Golden Supply Company (An Auditing Case)

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When performing an audit, the auditor must be aware of the impact of the final presentation of the financial statements will have on the auditee's stakeholders. This case provides a situation where an adjustment to inventory can be potentially dealt with in three different manners, each of which has very distinct different impact on various stakeholders. Following the steps in the requirements allows the student to recognize those differences which in turn, provides a basis for the selection of the best alternative treatment.

I. Introduction

Gary Wallace was a young entrepreneur with lots of energy but little money. This setback did not preclude him from looking for a great business opportunity. After months of searching in early 2011, he found what he believed to be the perfect company. It was a dry cleaning supply company called Golden Supply Co. The company was privately owned by a older woman by the name of Clara Shapiro. Her husband who had been the president of the company died last year. His business partner of thirty years had died three years earlier. The business was floundering without a leader. After much negotiation, Mrs. Shapiro agreed to appoint Gary as President of the company and allow him to operate it. Gary was to receive a salary of $250 thousand plus five percent of net income.

Every ounce of energy that Gary had was required to transform that floundering company into a financially successful industry leader in the Mid-Atlantic States. Gary could have never done it without the help of George Schmidt, his operations manager. George successfully redesigned the main warehouse to make inventory picking more efficient, implemented better materials handling procedures to minimize waste, but most importantly decreased days inventory by more than ten days while decreasing out of stocks on customer orders by more than seventy percent by implementing a new computer based inventory control system. Gary estimated that George's procedures saved the company about $200 thousand in warehouse expense and inventory holding costs each year and the positive impact on customer goodwill was immeasurable.

II. The Wholesale Dry Cleaning Supply Industry

Small supply houses that operate locally dominate the wholesale dry cleaning supply industry. There are a number of regional supply houses, similar to Golden Supply, that operate throughout the country, but only one is a serious competitor. The two only share about twent percent of Golden's distribution area. The customers, the local dry cleaners, are dominated by mom and pop operations. There are few dry cleaning chains and less than fifteen percent of the industry is operated by franchised operations.

Basic dry cleaning supplies do not come in thirty-one flavors; they only come in vanilla. Product differentiation is not possible. Golden's advantage in the market results from them being able to deliver any order in one to two days when the industry average is nearly five days. Although they do not depend on price competition heavily, Golden's prices are generally one half to one percent lower than the competition. Deeper discounts could be provided to Golden's customers while still maintaining an acceptable level of net income, but Gary prefers the high margins they are currently receiving.

The dry cleaning industry is generally unregulated and it does not appear to be a priority on any politician's list. The major exception to that is dry cleaning fluid and some stain removers are considered to be hazardous materials by the EPA. Therefore federal, state, and local laws regulate the transportation and disposal of them. Golden is inspected regularly by the EPA and has only had minor violations. This does not appear to be a problem.

Although bigger and better dry cleaning equipment and better products for pre-spotting and removing certain kinds of stains are being developed every year, the basic process has changed little in the last twenty-five years. The dry cleaning supply business is somewhat unique. Although Golden stocks nearly a thousand different items, four product lines drive the business. Those four product lines, clothes hangers, dry cleaning bags, laundry detergent, and dry cleaning fluid, constitute nearly ninety percent of sales.

III. The Audit

Golden Supply is a first year audit engagement. Your firm successfully bid on the client after the bank that issued the Golden's line of credit requested that they change auditors. The audit team performed interim audit work in October, observed the physical inventory on December 30, and performed two weeks of year end work beginning in the second week of February. The senior on the job, Jewel, who was assigned to do the inventory testing was delayed joining the team because of another client commitment. As a result inventory testing was completed somewhere near the end of year end field work.

The financial statements presented below present audited financial statements from 2012 and 2013 prepared by the previous accounting firm. The 2014 financial statements reflect the financial position, results of operations, and cash flows and include all adjustments to which your audit firm and the company have agreed. However, there is one adjustment left that the company and your audit firm have not yet agreed.

When performing the inventory costing tests, the auditor noted that invoices for the items tested for parts and equipment were often seven or eight years old. She investigated the issue further and determined that included in inventory was approximately $260,000 of dry cleaning equipment that was purchased seven years ago. When she investigated it further, she found out the equipment was ordered for a specific customer who, at that time, was a good friend of Mr. Shapiro, one of the owners. By the time Golden had received the equipment, the company had gone out of business. Further investigation into the matter found that the equipment was previous generation equipment that could be purchased on the open market for about $15,000.

A second issue she found during her inventory testing related to the dry cleaning equipment parts inventory. The parts inventory was recorded at approximately $65,000. When she performed an obsolescence test, she determined that the days inventory for parts was approximately thirty-two years. When she spoke to the Golden's sales representative that handled parts sales, he indicated that they really do not sell dry cleaning parts any longer. He stated that the parts Golden had in inventory was for equipment that they sold twenty-five years ago when dry cleaning equipment sales were a significant part of Golden's business. He said that when they do sell parts now, they direct ship them from the supplier to the customer merely as a service to the customer. They have sold only a couple of parts out of inventory in the last four or five years. Based on this information, the auditor concluded that the thirty-two years inventory was actually understated.

As a result of her testing she proposed that they write down the equipment inventory to $15,000 and write off the parts inventory. The amount of the adjustment to inventory is $308,732. Being quite thorough as she always was, Jewel then reviewed the audit working papers from the previous auditor and could not find anywhere the firm had performed a lower of cost or market analysis. She then spoke with the controller about the matter. The controller stated Golden had never written down inventory at any point in the three years he has been with the company nor has he ever performed a lower of cost or market analysis of inventory.

Golden Supply Company
Balance Sheet
December 31, 2012, 2013 and 2014
In Thousands

Assets	2012	2013	2014
Current assets			
Cash	55	110	307
Accounts receivable, net	2,744	3,401	4,407
Inventory	2,679	2,582	3,086
Other current assets	14	16	10
Total current assets	5,492	6,109	7,810
Land	180	180	180
Trucks	468	468	598
Computer equipment	52	86	128
Warehouse equipment		264	985
Furniture and fixtures	36	37	39
Buildings	3,824	3,845	3,863
Property, plant and equipment, gross	4,560	4,880	5,793
Accumulated depreciation	3,458	3,502	3,586
Property, plant and equipment, net	1,102	1,378	2,207
Total Assets	6,594	7,487	10,017
Liabilities			
Current Liabilities			
Line of credit	3,646	4,126	5,243
Accounts payable	436	484	637
Accrued expenses	165	172	171
Total current liabilities	4,247	4,782	6,051
Total Liabilities	4,247	4,782	6,051
Shareholders' Equity			
Common Stock	500	500	500
Retained earnings	1,847	2,205	3,466
Total stockholder's equity	2,347	2,705	3,966
Total liabilities and shareholder's equity	6,594	7,487	10,017

The Notes to the Financial Statements are an integral part of these statements
Draft – For Discussion Purposes Only

Golden Supply Company
Statement of Operations and Retained Earnings
For the Years Ended December 31, 2012, 2013, and 2014
In Thousands

	2012	2013	2014
Sales	31,680	38,284	50,974
Cost of sales	24,458	29,197	38,043
Gross Margin	7,222	9,087	12,931
Depreciation expense	129	165	212
Other operating expenses	7,250	8,061	10,233
Net income from operations	(157)	861	2,486
Interest expense	170	268	396
Net income before taxes	(327)	593	2,090
Income tax expense	(130)	235	829
Net Income	(197)	358	1,261
Retained earnings, beginning	2,044	1,847	2,205
Retained earnings, ending	1,847	2,205	3,466

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Golden Supply Company
Statement of Other Operating Expenses
For the Years Ended December 31, 2012, 2013, and 2014
In Thousands

	2012	2013	2014
Other operating expenses			
Salaries, Officers	254	268	375
Salaries, warehouse	2,278	2,648	3,239
Sales commissions	1,257	1,531	2,039
Salaries, other	861	905	1,017
Payroll taxes	528	608	758
Advertising	42	69	118
Bad debts	503	138	129
Computer expense	95	136	186
Delivery Expense	618	784	1,269
Office expense	118	127	165
Professional fees	85	308	142
Rent	58	62	59
Repairs and maintenance	95	102	138
Utilities	204	207	187
Other	254	168	412
Total Other Operating Expenses	7,250	8,061	10,233

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Golden Supply Company
Statement of Cash Flows
For the Year Ending December 31, 2014
In Thousands

	2012	2013	2014
Cash flow from operating activities			
Cash received from customers	31,592	37,627	49,968
Cash paid to suppliers and employees	(31,419)	(37,110)	(48,622)
Interest paid	(182)	(264)	(393)
Income taxes paid	(50)	(237)	(832)
Net cash flow from operating activities	(59)	16	122
Cash flow from investing activities			
Purchases of property, plant and equipment	(28)	(478)	(1,364)
Proceeds from the sale of property, plant and equipment	1	37	322
Net cash flow from investing activities	(27)	(441)	(1,042)
Cash flow from financing activities			
Borrowings on line of credit	94	480	1,117
Net cash flow from financing activities	94	480	1,117
Change in cash	8	55	197
Cash beginning	47	55	110
Cash ending	55	110	307
Reconciliation of net income to net cash flow from operations			
Net income	(197)	358	1,261
Depreciation	129	165	212
Bad debts	503	138	129
Changes in assets and liabilities			
(Increase) in accounts receivable	(541)	(795)	(1,135)
(Increase) decrease in inventory	(249)	97	(504)
(Increase) decrease in other current assets	1	(2)	6
Increase in accounts payable	32	48	153
Increase (decrease) in accrued expenses	(5)	7	(1)
Net cash flow from operating activities	(327)	16	122

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Notes to Financial Statements
For the Years Ending December 31, 2012, 2013, and 2014
In Thousands

1. Significant Accounting Policies

Accounts Receivable

An allowance for doubtful accounts is established based on collection experience. Bad debts are written off against the allowance account when recognized as a bad debt.

Inventory

Inventory is recorded at cost. Cost is determined based upon the First In – First Out (FIFO) method.

Fixed assets and Depreciation

Additions to fixed assets are recorded at cost. Depreciation is calculated using the straight line method over the useful lives of the assets. Minor improvements in fixed assets are charged to repairs and maintenance.

Income Taxes

Golden Supply Company is a C-Corporation for tax purposes. The provision for income taxes is included in accrued expenses.

2. Accounts Receivable

Accounts Receivable consists of the following:

	2012	2013	2014
Accounts receivable	3,232	3,518	4,511
Allowance for doubtful accounts	488	117	104
Accounts receivable, net	2,744	3,401	4,407

3. Inventory

Inventory consists of the following:

	2012	2013	2014
Dry cleaning supplies	2,126	1,950	2,518
Dry cleaning equipment	488	567	503
Parts	65	65	65
	2,679	2,582	3,086

4. Line of Credit

The Company maintains a line of credit with First West Bank. The maximum borrowing under the line is the lesser of $6.5 million or seventy percent of the sum of accounts receivable, net and inventory. Interest is at prime plus 1.5. The line of credit is collateralized by all of the assets of the Company and expires on December 31, 2016.

Required

1. Investigate the circumstances where Golden Supply does not have to post the adjustment proposed by Jewel and still allow the audit firm to issue an unqualified opinion.
2. The FASB ASC Master Glossary provides "inventory obsolescence" as one of the items subject to a change in accounting estimate. Identify the journal entry that would be used to record for the proposed adjustment to inventory if the adjustment was viewed as a change in accounting estimate and the entire amount is written off.
3. If the entry was posted, do the financial statements accurately reflect the financial position, the results of operations, and the cash flows of Golden Supply for 2014? Explain.
4. Based on the information in the case, when should Golden Supply have recognized the financial impact of the obsolescence of the inventory?
5. Is it possible to characterize the inventory adjustment as a change in accounting principle rather than a change in accounting estimate? Explain.
6. Identify the journal entry that would be used to record the proposed adjustment to inventory if the adjustment was viewed as a change in accounting principle.
7. If the entry was posted, do the financial statements accurately reflect the financial position, the results of operations, and the cash flows of Golden Supply for 2014? Explain
8. Which of the three alternatives – pass on the adjustment, treat as a change or accounting estimate, or change in accounting principle is preferable? Explain.

References

American Accounting Association. FASB Accounting Standards Codification. Retrieved from http://aaahq.org/ascLogin.cfm

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Case Learning Objectives and Implementation Guidance

Courses

Undergraduate and graduate auditing

Topics and Learning Objectives

Evaluation of auditing results
Materiality
Creative thinking
Problem solving

Statement of Learning Objectives

This case is designed to test the student's knowledge of Generally Accepted Accounting Principles they learned in their intermediate accounting classes and how to apply them in an audit situation. The solution is not straightforward so the student's creativity and problem solving ability is tested in their determination of a solution.

In an undergraduate auditing course this case has been used to supplement the students' understanding of the inventory segment of the payment cycle by presenting them with a problem that cannot be solved using traditional audit program steps. By addressing an issue which is potentially outside the comfort zone of even a staff auditor, the instructor can utilize this case to introduce or reinforce the concepts assessing alternative accounting treatment of an accounting issue and its impact on the stakeholders of the auditee.

Graduate students and undergraduate students in their second auditing course would generally be held to a higher standard when completing this case. Their higher level of knowledge of accounting principles and auditing methodologies generally allow the students to identify the issues more quickly, build a better framework for addressing the issues, and then focus more on the selection of the proper accounting treatment.

Regardless of the type of class that this case is presented, the discussion is lively. There are sufficient issues so that almost all students can identify a number of them. There are also sufficient number of wrong paths that the students can take that provide an excellent learning opportunity.