

## Case 03-05

### **Trademark, Inc. Part 2—Misstatements & Materiality**

This case study is the second part of the Earnings Management Case. The purpose of this part is to provide you with additional background information relating to Trademark and raise several auditing issues affecting Trademark that require evaluation during the current fiscal year. The auditing issues you identify in this case study will require you to use your professional judgment as well as auditing literature and SEC Staff Accounting Bulletin (SAB) No. 99, *Materiality* (Topic 1M), in order to evaluate the known and likely misstatements detected during the audit and resolve the related issues.

The first section of this case study (Part A) challenges participants to identify misstatements and potential misstatements, classify them as known misstatements, likely misstatements, or differences in judgment.

The second section of this case study (Part B) requires the participants to evaluate the results of the audit based on the misstatements detected in Part A of this case study and the accounting misstatements detected in Part 1—Accounting Issues. Was the scope of our audit sufficient? Are the financial statements materially misstated? What adjustments should the client be requested or required to record?

#### ***Background***

Trademark is a public company with four divisions: Greeting Cards and Stationary, Calendars, Party Goods, and Specialty Gifts. In the United States, the company's products are manufactured at five plants. Each division has its own plant, except that two plants manufacture the party goods merchandise due to the division's diverse merchandise.

Materiality for the June 30, 1999 audit was established at \$7,850,000 based on 5% of income after tax from continuing operations of \$157 million.

#### ***Accounts Receivable***

Trademark's collection history of receivables has typically been very good. If a customer does not pay on a timely basis (within 30 days), the company will not ship the next season's products, which typically results in the successful collection of past due amounts. Trademark historically has provided an allowance based on the following:

<b>Aging</b>	<b>Percentage</b>
60-90 days	20%
91-120 days	30%
>120 days	50%

In August 1999, Connor Pharmacies, Inc., one of Trademark's top ten customers, filed for protection under Chapter 11 of the United States Bankruptcy Code. Trademark's Controller, Maia Walker, grew up with the President of Connor Pharmacies, Jim Connor; their sons are best friends and Maia and Jim are both active in the same civic organizations. When payments from Connor Pharmacies started slowing in February 1999, Maia continued to permit shipment of mother's day and father's day greeting cards and graduation merchandise. At June 30, 1999, the outstanding receivable balance due from Connor Pharmacies had increased to \$1,725,000. Excluding the receivable for this one account, the allowance for doubtful accounts is otherwise adequate.

#### ***Audit Procedures—Accounts Receivable***

Nancy Drew, the senior on the Trademark audit engagement, met with the Controller to discuss her concerns about the adequacy of the allowance for doubtful accounts. Maia was convinced, based on recent conversations with Jim Connor, that Connor Pharmacies would emerge from bankruptcy and be able to pay a substantial portion of the outstanding balance. Accordingly, Maia believed that the \$585,750 included in the overall allowance calculated under the company's formula described above is sufficient. However, Nancy believes, based on her experience with other clients that had customers who had filed Chapter 11, that a reserve in the range of 75%-95% of the outstanding receivable balance is more likely for this specific customer account (i.e., \$1,293,750—\$1,638,750). Based upon the discussion with Nancy, Maia agreed to increase the allowance for doubtful accounts by \$125,000 but said to Nancy, "You will see, any extra reserve is unnecessary."

#### ***Spare Parts Inventory***

Due to the highly seasonal nature of the majority of Trademark's products, an interruption in the manufacturing process could substantially lower the company's sales volume, as they would not be able to make certain targeted dates for shipment. Accordingly, Trademark keeps a large inventory of spare parts for the printing and manufacturing equipment to minimize disruption of operations. Trademark records an allowance against the spare parts inventory to cover obsolescence and depreciation.

Trademark effectively depreciates the spare parts inventory over a five-year period and calculates the monthly provision at the start of the year based on a budgeted amount of current year acquisitions plus one-fifth of the acquisitions for the prior four years. For ease in bookkeeping, Trademark has chosen to expense the spare parts when used. This is an acceptable accounting alternative to capitalizing the costs in property, plant, and equipment. Accordingly, when a spare part is used, spare parts inventory is credited for the initial cost of the spare part, the allowance is debited for the estimated amount of the allowance based on number of months elapsed since the acquisition date, and the difference is recorded as a production expense.

On an annual basis (typically in January or February), each plant takes a physical inventory and identifies whether the part is usable. Unusable parts are scrapped and removed from the inventory listing. Trademark adjusts the general ledger based on the revised inventory reports.

***Audit Procedures—Spare Parts Inventory***

In connection with the audit of the spare parts inventory at June 30, 1999, Barry Green, one of the staff auditors, obtained the following information from the client's general ledger by plant:

<b>General Ledger Account</b>	<b>Balance</b>
Spare parts—Plant A (Greeting Cards & Stationary)	\$ 3,508,354
Spare parts—Plant B (Calendars)	2,369,307
Spare parts—Plant C (Specialty Gifts)	1,499,359
Spare parts—Plant D (Party Goods )	4,489,235
Spare parts—Plant E (Party Goods )	<u>6,773,216</u>
<b>Total spare parts</b>	<b>18,639,471</b>
Allowance for obsolescence of spare parts—Plant A	(1,045,002)
Allowance for obsolescence of spare parts—Plant B	(2,479,321)
Allowance for obsolescence of spare parts—Plant C	(450,948)
Allowance for obsolescence of spare parts—Plant D	(4,642,091)
Allowance for obsolescence of spare parts—Plant E	<u>(2,779,843)</u>
<b>Total allowance for obsolescence of spare parts</b>	<b><u>(11,397,205)</u></b>
<b>Net spare parts inventory</b>	<b><u>\$ 7,242,266</u></b>

Barry selected 15 “high ticket” items from the spare parts inventory listing and visited the plants to verify the existence of the spare parts. Barry could not locate one of the spare parts at Plant A, a motor that was acquired in the prior year at a cost of \$75,000. Roger Cardone, the Plant Manager, informed Barry that such motor was used when the card-cutting machine broke down in April 1999. Willie B. Late, the accounting clerk for the Greeting Cards & Stationary Division informed Barry that he had not had a chance to record any of the tickets for the spare parts used in the last quarter of the year and Willie was able to produce a bunch of tickets that were stored in his desk drawer. Such spare parts, including the spare motor, aggregated to \$371,024, with a net value of \$251,024 at June 30, 1999.

Barry discussed the results of his inventory tests with Nancy when he returned to Trademark's corporate office. Nancy was concerned that Barry had not extended his testing when the exception was detected. She would either have to send Barry back with additional selections or perform other tests to determine the extent of the misstatement. There were no exceptions to the existence test at any of the other plants and the reason for the error appears to be isolated to Plant A, where Willie works.

Nancy knew that the Engagement Manager, Louis Sanchez, would be in the next day to review the working papers and would expect that the exception to their inventory testing be evaluated. Accordingly, she phoned Plant A and spoke to Mr. Cardone about how they might perform other procedures to determine the scope of the issue at Plant A. Mr. Cardone introduced her to the Plant Maintenance Foreman, Mick Annick, who stated that he kept a log of his repair activities. Nancy obtained a copy and compared the tag numbers indicated in the log to Barry's listing of tags that were found in Willie's desk. Each of the tags listed on the log also appeared on Barry's listing. She also selected several tags from the maintenance record for the prior quarter and found that entries were recorded in the general ledger for the use of such parts.

In reviewing the working papers, including the analysis of the general ledger account balances, Louis Sanchez noted that the allowances for obsolescence of spare parts at Plants B and D were greater than the inventory balances at such plants. He requested that Nancy investigate these accounts further. In response to Nancy's inquiries, Liz Siegel, the Director of Accounting at Trademark's corporate headquarters, analyzed the detail activity in those accounts. She found that the Accounting Clerk, Noah Clue, who began working at Plant B in March 1998, was not aware that he was also supposed to prepare an entry to debit the allowance account when he credited spare parts for the parts used. As a result, he recorded an entry to production expense at the original cost of the spare parts rather than the net amount. Therefore, adjustments to the allowance for obsolescence of spare parts of \$65,000 for the fourth quarter of the prior year (fiscal 1998) and \$205,000 for the current year (fiscal 1999) were not made.

Liz Siegel also informed Nancy of a recent issue involving Plant D. In reviewing the adequacy of the spare parts reserve in relation to a particular item at June 30, 1999, the Plant Manager indicated that there was plenty of "elbow room" in the reserve as he had been providing an additional \$20,000 each month during the prior year and \$25,000 each month during the current year. Our audit procedures had not detected the additional provision. Liz stated that she strongly reprimanded the Plant Manager for deviating from company policy and directed the Plant Manager to correct the account by reducing the monthly amortization amount during the next year. Liz wanted Nancy to know that she was all over this issue in the event Nancy's audit procedures detected it.

Nancy concluded that based on the work performed with respect to Plants C and E, the allowances for obsolescence of spare parts for such plants was reasonable.

**Part A****Required:**

- Identify the misstatements and potential misstatements detected by the audit procedures above. Classify each as a known misstatement, a likely misstatement, or a difference in judgment. Cite the auditing literature considered.
- Prepare the correcting journal entry and post the known and likely misstatements to the summary of known and likely misstatements provided as Handout 5-2-1. Nancy has already posted certain entries from other working papers to the summary and a description of such entries is included in the tickmark legend, as you do not have access to the other working papers.

**Part B****Required:**

Review Handout 5-2-2. This worksheet includes the misstatements identified in Part A together with the misstatements identified in Part 1—Accounting Issues.

- Evaluate (a) whether the engagement team achieved its audit objective (i.e., whether the scope of their audit was sufficient) and (b) whether the financial statements are materially misstated based on quantitative and qualitative considerations. Identify which, if any, of the misstatements may be intentional.
- What adjustments, if any, should the engagement team request or require that the client record? Your considerations should also include the misstatements posted by Nancy Drew.