

Aerospace Lighting, Inc. (ALI): Linking Business Strategy to Audit Planning

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ABSTRACT: Aerospace Lighting Inc. (ALI) is a supplier of cabin lighting systems to the aerospace industry. A recent change in ALI's ownership has prompted a change in the company's business strategy, as well as a change in the company's external auditors. As a member of the audit team, your assignment is to write a memo that identifies significant business risks facing ALI and elaborates on potential audit issues.

INTRODUCTION

Aerospace Lighting Inc. (ALI)—previously a private company based in Chicago—has been a leading supplier of airplane cabin lighting systems for nearly ten years. Until recently, ALI had been satisfied with its profits and had sold all its products to Bombardier, a major aerospace company in Canada. This comfortable position began to change in 2003, when a large publicly traded German company (BmG) acquired 100 percent of ALI.

For ALI, the transition from a private, independent company to a subsidiary of a public conglomerate has not been an easy one. Before the takeover, ALI's management was afforded the luxury of making decisions and taking risks that affected only one owner. Being just one arm of a much larger international company, however, now requires ALI to satisfy more than its own personnel. Members of BmG's executive team dominate ALI's board of directors. These individuals have been very critical of ALI's management, particularly in the area of financial performance. Beginning with the first board meeting in 2003, the German executive team has scrutinized ALI's operating results and has never hesitated to remind ALI management that BmG views ALI as an investment that is evaluated based on its return to BmG stockholders. BmG does not tolerate any failures to meet financial targets, and is willing to replace entire management teams if required. BmG's executives take very seriously the "Financial Handbook" that they establish each year to communicate the parent company's financial principles, including equity and capital borrowing guidelines, monthly reporting requirements, and profit expectations.

Since the acquisition, ALI has been pursuing a rapid expansion strategy. The German parent company directed ALI to enter the U.S. aerospace supply industry in 2004, and quickly increase the number of U.S. contracts on which it bid, with the goal of increasing

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its revenues by 50 percent in 2005. To reach this goal, ALI adopted a strategy of submitting bid prices to U.S. manufacturers that, after adjusting for exchange rates, are approximately 20 percent lower than the prices ALI charges to Bombardier. This strategy has been successful so far, as ALI now has several large contracts with Boeing, Lockheed Martin, and Raytheon—the largest aerospace manufacturers in the U.S. ALI has already begun preparing to work on these contracts, having accumulated a significant quantity of raw materials inventory to use in producing goods for Boeing, Lockheed Martin, and Raytheon, as well as Bombardier.

ALI's management team has not discussed its new strategy with its board because management believes BmG is interested in financial results rather than the means by which they are achieved. ALI's management team also wants to keep this strategy quiet because if Bombardier's executives were to hear about it, they would likely discontinue their relationship with ALI or immediately demand a lower price, as well as insist on a refund of any excess prices charged in previous years.

Just last week, on June 29, 2005, your firm's German affiliate was appointed worldwide audit services provider for BmG's July 31, 2005 year-end. Another firm had provided audit services for BmG and all its subsidiaries in the previous year, but BmG's executive team was dissatisfied with the auditors' inability to identify significant business risks that they believed should have been brought to their attention. Your firm's office in Munich asked your Chicago office to perform the audit of ALI for its year ended July 31, 2005, and to provide your audit working papers to the Munich office by September 5, 2005. Because BmG's stock is not traded on a U.S. exchange, the company and its subsidiaries are not subject to the provisions of the Sarbanes-Oxley Act of 2002.

A recently promoted partner in your Chicago office has been assigned the responsibility for the 2005 ALI audit. She has communicated with ALI's predecessor auditor and has provided you with the notes from her review of the predecessor's working papers (see Exhibit 1). She also has obtained information from preliminary discussions with ALI's CFO

EXHIBIT 1

Notes from Review of Predecessor Auditor's Working Papers

1. Boeing, Lockheed Martin, and Raytheon have jointly formed several policies aimed at reducing their overhead costs. One policy is that they will not respond to confirmation requests from external auditors. Another policy is that they generate a single check for each supplier every 20 to 55 days for the outstanding balance recorded at the payment date. The payment cycle period for each supplier varies, depending on its status as a preferred-A or preferred-B supplier. ALI is currently a preferred-B supplier to the U.S. companies, so it is paid every 55 days. The U.S. aerospace manufacturers also have begun expecting reductions in bid prices from suppliers as the suppliers gain experience with their production processes. Bombardier has not yet adopted policies such as these, but is expected to do so by 2007.
 2. In November 2003, ALI acquired a 47% equity interest in GlueCo for \$5 million. ALI's financial statements for the 2004 fiscal year disclosed that GlueCo was accounted for using the equity method, but ALI's management contended that they did not exert significant influence and, consequently, did not report their share of GlueCo's loss of \$1.4 million in 2004. A loss of a similar amount is expected for 2005. The audit opinion in 2004 was not qualified for this issue.
 3. On February 8, 2004, a manufacturing plant leased by ALI in Milwaukee was lost in a fire. ALI filed with its insurance company, claiming total damages of \$6.8 million. As of July 31, 2004, ALI had recorded a \$3.0 million receivable that was included in other current assets. This amount comprised the net book value of previous plant assets of \$1.7 million, plus an accrual for business interruption insurance of \$1.3 million. The predecessor auditor confirmed the details of the claim with one of ALI's external attorneys.
 4. ALI disclosed its economic dependence on Bombardier in the 2004 financial statement notes.
 5. The predecessor auditor had set materiality at \$1.1 million.
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(see Exhibit 2). The partner has asked you—as an audit senior—to prepare a memo discussing the important audit issues and any other matters she should consider regarding the upcoming year-end engagement. She reminds you that she is required to obtain second partner approval of audit plans developed for high-risk client engagements. She expects your memo will help her to (1) assess whether ALI should be considered a high-risk engagement, (2) justify that assessment to other partners in the firm, and (3) outline what will be required of you and other members of the audit team to ensure the firm meets the high expectations that BmG has for its auditors.

REQUIREMENTS

Prepare a memo that addresses the following issues and their impact on ALI's financial statements and/or the audit plan:

- a. Client Business Risks
- b. Auditor Business Risk
- c. Audit Risks (including inherent and control risk)

EXHIBIT 2

Notes from Discussion with ALI's CFO

1. With ALI's success in bidding on contracts with the big aerospace manufacturers in the U.S., ALI is projecting a 55% increase in sales revenue, from \$99 million in fiscal 2004 to \$152 million in 2005. The majority of this increase has come from sales to the U.S. aerospace companies, which in 2005 comprise one-third of total revenues. In 2004, sales to these companies were less than 1% of total revenues. The increased sales volume will increase gross profit from \$21.5 million in 2004 to a projected \$23.0 million in 2005. Although ALI's gross profit percentage on Bombardier sales has remained steady at 22%, the U.S. contracts are projected to cause the overall margin to fall from 22% in 2004 to a projected 15% in 2005.
 2. During the 2005 fiscal year, ALI's insurance company offered \$5.1 million for the claim regarding the fire at the Milwaukee plant. Of this amount, ALI received \$1.3 million. The CFO claims that ALI will not accept the insurance company's offer, arguing that ALI deserves full compensation. ALI plans to report the \$5.5 million difference between its total claim and the amount received at year-end as a receivable in other current assets.
 3. All of ALI's bid submissions and sales transactions with Boeing, Lockheed Martin, and Raytheon are now being processed through Exostar—an electronic independent trading exchange (ITX). This business-to-business website was started by the three largest U.S. aerospace companies to enhance their ability to transact with suppliers and customers, and also to share data about their own production costs. Exostar is now soliciting aerospace companies from other countries to participate in the ITX so that it can truly become a global hub for all aerospace transactions. It has been rumored that the U.K.'s BAE Systems and Canada's Bombardier are currently talking with Exostar about joining the ITX later this summer. Industry experts fully expect these companies will join soon because ITXs in other related industries have grown rapidly and yielded significant cost savings for many of their participants. Presently, it appears that ALI's auditors will not be allowed to directly examine Exostar's accounting system.
 4. ALI has a variety of debt agreements, many of which require the company to meet certain debt covenant ratios. The most binding of these requirements is for a minimum current ratio of 1.5:1 on the audited financial statements for fiscal years ending July 31. Had this covenant been applied to ALI's unaudited financial statements at June 30, 2005, it would have been breached.
 5. BmG has instituted a performance pay plan for its subsidiaries in 2005. The plan grants BmG stock options to executives of BmG's subsidiaries that meet or exceed the expectations established in BmG's "Financial Handbook."
 6. ALI's CFO estimates that the company's 2005 year-end financial statements will report approximately \$10 million in net income before tax, \$100 million of total assets, of which \$30 million will be current, and \$19 million in current liabilities.
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- d. Materiality
- e. Specific Accounting and Other Audit 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 ALI engagement. Because the contents of your memo will form the basis of discussions that the partner is likely to have with other partners in the firm, make sure that you clearly identify any specific information that your partner should consider sensitive.