating cash flow for consecutive months
* Increased inventory and increased accounts payable

Auditors need to be aware that the integrity of management is questionable due to the amount of emphasis placed on earnings due to pressure by management. Another cause for concern is the inventory size. Based on the turnover rate, the inventory size is much larger than it needs to be which is an indicator that there has been a drop in sales. There are also an indication that fraud is occurring because of nonstandard accounts receivable confirmations and negative operating cash flows occurring over consecutive months. Another indicator of fraud is the increase in accounts payable and the increase in inventory where there is already an abnormally large inventory. It would give cause to ask why more inventory is being bought on credit when there is more inventory in-house than being sold. All of these items combined will suggest that the internal controls in place are highly ineffective and management in inefficient.

5) Put yourself in the position of Thomas Shine in this case. How would you have responded when Don-Allen Ruttenberg asked you to send a false confirmation to Deloitte & Touche? Before responding, identify the parties who will be affected by your discussion.

If I was in the position where I was asked to send a false confirmation to Deloitte & Touche I would refuse. This false confirmation would not only affect the business but also the vendors, customers and shareholders. If I sent a false confirmation it would not only cause me legal problems but it could also ruin my reputation. It would be highly unethical for me to take part of such a fraudulent activity.