Assignment #1
Planning the Integrated Audit

1. **Engagement Letter**

December 18, 2009

Mr. Kevin Chen, Chair
Audit Committee of the Board of Directors
Peach Blossom Cologne Company
1308 Bee Hive Boulevard
Chicago, Illinois

Dear Mr. Chen:

We are writing this letter to confirm our agreement with respect to our integrated audit of the financial statements of Peach Blossom Cologne Company and its internal control over financial reporting for the year ending December 31, 2009. The purpose of the audit will be to provide our opinion regarding the fairness of presentation of the financial statements in conformity with generally accepted accounting principles and the effectiveness of internal control over financial reporting in conformity with the COSO framework.

Our examination will be conducted in accordance with generally accepted auditing standards and will include examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. The examination will also include an audit of internal control over financial reporting, including such tests of the design and operation of these controls as we deem necessary to assess their effectiveness and the impact on the nature, timing, and extent of our audit evidence. In conjunction with our audit of internal control over financial reporting, we will provide a written communication to management and the Audit Committee of the Board of Directors describing any control deficiencies, significant deficiencies, and material weaknesses we encounter. Material weaknesses will preclude our providing an unqualified opinion on the effectiveness of internal control. Our audit will also include assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation.

We will plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. The examination will not include a detailed audit of transactions to the extent required to discover defalcations and/or other irregularities that are not material to the financial statements, although our examination may uncover such matters.

As in prior years, we will require assistance from Peach Blossom personnel, including the preparation of schedules and analyses of accounts. The expected date of completion of the audit is February 12, 2010. Our fee is based on estimates of time to be expended. It should be recognized that these estimates could be affected by unusual circumstances.

We appreciate the opportunity to perform the Audit of Peach Blossom Cologne Company. Please do not hesitate to contact us if you have any questions regarding the engagement. If the terms of this agreement are satisfactory, please sign in the space provided below and return the duplicate copy of the letter to us.

Sincerely,

Anderson, Olds, and Watershed

Anderson, Olds, and Watershed
Certified Public Accountants

Accepted by:____
Title ____
Date: ____

Peach Blossom Cologne Company							**P-1**		
Time Budget							**12/28/09**		
December 31, 2009							**JWP**		
							1 of 2		
	Prior		Current		Current		Var.	Explanation of	
	Year		Year		Year		from	Variance from	
Audit Area	Actual	%	Budget	%	Actual	%	Budget	Budget	
Planning	6	2.6%	24	12.0%					
Interim:									
Understanding internal control	5	2.1%	12	6.0%					
Testing control design effectiveness	3	1.3%	8	4.0%					
Testing control operting effectiveness	3	1.3%	8	4.0%					
Cash	2	0.9%	8	4.0%					
Accounts Receivable	2	0.9%	8	4.0%					
Inventory	4	1.7%	12	6.0%					
Fixed assets	2	0.9%	0	0.0%					
Accounts Payable	2	0.9%	6	3.0%					
Accrued liabilites	2	0.9%	0	0.0%					
Federal income taxes	2	0.9%	0	0.0%					
Notes Payable	2	0.9%	0	0.0%					
Capital Stock	1	0.4%	0	0.0%					
Retained Earnings	1	0.4%	0	0.0%					
Operating accounts	2	0.9%	0	0.0%					
Trial balance and adjusting entries	3	1.3%	1	0.5%					
Other (Explain):									
Total Interim	36	15.4%	63	31.5%					

Peach Blossom Cologne Company	P-1
Time Budget	12/28/09
December 31, 2009	JWP
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Audit Area	Prior Year Actual	%	Current Year Budget	%	Current Year Actual	%	Var. from Budget	Explanation of Variance from Budget
Year-end:								
Cash	16	6.8%	5	2.5%				
Accounts Receivable	18	7.7%	8	4.0%				
Inventory	24	10.3%	12	6.0%				
Fixed Assets	16	6.8%	8	4.0%				
Accounts Payable	22	9.4%	12	6.0%				
Accrued Liabilities	8	3.4%	2	1.0%				
Federal Income Taxes	8	3.4%	3	1.5%				
Notes Payable	7	3.0%	3	1.5%				
Capital Stock	1	0.4%	1	0.5%				
Retained Earnings	2	0.9%	1	0.5%				
Operating accounts	14	6.0%	4	2.0%				
Commitments & Contingencies	3	1.3%	1	0.5%				
Minutes & Correspondence	6	2.6%	3	1.5%				
Representations Letter	1	0.4%	1	0.5%				
Unrecorded Liabilities	8	3.4%	2	1.0%				
Report Preparation	8	3.4%	4	2.0%				
Internal Control Letter	1	0.4%	4	2.0%				
In-Charge Memorandum	5	2.1%	3	1.5%				
Other (Explain):								
Total Year-end	168	71.8%	77	38.5%				
Total Planning (from page 1)	6	2.6%	24	12.0%				
Total Interim (from page 1)	36	15.4%	63	31.5%				
Supervision & Review	24	10.3%	36	18.0%				
Total Hours	234	100.0%	200	100.0%				

3. (a) Organization Chart

Peach Blossom Cologne Company Organization Chart
As of December 31, 2009

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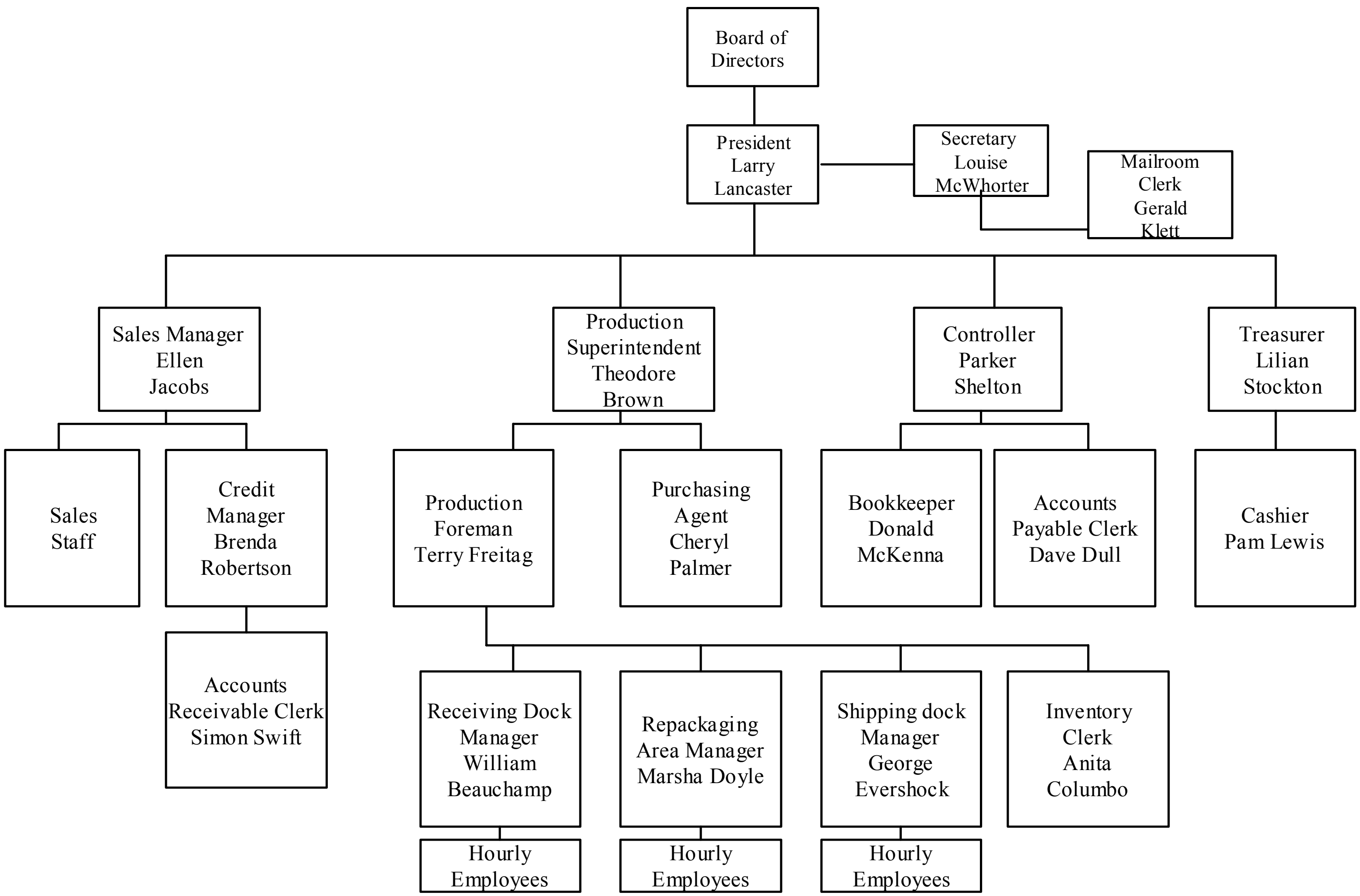


(b) Suggested Organizational Changes

The following organizational changes would help improve internal control:

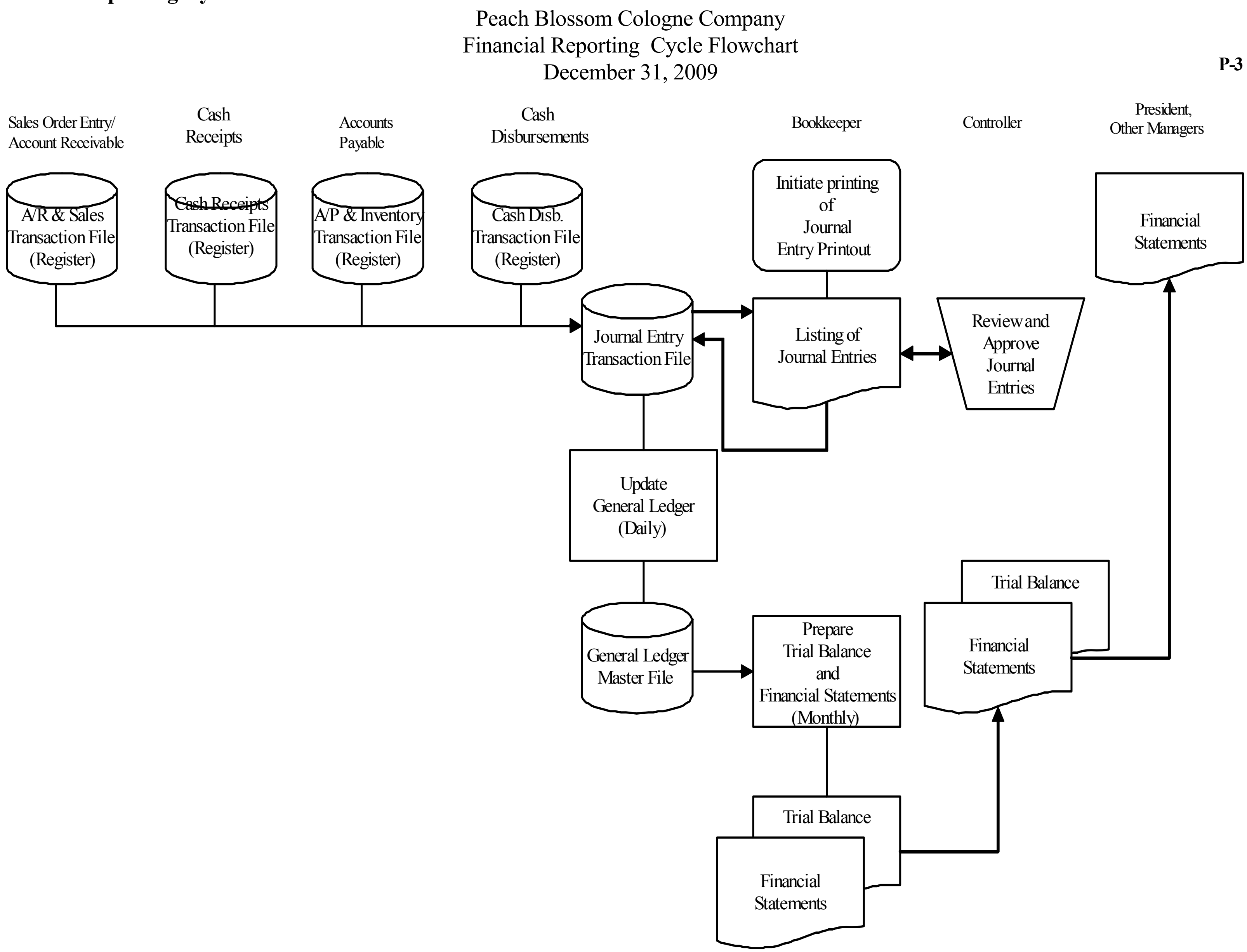
(1) The credit manager should not report to the sales manager. They have opposing goals. The sales manager is trying to increase sales whereas the credit manager's objective is to assure that only credit-worthy customers are accepted. The sales manager may direct the credit manager to disregard credit limits, giving rise to uncollectible accounts. The credit manager should report to the treasurer.

(2) The accounts receivable clerk should not report to the credit manager, as the credit manager may direct the accounts receivable clerk to perpetrate irregularities such as writing off disputed accounts or keeping cash remitted on accounts previously written off. The accounts receivable clerk should report to the controller.

(3) The purchasing agent should not report to the production superintendent. The production superintendent may direct the purchasing agent to purchase unauthorized or unnecessary materials. Purchasing should be established as a separate department.

(4) The inventory clerk, who issues and controls stock at the warehouse, should not maintain the inventory master file records. The inventory clerk may manipulate, or be directed to manipulate, the records to cover up a shortage. For example, the production foreman may direct the inventory clerk to record items in an irregular manner to cover up inventory obsolescence. The functions of recording and custody should be separated. The person who maintains the inventory master file records should report to the controller. The storeroom clerk can continue to report to the production foreman.

4. Financial Reporting Cycle Flowchart



Peach Blossom Cologne Company
Analytical Procedures
December 31, 2009

5. a. Comparative Analysis

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	Per Audit 12-31-08	Per Books 12-31-09	Dollar Change	Percent Change	
Balance Sheet Accounts					
ASSETS:					
101 Cash-Big City National Bank	339,415	420,678	81,263	23.9%	***
105 Accounts receivable	124,021	235,380	111,359	89.8%	***
106 Allowance for bad debts	(10,485)	(4,800)	(5,685)	-54.2%	***
Net receivables	113,536	230,580	117,044	103.1%	
109 Inventory	777,152	600,580	(176,572)	-22.7%	***
Total current assets	1,230,103	1,251,838	21,735	1.8%	
210 Land	82,250	82,250		0.0%	
220 Buildings	276,263	276,263		0.0%	
221 Accum. depn.- buildings	(65,416)	(74,625)	9,209	14.1%	
230 Machinery and equipment	540,845	737,045	196,200	36.3%	***
231 Accum. depn.- mach.& equip.	(160,866)	(185,939)	25,073	15.6%	***
240 Automotive equipment	99,425	118,925	19,500	19.6%	***
241 Accum. depn.- auto. equip.	(52,798)	(81,892)	29,094	55.1%	***
250 Office furniture & fixtures	106,433	113,233	6,800	6.4%	
251 Accum. depn.- off. furn.& fix.	(37,581)	(43,073)	5,492	14.6%	
Total assets	2,018,658	2,194,025	175,367	8.7%	
LIABILITIES:					
301 Accounts payable	223,161	176,790	(46,371)	-20.8%	***
305 Accrued interest	10,625	8,750	(1,875)	-17.6%	
306 Dividends payable	15,725	15,725		0.0%	
307 Federal income tax payable	23,023	25,000	1,977	8.6%	
308 Notes payable-short term	125,000		(125,000)	-100.0%	***
Total current liabilities	397,534	226,265	(171,269)	-43.1%	
401 Notes payable-long term		150,000	150,000		***
Total liabilities	397,534	376,265	(21,269)	-5.4%	
OWNERS' EQUITY:					
501 Common stock	925,000	925,000		0.0%	
505 Other contributed capital	95,979	95,979		0.0%	
601 Retained earnings	429,855	600,145	170,290	39.6%	***
605 Dividends	(15,725)	(15,725)		0.0%	
610 Current net income	186,015	212,361	26,346	14.2%	***
Total owners' equity	1,621,124	1,817,760	196,636	12.1%	
Total liabilities & owners' equity	2,018,658	2,194,025	175,367	8.7%	

*** Change exceeds $16,000 or 25%

Peach Blossom Cologne Company
Analytical Procedures
December 31, 2009

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	Per Audit 12-31-08	Per Books 12-31-09	Dollar Change	Percent Change	
Income Statement Accounts					
REVENUE:					
701 Sales	3,447,472	3,857,549	410,077	11.9%	***
703 Sales returns & allowances	(26,530)	(28,318)	1,788	6.7%	
Net sales	3,420,942	3,829,231	408,289	11.9%	
EXPENSES:					
801 Cost of goods sold	1,420,933	1,651,366	230,433	16.2%	***
Gross margin	2,000,009	2,177,865	177,856	8.9%	
OPERATING EXPENSES:					
820 Wage expense	1,418,720	1,487,700	68,980	4.9%	***
821 Payroll tax expense	99,310	105,924	6,614	6.7%	
822 Depreciation expense	64,422	76,368	11,946	18.5%	
823 Rent expense	3,750	3,750		0.0%	
824 Office supplies expense	8,615	10,825	2,210	25.7%	***
825 Small tools expense	2,988	5,650	2,662	89.1%	***
826 Advertising expense	6,313	7,980	1,667	26.4%	***
827 Insurance	15,737	22,415	6,678	42.4%	***
828 Repairs and maintenance	17,869	16,222	(1,647)	-9.2%	
829 Property tax	13,463	17,100	3,637	27.0%	***
830 Utilities	10,670	14,325	3,655	34.3%	***
831 Professional fees	26,875	35,875	9,000	33.5%	***
832 Miscellaneous expense	302	1,771	1,469	486.4%	***
833 Provision for bad debts	9,925	8,650	(1,275)	-12.8%	
834 Freight expense	28,150	32,386	4,236	15.0%	
Total operating expenses	1,727,109	1,846,941	119,832	6.9%	
Net income from operations	272,900	330,924	58,024	21.3%	
OTHER INCOME (EXPENSE):					
901 Interest expense	(27,500)	(14,063)	(13,437)	-48.9%	***
930 Gain(loss)sale of fixed assets	18,638	(4,500)	(23,138)	-124.1%	***
950 Miscellaneous income					
Net other income	(8,862)	(18,563)	9,701	109.5%	
Net income before taxes	264,038	312,361	48,323	18.3%	
940 Federal income tax	78,023	100,000	21,977	28.2%	***
Net income	186,015	212,361	26,346	14.2%	

*** Change exceeds $16,000 or 25%

Peach Blossom Cologne Company
Percentage of Sales Analysis
December 31, 2009

b. Percentage of Sales Analysis

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JWP

	Per Audit 12-31-08	2008 Percent	Per Books 12-31-09	2009 Percent
REVENUE:				
701 Sales	3,447,472	100.0%	3,857,549	100.0%
703 Sales returns & allowances	(26,530)	0.8%	(28,318)	0.7%
Net sales	3,420,942	99.2%	3,829,231	99.3%
EXPENSES:				
801 Cost of goods sold	1,420,933	41.2%	1,651,366	42.8%
Gross margin	2,000,009	58.0%	2,177,865	56.5%
OPERATING EXPENSES:				
820 Wage expense	1,418,720	41.2%	1,487,700	38.6%
821 Payroll tax expense	99,310	2.9%	105,924	2.7%
822 Depreciation expense	64,422	1.9%	76,368	2.0%
823 Rent expense	3,750	0.1%	3,750	0.1%
824 Office supplies expense	8,615	0.2%	10,825	0.3%
825 Small tools expense	2,988	0.1%	5,650	0.1%
826 Advertising expense	6,313	0.2%	7,980	0.2%
827 Insurance	15,737	0.5%	22,415	0.6%
828 Repairs and maintenance	17,869	0.5%	16,222	0.4%
829 Property tax	13,463	0.4%	17,100	0.4%
830 Utilities	10,670	0.3%	14,325	0.4%
831 Professional fees	26,875	0.8%	35,875	0.9%
832 Miscellaneous expense	302	0.0%	1,771	0.0%
833 Provision for bad debts	9,925	0.3%	8,650	0.2%
834 Freight expense	28,150	0.8%	32,386	0.8%
Total operating expenses	1,727,109	50.1%	1,846,941	47.9%
Net income from operations	272,900	7.9%	330,924	8.6%
OTHER INCOME (EXPENSE):				
901 Interest expense	(27,500)	0.8%	(14,063)	0.4%
930 Gain(loss)sale of fixed assets	18,638	0.5%	(4,500)	0.1%
950 Miscellaneous income	0	0.0%	0	0.0%
Net other income	(8,862)	0.3%	(18,563)	0.5%
Net income before taxes	264,038	7.7%	312,361	8.1%
940 Federal income tax	78,023	2.3%	100,000	2.6%
Net income	186,015	5.4%	212,361	5.5%

c. Financial Ratio Analysis

Peach Blossom Cologne Company
Financial Ratio Analysis
December 31, 2009

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JWP

Ratio	2008	2009	Median Industry
Current	3.09	5.53	1.90
Quick	1.14	2.88	0.90
Accounts Receivable Turnover	30.13	16.61	10.43
Days' Receivables	12.11	21.98	35.00
Inventory Turnover	1.83	2.75	5.85
Days' Inventory	199.63	132.75	62.39
Asset Turnover	1.69	1.75	2.83
Income to Net Worth	0.11	0.12	0.12
Income to Total Assets	0.09	0.10	0.05
Liabilities to Net Worth	0.25	0.21	1.11
Liabilities to Total Assets	0.20	0.17	0.53
Times Interest Earned	10.60	23.21	3.00

(d) (1) Accounts Requiring Attention

The student should first establish a decision rule. One heuristic is 5% of pretax income. Pretax income for 2009 is $312,361. Five percent of this figure is approximately $16,000. A percentage change is also important in assuring that material accounts are not overlooked while still maintaining efficiency, that is, the auditor wants to make sure the cutoff is high enough to preclude examining routine fluctuations. One way to determine a cutoff percentage is to array the accounts by percentage using the working trial balance file provided on the student diskette. If this is done, a convenient cutoff percentage appears to be 25%. Thus the decision rule can be stated as, "Examine all accounts with either a positive or negative fluctuation of $16,000 or 25%." The addition of the percentage to the decision rule assures that those accounts with a large percentage fluctuation will be examined even if the dollar change is less than $16,000. Using the decision rule that "a change will be investigated if it exceeds 25% or $16,000," the following accounts should be examined. For each account, a possible business reason for the fluctuation in the account is provided, as well as a type of error that may have caused the account to be misstated.

Account	Possible Business Reason for the Change	Possible Error in the Account
Cash-Big City National Bank	The company may have borrowed funds.	Fictitious entries may have been made to overstate cash.
Accounts receivable	The company may not be collecting receivables as quickly as in the past.	Fictitious sales may have been recorded.
Allowance for Doubtful Accounts	The company may be expecting a lower proportion of uncollectible accounts	The allowance may be understated.
Inventory	The company may be giving discounts to move merchandise more quickly.	Inventory may have been miscounted or priced improperly.
Machinery and equipment	The company may have purchased additional machinery.	The company may have made an error in recording additions to the account.
Accumulated depreciation-machinery and equipment	The company may have purchased additional machinery	Depreciation may have been calculated incorrectly.
Automotive equipment	The company may have purchased additional automotive equipment.	The company may have made an error in recording additions to the account.
Accumulated depreciation-automotive equipment	The company may have purchased additional automotive equipment	Depreciation may have been calculated incorrectly.
Accounts payable	Vendor payment terms may have changed.	There may be unrecorded liabilities.
Notes payable – short term	The company may have paid off the notes	There may be unrecorded notes.
Notes payable – long term	The company may have borrowed additional funds	Notes may be incorrectly classified.
Retained earnings	Increase in net income.	Revenues may be overstated or expenses understated.
Current net income	Increase in net income.	Revenues may be overstated or expenses understated.

Account	Possible Business Reason for the Change	Possible Error in the Account
Sales	The company may have sold more product or is charging higher prices.	Fictitious sales may have been recorded.
Cost of goods sold	The increase may reflect an increase in sales.	Possible error is the incorrect costing of inventory.
Wage and salary expense	The number of employees may have increased and/or salaries and wages were increased.	Persons may have been overpaid or fictitious persons were on the payroll.
Office supplies expense	The increase may reflect increased sales.	Possible error in the classification of expenses.
Small tools expense	The increase may reflect increased sales.	Possible error in the classification of expenses.
Advertising expense	The increase may reflect increased sales.	Possible error in the classification of expenses.
Insurance expense	The company may have acquired additional fixed assets.	Incorrect classification of expenses.
Property tax expense	Tax rates may have increased.	Incorrect classification of expenses.
Utilities	Weather conditions may have changed; additional equipment.	Incorrect classification of expenses.
Professional fees	The company may have become engaged in lawsuits resulting increased attorneys' fees.	The company may have misclassified expenses.
Miscellaneous expense	Additional miscellaneous items.	Management may be hiding fraudulent expenses in this account. There may be offsetting gains reflected in the account.
Interest expense	Company may have paid off notes.	Company may have failed to record notes and associated interest expense.
Gain (loss) on sale of fixed assets	May reflect legitimate loss on sale of assets.	The company may have made an error in calculating the loss.
Federal income tax expense	Increase may reflect rate changes or missed income tax deductions.	The income tax accrual may be overstated.

(2) Analysis of Questionable Accounts

The common size analysis, that is the income statement accounts as a percentage of sales, reflects many of the same observations with respect to the revenue and expense accounts. The common size analysis also reveals that interest expense has not increased proportionately with debt. The balance sheet shows a reduction in short-term debt but an increase in long-term debt of $150,000. All debt arrangements should be examined carefully. Another observation revealed by the common size analysis is that the gross margin percentage remained virtually unchanged. As sales increased, cost of goods sold increased proportionately, as expected.

(3) Assessment of the Risk of Financial Failure

An important point when assessing financial condition is that current year figures represent unadjusted balances. Auditor adjusting entries have not yet been posted. The credibility of the current year's amounts and resulting ratios must therefore be viewed with caution.

Some observations concerning the computed financial ratios follow:

- The current ratio for the year ended December 31, 2009 is higher than that of the previous year and much higher than the industry median. This could imply that, from an auditing standpoint, current assets are inflated or that there are unrecorded current liabilities. Alternatively, from a management standpoint, the ratio may imply that assets are underemployed.

- An examination of the quick ratio, in conjunction with the current ratio, suggests similar conclusions. Given the industry ratios, current assets are either underemployed, these assets are inflated, or current liabilities are overstated.

- The accounts receivable turnover ratio, as well as the number of days' receivables, shows that the company does better than the industry in collecting its receivables, although some deterioration has occurred between 2008 and 2009. This is consistent with the increase in receivables relative to sales.

- The inventory ratios indicate that inventories on hand have declined from 2008 levels; however, the inventory turnover and days' inventory are still not in line with the industry. This situation could imply that inventories are obsolete and therefore overstated. The decline in inventories from 2008 may mean that management is trying to use resources more efficiently. It may also mean that management has written off some obsolete inventories. It could also mean that the company has not recorded inventories and the corresponding accounts payable.

- The asset turnover ratio indicates that management is not employing assets judiciously, as the client ratio is lower than the median industry ratio.

- The profitability ratios indicate that the company is about as profitable as the industry as a whole. Although income to total assets increased, income to net worth would be higher if management were using leverage more judiciously. However, as the company is profitable, financial and audit risk appear low.

- The leverage ratios and the times interest earned indicate that this client is in better financial condition and is therefore in a lower risk class than other companies within this industry. However, these ratios and the profitability ratios indicate that the company is not employing leverage to the extent evident within the rest of the industry.

- Overall, the ratios disclose a fairly secure financial position, with little chance of bankruptcy.

(4) Overall Appraisal of Audit Risk

There appears to be low audit risk associated with this engagement, given the strong overall financial condition of the client. Assets appear to be underutilized; this may, however, be indicative of overstated assets. The auditor must be aware of this possibility while examining the asset accounts. Additionally, the higher than normal current and quick ratios may be a result of understated liabilities.

6. Assessing the Risk of Material Misstatement Due to Fraud

Having examined the permanent file materials and the internal control questionnaires, the risk of material misstatement due to fraud appears to be low. The following table includes examples of two risk factors that are pertinent to the Peach Blossom audit.

Risk Factor	Impact on the Risk of Fraud	Evidence and Auditor Actions
1. Lack of appropriate segregation of duties, for example, the accounts receivable clerk handles cash (prepares the cash prelist) and the inventory (storeroom) clerk also maintains inventory perpetual records.	There is a risk that assets can be misappropriated if a person has custody of the assets and access to the records.	The auditor should assess the control risk in these areas and expand the scope of the audit work. For example, the auditor could confirm a substantial number of accounts receivable and expand inventory test counts. If fraud is discovered as a result of the testing, the auditor should bring the matter to the attention of the appropriate level of management, generally a level higher than where the fraud is discovered or suspected. In addition the absence of segregation of duties in these areas may represent a significant deficiency in the design and operation of internal control, which could adversely affect Peach Blossom's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. These deficiencies may impact the ability to provide an unqualified opinion on internal control over financial reporting and need to be communicated to the Audit Committee.
2. Computer reports are not safeguarded and are accessible to unauthorized personnel.	The information in these reports could be used to misappropriate assets or manipulate the accounting records.	The auditor should further test controls over LAN security and also expand the scope of the audit work as noted in number (1) above. Any possibility of accessibility to computer records represents a significant fraud risk.

7. Internal Control Over Financial Reporting: Planning Memorandum

Peach Blossom Cologne Company	1/1/09
Planning Memorandum –Internal Control Audit	JWP
December 31, 2009	1 of 2

When conducting our integrated audit of the Peach Blossom Cologne Company for the year ended December 31, 2009, our audit plan will address the following matters pertaining to the audit of internal control over financial reporting:

(1) We will determine whether management has put into place procedures for assessing the effectiveness of internal control. As part of our understanding and evaluation of management's process, we will assess the results of tests the client conducted as part of their assessment process. In addition, we will determine whether there is sufficient documentation to provide reasonable support for management's assessment of internal control.

(2) Paragraph 104 of Auditing Standard 2 requires our firm to obtain evidence regarding the effectiveness of controls pertaining to all relevant assertions for all significant accounts each year—*each year must stand on its own.* The Standard also calls for us to vary the nature, extent, and timing of testing from year to year to introduce unpredictability and in response to changing client circumstances. Examples of variations include changing the number of tests performed and/or adjusting the combination of testing procedures.

(3) We will need to perform sufficient testing to obtain a very high level of confidence, in the range of 95-99%, that the controls can prevent, detect, and/or correct material misstatements in any particular assertion. Because many controls involving segregation of functions and control environment factors provide no documentary evidence of the control's performance, we will subjectively assess their effectiveness. The results of substantive testing also provide us an opportunity for assessing the effectiveness of controls. Although Auditing Standard 2 seems to preclude the rotation of testing over several fiscal periods, reduced testing seems reasonable if we find that client conditions have not changed significantly and controls are unaltered from last year.

(4) We intend to rely on any internal control testing that has been performed by competent client personnel as long as our work constitutes the principal evidence supporting our opinion. We will keep the following considerations to keep in mind regarding the extent of our reliance on tests performed by client personnel:
- The greater the materiality and degree of judgment and estimation in an account or class of transactions, the less reliance we will place on client testing of the account or class of transactions.
- The more pervasive the control and the higher the degree of judgment involved in evaluating the control's effectiveness, the more reliance we will place on our own testing.
- Where the potential for management override is substantial, we will place little reliance on client testing.

(5) We will apply considerable professional judgment when assessing the significance of internal control deficiencies. We will consider: (1) The *potential* for a misstatement, not whether a misstatement has actually occurred; (2) the impact of a deficiency, including the amounts or totals of transactions exposed and the volume of transactions in the affected accounts; (3) how the interaction of controls with other controls—their interdependence and redundancies—affects their proper functioning. Differentiating a significant deficiency from a material weakness is subjective. Any material weakness will preclude our being able to render an unqualified opinion on internal control.

The distinguishing characteristic of a material weakness is the existence of "more than a remote likelihood" that a material misstatement in the financial statements will not be prevented or detected. We will use the following approach in determining which deficiencies constitute material weaknesses:

- Estimate the monetary impact of each deficiency we find.
- Assign a "material misstatement likelihood factor" to each deficiency, for example, *remote, reasonably possible, or probable*—similar to the labels found in FASB *Statement No. 5, Accounting for Contingencies.*
- Rank all deficiencies on the material misstatement likelihood factor.
- Denote all deficiencies having more than a remote likelihood as "material weaknesses."
- Determine the "significance" of the remaining deficiencies by reviewing the estimated monetary impact of each.
- Differentiate between significant deficiencies and those deficiencies having only a minor impact
- Examine those deficiencies designated "significant" to decide whether a combination thereof constitutes a material weakness.

(6) If an unqualified opinion is appropriate, we will provide a report on internal control over financial reporting having the following components:

- Address – We will address the report to the Board of Directors and Stockholders
- Title – The title is "Report of Independent Registered Public Accounting Firm." This title indicates that our firm is registered with the PCAOB to conduct audits of public companies.
- Introductory Paragraph – We will state that we have audited management's assessment of internal control over financial reporting and differentiate our responsibility from that of management.
- Scope Paragraph – In this paragraph, we will describe the nature of our audit and state that our audit was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States). We will indicate what our audit consisted of.
- Definition Paragraph – We will explain the nature and objectives of internal control over financial reporting.
- Inherent Limitations Paragraph – We will indicate the limitations of internal control over financial reporting, indicating that not all misstatements are preventable or detectible.
- Opinion Paragraph – We will express our opinion on management's assessment of internal control over financial reporting and also provide our opinion on the effectiveness of internal control.
- Signature – We will add the firm's signature.
- Date – This date will coincide with the date of the report on the financial statements and with the last day of field work.

8. Planning Memorandum

Peach Blossom Cologne Company	12/28/09
Planning Memorandum	JWP
December 31, 2009	1 of 2

In planning the audit engagement for Peach Blossom Cologne Company for the year ended December 31, 2009, the following matters have been considered:

(1) The objective of this engagement is to render an opinion on the financial statements. In the past we have been able to render an unqualified opinion.

(2) The engagement takes approximately five weeks in total: approximately one and one-half weeks of interim and about three and one-half weeks at year-end. (The bulk of the interim work has been completed.) The field personnel for year-end work will consist of one senior and one assistant, as required. The partner-in-charge and engagement manager will supervise and review as necessary.

(3) The company has assets of approximately $2,200,000 and net income of approximately $210,000. These amounts are expected to change as we propose adjustments for accruals and so on.

(4) Peach Blossom Cologne Company is a small wholesale distributor of cosmetics and handles a broad line of fruit-scented cremes, lotions, oils, colognes, and spray perfumes. Peach Blossom has prospered because it has been able to service smaller stores that could not obtain reasonable volume discounts from the larger manufacturers.

(5) The Company was begun by James Martin and Larry Lancaster. James Martin is Chairman of the Board of Directors but is no longer active in the day-to-day management of the Company. Larry Lancaster is President; he was formerly a salesman for a large cosmetics manufacturer. There are several other large shareholders, but they are not active in the management of the Company.

(6) Our firm has audited Peach Blossom for over twenty years. In that time there has never been any question that management has the highest integrity. Nevertheless, skepticism demands that we be alert for unusual and possibly irregular transactions.

(7) The control structure is acceptable for a small company. Management's attitude toward controls is progressive and fosters an atmosphere that enhances the effectiveness of control policies and procedures.

(8) The company is capitalized primarily through equity (approximately 80%). There is one long-term note of $150,000. The balance of liabilities is primarily in accounts payable and accruals. The current ratio is 5.5/1.

(9) Peach Blossom is a closely-held Company; approximately 85% of the stock is held by four individuals. The Company is a public company as its stock is occasionally traded in the over-the-counter market. The company is subject to the small business issuer reporting requirements of the SEC and must include certified financial statements and our attestation report on internal control over financial reporting in its annual report.

(10) The Company has one plant location at 1308 Bee Hive Boulevard, Chicago. The Company purchases large quantities of its products directly from various factory locations. The product is repackaged and distributed to retailers throughout the Chicago metropolitan area and a four-state area extending about 300 miles from the plant location.

(11) Materiality will consist of combined errors amounting to 5% of pretax income. The client's pretax income is $312,361. Five percent of this amount is $15,618. We will use $16,000 as the materiality level. Since the president wants our firm to ensure that items are recorded to close tolerances, we will propose and record all adjustments we find, even if the adjustments in the aggregate are less than the materiality level. I will reevaluate this materiality level at the end of the audit since pretax income may be reduced because of adjustments we propose.

(12) Based on previous years' results, we can expect the more material adjustments affecting income to occur in accrued liabilities as an adjustment for income taxes. Other likely adjustments are apt to be found in receivables to adjust for uncollectible accounts, in inventory for possible clerical errors, and in accounts payable for unrecorded liabilities.

(13) I expect that our firm will be able to render an unqualified opinion on both the financial statements and internal control over financial reporting. However, this expectation may change as the audit progresses.

I plan to carry out the following procedures in planning this engagement:

(14) Review the correspondence files, the permanent file, the prior year's working papers and financial statements. I will review these items to familiarize myself with the client and its history and to determine our audit risk (exposure). I will study trade journals for the cosmetics industry, as well as current trends for the industry. I will query the president and other officers as to any recent developments in the industry that may impact adversely on the company. I will also scan The Wall Street Journal and other financial sources.

(15) I will send a letter of inquiry to the client's counsel and will consult with client's counsel personally if deemed necessary.

(16) I will discuss the scope and timing of the examination with the president, sales manager, controller, treasurer, and production superintendent to set time schedules for audit tests. The internal control questionnaires and most of the interim work and internal control testing have already been completed. The physical inventory will be observed on January 1, 2010. The balance of the audit work will be performed beginning mid-January, with an estimated completion date in the early part of February.

(17) I will ask the client to prepare various confirmations and have accounting personnel prepare various schedules.

(18) We plan to issue an unqualified opinion during the early part of February.

James W. Pritchard
Audit Senior
January 1, 2010