CHAPTER 13

Property, Plant, and Equipment: Depreciation and Depletion

Review Questions

13–1 Factors that facilitate the auditors' verification of plant and equipment but are not applicable to audit work on current assets include the following:

1. **High dollar amount of individual items.** A relatively few transactions may support a large balance sheet amount.

2. **Usually little change in property accounts year to year.** Land, buildings, and equipment often remain unchanged for many years; hence there is little accounting activity to verify. In contrast, such current assets as accounts receivable and inventory may have a complete turnover several times a year.

3. **Minor effect on net income from cutoff errors.** Cutoff errors in recording transactions in plant and equipment are much less likely to have a material effect on net income than are errors in the cutoff of transactions for purchase and sale of merchandise. For example, a cutoff error that causes a $30,000 year-end sales transaction to be recorded a day prior to shipment may cause a $30,000 overstatement of the current year's pretax income. The effect on net income of a cutoff error involving plant and equipment is often limited to the error in depreciation.

13–2 The audit of plant and equipment would probably require less time than the audit of current assets because:

1. Transactions in plant and equipment are usually of substantial dollar amount, and relatively few transactions may account for the $5,000,000 balance of plant and equipment.

2. There is often little change in the property accounts from year to year.

3. Errors in year-end cutoff of plant assets transactions do not usually affect net income, as do cutoff errors in inventory.

13–3 The principal objective of internal control over property, plant, and equipment is to obtain maximum efficiency from the amounts expended for the assets. Other objectives include (a) safeguarding the assets, (b) maintaining accurate records of property, plant, and equipment, and (c) assuring that acquisitions and retirements are properly authorized.
Elements of strong internal control for property, plant, and equipment include the following (only three required):

1. A budget to forecast and control acquisitions and retirements of plant assets.
2. A subsidiary ledger consisting of a separate record for each unit of property.
3. A system of authorization requiring advance executive approval of all plant and equipment acquisitions.
4. A reporting procedure assuring prompt disclosure and analysis of variances between authorized expenditures and actual costs.
5. An authoritative written statement of company policy distinguishing between capital expenditures and revenue expenditures.
6. A policy requiring all purchases of plant and equipment to be handled through the purchasing department and subjected to standard routines for receiving, inspection, and payment.
7. Periodic physical inventories of all property.
8. A system of retirement procedures, including retirement work orders.

A "system of authorizations" for property and equipment additions is a plan requiring written executive approval in advance for all acquisitions of plant assets, whether by purchase, lease, or construction. Serially numbered capital work orders may be used to record authorizations.

Company policy should provide for a plant ledger, identification tags on all plant assets, and a system of retirement work orders. Factory supervisors should be informed that no item of equipment should be retired from use without prior executive approval on a serially numbered retirement work order. Copies of these work orders should be routed to the accounting department.

Yes. Failure to record the retirement of machinery can affect net income. The machines will continue to be depreciated if not already fully depreciated, and any loss on the retirement will be omitted from the income statement.

The auditors place much less emphasis on proving the existence of recorded plant assets than they do for current assets. Current assets normally are subject to a complete turnover from one audit to the next; plant and equipment are not. When the balances of plant asset accounts have been verified in an initial audit, the auditors in subsequent examinations are primarily concerned only with additions and retirements. They will probably observe the major new additions, and make a general tour of the plant. Plant assets at distant locations and widely scattered units of property may be observed on a test basis, on a rotating basis, or not at all, depending upon the adequacy of internal controls and the materiality of the amounts involved. This audit pattern is influenced by the fact that plant assets are less susceptible to theft and fraud than are current assets. Also, cutoff errors do not normally affect net income. Consequently, the factor of inherent risk is normally much lower for plant assets than for current assets.

In the first audit of a company for which other independent public accountants have previously made satisfactory audits, the auditors normally may limit their work on the beginning balances of plant and equipment to a general review of past transactions in plant assets.
In the first audit of a concern that has not been previously audited by independent public accountants, the auditors must make a complete historical analysis of the property account. Only by such an approach can the costs and depreciation charges shown by the records be verified.

13–10 Documentary evidence usually available in the client's office to substantiate legal ownership of property, plant, and equipment includes deeds, title insurance policies or abstract of title and an attorney's opinion as to title, property tax bills, insurance policies, purchase contracts, purchase orders, invoices, and paid checks. The auditors may also secure written representations from the client as to ownership of these assets.

13–11 Most accountants believe that examination of public records is a legal rather than an accounting function. They prefer to rely upon documents in the client's possession, supplemented, if necessary, by a statement from the client's attorney establishing legal ownership of real property.

13–12 Inclusion of the costs of fences, gates, barriers, and underground parking facilities in the Land account is not acceptable. The benefits from these expenditures will be received for only a limited number of years. After the estimated useful life has ended, these facilities will have to be replaced or disposed of. In short these costs must be depreciated over their useful lives, and therefore do not belong in the same account as land, which is not subject to depreciation.

The nature of the installation suggests that this cost is material and that the usefulness will extend over several years; therefore, it is appropriate to capitalize these costs rather than to treat them as expense. The costs in question belong in the Land Improvement account.

13–13 Periodic physical inventories of property and equipment are essential for adequate internal control over plant assets. If such an inventory takes place during the audit engagement, the auditors may decide to observe the inventory taking. It is not customary to observe a physical inventory of property and equipment on every engagement, however. If internal controls for plant and equipment are weak, the auditors might reasonably request a physical inventory.

13–14 The only special features of the substantive tests of a fleet of automobiles would be the examining of the certificates of title or automobile registration to establish legal ownership, and making physical identification of some of the automobiles by make, model, year, and serial number. Of course, not all of the automobiles would be at a location convenient for inspection. These procedures will provide assurance that sales and trades have been reflected in the accounts. In all other respects, the substantive procedures should be along the lines suggested by the audit program for plant and equipment.

13–15 The principal objective of the auditors in analyzing a Maintenance and Repairs expense account is to disclose any capital expenditures that were erroneously recorded as expense.

13–16 The most appropriate balance sheet presentation of factory machinery not being used in present operations but capable of being used when needed is dependent upon the likelihood of sustained future use. If the equipment is merely temporarily idle, no special treatment is required; but if there appears to be little prospect for sustained use, the equipment should probably be written down to estimated realizable value and removed from the property and equipment group.

13–17 The auditors use the following substantive procedures to detect unrecorded retirements of property, plant, and equipment (only 3 required):

(1) If major additions of plant and equipment have been made during the year, ascertain whether old equipment was traded in or superseded by the new units.
(2) Analyze the Miscellaneous Revenue account to locate any cash proceeds from sale of plant assets.

(3) If any of the company's products have been discounted during the year, investigate the disposition of plant facilities formerly used in manufacturing such products.

(4) Inquire of executives and supervisors whether any plant assets have been retired during the year.

(5) Examine retirement work orders or other source documents for authorization by the appropriate official or committee.

(6) Investigate any reduction of insurance coverage to see whether this was caused by retirement of plant assets.

(7) When vouching purchases of equipment, examine invoices for indications of trade-in allowances.

13–18 The auditors must question the service lives adopted by the client for plant assets. To do otherwise would be to fail in the collection of sufficient competent evidence for the client's depreciation policies and procedures.

13–19 Under generally accepted accounting principles goodwill is no longer amortized. Instead it is tested for impairment annually or more often if certain circumstances or events occur. In establishing the initial value for goodwill and testing it for impairment, the company must determine the fair value of the reporting units to which goodwill is assigned and the identifiable assets and liabilities of those units. A business valuation specialist may be needed to establish these values.

13–20 Lease agreements are accounted for as either operating leases or capital leases. If lease agreements exist that should be accounted for as capital leases, the failure to record the present value of future payments results in an understatement of plant assets.

13–21 a. In the auditors' analytical procedures applied to plant and equipment, comparisons may be made of:

(1) Cost of plant assets and annual plant output in dollars, pounds, or other units.
(2) Cost of plant assets and cost of good sold.
(3) Repairs and maintenance expense on a monthly basis and from year to year.
(4) Acquisitions for current year and for prior years.
(5) Retirements for current year and for prior years.

b. In the auditors' analytical procedures applied to depreciation, comparisons may be made of:

(1) The ratio of depreciation expense to total cost of plant assets from year to year.
(2) The percentage relationship between accumulated depreciation and related property accounts on a year-to-year basis.

Questions Requiring Analysis

13–22 Accounts receivable will ordinarily require more audit time because the account will have turned over multiple times during the year and the year-end total will be composed of different transactions (ordinarily current year sales for which collection has not been made yet) as compared to the
beginning of the year balance. Ordinarily, equipment account will turn over slowly and the auditors will only need to verify acquisitions during the year and retirements, as contrasted to the entire balance.

13–23 Internal control practices governing retirements of machinery and equipment include:

(1) Materially numbered retirement work orders requiring written executive approval.

(2) Forwarding to the property accounting department of a copy of the retirement work order for every asset sold, scrapped, or transferred.

(3) Removal of metal identification tags from units retired and submission of tags to property accounting department.

13–24

a. A significant decline in a number of lines of business may indicate that the recorded amounts of certain property, plant and equipment and intangible assets may be impaired. Therefore, there is a risk of material misstatement related to the overstatement of the values of these assets.

b. Companies are required to do a test of impairment of the value of goodwill annually, or more often if certain events and circumstances indicate that the asset may be impaired. Management’s test must be at the business reporting unit level and will involve a valuation of each reporting unit. This will normally involve the development of a value for the reporting units by discounting expected future cash flows. The auditors will test the valuation by evaluating the reasonableness of the management’s assumptions about future cash flows, and considering the reasonableness of the discount rate used to develop the valuation. They will also test the fair values assigned to assets other than goodwill for each reporting unit. A business valuation specialist may have to utilize to evaluate the reporting unit values as well as the fair values assigned to certain assets.

13–25

a. This is the first audit of Kadex Corporation by Jones & Scranton. Moreover, the company has not been audited by other public accountants during the two previous years of operation. Under these circumstances, the auditors must investigate fully transactions relating to plant and equipment during the two prior years of the company’s existence, as well as the records of the year under audit. The adequacy of internal control over plant acquisitions and disposals would be an important part of this review. Since Kadex is a relatively new company, this study of prior years’ transactions can be completed within reasonable time limits.

The review of prior years' transactions relating to plant and equipment would include analysis of the Repairs and Maintenance expense account and should bring to light the erroneous treatment of plant acquisitions as revenue expenditures during Years 1 and 2.

If Jones and Scranton did not investigate the property transactions of the two prior years and the internal controls in force, there would be no satisfactory support for the balances of the property accounts at the end of Year 3, or for the depreciation expense of the year under audit. Remember that one of the auditors' basic objectives for plant and equipment is to determine that the property accounts (including the amounts carried forward from prior years) are fairly stated.

b. Both the income statement and the balance sheet prepared at the end of Year 3 would be affected by the errors made in Years 1 and 2. In the balance sheet, the plant and equipment and also the total assets would be understated by the undepreciated cost of the assets that were improperly expensed. Current liabilities and total liabilities would be understated by the
additional income taxes applicable to the underestimation of prior periods' net income due to the accounting errors. The retained earnings and total stockholders' equity would be understated by the difference between the underestimation of total assets and the underestimation of total liabilities. In the Kadex income statement, depreciation expense would be understated, income taxes expense overstated, and net income overstated.

13–26 As a general rule, financial statements should recognize the substance of a related party transaction rather than its mere form. In this case, the auditors are concerned that the sales price of the land and buildings may exceed the market value. The auditors will carefully evaluate the evidence of value of these assets, including the appraisal. Even if the auditors are satisfied that the land and building are valued appropriately, the related party nature of the transaction requires that the financial statement disclose the nature of the relationships, describe the transaction, and the amounts involved.

13–27 Because Ross Products, Inc. acquired its building in a related-party transaction, the auditors cannot rely upon the $2,400,000 valuation as actual cost. To determine the genuine cost of the building, the auditors must obtain permission from J. A. Ross, who is sole owner of both Ross Products, Inc. and J. A. Ross Construction Co., to examine the records of the construction company. Assuming permission is obtained, the auditors may review the materials, labor, and overhead charges to the construction of the building. In addition, the auditors must investigate the customary profit margins of the construction company; it would be appropriate to value the building at cost plus normal profit. The auditors may request J. A. Ross to obtain an independent appraisal of the building’s fair value as of April 1, Year 9. As a result of these audit procedures, the auditors will have evidence as to construction cost plus normal profit and replacement cost. Construction cost plus profit is an appropriate valuation for the building unless it exceeds replacement cost, in which case the latter value should be used.

13–28 This is a practical but difficult question on which to generalize. Auditors should not lend their approval to an allocation of the lump-sum purchase price which is clearly unreasonable and which shows unjustifiable amounts for tangible assets in order to avoid recognition of the intangible asset of goodwill. Since the business acquired was that of the client's competitor, it is probable that one motive for the purchase was to eliminate competition and thus pave the way to above-normal earnings. The auditors might suggest a review by the board of the allocated values or independent appraisals of the assets. Other alternatives are the issuance of a qualified or adverse opinion, or, if the circumstances are extreme, withdrawal from the engagement.

13–29 (1) An examination of the minutes of the meetings of the board of directors and the executive committee, if one exists, may provide information as to retirement of plant assets. Tracing these authorizations to the accounting records affords some evidence on the existence of unrecorded retirements.

(2) Frequently, it is possible to observe the physical existence of property and equipment. Such tests may disclose unrecorded retirements.

(3) Examination of invoices for the acquisition of equipment may provide an indication of unrecorded trade-ins.

(4) Examination of scrap proceeds or miscellaneous revenue entries may lead to information regarding the sale or scrapping of retired assets.

(5) Consideration of changes in products and production methods may offer clues as to the abandonment of plant assets formerly needed but now not used or useful.
(6) Analysis of maintenance expense may indicate changes in assets in use, particularly if certain maintenance expenses cease abruptly.

(7) Examination of tax bills may indicate the abandonment or possible sale of plant assets.

(8) Abandonment, sale, or partial abandonment of major items of plant assets may be indicated by changes made in insurance policies covering the assets.

(9) Scrutiny of the cash receipts journal, especially for unusual items, may reveal sale of assets, which have not been recorded as retirements.

(10) Requesting representations from responsible officials of the client covering the existence and usefulness of the assets shown in the accounting records may result in the disclosure of unrecorded abandonment of plant assets.

13–30 Since the acquisition involves a purchase price greater than the value of the identifiable assets, goodwill must be recognized in the amount of the difference. In addition, goodwill must be allocated to the individual reporting units of the acquired business. The auditors must be able to establish the reasonableness of the valuation of the reporting units as well as their identifiable assets. Accordingly, a business valuation specialist may need to be involved.

13–31

a. The audit of financial statement items valued at fair value may be difficult because the values are often determined using assumptions that are subjective.

b. One approach to auditing the value of the franchise location is to test and evaluate management’s model for valuation. In taking this approach, the auditors would:

- The appropriateness of the valuation model used;
- Whether the significant assumptions are reasonable and consistent with economic conditions, existing market information, management’s plans and strategies, past experience, other financial statement assumptions, and the risk associated with the cash flows; and
- The accuracy, completeness, and relevance of the important data on which the fair value measurements are based.

Alternatively, the auditors may decide to use the work of a valuation specialist.

c. If the auditors decide to use the work of a valuation specialist, they should evaluate the professional qualifications of the specialist and obtain an understanding of the nature of the work and the conclusions.

d. Among the approaches that may be used, each of which may use somewhat different assumptions.

Approach 1: Estimate cash consequences of the investment.
- Expected future cash inflows.
- Expected future cash outflows.
Depending upon the circumstances, this might be done on cash flows for the entire store, or of particularly important assets.

Approach 2: Base estimate on recent operations of a store with similar characteristics.

Approach 3: Base estimate on an available market value for such a store.
e. To begin, depending upon the approach selected by management, it may be possible to address its reasonableness by making estimates using the other two approaches. Also, in all cases use of a specialist may be appropriate.

Approach 1: This one is difficult. Typically an auditor is provided a spreadsheet with inflows and outflows (alternatively, income and expenses) and must determine if they are reasonable. The auditor will question management on how they arrived at the figures and determine whether the method seems reasonable.

Approach 2: The auditors here will need to assure themselves that the store is similar on all the important characteristics—whether identified by management or by themselves.

Approach 3: If such market data is available it will be valuable to the auditor if s/he can be assured that the market data is describing a store such as this one.

**Objective Questions**

13–32 Multiple Choice Questions

a. (3) Serially numbered retirement work orders provide a systematic means of assuring that units of plant and equipment are not retired without authorization by management. Retirement work orders also provide the accounting department with the information necessary to record the retirement of equipment in the accounting records. The alternative procedures suggested are not satisfactory. Some retirements of plant asset do not involve cash receipts. The inquiries and observations by internal auditors would come after the fact of asset retirements.

b. (4) Excessive recurring losses on assets retired show that the depreciation expense recognized during the actual useful lives of the assets has been less than the real cost of using the assets.

c. (2) The purchase of factory equipment should be made by the purchasing department regardless of which unit of the company will use the equipment. The purchasing department has the expertise and the established procedures and documents to insure that all purchases are made in accordance with company policy.

d. (4) In recording expenditures on property, plant, and equipment, the logical choice usually is between a revenue expenditure and a capital expenditure. If the outlay is judged to be a revenue expenditure (rightly or wrongly), it will probably be recorded in the Repairs and Maintenance account. If items that should be capitalized are erroneously charged to Repairs and Maintenance, the result will be an understatement of property, plant, and equipment. Consequently, the auditors can gain evidence that additions to property, plant, and equipment are not understated by reviewing the Repairs and Maintenance account. The other alternatives suggested in the question are not plausible. An erroneous debit to cash would be disclosed quickly because of the disagreement between cash receipts and the cash being deposited daily in the bank. A debit to Accounts Payable would lead to protests from creditors. A debit to Depreciation Expense would be a conspicuous error because of the timing of the entry and the lack of a related credit to Accumulated Depreciation.

e. (3) The plant manager would be the most appropriate individual for inquiries about the existence of machinery that is no longer useable.
f. (2) Inspection of equipment and the reconciliation of the equipment with accounting records will strengthen internal control over custody of the equipment.

g. (1) A property, plant, and equipment cutoff error has less of an effect, not more, on net income. This is because the only effect on income is the small amount of depreciation involved.

h. (3) Ordinarily, the emphasis for testing property accounts is on transactions that occurred during the year because the account turns over so slowly. Note, however, that audits performed under the PCAOB Standard 2 also require consideration of internal control over property, plant and equipment.

i. (1) Because the proper recording of a retirement requires elimination of the accumulated depreciation related to the retired equipment, review of this account is most likely to provide evidence about a recorded retirement.

j. (3) An inability to locate assets may reveal to the auditors that unrecorded retirements have occurred.

k. (3) Assets purchased during the year should not result in deductions from the accumulated depreciation account.

l. (1) The audit of intangible assets typically involves both vouching the cost of assets and testing the allocation of that cost.

13–33 Task-Based Simulation

<table>
<thead>
<tr>
<th>Situation</th>
<th>Propose an Adjusting Entry?</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Hwang purchased land for a new plant that it intends to construct. A portion of the cost was a commission paid to a real estate agent. That commission was capitalized as part of the cost of the land.</td>
<td>No</td>
</tr>
<tr>
<td>b. The purchased land was in part financed through obtaining a loan from a financial institution. Interest on that loan is being capitalized as part of the cost of the land.</td>
<td>Yes</td>
</tr>
<tr>
<td>c. An existing building on the land was torn down to allow construction of a new building on the land. The cost of the demolition was capitalized as part of the cost of the new building.</td>
<td>No</td>
</tr>
<tr>
<td>d. Subsequent to the land purchase, Hwang purchased certain equipment from a vendor who had filed for bankruptcy. Hwang’s management believes that the equipment was purchased for an amount equal to approximately half what at least one other supplier sells it for. Hwang recorded the transaction at its cost.</td>
<td>No</td>
</tr>
<tr>
<td>e. Hwang cut down a number of trees on the land and sold the wood. Other income was recorded on the transaction for the amount of the cash received.</td>
<td>Yes</td>
</tr>
</tbody>
</table>
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13–34 Multiple Choice Questions

a. (4) Purchase returns and allowances.
b. (2) Plant assets were retired during the year.
c. (1) Deed.
d. (1) Existence.
e. (2) Property, plant, and equipment.

Problems

13–35 SOLUTION: Internal Control, Tests of Controls, Substantive Procedures (Estimated time: 20 minutes)

a. (1) The purpose of establishing a dollar minimum for expenditures to be capitalized is to encourage consistent accounting practice from year to year in distinguishing between capital expenditures and revenue expenditures. Some items of low cost may last for years, but the extra work of capitalizing and depreciating a low-cost item must be weighed against the benefits that result from more precise information. The factors of convenience and economy dictate that expenditures that are not material in dollar amount be treated in the accounts as expenses of the current year.

b. (1) Tests of controls to measure compliance with the policy of not capitalizing items below a given dollar amount consist of reviewing the subsidiary ledger for plant and equipment to locate any items below the established amount. The income statement account used to expense plant and equipment (e.g., Repairs and Maintenance or supplies) can be reviewed for items that should have been capitalized. The information may be accumulated quickly by use of a computer.

(2) The purpose of regular reconciliation of plant ledgers with general ledger controlling accounts is to provide assurance of the integrity and completeness of the property records. Agreement of the subsidiary ledgers with the controlling accounts indicates that additions and disposals have been recorded and that detailed information exists to show the age, cost, accumulated depreciation, and location of individual units of plant and equipment.

b. (1) The appropriate tests of controls to verify that plant ledgers are regularly reconciled with controlling accounts include obtaining from the client copies of the reconciliations. The auditors should verify that the reconciliations are complete, that any necessary adjustments have been made, and that an appropriate official of the client organization has given written approval to the reconciliations.

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b. (1) If the tests of controls show that the minimum dollar amount to be capitalized is not being observed, the auditors' substantive procedures should include obtaining or preparing a list of the capitalized items of substandard amount. These items should be reviewed with the client and consideration given to transferring them to an expense account such as Repairs and Maintenance.

The Repairs and Maintenance and Supplies expense accounts should also be analyzed to determine if it contains high cost capital items that were treated as revenue expenditures. If this is the case, the auditors should review with the client the need for more consistent accounting practices. The auditors should determine
whether employees have been provided with an adequate written policy statement on the distinction between capital expenditures and revenue expenditures.

(2) If the control procedure of regular reconciliation of the subsidiary ledgers for plant and equipment is not being performed effectively, there is a risk that additions and retirements may not have been properly recorded in both sets of records. The auditors' substantive procedures should be expanded to include a complete reconciliation of the subsidiary ledgers with the controlling accounts at the balance sheet date. By using the computer as an audit tool, this reconciliation can be performed quickly. If problems are encountered, the auditors should substantiate the year-end balances of plant and equipment by extensive vouching of vendors' invoices. If serially numbered retirement work orders are in use, the auditors should account for all documents in the series and trace retirements to the subsidiary ledger. Selected items listed in the subsidiary ledgers should be located in the plant and inspected to determine that they are in current use and correspond to the descriptive data in the subsidiary ledgers.

13–36 SOLUTION: Agee Corporation  (Estimated time: 20 minutes)

(1) This line of business is most likely a component of the company’s business that has operations and cash flows that are clearly distinguished from the rest of the company. Accordingly it should be reported as discontinued operations in the first period that it meets the FASB ASC 360-10-45 criteria as being held for sale. The auditors would have to investigate to determine whether the component meets the criteria and, if so, ascertain that its operations are accurately broken out separately as discontinued operations on the income statement.

(2) It appears that the accounting for the lease is inappropriate. The benefit of the “rent holiday” should not be taken in the first year. Instead, the benefit should be amortized over the life of the lease. The auditors should read the lease contract and determine that the lease expense is being accounted for in accordance with generally accepted accounting principles.

(3) Unless extension of the lease is reasonably assured, the leasehold improvements should be depreciated over the shorter of the lease term or their useful lives, in this case 10 years. The auditors should read the terms of the lease and make inquiries of management to determine whether extension is reasonably assured. Then, they should determine that the assets are depreciated over the appropriate number of years.

(4) **Impairment of Goodwill.** The goodwill related to the Clothing and Apparel unit appears to be impaired. FASB ASC 350-20-35 requires a write-down when the carrying value of the unit is greater than its fair value (market value); there is no consideration of “undiscounted estimated future cash flows” as is the case with the equipment in the latter part of this solution. The impairment is equal to $1,100,000 ($12,600,000 – $11,500,000). Therefore, the $1,200,000 in goodwill should be written down by $1,100,000 to $100,000.

The auditors would need to perform procedures to audit management’s determination of the market value of the unit. Since this is an accounting estimate, the auditors can either evaluate management’s process for determining market value or develop their own estimate. In most audits, these valuations are prepared by business valuation experts (specialists). If this is the case here, AICPA AU 620 requires the auditors to evaluate the qualifications and reputation of the specialist and obtain an understanding of the nature of the work performed. The
auditors should also obtain an understanding of the methods and assumptions used by the specialist, make appropriate tests of data provided to the specialist, and evaluate whether the specialist’s findings support the related assertions in the financial statements.

**Impairment of the Equipment.** Since the carrying value of the equipment is less than its undiscounted estimated future cash flows, per *FASB ASC 360-10-35*, an impairment loss does not appear to be required. However, the auditors must perform procedures to audit the reasonableness of management’s cash flow projections used in the impairment test. Accordingly, the auditors should evaluate the reasonableness of the assumptions underlying the projections, and test the data used and the computations. If there is not a sufficient basis for any significant assumption, the auditors will require management to obtain sufficient evidence to support that assumption.

Note: If the undiscounted value of the estimated future cash flows had been less than the carrying value of the equipment, *FASB ASC 360-10-35* would require a write-down to market value ($975,000).

### 13–37 SOLUTION: Holman Corporation (Estimated time: 35 minutes)

**HOLMAN CORPORATION**

**Proposed Adjusting Journal Entries**

**December 31, 20X6**

(1) **Prepaid Rent** $ 1,250
Accum. Depr. Mach. & Equip 2,020
Contract Payable 35,400
Rent Expense 3,750

**Machinery and Equipment** $40,400
**Depreciation Expense** 2,020

To correct April 1, 20X6, entry for lease of die casting machine under a 10-year, cancelable lease having no renewal or purchase option.

(2) **Gain on Construction of Building** 1,500
Depreciation Expense 317

**Accum. Depr. Buildings** 317
**Buildings** 1,500

To correct June 30, 20X6, entry for addition to building, and to correct depreciation on addition as follows:

Should be 1/12 x 1/2 x $16,000 (12-year life from 6/30/X6) $667
Per client (computed on 25-year life) 350
**DIFFERENCE** $317
### 13–13 SOLUTION:  Chem-Lite, Inc. (Estimated time: 25 minutes)

**CHEM-LITE, INC.**

#### Proposed Adjusting Journal Entries
March 31, 20X1

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment</td>
<td>$17,955</td>
</tr>
<tr>
<td>Deferred Interest</td>
<td>2,800</td>
</tr>
<tr>
<td>Interest Expense</td>
<td>560</td>
</tr>
<tr>
<td>Contract Payable</td>
<td>21,315</td>
</tr>
</tbody>
</table>

To correct entries to Equipment account for payments

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on installment contract originating December 1, 20X0 as follows:

- **Equipment:** $31,500 cost – $13,545 recorded = $17,955
- **Deferred interest:** \(\frac{20}{24} \times 3,360\) total interest = $2,800
- **Interest expense (December 1-March 31):** \(\frac{4}{24} \times 3,360\) = $560
- **Contract payable:** $24,360 original balance - 3 payments of $1,015 = $21,315

### Depreciation Expense, Equipment

<table>
<thead>
<tr>
<th></th>
<th>1,616</th>
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</thead>
<tbody>
<tr>
<td><strong>Accumulated Depreciation, Equipment</strong></td>
<td>1,616</td>
</tr>
</tbody>
</table>

To correct depreciation taken on equipment purchased under installment contract of December 1, 20X0 as follows:

- Depreciation should be \((31,500 - 3,150) \times 10\%\) = $2,835
- Depreciation recorded \((13,545 - 1,355) \times 10\%\) = $1,219
- **Adjustment required** $1,616

#### 13–39 SOLUTION: Granger Grain Corporation (Estimated time: 40 minutes)

**a.** The analysis is incomplete because it does not present sufficient evidence to express an opinion as to the propriety of the transactions recorded in the account. No indication is given as to the nature of the transactions other than the disbursement and receipt of cash. Additional audit procedures will be necessary to accumulate evidence the reviewer needs.

**b.** There is the possibility that either of two different contractual agreements underlie the client's transactions:

1. **(1) The construction of the barges was financed by a loan from City Life Insurance Company.** Crediting the loan to the advance account results in failure to disclose the existence of the assets constructed and the related loan payable.
2. **(2) Granger sold the barges to City, probably with a leaseback agreement.**

**c.** The following auditing procedures appear necessary to complete the analysis:

1. **(1) Determine by inquiry the nature of the transactions.**
2. **(2) Examine minutes of the board of directors' meetings for proper authorization. Obtain copies for the permanent file.**
3. **(3) Examine contracts relating to the transactions. Obtain copies for inclusion in the working papers.**
4. **(4) Ascertain that payments conform to the construction contracts and no unrecorded liabilities exist.**
5. **(5) Confirm the transactions with Jones Barge Construction Co., including specific requests for information regarding percentages withheld, existence of other construction contracts, and warranties for barges constructed.**
6. **(6) Confirm the transaction with City Life Insurance Company.**
7. **(7) If the transaction represents financing the construction by a loan, ascertain whether the barges are completed and, if so, determine the adjusting entries to record the**
asset, loan liability, depreciation, and accrued interest. Establish that any extra costs have been properly authorized. Ask if a certificate from an engineer or naval architect has been acquired relating to cost and performance of the barges.

If the transaction represents sale of the barges to City and subsequent leasing by Granger, determine the adjusting entries to record the complete transaction including gain or loss on the sale. Compute rental liability under the charter or leasing contract. Ascertain if any maintenance costs may be chargeable to City as owner.

(8) For the analytical procedures applied to expenses consider the significance of the costs of operating the barges, such as: Are they an expansion of the fleet? Or do they replace old barges that may have been leased?

(9) Consider the nature and materiality of the transactions to determine whether note disclosure is required.

In-Class Team Case

13–40 SOLUTION: Mandville Company (Estimated time: 40 minutes)

a. Land. This is a proper entry to record the purchase of the land. Since no commitments were made on June 17 when the stock was selling for $77.50 per share, basing the purchase on that price is not appropriate. Because Mandville is assuming the debts relating to the taxes and the assessment, this is also properly (as recorded) a cost of the acquisition.

Land Improvements. Capitalization of the three expenditures seems appropriate as they each represent expenditures necessary to prepare the land for its intended use. Note that if the expenditures for replacing the road and the fence had been related to existing property they might well be considered expenses rather than capitalizable items.

Building. FASB ASC 835-20-15 requires capitalization of interest on self-constructed assets. Capitalization of interest for purchased assets is not considered appropriate. Accordingly, the $22,000 of interest during construction should not be capitalized. The building account should be credited for that amount and the interest expense debited.

Equipment. This entry is incorrect as no gain should be recognized on the exchange. Since the fair value of the equipment traded in is equal to its book value, the actual cost of the new equipment is the equipment’s book value ($9,400) plus the cash given up ($90,600). Accordingly, the gain should be eliminated (debit Gain on exchange of dissimilar assets) and equipment decreased by $10,000 (credit Equipment-computer servers).

b. Depreciation provisions. An estimate of depreciation expense is as follows:

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</thead>
<tbody>
<tr>
<td>152–3</td>
<td>5%</td>
<td>$ 6,750</td>
<td>$ 250</td>
<td>0</td>
<td>$ 7,000</td>
<td>$ 7,000</td>
<td>$ 0</td>
</tr>
<tr>
<td>154–5</td>
<td>3%</td>
<td>135,000</td>
<td>7,095π</td>
<td>0</td>
<td>142,095</td>
<td>142,470</td>
<td>(375)</td>
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<tr>
<td>156–7</td>
<td>10%</td>
<td>80,000</td>
<td>5,000#</td>
<td>3,000</td>
<td>82,000</td>
<td>70,600</td>
<td>11,400</td>
</tr>
<tr>
<td>Totals</td>
<td></td>
<td>$221,750</td>
<td>$12,345</td>
<td>$3,000</td>
<td>$231,095</td>
<td>$220,070</td>
<td>$11,025</td>
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*Subtracted because the depreciation on the beginning balance assumes that all of the beginning balance was maintained all year.

πBecause the entry to record the building improperly includes $22,000 of capitalized interest, this calculation is based on $473,000 * .05 * 1/2 year.

#Because the entry to record the equipment improperly includes a $10,000 gain, this calculation is based on $100,000 * .10 * 1/2 year.

The depreciation on the building seems low. The auditors may choose to discuss the timing of the expenditures relating to the equipment to determine whether the book depreciation of $70,600 is reasonable. In addition, one might question whether the life of the new servers (and software) as 10 years seems too long.