

# CHAPTER 13

## 13.67 Inventory and Deferred Cost Overstatement.

### INSTRUCTIONS FOR DISCUSSION CASES 13.67–13.68:

These cases are designed like the ones in the chapter. They give the problem, the method, the paper trail and the amount. Your assignment is to write the audit approach portion of the case organized around these sections:

*Objective:* Express the objective in terms of the facts supposedly asserted in financial records, accounts and statements. (Refer to discussion of assertions in Chapter 6.)

*Control:* Write a brief explanation of desirable controls, missing controls and especially the kinds of “deviations” that may arise from the situation described in the case.

*Test of controls:* Write some procedures for getting evidence about existing controls, especially procedures that could discover deviations from controls. If there are no controls to test, then there are no procedures to perform; go then to the next section. A “procedure” should instruct someone about the source(s) of evidence to tap and the work to do.

*Audit of balance:* Write some procedures for getting evidence about the existence, completeness, valuation, ownership or disclosure assertions identified in your objective section above.

*Discovery summary:* Write a short statement about the discovery you expect to accomplish with your procedures.

### TOYING AROUND WITH THE NUMBERS

*Problem:* Mattel, Inc., a manufacturer of toys, failed to write off obsolete inventory, thereby overstating inventory, and improperly deferred tooling costs, both of which understated cost of goods sold and overstated income.

*Method:* “Excess” inventory was identified by comparing types of toys (wheels, general toys, dolls, games), parts and raw materials with the forecasted sales or use. Lower-of-cost-or-market (LCM) determinations then were made to calculate the obsolescence write-off. Obsolescence was expected, and the target for the year was \$700,000. The first comparison computer run showed \$21 million “excess” inventory! The company “adjusted” the forecast by increasing the quantities of expected sales for many toy lines. (Forty percent of items had forecasted sales greater than the recent actual sales experience.) Another “adjustment” was to forecast toy closeout sales not at reduced prices but at regular prices. Also, certain parts were labelled “interchangeable” without the normal reference to a new toy product. These “adjustments” to the forecast reduced the “excess” inventory exposed to LCM valuation and write-off.

The cost of setting up machines, preparing dies and other preparations for manufacture are “tooling costs.” They benefit the lifetime run of the toy manufactured. The company capitalized them as prepaid expenses and amortized them in the ratio of current-year sales to expected product lifetime sales (much like a natural resource depletion calculation). To get the amortization cost lower, the company transferred unamortized tooling costs from toys with low forecasted sales to ones with high forecasted sales. This caused the year’s amortization ratio to be smaller, the calculated cost write-off lower and the cost of goods sold lower than it should have been.

*Paper trail:* The computer-forecast runs of expected use of interchangeable parts provided a space for a reference to the code number of the new toy where the part would be used. Some of these references contained the code number of the part itself, not a new toy. In other cases the forecast of toy sales and parts use contained the quantity on hand, not a forecast number.

In the tooling cost detail records, unamortized cost was classified by lines of toys (similar to classifying asset cost by asset name or description). Unamortized balances were carried forward to the next year. The company changed the classifications shown at the prior year-end to other toy lines that had no balances or different balances. In other words, the balances of unamortized cost at the end of the prior year did not match the beginning balances of the current year, except that the total prepaid expense amount was the same.

*Amount:* For lack of obsolescence write-offs, inventory was overstated \$4 million. The company recorded a \$700,000 obsolescence write-off. It should have been about \$4.7 million, as later determined.

The tooling cost manipulations overstated the prepaid expense by \$3.6 million.

The company reported net income (after taxes) of \$12.1 million in the year before the manipulations took place. If pretax income was in the \$20–\$28 million range in the year of the misstatements, the obsolescence and tooling misstatements alone amounted to about 32 percent income overstatement.

**13.68 Inadequate Payroll Time Records.** Follow the instructions accompanying Discussion Case 13.67.

### PAYROLL IN THE BLUE SKY

*Problem:* SueCan Corporation deferred costs under the heading of defence contract claims for reimbursement and deferred tooling labour costs, thus overstating assets, understating cost of goods sold and overstating income.

*Method:* SueCan manufactured electronic and other equipment for private customers and government defence contracts. Near the end of the year, the company

used a journal entry to remove \$110,000 from cost of goods sold and defer it as deferred tooling cost. This \$110,000 purported to be the labour cost associated with preparing tools and dies for long production runs.

The company opened a receivables account for “cost overrun reimbursement receivable” as a claim for reimbursement on defence contracts (\$378,000).

*Paper trail:* The company altered the labour time records for the tooling costs in an effort to provide substantiating documentation. Company employees prepared new work orders numbered in the series used late in the fiscal year and attached labour time records dated

much earlier in the year. The production orders originally charged with the labour cost were left completed but with no labour charges!

The claim for reimbursement on defence contracts did not have documentation specifically identifying the labour costs as being related to the contract. There were no work orders. (Auditors know that Defence Ministry auditors insist on documentation and justification before approving such a claim.)

*Amount:* SueCan reported net income of about \$442,000 for the year, an overstatement of approximately 60 percent.

## DISCUSSION CASES

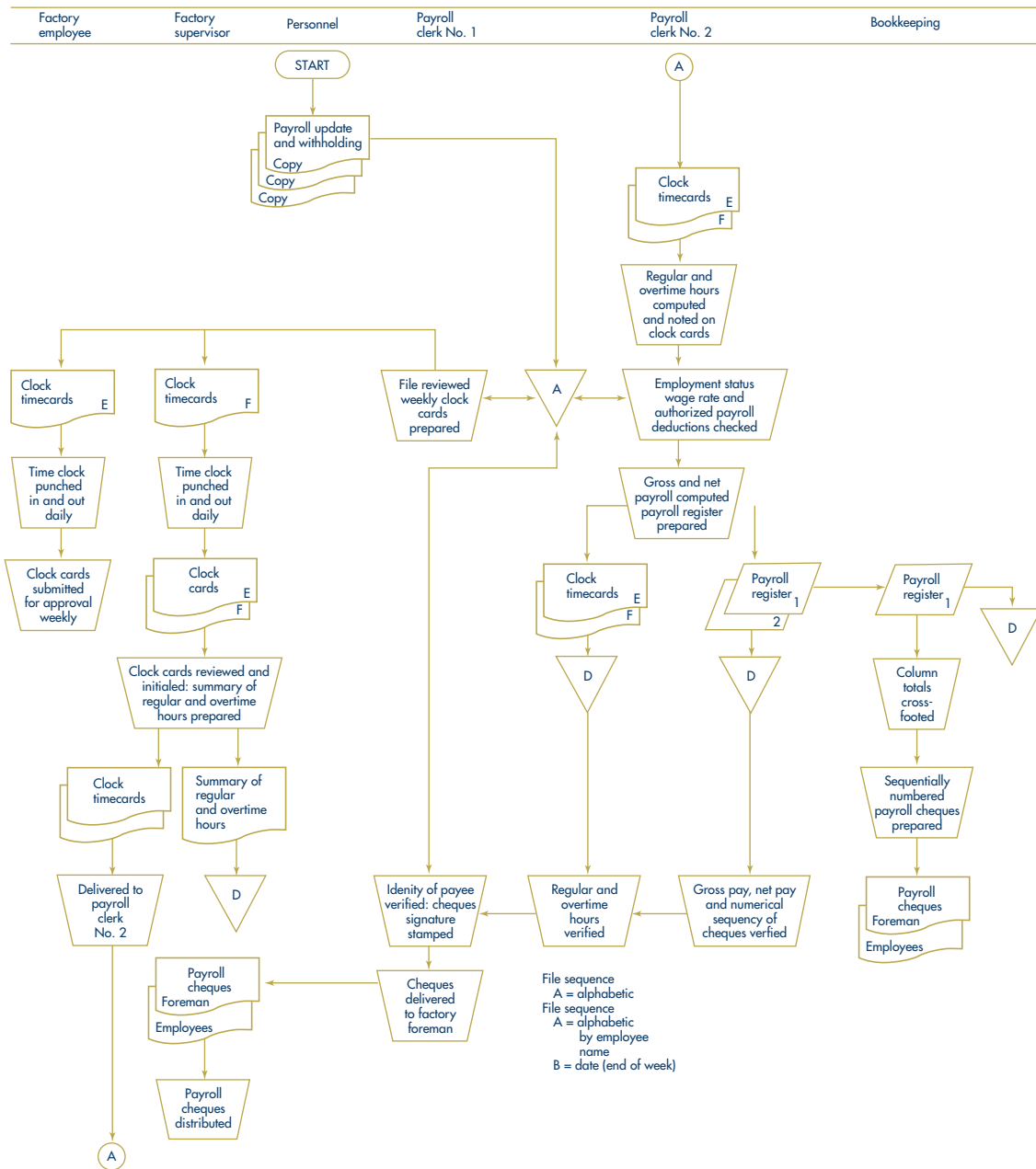
**13.69 Croyden Factory, Inc.: Evaluation of Flowchart for Payroll Control Weaknesses.** A PA's audit working papers contain a narrative description of a segment of the Croyden Factory, Inc., payroll system and an accompanying flowchart (Exhibit 13.69-1) as follows:

**NARRATIVE:**

The internal control system, with respect to the personnel department, is well functioning and is not included in the accompanying flowchart.

At the beginning of each workweek, payroll clerk

**EXHIBIT 13.69-1 CROYDEN, INC., FACTORY PAYROLL SYSTEM**



No. 1 reviews the payroll department files to determine the employment status of factory employees. Clerk No. 1 then prepares clock time cards and distributes them as each individual arrives at work. This payroll clerk, who also is responsible for custody of the cheque signature stamp machine, verifies the identity of each payee before delivering signed cheques to the supervisor.

At the end of each workweek, the supervisor distributes payroll cheques for the preceding workweek. Concurrent with this activity, the supervisor reviews the current week's employee timecards, notes the regular and overtime hours worked on a summary form, and initials the clock time cards. The supervisor then delivers all time cards and unclaimed payroll cheques to payroll clerk No. 2.

**Required:**

- a. Based on the narrative and accompanying flowchart (Exhibit 13.69–1), what are the weaknesses in the system of internal control?
- b. Based on the narrative and accompanying flowchart, what enquiries should be made with respect to clarifying the existence of possible additional weaknesses in the system of internal control?

Note: Do not discuss the internal control system of the personnel department.

*(AICPA adapted)*