Chapter 19

Completing the Tests in the Acquisition and Payment Cycle: Verification of Selected Accounts

■ **Concept Checks**

P. 645

1. The reason for the emphasis on current period acquisitions in auditing property, plant, and equipment is that there is an expectation that permanent assets will be kept and maintained on the records for several years. The assets carried over from the preceding years can be assumed to have been verified in the prior years' audits.

   If tests of controls and substantive tests of transactions do not show that all disposals have been recorded, additional testing of the prior balance could be required. A first-year audit also necessitates tests of the beginning balance.

2. In testing depreciation expense, the auditor is primarily concerned with the accuracy balance-related objective, including whether the client has followed a consistent policy from period to period.

P. 653

1. The evaluation of the adequacy of insurance is a test of reasonable protection against the loss of existing assets. The verification of prepaid insurance is performed to determine whether:
   - The balances represent proper charges against future operations.
   - The additions represent charges to these accounts and are reflected at actual cost.
   - Amortization or write-off is reasonable under the circumstances.

   The evaluation of adequacy of insurance coverage is more important because of the potential loss due to under-insurance. Verification of prepaid insurance usually involves an immaterial amount and is not emphasized in most audits.

2. Property tax accruals take little audit time for most audits, and since there are relatively few transactions to test and they are typically material in amount, it is common to verify the accounts 100 percent. On the other hand, accounts payable takes quite a bit of audit time and since there are usually a large number of transactions to test and they are typically varied in amount, it is common to verify the account on a test basis.

Concept Check, P. 645 (continued)

3. The analysis of expense accounts is a procedure by which selected expense accounts are verified by examining underlying supporting vendors' invoices or other documentation to determine if the transactions making up the total are correctly stated. The emphasis in most expense account analysis is on the occurrence of recorded amounts, accuracy, and classification.

   Four expense accounts that are commonly analyzed in audit engagements are:
   1. Legal expense
   2. Travel and entertainment expense
   3. Tax expense
   4. Repair and maintenance expense

■ Review Questions

19-1 There are many asset, expense, and liability accounts associated with the acquisitions and payment cycle. Some examples of these accounts are included in Table 19-1 on page 637.

19-2 Because the source of the debits in the asset account is the acquisitions journal (or similar record), the current period acquisitions of property, plant, and equipment have already been partially verified as part of the acquisition and payment cycle. In that testing, the occurrence, completeness, accuracy, cutoff, and classification of acquisitions of property, plant, and equipment would have been examined. The disposal of assets, depreciation, and accumulated depreciation are not tested as a part of the acquisition and payment cycle.

19-3 Many clients may accidentally or intentionally record purchases of assets in the repair and maintenance account. The misstatement is caused by a lack of understanding of accounting standards and some clients' desire to avoid income taxes. Repair and maintenance accounts are verified primarily to uncover unrecorded property purchases. In other cases, however, management has fraudulently capitalized repair and maintenance expenses to boost profitability and assets.

The auditor typically vouches the larger amounts debited to those expense accounts at the same time that property accounts are being audited.

19-4 The audit procedures that may be applied to determine that all property, plant, and equipment retirements have been recorded are as follows:

1. Review whether newly acquired assets replace existing assets and inquire as to whether the old asset has been removed from the books.
2. Analyze gains on the disposal of assets and miscellaneous income for receipts from the disposal of assets. Compare these to property, plant, and equipment accounts to see whether the asset has been removed from the books.
3. Review planned modification and changes in product lines, taxes, or insurance coverage for indications of deletions of equipment.
4. Make inquiries of management and production personnel about the disposal of assets.

19-5 In developing an expectation for depreciation expense, the auditor multiplies the undepreciated balance by the appropriate depreciation rate. The auditor may also need to consider additional factors to improve the precision of the expectation, such as:

1. The needs to separate fixed assets by depreciation method and life.
2. Consideration of depreciation on newly-acquired assets and fully-depreciated assets.

In most cases, the auditor can develop an expectation that is sufficiently precise to reduce or eliminate the need for detailed tests of depreciation expense. Although most detailed tests can be eliminated, the auditor will normally perform detail tie-in tests that depreciation expense and accumulated depreciation in the fixed assets records agree with the general ledger.

19-6 Since the source of the debits to prepaid insurance is the acquisitions journal or similar record (assuming all insurance premiums are charged to prepaid insurance rather than insurance expense), the current period premiums have already been partially verified as a part of the acquisition and payment cycle. The allocation of the premium between prepaid insurance is not tested as a part of the acquisition and payment cycle.

19-7 The audit of prepaid insurance should ordinarily take a relatively small amount of audit time because:

1. The balance in prepaid insurance is normally immaterial;
2. There are ordinarily few transactions during the year and most transactions are immaterial;
3. The transactions are ordinarily not complex.

19-8 The audit of prepaid expenses differs from the audit of other asset accounts, such as accounts receivable or property, plant, and equipment, because prepaid expenses are often immaterial. Substantive analytical procedures are often sufficient for auditing prepaid expenses, while tests of details of balances are usually required for other accounts such as accounts receivable and property, plant, and equipment.

19-9 Debits to accrued rent arise from the cash disbursements journal, which is verified as a part of tests of controls and substantive tests of transactions for cash disbursements. The credits typically arise from the general journal and may not have been verified as a part of these tests. Furthermore, tests of controls and substantive tests of transactions do not include verification of the inclusion of accruals on all existing property and verification of the consistent treatment of the accruals from year to year.

19-10 The following documents will be used to verify accrued property taxes and related expense accounts:

1. Deeds to properties
2. Property tax returns
3. Cancelled checks
4. Invoices from the taxing authority

19-11 Three expense accounts that are tested as part of the acquisition and payment cycle or the payroll and personnel cycle are:

1. Property tax expense
2. Payroll expense
3. Rent expense

Three expense accounts that are not directly verified as part of either of these cycles are:

1. Depreciation expense
2. Amortization of patents
3. Year-end bonuses to officers

19-12 The analysis of expense accounts is a procedure by which selected expense accounts are verified by examining underlying supporting vendors' invoices or other documentation to determine if the transactions making up the total are correctly stated. The emphasis in most expense account analysis is on the occurrence of recorded amounts, accuracy, and classification.

Potentially the same objectives are accomplished in tests of controls and substantive tests of transactions as for expense account analysis. The major differences are that tests of controls and substantive tests of transactions are selected from all of the acquisitions and cash disbursements journals for the entire period, whereas transactions examined for expense analysis are limited to the account being analyzed. Nevertheless, the procedures are closely related, and if the tests of controls and substantive tests of transactions procedures results are satisfactory, reduced expense account analysis is implied.

19-13 The approach for verifying depreciation expense should emphasize the consistency of the method of depreciation used and the related computations, since these aspects of depreciation expense are the main determinants of the account balance. The use of substantive analytical procedures and reperformance tests is important for depreciation expense.

In verifying repair expense, the emphasis should be on vouching transactions that may be capital items; therefore, examining supporting documentation for transactions from months with unusually large totals or transactions that are themselves large or unusual is the normal audit approach followed.

The approach is different because in repairs and maintenance the primary objective is to locate improperly classified fixed assets, whereas in depreciation the emphasis is on consistency from period to period and accurate depreciation calculations.

19-14 The factors that should affect the auditor's decision whether or not to analyze an account balance are:

1. The analytical procedures indicate there is a high likelihood of misstatement in an account.
2. The tests of controls and substantive tests of transactions indicate there is a high likelihood of misstatement in an account.
3. The account is likely to contain misstatements because it is difficult for the client to properly classify or value the transactions.
4. The auditor knows that the account is frequently subject to abuse or misstatement.
5. The analysis of the account might disclose a contingency.
6. Tax returns and the SEC require the disclosure of certain information, which the account is likely to provide.

■ Multiple Choice Questions From CPA Examinations

19-15 a. (1) b. (3) c. (4)

19-16 a. (1) b. (2) c. (3)

19-17 a. (4) b. (3) c. (3)

■ Multiple Choice Questions From Becker CPA Exam Review

19-18 a. (4) b. (1) c. (2)

■ Discussion Questions and Problems

19-19

ITEM NO.	INTERNAL CONTROL	SUBSTANTIVE AUDIT PROCEDURE
1	Have office manager periodically report to the accounting department whether or not there have been abandonments or replacements.	Trace from equipment recorded on the accounting records to the equipment.
2	Internally verify charges for depreciation expenses.	Compare depreciation expense for administration and manufacturing to previous years.
3	Use of government study depreciation tables.	Compare to government study depreciation table.
4	Establish a policy for deciding which items require capitalization and establish an internal verification procedure.	Test all expense charges to these accounts that exceed a certain amount.
5	Require internal verification in the recording of property acquisitions.	Compare supporting documentation on property acquisitions to the recorded value.
6	Require the deposit of all cash directly into the bank account.	(1) Confirm loans with the bank and perform other tests for unrecorded loans. (2) Examine plant asset additions and agree to recorded amounts and date.
7	Assign tools to individual foreman and periodically count the tools.	Check the client's physical count of the tools.

19-20

a. PURPOSE	b. TEST OF CONTROL TO TEST FOR EXISTENCE OF CONTROL	c. SUBSTANTIVE PROCEDURE TO TEST FOR MISSTATEMENTS
1. To minimize accounting classification misstatements. (Classification)	Verify that written policies exist.	Examine supporting documentation for transactions to determine if policies are followed for account classification.
2. To assure that recording asset misstatements are minimized. (Existence, completeness)	Verify that master file exists and is used.	Physically examine fixed assets and trace to master file. Vouch items in the master file to actual fixed assets.
3. To minimize improper purchases. (Existence)	Examine a sample of purchase invoices of fixed assets in excess of $50,000 for Board of Directors' approval.	Examine a sample of purchase invoices of fixed assets for propriety and reasonableness.
4. To provide a record of fixed assets and protect against their loss. (Completeness and existence)	Examine the company's physical count of equipment that compares tags on the equipment to records of tags.	Trace a sample of recorded equipment to the related equipment to make sure it exists.
5. To minimize depreciation calculation and recording misstatements. (Accuracy)	Examine records for indication of periodic verification of master file.	Test calculations and postings of depreciation charges.

19-21

ITEM NO.	a. TYPE OF EVIDENCE USED	b. TYPE OF PROCEDURE	c. & d. OBJECTIVE(S)
1	Analytical procedure	Substantive analytical procedure	Occurrence Accuracy Classification
2	Observation	Test of control	Occurrence
3	Inspection of external documentation	Test of details of balances	Completeness Cutoff Accuracy
4	Inspection of external documentation	Test of control and Substantive test of transactions	Occurrence Accuracy Timing Classification
5	Recalculation	Substantive test of transactions	Posting and summarization
6	Confirmation	Test of details of balances	Existence Completeness Accuracy Cutoff
7	Inspection of internal documentation	Test of control	Completeness
8	Physical examination	Test of details of balances	Existence Realizable Value
9	Analytical procedure	Substantive analytical procedure	Existence Completeness Accuracy
10	Inquiry of client	Test of details of balances	Completeness Accuracy
11	Inspection of external documentation (cancelled checks)	Substantive test of transactions	Completeness Timing Accuracy
12	Recalculation	Test of details of balances	Accuracy

19-22 a. The amounts listed in the beginning balance column would be verified by examining the ending audited balances in the prior year audit files. Each ending balance for land, building-office, production equipment, office equipment, and IT hardware would be verified in addition to the mathematical accuracy of the beginning balance column.

b. To obtain evidence about the items in the additions column, the auditor would obtain detailed information of what individual additions comprise the additions amount for each account category. The auditor would then examine supporting documentation, such as invoices, purchase contracts, and receiving reports, for equipment accounts while the auditor may examine property deeds and other legal documents and contracts for purchases of land and buildings that make up the additions amount on the schedule. For large purchases, the auditor may want to examine approvals noted in board of director minutes or on purchase orders. The auditor should be alert for whether an addition to these accounts is associated with the disposal of an existing asset that should be considered as part of the steps in c. below.

c. To obtain evidence about the items in the disposal column, the auditor would obtain detailed information of what individual disposals comprise the disposal amounts for each category and then examine supporting documentation, such as shipping documents and cash receipts for disposal transactions. The auditor should determine if any disposals noted as part of the procedures performed in step b. are included as disposals in this schedule.

d. The auditor would verify the mathematical accuracy of the summation of the beginning balances plus additions less disposals crossfoots to the ending balance for each property item listed on the schedule. The auditor would also recalculate the summation of the amounts listed in the ending balance column to the total shown on the schedule. Each ending balance would be tied to the total in the fixed asset ledger and agreed to the general ledger balances, and the total would be traced to the line item in the balance sheet.

e. The following accounts may be affected by additions and disposals of property, plant, and equipment:

(1) Additions of buildings and equipment may impact short-term and long-term debt on the balance sheet as large purchases of buildings and equipment may be financed with debt or creation of long-term capital leases that must be reflected as liabilities on the balance sheet. This would also impact interest and depreciation expense accounts.

19-22 (continued)

(2) Disposals of equipment are likely to impact the cash accounts for cash received from the sale of disposed items, accumulated depreciation accounts for equipment, and other income and expenses due to any gain or loss on the sale.

19-23

a. PURPOSE	b. EVALUATION OF ADEQUACY
1. To assure that the client's detailed schedule equals the total in the general ledger. (Detail tie-in)	This procedure is necessary as a starting point to perform detailed tests.
2. To assure that taxes on property included on the schedule of accrued taxes are not over- or underpaid. (Accuracy)	This procedure is adequate for its purpose.
3. To assure that the accrued/prepaid account is correctly stated. (Accuracy)	This procedure is adequate for its purpose.

Overall, the program fails to emphasize the possibility of omitted property from the list. The key to an adequate audit of accrued property taxes is making sure all owned property and only owned property is included and on the list.

19-24

LIABILITY THAT COULD BE UNCOVERED	AUDIT PROCEDURE TO UNCOVER LIABILITY
a. Contingent liability related to a lawsuit	Review minutes of the Board of Directors' meetings.
b. Building used as collateral for a loan or a mortgage tied to the building's purchase	Examine documents of ownership to determine if the loan is collateralized and send confirmations to major banks.
c. Unrecorded lease	Examine lease agreements.
d. Note payable	Examine underlying records for loans related to the interest expense and send confirmations to major banks.
e. Loan by borrowing against an insurance policy	Obtain a confirmation from the life insurance company.
f. Note payable	Obtain confirmation from bank for loans.
g. Income taxes payable for nondeductible expenses	Examine a sample of travel and expense reports to make sure they comply with IRS requirements.

19-25 a. Both U.S. GAAP and IFRS standards generally contain similar requirements for assessing the impairment of assets, including goodwill. Both standards require the testing of goodwill for impairment at least annually, or more frequently if there are indications that impairment exists. When there is impairment, both standards require the write-down of impaired assets and recognition of an impairment loss. Impairment occurs when the recorded value of goodwill exceeds its fair value.

b. The auditor would need to examine evidence and assumptions management used to determine its estimate of the fair value of goodwill, which is used to determine the impairment amount. Often management uses estimates of future discounted cash flows that are based on financial plans and their best estimates of future developments.

c. Arriving at estimates of expected discounted future cash flows of a business can be extremely complex, requiring an extensive amount of business judgment. Because financial statement auditors may not regularly engage in activities associated with valuing a business, they often seek the assistance of business valuation specialists to evaluate the reasonableness of management's process for estimating the fair value of the underlying assets that is used to calculate the need for recognition of an impairment loss. Valuation of fair value requires consideration of a number of factors, such as macroeconomic conditions, industry and market conditions, anticipated changes in costs of business, and other relevant company-specific events, among a number of other matters. Business valuation specialists have unique skills and expertise often necessary to evaluate these kinds of factors to determine if management's estimates of the fair (or recoverable) values are reasonable and appropriate.

■ Case – Ward Publishing Company

19-26 a. The tests of acquisition and cash disbursement transactions have two purposes: to determine whether related internal accounting controls are functioning (tests of controls), and to determine whether the transactions actually contain any monetary misstatements (substantive). The results of the tests apply to the population of all acquisitions and cash disbursements, including plant and equipment and lease acquisitions and cash disbursements, even though the specific sample tested does not include any such transaction. Thus, if the results of the tests are favorable, it is concluded that there is a lower expectation of misstatements in plant and equipment and lease transactions, and vice-versa.

19-26 (continued)

b. A summary of the results from tests of controls and substantive tests of transactions for acquisitions and cash disbursements from Case 18-30 is: all transaction-related audit objectives are being met at a satisfactory level except:

1. All supporting documents are not always attached to the vendor's invoice. *Note: Students using a **nonstatistical** approach to Case 18-30 may not conclude that the results for this attribute [9.b.(1)] are unacceptable, depending on their estimate of CUER. However, most students will likely conclude that the results are unacceptable.*
2. All vendors' invoices are not initialed for internal verification. Half of those not initialed had account classification errors.

The impact of these results and the results from items 1 through 7 affect the balance-related audit objectives for plant and equipment in the following way:

BALANCE-RELATED AUDIT OBJECTIVE	RESULTS OF TESTS OF CONTROLS AND SUBSTANTIVE TESTS OF TRANSACTIONS	RESULTS FROM CONCLUSIONS 1-7
Detail tie-in	Misstatements unlikely	—
Existence	Misstatements moderately likely	—
Completeness	Misstatements unlikely	Conclusion 1 supports
Accuracy	Misstatements moderately likely	Conclusion 4 indicates a need for additional evidence
Classification	Misstatements highly likely	Conclusion 6 indicates a need for additional evidence
Cutoff	Misstatements unlikely	—
Realizable value	No significant evidence provided	Conclusion 3 indicates a need for additional evidence
Rights and obligations	Misstatements unlikely	—

Conclusions 3, 5, and 7 indicate a need for more extensive auditing for existence, completeness, accuracy, and classification. All large items should be verified and samples should be larger than normal. All other tests can be performed at minimum levels.

19-26 (continued)

c. The results of tests of controls and substantive tests of transactions are directly related to the tests of many expense accounts, primarily through tests for account classification, but also through tests of accuracy and existence. For example, if the auditor concludes that the internal controls are effective for recording acquisition transactions, the likelihood of misstatements for accounts such as supplies, purchases, and repairs and maintenance is greatly reduced. The auditor must keep in mind, however, that certain expense accounts are not usually verified as a part of tests of controls and substantive tests of transactions. An example is depreciation expense. Similarly, certain accounts may have a higher inherent risk such as legal expense and therefore require additional testing even if tests of controls and substantive tests of transactions results are satisfactory. Also, substantive analytical procedures and tests of details of balances for balance sheet accounts results affect the extent of auditing needed for expense accounts.

d. The results of tests of controls and substantive tests of transactions indicate the potential for significant classification misstatements. (See the results for Audit Procedure 9b(5) for classification in Part 2 of Case 18-30.) This potential for misclassification misstatement combined with the substantive analytical procedures results in Conclusion 6 indicate a need for more extensive account analysis for repairs and maintenance, small tools expense, and the three other accounts where there are significant changes from prior years. No other conclusions should cause the auditor significant concern in the audit of expense accounts.

19-27 a. Items 1 through 6 would have been found in the following way:

1. The company's policies for depreciating equipment are available from several sources:

   a) The prior year's audit schedules and permanent file.
   b) Footnote disclosure in the annual report and SEC Form 10-K.
   c) Company procedures manuals.
   d) Detailed fixed asset records.

2. The ten-year lease contract would be found when supporting data for current year's equipment additions were examined. Also, it may be found by a review of company lease files, contract files, or minutes of meetings of the board of directors. The calculations would likely be shown on a supporting schedule and can be traced to the general journal.

19-27 (continued)

3. The building wing addition would be apparent by the addition to buildings during the year. The use of the low construction bid amount would be found when support for the addition was examined. When it was determined that this inappropriate method was followed, the actual costs could be determined by reference to construction work orders and supporting data. The wing could also be examined.

4. The paving and fencing could be discovered when support was examined for the addition to land.

5. The details of the retirement transactions could be determined by examining the sales agreement, cash receipts documentation, and related detailed fixed asset record. This examination would be instigated by the recording of the retirement in the machinery account or the review of cash receipts records.

6. The auditor would become apprised of a new plant in several ways:

   a) Volume would increase.
   b) Account details such as cash, inventory, prepaid expenses, and payroll would be attributed to the new location.
   c) The transaction may be indicated in documents such as the minutes of the board, press releases, and reports to stockholders.
   d) Property tax and insurance bills examined show the new plant.

   One or more of these occurrences should lead the auditor to investigate the reasons and circumstances involved. Documents from the city and appraisals could be examined to determine the details involved.

b. The appropriate adjusting journal entries are as follows:

1. No entry necessary.

19-27 (continued)

2. This is an operating lease and should not have been capitalized.

Prepaid rent	$ 50,000	
Lease liability	354,000	
Allowance for depreciation-machinery and equipment	20,200	
Machinery and equipment		$404,000
Depreciation expense		20,200

To correct initial recording of lease.

Equipment rent expense	$37,500	
Prepaid rent		$37,500

To record nine months' rent based on the following calculation:

9/12 x $50,000 = $37,500

3. The wing should have been recorded at its cost to the company.

(Accounts originally credited)	$15,000	
Buildings		$15,000

To correct initial recording of new wing.

Depreciation expense	$3,167	
Allowance for depreciation—Buildings		$3,167

To correct depreciation for excess cost based on the following calculations:

Depreciation on beginning balance
1,200,000/25 = 48,000

Depreciation recorded on addition
51,500 - 48,000 = 3,500

Correct depreciation for addition:

Remaining useful life of addition is 12 years
(600,000/1,200,000 x 25 = 12-1/2 years;
12-1/2 - ½ = 12 years)

Depreciation = $160,000/12 x ½ = $6,667
Correction = $6,667 - $3,500 = $3,167

19-27 (continued)

4. The paving and fencing are land improvements and should be depreciated over their useful lives.

Land improvements (may be combined with buildings account — buildings and improvements)	$50,000	
Land		$50,000

To correct initial recording of paving and fencing.

Depreciation expense	$2,500	
Allowance for depreciation—Land Improvements		$2,500

To record first year's depreciation on paving and fencing based on the following calculation:

$50,000/10 x ½ = $2,500

5. The cost and allowance for depreciation should have been removed from the accounts and a gain or loss on sale recorded.

Cost of asset	$480,000
Allowance for depreciation:	
To 12/31/15 – 480,000/10 x 3-1/2	168,000
For 20163 – 480,000/10 x ½	24,000
	192,000
Net book value	288,000
Cash proceeds	260,000
Loss on sale	$28,000

The correcting entry is:

Allowance for depreciation—Machinery and Equipment	$203,000	
Loss on sale of assets	28,000	
Machinery and Equipment		$220,000
Depreciation expense		11,000

6. Donated property should be capitalized at its fair market value.

Land	$100,000	
Buildings	400,000	
Contributed capital-Donated Property		$500,000

To record land and building for new plant donated by Crux City.

19-27 (continued)

Depreciation expense	$8,000	
Allowance for depreciation—Buildings		$8,000

To record depreciation on new plant based on the following calculation:

$400,000/25 x ½ = $8,000

19-28 a.

To: In-Charge Auditor
From: Audit Manager
Subject: Concerns about the schedule prepared by the client and the staff assistant in the audit of Vernal Manufacturing Company

The analytical procedures schedule for the audit of Vernal Manufacturing Company is completely inadequate and needs to be redone. There are several deficiencies:

1. The headings, references, and indexing on the audit schedule are incomplete. It appears that the schedule was prepared by the client, but it is not possible to determine from the schedule.

2. A classified income statement would provide more useful information than the single-step statement provided.

3. The schedule should include the additional columns showing the percent of net sales for 12-31-15 and 12-31-16. This information would permit us to more effectively evaluate the relative change in each account.

4. There is no indication that the general ledger totals were compared to general ledger balances or that calculations were tested.

5. There is no identification of accounts that we are concerned may be materially misstated. For example, the $1,381 change in insurance expense appears immaterial but the 427% change in other expense may be significant.

6. There is no indication of specific accounts that require additional investigation and the nature of such investigation.

7. There is no indication that the client's explanations have been evaluated and supported by evidence. Management inquiry is a weak form of evidence and insufficient by itself.

19-28 (continued)

b. For every explanation provided by the client, an alternative possibility is a misstatement in the financial statements. The auditor must be satisfied that significant differences are not material misstatements. The following table illustrates a few examples:

ACCOUNT	POSSIBLE MISSTATEMENT
Sales	Cutoff error for sales
Sales returns and allowances	Returns due to technological deficiencies in products that may indicate obsolete inventory
Miscellaneous income	Including proceeds of the sale of equipment as income rather than decreasing the equipment account
Cost of goods sold	Small increase in cost of goods sold compared to net sales may indicate an overstatement of ending inventory or understatement of any of the accounts making up cost of goods sold

c. To perform a meaningful determination of the most important variances, an alternative design of the audit schedule follows. It is much easier to determine relevant variances with an adequate substantive analytical procedures schedule.

	PER G/L 12-31-15	PERCENT 12-31-15	PER G/L 12-31-16	PERCENT 12-31-16	CHANGE Amount	Percent
Sales	$8,467,312	100.8%	$9,845,231	102.5%	$1,377,919	16.3%
Sales returns and allowances	(64,895)	(0.8%)	(243,561)	(2.5%)	(178,666)	275.3%
Net Sales	8,402,417	100.0%	9,601,670	100.0%	1,199,253	14.3%
Cost of goods sold:						
Beginning inventory	1,487,666	17.7%	1,389,034	14.5%	(98,632)	(6.6%)
Purchases	2,564,451	30.5%	3,430,865	35.7%	866,414	33.8%
Freight-in	45,332	0.5%	65,782	0.7%	20,450	45.1%
Purchase returns	(76,310)	(0.9%)	(57,643)	(0.6%)	18,667	(24.5%)
Factory wages	986,755	11.7%	1,145,467	11.9%	158,712	16.1%
Factory benefits	197,652	2.4%	201,343	2.1%	3,691	1.9%
Factory overhead	478,659	5.7%	490,765	5.1%	12,106	2.5%
Factory depreciation	344,112	4.1%	314,553	3.3%	(29,559)	(8.6%)
Ending inventory	(1,389,034)	(16.5%)	(2,156,003)	(22.5%)	(766,969)	55.2%
Total	4,639,283	55.2%	4,824,163	50.2%	184,880	4.0%
Gross margin	3,763,134	44.8%	4,777,507	49.8%	1,014,373	27.0%

19-28 (continued)

	PER G/L 12-31-15	PERCENT 12-31-15	PER G/L 12-31-16	PERCENT 12-31-16	CHANGE Amount	Percent
Selling, general and administrative:						
Executive salaries	167,459	2.0%	174,562	1.8%	7,103	4.2%
Executive benefits	32,321	0.4%	34,488	0.4%	2,167	6.7%
Office salaries	95,675	1.1%	98,540	1.0%	2,865	3.0%
Office benefits	19,888	0.2%	21,778	0.2%	1,890	9.5%
Travel and entertainment	56,845	0.7%	75,583	0.8%	18,738	33.0%
Advertising	130,878	1.6%	156,680	1.6%	25,802	19.7%
Other sales expense	34,880	0.4%	42,334	0.4%	7,454	21.4%
Stationery and supplies	38,221	0.5%	21,554	0.2%	(16,667)	(43.6%)
Postage	14,657	0.2%	18,756	0.2%	4,099	28.0%
Telephone	36,551	0.4%	67,822	0.7%	31,271	85.6%
Dues and memberships	3,644	0.0%	4,522	0.0%	878	24.1%
Rent	15,607	0.2%	15,607	0.2%	0	0.0%
Legal fees	14,154	0.2%	35,460	0.4%	21,306	150.5%
Accounting fees	16,700	0.2%	18,650	0.2%	1,950	11.7%
Depreciation, SG&A	73,450	0.9%	69,500	0.7%	(3,950)	(5.4%)
Bad debt expense	166,454	2.0%	143,871	1.5%	(22,583)	(13.6%)
Insurance	44,321	0.5%	45,702	0.5%	1,381	3.1%
	961,705	11.4%	1,045,409	10.9%	83,704	8.7%
Total operating income	2,801,429	33.3%	3,732,098	38.9%	930,669	33.2%
Other expenses:						
Interest expense	120,432	1.4%	137,922	1.4%	17,490	14.5%
Other	5,455	0.1%	28,762	0.3%	23,307	427.3%
Total	125,887	1.5%	166,684	1.7%	40,797	32.4%
Other income:						
Gain on sale of assets	43,222	0.5%	(143,200)	(1.5%)	(186,422)	(431.3%)
Interest income	243	0.0%	223	0.0%	(20)	(8.2%)
Miscellaneous income	6,365	0.1%	25,478	0.3%	19,113	300.3%
Total	49,830	0.6%	(117,499)	(1.2%)	(167,329)	(335.8%)
Income before taxes	2,725,372	32.4%	3,447,915	35.9%	722,543	26.5%
Income taxes	926,626	11.0%	1,020,600	10.6%	93,974	10.1%
Net income	$1,798,746	21.4%	$2,427,315	25.3%	$ 628,569	34.9%

The following are variances of special significance to the audit that have been determined from the revised analytical procedures worksheet. Before doing additional work, there should be further discussion with knowledgeable management about the variances identified. After investigating management's explanations, the following additional audit procedures may be appropriate:

ACCOUNT	POTENTIAL ADDITIONAL AUDIT PROCEDURES
1. Sales	Perform extensive cutoff tests and other tests for possible overstatements.
2. Sales returns and allowances	Examine supporting documents for the largest sales returns and allowances and consider the effect on inventory valuation.

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ACCOUNT	POTENTIAL ADDITIONAL AUDIT PROCEDURES
3. Cost of goods sold. Cost of goods sold increased only $185,000, but sales increased 1.2 million.	Do careful tests of physical counts, costing, cutoff, inventory, and tests for obsolescence.
4. Travel and entertainment	Examine supporting documentation for large travel and entertainment expenses.
5. Telephone	Compare telephone expense by month to determine the possibility of a misclassification.
6. Legal expense	Analyze legal expense to determine the possibility of lawsuits or other legal actions that might affect the financial statements.
7. Depreciation expense	Compare depreciation by month to determine the possibility of the failure to record one month's depreciation.
8. Bad debt expense	Performed detailed analytical procedures and other tests of accounts receivable to evaluate the adequacy of the allowance for uncollectible accounts.
9. Other expense	Analyze other expense to determine the nature of other expense and the possibility of misclassification or incorrect accounting.
10. Gain on the sale of assets	Analyze the account to determine the nature of the transactions and any misclassification or incorrect accounting.

19-29

a. Property, plant, and equipment is in Topic 360 under Assets. Disclosure requirements are included in 360-10-50.

b. Topic 360-10-50-1 indicates:

Because of the significant effects on financial position and results of operations of the depreciation method or methods used, all of the following disclosures shall be made in the financial statements or in notes thereto:

a. Depreciation expense for the period
b. Balances of major classes of depreciable assets, by nature or function, at the balance sheet date

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c. Accumulated depreciation, either by major classes of depreciable assets or in total, at the balance sheet date.
d. A general description of the method or methods used in computing depreciation with respect to major classes of depreciable assets.

c. The ASC indicates that impairment is the condition that exists when the carrying amount of a long-lived asset (asset group) exceeds its fair value.

d. Topic 310-50-2 indicates:

All of the following information shall be disclosed in the notes to financial statements that include the period in which an impairment loss is recognized:

a. A description of the impaired long-lived asset (asset group) and the facts and circumstances leading to the impairment
b. If not separately presented on the face of the statement, the amount of the impairment loss and the caption in the income statement or the statement of activities that includes that loss
c. The method or methods for determining fair value (whether based on quoted market prices, prices for similar assets, or another valuation technique)
d. If applicable, the segment in which the impaired long-lived asset (asset group) is reported under Topic 280.