**Introduction**

Apollo Shoes, Inc. is an audit case designed to introduce you to the entire audit process, from planning the engagement to drafting the final report. You are asked to assume the role of a veteran of two-to-three “busy” seasons, “in-charging” for the first time.

While Apollo Shoes’ growth has been phenomenal (there has been a dramatic growth in unaudited net income over the past year), there are some concerns: the client doesn’t want your firm (Anderson, Olds, and Watershed (AOW)) to talk with the predecessor auditor, a labor strike is looming, and one of Apollo Shoes’ largest customers is suffering some financial difficulties.

Because of busy season, there is little help, other than from an untrained intern. While the intern can do “grunt work,” such as vouching and gathering information for you, he appears incapable of preparing workpapers, making adjusting entries, or even getting good coffee and doughnuts. Assistance does come in the form of an objective, competent internal audit staff. Communication between client personnel and other firm members takes the form of e-mail messages from the engagement partner (Arnold Anderson), the engagement manager (Darlene Wardlaw), the intern (Bradley Crumpler), and the director of Apollo’s internal audit department (Karina Ramirez). **Required assignments and memos are in bold print.** Page indexing suggestions are given, but feel free to adjust page numbering as you see fit.

The AOW intranet website ([http://**www.mhhe.com/louwers3e**/](http://www.mhhe.com/louwers3e/)) has many useful resources such as a repository of electronic documents (so that you won’t need to input data or retype documents) and an archive of e-mail messages and their attachments, all filed by account group.

While we tried to make the case as realistic as possible, limitations remain. Since you are unable to follow up directly with client personnel, you may need to rely on some evidence with which you may be uncomfortable. In an actual audit, you would be able to inquire, observe, and otherwise follow-up on any questions that you have until you feel comfortable relying on the evidence. To make sure that the case can be completed in a reasonable amount of time, we cut some corners with respect to audit sampling. Understand that audit sampling plays a large role in actual audit practice.

The information is sequential in nature. In other words, pay close attention to information disclosed early in the audit (for example, in the Board of Director’s minutes) as it may play a role in subsequent audit work. Similarly, the bank cutoff statement in the cash workpapers and invoices used for valuing inventory may be useful later in the search for unrecorded liabilities. Similarly, the bank confirmation contains information about long-term liabilities.

Lastly, while it is difficult for us to believe that not everyone enjoys auditing as much as we do, we have tried to make the case both interesting and enjoyable (in a perverse sort of way). You can think of the project as a puzzle, in which you have to fill in all the pieces. Alternatively, you could look at the project as a murder mystery that needs a solution. In either case, have fun!

Tim Louwers J. Kenneth Reynolds

Harrisonburg, VA Baton Rouge, LA

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

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FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF

THE SECURITIES EXCHANGE ACT OF 1934

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2006

COMMISSION FILE NUMBER 1-9Z40

APOLLO SHOES INC.

(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

MAINE X8-061325

(STATE OR OTHER JURISDICTION OF (IRS EMPLOYER

INCORPORATION OR ORGANIZATION) IDENTIFICATION NO.)

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:

TITLE OF EACH CLASS NAME OF EACH EXCHANGE

ON WHICH REGISTERED

------------------- -----------------------------------------

COMMON STOCK, PAR VALUE, $1.00 PER SHARE STUDS

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT: NONE

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No [ ]

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this

Form 10-K. [X]

As of March 8, 2007, the aggregate market value of the registrant's voting stock held by non-affiliates of the registrant was approximately $24,315,000.

As of March 8, 2007, 8,105,000 shares of the registrant's Common Stock were issued and outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Definitive Proxy Statement dated December 12, 2006 for the Annual Meeting of Shareholders to be held on Tuesday, February 27, 2007 at the End of the Universe Restaurant in downtown Shoetown.

APOLLO SHOES INC.

ANNUAL REPORT ON FORM 10-K

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This Annual Report on Form 10-K contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, including statements with regard to the Company's revenues, earnings, spending, margins, cash flow, orders, inventory, products, actions, plans, strategies and objectives. Forward-looking statements include, without limitation, any statement that may predict, forecast, indicate or imply future results, performance or achievements, and may contain the words "believe," "anticipate," "expect," "estimate," "intend," "plan," "project," "will be," "will continue," "will result," "could," "may," "might," or any variations of such words or other words with similar meanings. Any such statements are subject to risks and uncertainties that could cause the Company's actual results to differ materially from those discussed in such forward-looking statements. Prospective information is based on management's then current expectations or forecasts. Such information is subject to the risk that such expectations or forecasts, or the assumptions underlying such expectations or forecasts, become inaccurate. For a description of such risks, see the section below entitled "ISSUES AND UNCERTAINTIES."

ITEM 1. BUSINESS.

Apollo Shoes, Inc. is a planetary distributor specializing in technologically superior athletic podiatric products. The Company’s brands-- ***SIREN***, ***SPOTLIGHT***, and ***SPEAKERSHOE***--are used extensively in many athletic competitions, such as the Switzerland Watersports Games in Zurich. The Company is excited about this annual event that exhibits to the entire world the skills and spirit of outstanding Swiss aquatic athletes.

The Company’s products are shipped to large and small retail outlets in a six-state area. The company stocks a wide range of shoe products and has a large base of retail store customers. Apollo operates from a large office, operations, and warehouse facility in the Shoetown, Maine area.

Apollo Shoes, incorporated in the state of Delaware, is a public corporation. Its stock is traded in the over-the-counter market. No one presently owns more than 4 percent of the outstanding common stock. The company is subject to the reporting requirements of the Securities and Exchange Act of 1934.

Organization and Personnel

Apollo Shoes is a medium-sized corporation. It has over 100 employees organized in five departments headed by vice presidents.

Marketing

The marketing department handles advertising and direct contact with customers. The marketing department vice president supervises the sales staff, the advertising staff, and the customer relations staff.

Finance

The finance department has two subordinate offices—the treasurer and the controller. The treasurer supervises the cashiers and the cash management professionals. The controller’s office has the following departments and personnel: billing department, accounts receivable/cash receipts department, accounts payable/cash disbursements department, inventory records department, payroll department, general ledger department, and financial statement department.

Information Systems

An information systems department was created this past year. At present, the staff consists of a Director of IS (information systems), a systems development project manager and two programmer/analysts, an operations manager (who also serves as the librarian and control clerk), and two machine operators.

When the information systems department became active, the director was promoted to vice president. Apollo obtained a wireless local area network (LAN) multiserver soon after and began testing the hardware and software. Since the new computer system was designed and customized to Apollo’s needs, every effort was made to keep as many as possible of the procedures and business documents used in the manual system. This made the transition to the computer system easy on the employees, thus reducing training and employee objections to the computer.

Operations

The operations department contains production planning specialists and some production control professionals, who assist the marketing department in technical matters and assist customers with product specifications. Operations supervisors supervise hourly workers who move products from receiving, inventory, and shipping to serve customer demand. The department also supervises the timekeepers, who maintain the workers’ time clocks and collect payroll time cards. The operations department contains the critical functions of purchasing, receiving, and shipping. Inventory storekeeping responsibility is also in this department, with some inventory managers. For reasons lost to history, the department also has the mailroom and the personnel department.

ITEM 2. PROPERTIES.

Until February of 2004, the Company leased most of the properties that were used in its business. Its corporate headquarters relocated at that time to office facilities in Shoetown, Maine. At its corporate headquarters, the Company occupies approximately 10,000 square feet of space. A lease on an operations facility expires on June 30, 2007. This warehouse and distribution center is located approximately one mile from the Company headquarters and contains approximately 450,000 total square feet of usable space.

ITEM 3. LEGAL PROCEEDINGS.

On September 15, 2006, the Company agreed to settlement of a suit brought against the Company by a competitor for patent infringement for the Company's use of the Siren. While the Company denies any wrongdoing, the Company felt that the settlement would be preferable to a long litigation process. The final settlement totaled $11,695,000 ($19,172,000, net of a tax benefit of $7,477,000).

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

No matter was submitted during 2006 to a vote of security holders, through the solicitation of proxies or otherwise.

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS.

The Company's common stock is quoted on the Security Traders, Underwriters, and Dealers System (STUDS) under the symbol APLS. The following table, derived from data supplied by STUDS, sets forth the quarterly high and low sale prices during 2006 and 2005.

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | 2006 |  |  |  | 2005 |  |
|  | High |  | Low |  | High |  | Low |
| First | 14 5/8 |  | 3 3/8 |  | 4 |  | 3 1/2 |
| Second | 11 |  | 2 5/8 |  | 4 5/8 |  | 4 1/4 |
| Third | 8 1/4 |  | 3 1/4 |  | 8 1/8 |  | 4 |
| Fourth | 5 5/8 |  | 3 1/8 |  | 11 1/2 |  | 5 |

The stock price at closing on December 31, 2006, was $3 1/4 per share.

As of December 31, 2006, there were approximately 15,342 holders of record of the Company's Common Stock including those shares held in "street name". The Company believes that it has in excess of 16,000 shareholders.

The Company has never paid cash dividends on its Common Stock and the Board of Directors intends to retain all of its earnings to finance the development and expansion of its business. However, there can be no assurance that the Company can successfully expand its operations, or that such expansion will prove profitable. Future dividend policy will depend upon the Company's earnings, capital requirements, financial condition, and other factors considered relevant by the Company's Board of Directors.

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ITEM 6. SELECTED FINANCIAL DATA.

APOLLO SHOES, INC.

*in thousands* (except per share data)

**Income Statement Data**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | Year Ended December 31 | | | | |
|  | **2006** | **2005** | **2004** | **2003** |  |
| Net Sales | $240,575 | $236,299 | $182,209 | $138,920 |  |
| Income Before Taxes | $26,337 | $54,680 | $2,226 | $1,757 |  |
| Income Taxes | $10,271 | $21,634 | $636 | $502 |  |
| Net Income | $4,371 | $1,745 | $1,590 | $1,255 |  |
| Earnings Per Share | $0.54 | $0.22 | $0.55 | $0.44 |  |

**Balance Sheet Data**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | As of December 31, | | | | |
|  | **2006** | **2005** | **2004** | **2003** |  |
| Working Capital | $20,482 | $16,866 | ($1,951) | ($2,356) |  |
| Total Assets | $36,794 | $21,304 | $6,754 | $6,062 |  |
| Long‑Term Debt | $0 | $0 | $0 | $0 |  |
| Shareholders' Equity | $22,119 | $17,748 | $5,470 | $3,880 |  |

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ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

**2006 Financial Results**

Net sales for the year ended December 31, 2006 increased 2% to $240,575,000, when compared to the same period in 2005. The sales growth was primarily due to new products introduced during the 2006 fiscal year. The average selling price per product in the year ended December 31, 2006 increased approximately 2% from the year ended December 31, 2005.

Gross profit for the year ended December 31, 2006 was 41% of sales compared with 49% for the year ended December 31, 2005. The decrease was primarily due to higher prices charged by our suppliers for raw materials.

Selling, general and administrative expense for the year ended December 31, 2006 was 30% of net sales as compared to 26% for the year ended December 31, 2005. The increase of 16% to $71,998,000 was primarily the result of increases in staffing and increased professional expenses. The increased professional fees were primarily related to the settlement of litigation brought against us by a competitor. Rather than face a costly, lengthy litigation process, the Company decided to settle out of court. The Company vehemently denies any wrongdoing in the matter.

Total research and development expenses for the year ended December 31, 2006 were 5% of net sales and increased by 10% when compared to the year ended December 31, 2005. The increase was primarily due to the addition of engineering personnel. Research and development activities were focused on continued development of ***PHONESHOE*** and ***SPEAKERSHOE*** technology.

**Liquidity and Capital Resources**

The Company's principal source of operating funds has been from proceeds from short-term borrowing against a $50 million line of credit. While the credit facility must be renewed each year, the Company foresees no problems with renewal for the foreseeable future.

The Company intends to use its capital resources to expand its operations facilities and to increase research and development in order to maintain its competitive advantage in podiatric technology. There are no other significant capital requirements identified at this time.

Management believes that the effect of inflation on the business of the Company for the past three years has been minimal.

The Company believes that its current working capital of $20,482 million and anticipated working capital to be generated by future operations will be sufficient to support the Company's working capital requirements for the foreseeable future.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

**STATEMENTS OF INCOME**

APOLLO SHOES, INC.

*in thousands* (except per share data)

|  |  |  |  |
| --- | --- | --- | --- |
| For year ended, December 31, | 2006 | 2005 | |
| Net Sales (Note 2) | $240,575 | $236,299 | |
| Cost of Sales | $141,569 | $120,880 | |
| Gross Profit | $99,006 | $115,419 | |
| Selling, General and Administrative Expenses | $71,998 | $61,949 | |
| Interest Expense (Note 7) | $875 | 0 | |
| Other Expense (Income) | ($204) | ($1,210) | |
| Earnings from Continuing Operations Before Taxes | $26,337 | $54,680 | |
| Income Tax Expense (Note 10) | $10,271 | $21,634 | |
| Earnings from Continuing Operations | $16,066 | $33,046 | |
| Discontinued Operations, Net of tax benefit |  | ($31,301) | |
| Extraordinary Item, Net of tax benefit (Note 11) | ($11,695) |  |
| Net Income | $4,371 | $1,745 | |
| Earnings Per Common Share |  |  | |
| From Continuing Operations | $1.98 | $4.08 | |
| Other | ($1.44) | ($3.86) | |
| Net Income | $0.54 | $0.22 | |
| Weighted shares of common stock outstanding | 8,105 | 8,105 | |

The accompanying notes are an integral part of the consolidated financial statements.

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**STATEMENT OF FINANCIAL CONDITION**

APOLLO SHOES, INC.

*in thousands*

|  |  |  |
| --- | --- | --- |
| As of December 31 | **2006** | **2005** |
| **Assets** |  |  |
| Cash | $3,245 | $3,509 |
| Accounts Receivable (Net of Allowances of $1,263 and 210, respectively) (Note 3) | 15,148 | 2,738 |
| Inventory (Note 4) | 15,813 | 13,823 |
| Prepaid Expenses | 951 | 352 |
| Current Assets | $35,157 | $20,422 |
| Property, Plant, and Equipment (Note 5) | 1,174 | 300 |
| Less Accumulated Depreciation | (164) | (31) |
|  | $1,010 | $269 |
| Investments (Note 6) | 613 | 613 |
| Other Assets | 14 | 0 |
| Total Assets | $36,794 | $21,304 |
| **Liabilities and Shareholder's Equity** |  |  |
| Accounts Payable and Accrued Expenses | $4,675 | $3,556 |
| Short-Term Liabilities (Note 7) | 10,000 | 0 |
| Current Liabilities | $14,675 | 3,556 |
| Long-Term Debt (Note 7) | 0 | 0 |
| Total Liabilities | $14,675 | 3,556 |
| Common Stock | 8,105 | 8,105 |
| Additional Paid-in Capital | 7,743 | 7,743 |
| Retained Earnings | 6,271 | 1,900 |
| Total Shareholders' Equity | $22,119 | $17,748 |
| Total Liabilities and Shareholders' Equity | $36,794 | $21,304 |

The accompanying notes are an integral part of the consolidated financial statements.

**STATEMENTS OF SHAREHOLDERS' EQUITY**

APOLLO SHOES, INC.

*in thousands*

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | Shares | Par Value  ($1 per share) | Additional Paid-in Capital | Retained  Earnings | Other | Total |
| Balance, December 31, 2004 | 2,873 | $2,873 | $2,442 | $155 | $0 | $5,470 |
| Net Income |  |  |  | $1,745 |  | $1,745 |
| Exercise of Stock Options | 232 | $232 | $301 |  |  | $533 |
| Other | 5,000 | $5,000 | $5,000 |  |  | $10,000 |
| Balance, December 31, 2005 | 8,105 | $8,105 | $7,743 | $1,900 | $0 | $17,748 |
| Net Income |  |  |  | $4,371 |  | $4,371 |
| Exercise of Stock Options | 0 | $0 |  |  |  | $0 |
| Other |  |  |  |  |  | $0 |
| Balance, December 31, 2006 | 8,105 | $8,105 | $7,743 | $6,271 | $0 | $22,119 |

The accompanying notes are an integral part of the consolidated financial statements.

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

APOLLO SHOES, INC.

*in thousands*

|  |  |  |
| --- | --- | --- |
| For the year ended December 31, | 2006 | 2005 |
| Cash Flows from Operating Activities |  |  |
| Net Income | $4,371 | $1,745 |
| Adjustments to Reconcile Net Income to Net Cash Provided |  |  |
| Depreciation and Amortization | $133 | $26 |
| Changes in Operating Assets and Liabilities |  |  |
| Decrease (Increase) in Current Assets |  |  |
| Accounts Receivable | ($12,410) | ($2,073) |
| Inventory | ($1,990) | ($11,861) |
| Prepaid Expenses | ($599) | ($123) |
| Increase (Decrease) in Current Liabilities |  |  |
| Accounts Payable and Accrued Expenses | $1,119 | $5,504 |
| Total Adjustments | ($13,747) | ($8,527) |
| Net Cash Provided by Operating Activities | ($9,376) | ($6,782) |
| Cash Flows from Investing Activities |  |  |
| Capital Expenditures | ($874) | ($255) |
| Purchase of Other Assets | ($14) |  |
| Net Cash Provided by Investing Activities | ($888) | ($255) |
| Cash Flows from Financing Activities |  |  |
| Proceeds from the Issuance of Debt | $10,000 |  |
| Proceeds from the Issuance of Common Stock |  | $10,533 |
| Net Cash Provided by Financing Activities | $10,000 | $10,533 |
| Net Increase (Decrease) in Cash | ($264) | $3,496 |
| Cash at Beginning of Year | $3,509 | $13 |
| Cash at End of Year | $3,245 | $3,509 |

The accompanying notes are an integral part of the consolidated financial statements.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

APOLLO SHOES, INC.

**1. Summary of Significant Accounting Policies**

**Business activity** The Company develops and markets technologically superior podiatric athletic products under various trademarks, including *SIREN*, *SPOTLIGHT*, and *SPEAKERSHOE*.

**Marketable Securities** Investments are valued using the market value method for investments of less than 20%, and by the equity method for investments greater than 20% but less than 50%.

**Cash equivalents** Cash equivalents are defined as highly liquid investments with original maturities of three months or less at date of purchase.

**Inventory valuation** Inventories are stated at the lower of First-in, First-out (FIFO) or market.

**Property and equipment and depreciation** Property and equip­ment are stated at cost. The Company uses the straight-line method of depreciation for all additions to property, plant and equipment.

**Intangibles** Intangibles are amortized on the straight-line method over periods benefited.

**Net Sales** Sales for 2006 and 2005 are presented net of sales returns and allowances of $4.5 million, and $0.9 million, respectively, and net of warranty expenses of $1.1 million, and $0.9 million, respectively.

**Income taxes** Deferred income taxes are provided for the tax effects of timing differences in reporting the results of operations for financial statements and income tax purposes, and relate principally to valuation reserves for accounts receivable and inventory, accelerated depreciation and unearned compensation.

**Net income per common share** Net income per common share is computed based on the weighted average number of common and common equivalent shares outstanding for the period.

**Reclassification** Certain amounts have been reclassified to con­form to the 2006 presentation.

**2. Significant Customers**

Approximately 15%, and 11% of sales are to one customer for years ended December 31, 2006 and 2005, respectively.

**3. Accounts Receivable**

Accounts Receivable consists of the following at December 31:

|  |  |
| --- | --- |
| *in thousands* | **2006** |
| Trade Receivables | $16,411 |
| Employee and Officer Receivables | 0 |
|  | 16,411 |
| Less Allowance for Doubtful Accounts | (1,263) |
| Net Accounts Receivable | $ 15,148 |

Amount charged to bad debt expense for the year ended December 31, 2006 was 1,622,000. Writeoffs for the year were approximately the same.

**4. Inventories**

Inventories consist of the following at December 31:

|  |  |
| --- | --- |
| *in thousands* | **2006** |
| Siren | $3,098 |
| Speaker | 9,571 |
| Spotlight | 6,156 |
|  | 18,825 |
| Less Reserve for Inventory Obsolescence | (3,012) |
| Ending Inventory | $15,813 |

**5. Property and equipment**

Property is stated at cost net of accumulated depreciation. Property and Equipment at December 31 was as follows:

|  |  |
| --- | --- |
| *in thousands* | **2006** |
| Land | $117 |
| Buildings and Land Improvements | 624 |
| Machinery, Equipment and Office Furniture | 433 |
| Total Land, plant and equipment | 1,174 |
| Less Accumulated depreciation | (164) |
| Net Land, Plant and Equipment | $1,010 |

6**. Investments**

In order to receive a higher rate of return on its excess liquid assets, the Company invested approximately $0.6 million in stock for a 25% share in the SHOCK-PROOF SOCKS Company in 2004. This investment is valued in the financial statements using the Equity method. SHOCK-PROOF SOCKS did not recognize any income and did not pay any dividends in 2005 and 2006. In addition, the Company incurred approximately $14,000 in legal fees to register the patent for the *PHONESHOE*. The asset will be amortized over its useful life of 17 years.

**7. Debt**

At December 31, 2006, the Company had $10,000,000 outstanding in short-term borrowings under a $50 million secured revolving credit line with a local financial institution. The line of credit is secured by the Company’s inventory. The interest rate charged on this agreement is the Prime Rate plus 3%. This credit line is evaluated annually on June 30 by the lending institution.

Annual maturities of debt obligations are as follows:

2007 $10,000,000

2008 0

Total Debt $10,000,000

**8. Commitments**

Annual obligations under non‑cancelable operating leases are as follows:

2007 $1,200,000

Thereafter 0

Rent expense charged to operations for the years ended December 31, 2006 and 2005 was $2.6 million and $3.7 million, respectively.

**10. Income taxes**

The provision (benefit) for income taxes consists of the following for the years ended December 31:

**2006 2005**

Current:

Federal $ 2,025 $ 873

State 365 154

$ 2,390 $ 1,027

Deferred:

Federal $ 340 $ (42)

State 64 (7)

$ 404 $ (49)

$ 2,794 $ 978

Deferred income taxes are provided for the tax effects of timing differences in reporting the results of operations for financial statements and income tax purposes, and relate principally to valuation reserves for accounts receivable and inventory, accelerated depreciation and unearned compensation. A reconciliation of the statutory federal income tax provision to the actual provision follows for the years ended December 31:

**2006 2005**

Federal Statutory Rate 34.0% 34.0%

State taxes, less federal benefit 6.0% 6.0%

Research and experimentation credit (2.0%) (1.4%)

Other 1.0% 1.0%

Effective Tax Rate 39.0% 39.6%

**11. Litigation**

On September 15, 2006, the Company agreed to settlement of a suit brought against the Company by a competitor for patent infringement for the Company's use of the *Siren*. While the Company denies any wrongdoing, the Company felt that the settlement would be preferable to a long litigation process. The final settlement totaled $11,695,000 ($19,172,000, net of a tax benefit of $7,477,000).

**12. Related-party transactions**

On February 1, 2006, the Company purchased its operating facility and equipment from a company controlled by two previous directors and shareholders of the Company for $623,905.92. Currently, the Company leases a second facility and equipment from the same company for approximately $200,000 per month. The Company’s lease ends in June 2007 at which time all operations will be moved to the central headquarters building.

**13. Employee benefit plans**

The Company sponsors a defined-contribution retirement plan covering substantially all of its earth employees. Contributions are deter­mined at the discretion of the Board of Directors. Aggregate contribu­tions made by the Company to the plans and charged to operations in 2006, 2005 and 2004 were $3 million, $3 million and $3 million, respectively.

**14. Concentrations of credit risk**

Financial instruments which potentially subject the Company to credit risk consist principally of trade receivables and interest-bearing investments. The Company sells a significant amount of its product to one retail distributor with sales operations located throughout North America, Europe and Asia Pacific. The Company is currently negotiating to increase its sales to that company, as well as enter into long-term relationships with two other large retail distributors. The Company performs on‑going credit evaluations of all of its customers and generally does not require collateral. The Company maintains adequate reserves for potential losses and such losses, which have been minimal, have been included in management's estimates.

The Company places substantially all its interest-bearing investments with several major financial institutions. Corporate policy limits the amount of credit exposure to any one financial institution.

**CERTIFICATIONS**

We, Larry Lancaster and Joe Bootwell, certify that:

1. We have reviewed this annual report on Form 10-K of Apollo Shoes, Inc.;

2. Based on our knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on our knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. We are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Evaluated the effectiveness of the registrant’s disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

c) Disclosed in this report any change in the registrant’s internal control over financial reporting that occurred during the registrant’s most recent fiscal quarter (the registrant’s fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant’s internal control over financial reporting; and

5. We have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant’s auditors and the audit committee of registrant’s board of directors (or persons performing the equivalent functions):

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant’s ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant’s internal control over financial reporting.

Date: February 4, 2007

|  |  |  |  |
| --- | --- | --- | --- |
| Larry Lancaster | | Joe Bootwell | |
| Larry Lancaster | | Joe Bootwell | |
| Chairman of the Board of Directors,  President and CEO | | Executive Senior Vice-President and CFO | |

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Shareholders of APOLLO SHOES, INC.

We have audited the accompanying balance sheets of APOLLO SHOES, INC. as of December 31, 2006 and 2005 and the related statements of income, comprehensive income, shareholders’ equity, and cash flows for the two years in the period ended December 31, 2006. We have also audited management’s assessment, included in the accompanying Management’s Report on Internal Control Over Financial Reporting, that APOLLO SHOES, INC. maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control ­– Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO criteria). APOLLO SHOES’ management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of internal control over financial reporting. Our responsibility is to express an opinion on these financial statements, an opinion on management’s assessment, and an opinion on the effectiveness of the company’s internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audit of the financial statements including examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, evaluating management’s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company’s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company’s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of APOLLO SHOES, INC. as of December 31, 2006 and 2005 and the results of its operations and cash flows for each of the three years in the period ended December 31, 2006 in conformity with U.S. generally accepted accounting principles. Also in our opinion, management’s assessment that APOLLO SHOES, INC. maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on the COSO criteria. Furthermore, in our opinion, APOLLO SHOES, INC. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on the COSO criteria.

Smith & Smith, CPA's

Shoetown, Maine

January 29, 2007 xvi

Smith and Smith, CPAs, withdrew as the Company’s auditors after completing the 2006 audit. The auditors expressed concerns about “mutually incongruent goals.”

The Company is considering legal action against the firm.

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

The president, Larry Lancaster, is both chairman of the board of directors and President and chief executive officer (CEO). Eric Unum (Vice-President – Finance) is also a member of the board, along with five outside (independent) directors who never worked for the Apollo organization. Three outside board members constitute the audit committee of the board.

ITEM 11. EXECUTIVE COMPENSATION

(Approximate amounts expressed *in thousands*)

Larry Lancaster, Chairman, President and CEO 2,500

Sue D. Fultz, Vice-President - Legal Affairs 1,500

Joe Bootwell, Executive Senior Vice President and CFO 1,200

Fred Durkin, Vice-President – Marketing 1,000

Eric. P. Unum, Vice-President – Finance 590

Daisy Gardner, Vice-President – Operations 410

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT.

Currently, no management personnel hold stock ownership in the Company

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS.

On February 1, 2006, the Company purchased its operating facility and equipment from a company controlled by two previous directors and shareholders of the Company for $623,905.92. Currently, the Company leases a second facility and equipment from the same company for approximately $200,000 per month. The Company’s lease ends in June 2007 at which time all operations will be moved to the central headquarters building. The two previous directors are no longer associated with Apollo Shoes.

ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K

**QUARTERLY RESULTS OF OPERATIONS** (Unaudited)

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **2006** | **March 31** | **June 30** | **September 30** | **December 31** | **Total** |
| Net Sales | $58,236 | $59,759 | $60,239 | $62,341 | $240,575 |
| Gross Profit | $24,372 | $24,996 | $24,356 | $25,282 | $99,006 |
| S,G, & A Expenses | $16,478 | $17,695 | $17,347 | $20,478 | $71,998 |
| Net Income | $4,815 | $4,454 | ($7,785) | $2,887 | $4,371 |
| Earnings Per Share | $0.59 | $0.55 | ($0.96) | $0.36 | $0.54 |

The Company filed one 8-K dealing with the withdrawal of its auditor on January 30, 2007. It is incorporated in this document by reference.

**Apollo Shoes**

**Accounting and Control Procedure Manual**

**Sales and Accounts Receivable**

**Daily batches of sales invoices shall be analyzed by sales totals in the athletic shoes product lines. Sales credits are coded to three product line sales revenue accounts.**

**Charges to customer accounts should be dated the date of shipment.**

**When sales invoices are recorded, the numerical sequence shall be checked by an accounts receivable clerk, and missing invoices must be located and explained. The items shipped shall be compared to the items billed for proper quantity, price, and other sales order terms.**

**The general ledger supervisor shall compare the copy 2 daily batch total with the copy 4 individual accounts posting total sent from the accounts receivable department.**

**Discrepancies shall be investigated to help assure that the customer subsidiary accounts are posted for the same total amount posted to the control account.**

**At the end of each month, the total of the trial balance of customer account balances (prepared by the accounts receivable department) shall be reconciled to the general ledger control account by the general ledger supervisor.**

**Sales invoice batches shall be dated with the date of shipment, and totals of batches (including product line sales for athletic shoes) shall be accumulated each month and recorded in the accounts receivable control and sales revenue accounts. The general ledger supervisor shall approve all monthly summary entries before they are posted to the general ledger.**

**The treasurer shall approve all cash refunds and allowance credit memos for sales returns, after initiation by customer relations personnel.**

**The marketing vice president shall periodically analyze sales activity by product lines in comparison to budgets and forecasts and prior years’ activity.**

**Cash Management**

**The monthly bank statements shall be mailed to the cash management department in the treasurer’s office. Personnel use the duplicate deposit slips retained when bank deposits were made, the cash receipts journal listing, and the cash disbursements listing to reconcile the general bank accounts. The payroll bank account is also reconciled, utilizing the payroll register retained by the treasurer’s office.**

**Cash management personnel shall compare cash receipts journal daily deposit records with the bank deposits and duplicate deposit slips when the general bank account reconciliation is performed.**

**At the discretion of the director of internal audit, internal auditors will occasionally make unannounced reviews of the bank account reconciliations. They may also prepare reconciliations without prior notice given to cash management personnel.**

**Cash Receipts and Accounts Receivable Processing**

**All cash receipts from customers related to sales shall be credited to accounts receivable individual and control accounts.**

**The accounts receivable department shall post credits to individual customer accounts, dating the entries with the date of the remittance list.**

**Statements of accounts receivable balances shall be mailed to customers each month by the accounts receivable accounting department. Customers’ reports of disputes or differences shall be handled by customer relations personnel in the marketing department.**

**Cash Disbursements**

**All disbursements shall be made by check, signed by the treasurer, including reimbursements of the petty cash funds.**

**Checks shall be made payable to a named payee and not to “cash.”**

**Blank check stock shall be kept under lock and key in the accounts payable accounting department. Under no circumstances may blank checks be signed by the treasurer.**

**Voided and spoiled checks shall be transmitted to the treasurer for inspection and later filed in numerical order with paid checks.**

**Cash disbursement journal entries shall be dated with the date of the check. The related monthly general ledger summary entries shall carry the date of the month summarized.**

**Inventory Perpetual Records**

**Inventory additions shall be dated with the date of the receiving report.**

**Inventory issues shall be dated with the date of shipment.**

**Fixed Asset Records and Transactions**

**When acquisition costs exceed the capital budget authorization by 10 percent or more, the additional expenditure shall be approved by the treasurer and board of directors, in advance if possible.**

**Zero salvage values shall be used in all depreciation calculations.**

**Useful life and depreciation method assignments for financial statement calculations shall follow these general guidelines:**

**Buildings Declining Balance 15 years**

**Equipment Declining Balance 3-6 years**

**All repair, maintenance, and capital additions less than $5,000 shall be expensed. Amounts over $5,000 should always be capitalized unless unusual conditions point to proper expensing.**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | | Preclosing Trial Balance (Audited) | |  |  | |
|  | | December 31, 2006 | |  |  | |
|  | |  | |  |  | |
| Account ID | | Account Description | | Debit | Credit | |
| 10100 | | Cash on Hand | | $1,987.28 |  | |
| 10200 | | Regular Checking Account | | $198,116.52 |  | |
| 10300 | | Payroll Checking Account | | $0.00 |  | |
| 10400 | | Savings Account | | $3,044,958.13 |  | |
| 11000 | | Accounts Receivable | | $16,410,902.71 |  | |
| 11500 | | Allowance for Doubtful Accounts | |  | $1,262,819.88 | |
| 12000 | | Inventory – Spotlight | | $18,825,205.24 |  | |
| 12300 | | Reserve for Inventory Obsolescence | |  | $3,012,000.00 | |
| 14100 | | Prepaid Insurance | | $743,314.38 |  | |
| 14200 | | Prepaid Rent | | $200,000.00 |  | |
| 14300 | | Office Supplies | | $7,406.82 |  | |
| 14400 | | Notes Receivable-Current | |  |  | |
| 14700 | | Other Current Assets | |  |  | |
| 15000 | | Land | | $117,000.00 |  | |
| 15100 | | Buildings and Land Improvements | | $623,905.92 |  | |
| 15200 | | Machinery, Equipment, Office Furniture | | $433,217.10 |  | |
| 17000 | | Accum. Depreciation | |  | $164,000.00 | |
| 19000 | | Investments | | $612,691.08 |  | |
| 19900 | | Other Noncurrent Assets | | $13,840.59 |  | |
| 20000 | | Accounts Payable | |  | $4,633,118.09 | |
| 23100 | | Sales Tax Payable | |  | $0.00 | |
| 23200 | | Wages Payable | |  | $29,470.32 | |
| 23300 | | FICA Employee Withholding | |  | $1,318.69 | |
| 23350 | | Medicare Withholding | |  | $583.99 | |
| 23400 | | Federal Payroll Taxes Payable | |  | $6,033.01 | |
| 23500 | | FUTA Tax Payable | |  |  | |
| 23600 | | State Payroll Taxes Payable | |  | $2,815.47 | |
| 23700 | | SUTA Tax Payable | |  |  | |
| 23800 | | FICA Employer Withholding | |  | $1,318.69 | |
| 23900 | | Medicare Employer Withholding | |  | $583.99 | |
| 24100 | | Line of Credit | |  | $10,000,000.00 | |
| 24200 | | Current Portion Long-Term Debt | |  |  | |
| 24700 | | Other Current Liabilities | |  |  | |
| 27000 | | Notes Payable-Noncurrent | |  |  | |
| 39003 | | Common Stock | |  | $8,105,000.00 | |
| 39004 | | Paid-in Capital | |  | $7,743,000.00 | |
| 39005 | | Retained Earnings | |  | $1,899,120.65 | |
| 40000 | | Sales | |  | $246,172,918.44 | |
| 41000 | | Sales Returns | | $4,497,583.20 |  | |
| 42000 | | Warranty Expense | | $1,100,281.48 |  | |
| 45000 | | Income from Investments | |  | $0.00 | |
| 46000 | | Interest Income | |  | $204,302.81 | |
| 50010 | | Cost of Goods Sold | | $141,569,221.61 |  | |
| 57500 | | Freight | | $4,302,951.46 |  | |
| 60000 | | Advertising Expense | | $897,140.01 |  | |
| 61000 | | Auto Expenses | | $208,974.39 |  | |
| 62000 | | Research and Development | | $31,212,334.17 |  | |
| 64000 | | Depreciation Expense | | $133,000.00 |  | |
| 64500 | | Warehouse Salaries | | $4,633,383.82 |  | |
| 65000 | | Property Tax Expense | | $80,495.32 |  | |
| 66000 | | Legal and Professional Expense | | $3,605,133.96 |  | |
| 67000 | | Bad Debt Expense | | $1,622,425.99 |  | |
| 68000 | | Insurance Expense | | $853,942.65 |  | |
| 70000 | | Maintenance Expense | | $61,136.04 |  | |
| 70100 | | Utilities | | $135,642.99 |  | |
| 70110 | | Phone | | $76,373.78 |  | |
| 70120 | | Postal | | $128,033.21 |  | |
| 71000 | | Miscellaneous Office Expense | | $17,023.27 |  | |
| 72000 | | Payroll Tax Exp | | $1,550,989.06 |  | |
| 73000 | | Pension/Profit-Sharing Plan Ex | | $3,000,000.00 |  | |
| 74000 | | Rent or Lease Expense | | $2,603,485.87 |  | |
| 77500 | | Administrative Wages Expense | | $16,875,305.98 |  | |
| 78000 | | Interest Expense | | $875,000.00 |  | |
| 78500 | | Income Tax Expense – Federal | | $2,365,000.00 |  | |
| 78510 | | Income Tax Expense – State | | $429,000.00 |  | |
| 80000 | | Loss on Legal Settlement | | $19,172,000.00 |  | |
|  | |  | | $283,238,404.03 | $283,238,404.03 | |
|  | | Apollo Shoes, Inc |  | |  | |
|  | | Preclosing Trial Balance |  | |  | |
|  | | December 31, 2007 |  | |  | |
|  | |  |  | |  | |
| Account ID | | Account Description | Debit Amt | | Credit Amt | |
| 10100 | | Cash on Hand | $2,275.23 | |  | |
| 10200 | | Regular Checking Account | $532,125.92 | |  | |
| 10300 | | Payroll Checking Account |  | |  | |
| 10400 | | Savings Account | $3,670,599.15 | |  | |
| 11000 | | Accounts Receivable | $49,780,259.98 | |  | |
| 11400 | | Other Receivables | $1,000,000.00 | |  | |
| 11500 | | Allowance for Doubtful Accounts |  | | $1,254,009.75 | |
| 12000 | | Inventory | $67,424,527.50 | |  | |
| 12300 | | Reserve for Inventory Obsolescence |  | | $867,000.00 | |
| 14100 | | Prepaid Insurance | $3,374,213.78 | |  | |
| 14200 | | Prepaid Rent |  | |  | |
| 14300 | | Office Supplies | $8,540.00 | |  | |
| 14400 | | Notes Receivable-Current |  | |  | |
| 14700 | | Other Current Assets |  | |  | |
| 15000 | | Land | $117,000.00 | |  | |
| 15100 | | Buildings and Land Improvements | $674,313.92 | |  | |
| 15200 | | Machinery, Equipment, Office Furniture | $2,929,097.13 | |  | |
| 17000 | | Accum. Depreciation |  | | $610,000.00 | |
| 19000 | | Investments | $2,038,780.39 | |  | |
| 19900 | | Other Noncurrent Assets | $13,840.59 | |  | |
| 20000 | | Accounts Payable |  | | $1,922,095.91 | |
| 23100 | | Sales Tax Payable |  | |  | |
| 23200 | | Wages Payable |  | |  | |
| 23300 | | FICA Employee Withholding |  | | $4,291.25 | |
| 23350 | | Medicare Withholding |  | | $11,414.99 | |
| 23400 | | Federal Payroll Taxes Payable |  | | $118,086.12 | |
| 23500 | | FUTA Tax Payable |  | |  | |
| 23600 | | State Payroll Taxes Payable |  | | $42,397.24 | |
| 23700 | | SUTA Tax Payable |  | |  | |
| 23800 | | FICA Employer Withholding |  | | $4,291.25 | |
| 23900 | | Medicare Employer Withholding |  | | $11,414.99 | |
| 24100 | | Line of Credit |  | | $44,053,000.00 | |
| 24200 | | Current Portion Long-Term Debt |  | |  | |
| 24700 | | Other Current Liabilities |  | |  | |
| 27000 | | Notes Payable-Noncurrent |  | | $10,000,000.00 | |
| 39003 | | Common Stock |  | | $8,105,000.00 | |
| 39004 | | Paid-in Capital |  | | $7,743,000.00 | |
| 39005 | | Retained Earnings |  | | $6,270,483.64 | |
| 40000 | | Sales - Spotlight |  | | $245,213,452.88 | |
| 41000 | | Sales Returns | $13,600,220.89 | |  | |
| 42000 | | Warranty Expense | $1,158,128.47 | |  | |
| 45000 | | Income from Investments |  | | $1,426,089.31 | |
| 46000 | | Interest Income |  | | $131,881.46 | |
| 47000 | | Miscellaneous Income |  | | $2,145,000.00 | |
| 50010 | | Cost of Goods Sold | $130,246,645.26 | |  | |
| 57500 | | Freight | $4,236,263.09 | |  | |
| 60000 | | Advertising Expense | $986,854.01 | |  | |
| 61000 | | Auto Expenses | $214,502.80 | |  | |
| 62000 | | Research and Development | $212,864.02 | |  | |
| 64000 | | Depreciation Expense | $446,000.00 | |  | |
| 64500 | | Warehouse Salaries | $4,720,715.56 | |  | |
| 65000 | | Property Tax Expense | $84,332.45 | |  | |
| 66000 | | Legal and Professional Expense | $1,902,224.45 | |  | |
| 67000 | | Bad Debt Expense |  | |  | |
| 68000 | | Insurance Expense | $36,106.92 | |  | |
| 70000 | | Maintenance Expense | $49,502.87 | |  | |
| 70100 | | Utilities | $137,332.18 | |  | |
| 70110 | | Phone | $52,599.02 | |  | |
| 70120 | | Postal | $77,803.61 | |  | |
| 71000 | | Miscellaneous Office Expense | $24,891.82 | |  | |
| 72000 | | Payroll Tax Exp | $1,577,811.85 | |  | |
| 73000 | | Pension/Profit-Sharing Plan Ex | $3,300,000.00 | |  | |
| 74000 | | Rent or Lease Expense | $1,203,574.00 | |  | |
| 77500 | | Administrative Wages Expense | $16,197,225.43 | |  | |
| 78000 | | Interest Expense | $2,591,736.50 | |  | |
| 78500 | | Income Tax Expense - Federal | $13,069,000.00 | |  | |
| 78510 | | Income Tax Expense - State | $2,241,000.00 | |  | |
|  | |  | $329,932,908.79 | | $329,932,908.79 | |

Date: Wed, 9 JAN 2008 10:44:22 +0000   
From: "Darlene Wardlaw" <DW@aow.cpa>   
Subject: Analytic Procedures

1. I need you to perform preliminary analytical procedures on the financial statements.
   1. **Calculate common-size financial statements and dollar amount and percent changes.** I suggest you simply make a copy of your spreadsheet from your pro-forma financial statements that I asked you to prepare yesterday and remove the adjustment columns. Have there been any significant changes that we need to examine closer?
   2. **Calculate financial ratios.** Assume the market value of the common stock is $24 million in both the current and prior years. Does anything jump out at you?
   3. *If you have time*, **compare Apollo’s numbers with those of its closest competitors, Nike and Reebok.** You can get those companies’ numbers from EDGAR ([**www.sec.gov**](http://www.sec.gov)). I am not sure if industry averages are available, but that too would be helpful.
2. **Write a brief memo** (***GA-4***) highlighting what you believe are potential problem areas. Include printouts of your calculations as support (***GA-4-1, GA-4-2***, etc.)

Date: Wed, 9 JAN 2008 12:15:49 +0000   
From: "Darlene Wardlaw" <DW@aow.cpa>   
Subject: Materiality for Apollo Shoes Engagement

**You need to prepare a memo (*GA-5*) addressing materiality for Apollo Shoes.** Remember that the workpapers document that we are following Generally Accepted Auditing Standards. In the memo,

1. **Briefly describe independent auditors’ concept of materiality.**
2. **Describe some common relationships and other considerations used by auditors when assessing the dollar amount considered material.** In other words, what are some common measures of materiality with respect to income, sales, and total assets?
3. Based upon your professional judgment and your discussion of items 1 and 2 above, **determine an amount you consider to be a minimum material misstatement for Apollo Shoes and justify your recommendation in your memo.**

DW

Date: Thur, 10 JAN 2008 1:15:49 +0000   
From: "Darlene Wardlaw" <DW@aow.cpa>   
Subject: SAS 99 Memo

**We need a memo (*GA-6*) addressing the potential for fraud for Apollo Shoes.** This workpaper is necessary to document that we are following SAS 99 fraud guidance. Some things you might want to include in your memo:

* Have you noticed any “red flags” in either the minutes or your analytic procedures so far?
* Address fraud risk in general terms: types of risk (Remember that improper revenue recognition is always a “red flag.”), significance of risk, likelihood of risk (what is the probability of fraud?), pervasiveness or risk (is fraud risk centralized to one function or individual or is it throughout the organization?)
* How might a fraud might be perpetrated and concealed in the entity
* Suggest ways that we might alter our audit approach to address the potential for fraud, such as assignment of personnel, predictability of auditing procedures, and examination of journal entries and other adjustments

We will need to get together with the entire audit team (you, me, and Bradley) for a “brainstorming” session next week.

DW

Date: Thu, 10 JAN 2008 07:42:35 +0000   
From: "Arnold Anderson" <AA@aow.cpa>   
Subject: Apollo Shoes and Computers

Darlene mentioned your inquiry earlier this week, and yes, Anderson, Olds, and Watershed (AOW) was aware of Apollo’s mid-year computer installation. In fact, the planned conversion was discussed and AOW was advised of the conversion process by the director of internal audit. I haven’t thought about it much, so I appreciate you bringing it to my attention. The more I think about it, the more I am concerned about how the computer processing of the last two quarters’ transactions will affect our audit this year.

Also, our firm has recently obtained several laptop computers but we have not used them on any audit to date. To be honest, I am not too comfortable with computers but I am interested in how they can increase our firm’s profitability. Any suggestions as to how computers might be used on the Apollo Shoes engagement? For example, can correspondence, memos, and auditing working papers be prepared and maintained on the computer? Could they save audit time as well as make the audit easier for me to supervise and review?

**Prepare a memo in the General and Administrative section of the current year workpapers (GA series) to document how planning might be affected by the computer processing of accounting transactions.** I suggest you consider such things as the extent of computer usage, complexity of computer operations, organization structure of computer activities, availability of data, computer-assisted audit techniques, and need for specialized skills.

“Uncle” Arnie

Date: Thu, 10 JAN 2008 10:07:15 +0000   
From: "Karina Ramirez" <[Kramirez@ApolloShoes.com](mailto:Kramirez@ApolloShoes.com)>   
Subject: Upcoming Apollo Shoes Engagement

Attachment: <<InfoSystemDocumentation.doc>>

I’m sorry I missed you when you stopped by earlier today. Per your request, I have tried to summarize the new information processing system:

The computer accounting system is a combination of a simple batch computer system and an advanced computer system. Accounting clerks directly enter accounting transactions from their terminals located in the various accounting departments; thus, entry is online. However, the transactions are not validated at entry to check for input errors. To prevent errors from entering the financial records, the transactions are not immediately posted to the various subsidiary ledgers maintained in the database.

Validation occurs after the transactions are balanced by batch. The transactions are then posted to the ledgers by batches every night; therefore, the various databases, such as inventory, are only up-to-date as of the prior working day’s transactions. (I insisted that Apollo start the accounting processing in this mode to establish control. As employees become more familiar with the terminal entry and control over transaction entry proves adequate, I will consider moving to online data entry and online input validation.)

In addition, Apollo Shoes is using a wireless local area network multiserver with a small information systems staff. This small staff cannot support all of the ideal division of duties that would provide the proper separation auditors desire among computer personnel.

I’ve attached an excerpt from our workpapers that describes the system in more detail. I hope this summary satisfies your needs. Please let us know if there is any additional information that you require.

Karina

**Karina Ramirez**

Director, Internal Audit

Apollo Shoes, Inc.

**This Apollo message (including any attachments) contains confidential information intended for a specific individual and purpose, and is protected by law.  If you are not the intended recipient, you should delete this message and are hereby notified that any disclosure, copying, or distribution of this message, or the taking of any action based on it, is strictly prohibited.**

The information systems department became active in June. At that time the director, Ernst Hathaway, was promoted to vice president. Apollo obtained a wireless local area network (LAN) multiserver soon after and began testing the hardware and software. The testing of the new computer system progressed throughout the early fall with the accounting processing run on both the old manual system and the new computer system for the month of September. On October 1, Apollo converted to the wireless multiserver system. As the new computer system was designed and customized to Apollo’s needs, every effort was made to keep as many as possible of the procedures and business documents used in the manual system. This made the transition to the computer system easy on the employees, thus reducing training and employee objections to the computer. Further, most of the controls and separation of duties previously described were retained.

Hardware Description

Apollo purchased a wireless local area network (LAN) multiserver, featuring 200 GB (gigabytes, or 200 billion bytes) of storage capacity. This system can support 400 terminals, but Apollo currently uses about 20. This system utilizes several disk drives where the computer software and the active accounting databases are stored. Two tape drives are online to provide the logging of transactions and to provide means to back up the data on the disk drives. The computer room contains two printers, a laser printer and a 1,000-lines-per-minute line printer. A printer bank is located in the accounting department.

Accounting Software

The financial accounting software is an integrated application combining a comprehensive set of general ledger, accounts receivable, and accounts payable functions. The financial accounting system allows online entry with online data validation and online posting. However, to provide better control, Apollo has elected to utilize batch entry, deferred validation, and deferred posting. In this mode, the data are not validated at the time of entry. A special input validation routine, which reports all validation errors, is employed after the batches are balanced. The erroneous entries can be corrected through maintenance functions. The transfers of transactions from the Accounts Receivable and Accounts Payable modules to the General Ledger module also are done in batch mode. Batches are validated and posted every night; thus, the detailed accounting records are never more than one day from being accurate. Two levels of security are provided in the system. The terminals require a special password. Access to any function (data entry, data review, review invocation) for each unique set of transactions is controlled by another set of passwords. Thus, allowed operations are isolated to the department that must enter and use the data. For example, the order entry accounting clerks cannot access the cash disbursement records or enter cash disbursement transactions without knowledge of the appropriate passwords.

Organization and Duties of Information Systems Personnel

The information systems department consists of Ernst Hathaway—the Vice President of Information Systems, a systems development project manager and two programmer/analysts, an operations manager (who also serves as the librarian and control clerk), and two machine operators. Following is a brief summary of the responsibilities and duties of each.

*Vice President of Information Systems (VP-IS).*  The VP-IS is responsible for computer processing operations. Included responsibilities include long-range planning, setting policy and procedures for information systems (IS) employees, approving all equipment purchases, and preparing the department budget. The VP-IS also provides the primary contact with other department vice presidents and has overall responsibility for training other department personnel in the use of the new system. The VP-IS works with the systems development manager and the various users to set priorities for the programmer/analysts.

*Systems Development Project Manager.*  The project manager is primarily responsible for all modifications to the financial accounting system and other systems development projects. He creates the specifications for projects after consultation with the users and assigns projects to the programmer/analysts. Other responsibilities include interface with the users on a one-to-one basis to resolve their problems and consider their requests for modifications, education of the programmer/analysts, and working with the vendor service representatives on software problems.

*Operations Manager.*  The operations manager’s primary responsibilities are to ensure that the computer is operating properly and to direct the work of the two operators. Additional duties include system security, librarian, database administrator, and control clerk. The operations manager also is the person who works with vendor hardware service and maintenance personnel.

Date: Thu, 17 JAN 2008 7:42:53 +0000   
From: "Darlene Wardlaw" <DW@aow.cpa>   
Subject: Understanding the Revenue Cycle

Attachment: <<RevenueICQ.doc>>

I’ve attached a Sales internal control questionnaire from another engagement that I think you can use for Apollo. You may want to talk to Karina Ramirez to get answers to the questions.

1. **Complete the ICQ for Apollo.** For “yes” answers, add a comment stating which department and clerk performs the function. For “no” answers, describe the possible “errors” or “frauds” that could occur because of the control weakness.
2. I’ve started a flowchart and listed some strengths and weaknesses, but had to leave before I could finish it. **See if you need to add any more strengths and/or weaknesses that you find from the ICQ and narrative descriptions of the revenue cycle.**