BILTRITE BICYCLES, INC.

[Adapted and modified from *Auditing: A Risk Analysis Approach* 5th edition by Konrath and *Auditing: A Business Risk Based Approach* 6th edition by Rittenberg, Schwieger, and Johnstone.]

BILTRITE'S PRESIDENT AND CEO, TREVOR LAWTON

In 2007, Trevor Lawton assumed control of Biltrite after the retirement of his father, the founder of the company. The company was founded in 1980 to manufacture bicycles.

Lawton managed conservatively when first becoming CEO and President of Biltrite. In recent years he has become increasingly aggressive, believing that strategic changes must be bold, frequent and swift in order to prevail in the highly competitive bicycle industry. He has worked to make his management perspective the basis of Biltrite's corporate culture. Lawton believes that success can only be attained via aggressive marketing and containment of production costs. As a result of devoting most of his attention to sales and production, he is relatively detached from financial reporting matters. Lawton generally views the accounting function as a necessary evil conducted by "bean counters" who don't seem to understand the need for Biltrite's financial statements to "look good." Consistent with these views, the accounting group has received modest allocations of resources in recent years, and operates with a relatively small, but seemingly competent and trustworthy staff.

Reflecting Lawton's preference for centralized management, Lawton and the vice presidents of production and marketing determine Biltmore's objectives and strategic plan with limited input from other managers. Once determined, the objectives and strategic plan are not widely disseminated to employees, but are presented for feedback and approval at board of directors' meetings. Privately, some managers and board members believe the financial objectives to be overly optimistic and unlikely to be attained. In addition, many middle- and lower-level managers feel the supporting budgets lack the necessary resources to meet financial objectives.

For the past couple of years, Lawton has been unable to devote the time he would like to identifying and managing an increasing array of risks. To address this problem, Lawton has begun forming a small enterprise risk management team comprised of managers with finance, marketing, and production expertise. The team would manage risks from both internal and external sources, and report directly to Lawton. Due to heavy demands on his time, Lawton has not been able to finalize formation of the risk management team. Currently, the mechanisms in place for identifying, analyzing, and acting on risk matters are rather unstructured and vary in quality from department to department. For example, risk management in production and procurement is known to be rather weak, while the corporate controller is thought to be doing quality risk management regarding financial reporting and information systems matters.

BOARD OF DIRECTORS AND AUDIT COMMITTEE

Lawton is the chairman of the board of directors. Also on the board are two of Lawton's siblings, neither of which is engaged in day-to-day management of Biltrite. The rest of the board is comprised of Biltrite's treasurer and vice presidents of production and marketing, as well as a number of external members that were longtime business associates of Lawton's father. The external members of the board have considerable financial expertise in their respective industries (insurance, road construction, banking, health care and software). The board meets quarterly (March, June, September and December). At the December meeting, Biltrite's top managers present the board with the budget for the upcoming year and analyses of budget variances for the current year through November. Board members receive the budget and variance analyses approximately two weeks prior to the meeting. Given their limited financial expertise in the bicycle industry, Board members question or challenge the upcoming budget on few matters and seldom have probing questions regarding budget variances.

The audit committee (one of three committees along with the compensation and nomination committees) is made up exclusively of external members. At the June and December board meetings, the audit committee holds a joint meeting with the external audit partner, director of internal audit, and controller to be briefed on audit findings and approve the scope of planned audit activities. In addition, significant changes in internal control over financial reporting are presented and explained. The audit committee, in joint consultation with the compensation committee, approves the recommendations of the controller regarding the annual appointment of the external auditor, and the compensation and retention of the director of internal audit.

OPERATIONS AND HISTORICAL PERFORMANCE

Biltrite currently manufactures five bike models: the Grand and Phoenix are touring bikes; the Waist is an exercise bike; and the Himalaya and Pike are mountain bikes. Biltrite experienced steady growth in sales and profitability in all product lines until 2008. Once their sales started to recover, intense competition has had a significant impact on both sales and profit.

All products are manufactured in one Texas factory built in 1980 and refurbished in 2006. Increased automation enabled Biltrite to decrease its factory workers from 3,000 in 2008 to 2,000 today, and to reduce its sales force from 150 to 120 in response to declining sales. The vice president of production observed that automation enabled Biltrite to significantly increase production-worker productivity. The marketing vice president agrees and predicts revenue and profit growth through at least the current year. However, the corporate controller is concerned about a decline in operating income margin as a percent of sales, attributing the decline to the increased fixed manufacturing overhead costs from increased automation.

Derailleurs are a major portion of the parts inventory. Other purchased parts are tires, handle grips, pedals, wheels, and spokes. Materials and supplies consist primarily of paint and steel. Biltrite manufactures frames and handlebars, and assembles and paints the bikes. Inventories of materials, purchased parts, and finished goods are secured, and inventory managers have been assigned responsibility for safekeeping. Internal audit performs periodic test counts and comparisons with perpetual records; all inventory items are counted once every 18-24 months. When they do plan these counts, auditors notify inventory managers four or five weeks in advance so that the count doesn't interfere with production.

Administrative offices are located in another building in the same complex as the factory. Biltrite's regional locations across the U.S. have grown over the years to ten, each consisting of a distribution warehouse headed by a superintendent and a sales office directed by a sales manager. Products are shipped to warehouses upon completion at the factory, and from the warehouses shipped to licensed dealers in the respective regions. The dealer network consists of about 1,500 outlets throughout the U.S. and Canada.

Products carry a one-year warranty covering parts and labor. Biltrite is known for the quality of its products and for strong after-sale service support (100 percent parts and labor warranty for one year following sale). At the end of the prior year, Biltrite had a total of 60 customer accounts ranging in amounts from approximately $2,200 to $1,350,000. The total accounts receivable at the same date was $12 million.

The company employs about 2,000 production workers and 200 salaried administrative employees, including corporate management staff, warehouse superintendents, and regional sales managers. In addition, 100 warehouse personnel and 120 salespersons are employed by regional units. Hourly employees (production workers and warehouse personnel) are paid weekly; salaried employees are paid biweekly. Salespersons receive a modest salary; most of their compensation comes in the form of a commission on gross sales.

In an attempt to combat the strong competition from bicycle producers, managers at Biltrite, particularly those responsible for marketing and controlling production costs, have been given demanding performance targets in recent years. While the financial rewards for meeting or exceeding these targets are great, the targets are deemed very difficult to attain. In response, many marketing and production-control managers have left the firm for opportunities elsewhere, leaving Biltrite relatively understaffed in these areas. In addition, many recent hires to the management team have not been provided with sufficient descriptions of or training for the tasks, knowledge and skills needed to succeed.

ACCOUNTING AND INFORMATION SYSTEMS

Biltrite closes its general ledger on a calendar-year basis. Unaudited quarterly financial statements are reviewed by Vaughan & Co, Biltrite's auditor since incorporation. The accounting information system, including the general ledger, inventories, receivables, payables, and plant assets, was upgraded to a real-time system in 2011. After extensive debugging, the real-time system seems to be functioning smoothly. Bank accounts are reconciled monthly. Biltrite provides the auditors with a year-end adjusted trial balance and a complete set of financial statements, together with supporting schedules.

Groth, the corporate controller, has been with Biltrite since 1995. He is an MBA and a CPA and worked with Vaughan & Co. from 1987-1995, attaining the level of audit manager. Biltrite's internal audit staff of three members is viewed as competent. The internal audit group conducts evaluations of important processes (e.g., sales, purchases, payroll, etc.) on a recurring basis, usually once every 10-14 months. In addition, the group works on special projects as warranted. Any weaknesses in accounting and information systems are reported immediately to Groth and the responsible function manager. The director of internal audit reports directly to Groth and also makes periodic presentations of recommendations and findings to Lawton and the audit committee.

Groth has made efforts to minimize the chance of financial reporting improprieties at Biltrite. To date, no cases of improprieties have been documented. One approach has been to widely publicize among the accounting group the seriousness of and severe penalties (loss of job and prosecution to the full extent of the law) for any improprieties.

Another approach taken by Groth to minimize improprieties was to create a process for anonymously communicating information upstream through someone other than a direct superior. The process promises that "whistleblowers" will be protected from possible reprisals.

Finally, Groth has overseen the development of detailed job descriptions for each of the accounting and information systems managers. In addition to providing explicit responsibilities and authority for each manager, the job descriptions provide detailed guidance on the situations in which a manager may override established controls, and the process for documenting, explaining, and disclosing to superiors such overrides.

Monthly financial statements are generated. Month-end adjustments for accruals (e.g., payroll, taxes, warranty, commissions, profit sharing, interest, and fringe benefits) and apportionments (e.g., depreciation, insurance, bad debts, and amortization) are determined by Mesarvey, chief accountant, and submitted to the Computer-Based Information System (CBIS) on standard recording forms. CBIS enters the data and invokes the command for printing the financial statements. In addition to financial statements, adjusting entries are printed and forwarded by the control group to Mesarvey for comparison with his copy of the adjustments as originally submitted to CBlS.

Sales invoices, purchase orders, disbursement checks, and payroll checks are pre-numbered and computer-generated. Manually prepared documents (e.g., vouchers and receiving reports) are pre-numbered, safeguarded and the responsibility of designated individuals. Used documents are canceled. Bills of lading are not pre-numbered or otherwise accounted for. Internal auditing regularly accounts for the numeric sequence of used documents. Voided documents are retained until the independent audit has been completed.

Within CBIS, duties are separated among the following functions: systems analysis and programming; data entry; data processing; and control. Systems analysts and programmers provide extensive documentation of all programs and systems, as well as program changes. Complete instructions are provided for computer operators who enter data as part of various processing modules. All program changes must be approved in writing by Rust, director of information systems and data processing, as well as by affected user departments. Current backup programs and data files are maintained in a location outside data processing. Internal auditors have current copies of programs and test transaction processing regularly. In order to not interfere with CBIS activities, such tests are seldom conducted on an unannounced basis.

All computer output is distributed by the control group to authorized recipients. Any errors occurring during processing runs are logged into and accessible only by the control group. The control group then monitors reprocessing of the errors after satisfying themselves that they were unintentional. Data processing personnel have no access to the error log and must contact the control group, inasmuch as processing cannot continue until an error is corrected.

An accounts receivable aging analysis is produced monthly. This analysis is used by the credit manager and chief accountant, for determining the monthly adjustment to the allowance for doubtful accounts; the credit manager also performs extensive follow-up of customers whose accounts are past due.

Three years ago, accounting and CBIS created a financial reporting and technology steering committee to identify emerging needs and strategies for meeting those needs. In addition, the committee develops plans to link information technology with financial reporting implications of strategic initiatives.

HUMAN RESOURCES

Schroeder, director of human resources, recently instituted and implemented a program for updating job descriptions. Training programs have been developed for new and existing employees in all functional areas. Directors and department heads are responsible for making hiring and termination recommendations. Human resources, however, screens and investigates all applicants for proper background and required education, training, and experience. In addition, final hiring and termination authority rests with the human resources director.

Five years ago, human resources developed a code of conduct for Biltrite detailing expected standards of ethical behavior, and distributed it to all existing employees. Since then, all new hires have been provided the code of conduct, along with other firm-related materials, at orientation. There are no formal employee training programs regarding the code but each monthly newsletter devotes one page to some aspect of the code. The six-page newsletter is mailed to the home address of each employee.

ORGANIZATION STRUCTURE

The reporting relationships in Biltrite's organization chart have changed little since the mid-1980s even though Biltrite has experienced considerable growth in production volume and the warehouse distribution network, as well as having experienced a major transformation of its information system. Despite stable reporting relationships, responsibilities and authority for decision-making have become more centralized.