

Sun City Savings and Loan Company

Pina, Johnson & Associates has recently been awarded the audit of Sun City Savings and Loan Company for the year just ended. Sun City Savings and Loan is now the largest client of the firm, and the fees from this engagement represent a significant portion of the firm's revenues. Upon accepting the Sun City engagement, the firm incurred additional costs by hiring several new employees and a new manager from a larger firm. In bidding on the engagement, Sam Johnson knew that the first-year fees would be just enough to cover the actual cost of the first year's audit, but he hoped that future audit fee increases might lead to a long-term, profitable engagement. Based on his discussions with the predecessor auditors, Johnson knew that there were possible problems with Sun City's loans because of the collateral used for security. Johnson was also concerned that there might be problems with loan-loss reserves due to the effects of the economic slowdown on the tourist industry in Sun City over the last two years. However, Johnson felt that these problems were manageable.

During the current year, the amount included in the loan-loss reserves account was \$675,000, approximately the same as the figure for the prior year. The state's banking regulations require that an amount equal to 1.5 percent of the loans outstanding be included as a reserve against losses. The \$675,000 was slightly above the statutory requirement. However, the audit staff identified two large loans, aggregating to \$15 million, that appeared not to be collectible in full. The working papers disclosed that each loan had originated during the current year and that both had been in default for four months. Additionally, the collateral used to secure the loans was worth considerably less than the amount of the loans and was not in accordance with Sun City's loan policy procedures. Based on this information, the staff estimates that about 40 percent of the \$15 million, or \$6 million, will not be collected. The staff has also determined that these loans are to entities owned by Patricia Cabot, Sun City's CEO, and some of her business associates.

When Johnson met with Cabot to discuss the two delinquent loans, Cabot assured Johnson that the loans would be paid in full. She told Johnson that the loans had been properly made and that as soon as the economy picked up, payments would be made on the loans. She indicated that no additional reserves were needed and that if Johnson requires such adjustments, his firm might be replaced.

Johnson is concerned that if the loan-loss reserves are increased, Sun City Savings & Loan's owners and investors might be hurt financially. Further, if Johnson requires the adjustment, Pina, Johnson & Associates may lose Sun City as a client, his own career goals may be damaged, and the firm may have to lay off professional and staff employees. Johnson believes there could be serious consequences to several different parties whatever decision he makes.