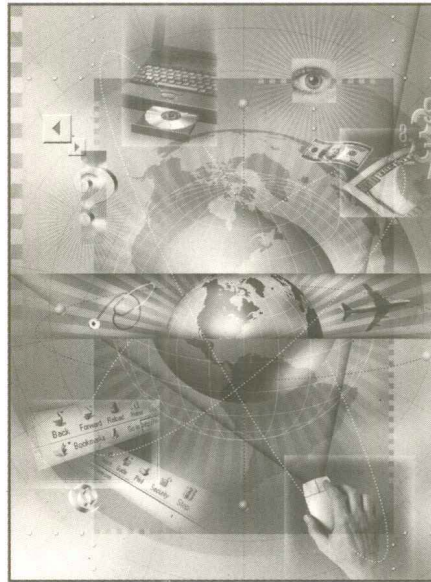


# Apollo Shoes Casebook

for use with

AUDITING &  
ASSURANCE SERVICES



tenth edition

Robertson • Louwers

Prepared by  
Timothy J. Louwers  
J. Kenneth Reynolds

Apollo Shoes Casebook  
for use with  
**Auditing and  
Assurance Services**

Tenth Edition

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Apollo Shoes Casebook for use with  
**AUDITING AND ASSURANCE SERVICES**  
Jack C. Robertson and Timothy A. Powers

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## 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 from 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/business/accounting/robertson10e/aow.intranet>) has many useful resources such as a repository of electronic documents (so that you won’t need to input data or retype documents), an archive of e-mail messages and their attachments, and a bulletin board of frequently asked questions (FAQ) so that you may find assistance from other members of the firm.

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 will be able to inquire, observe, and otherwise follow-up on any questions that you still may have until you feel that you can rely 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. 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 fun. 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  
Baton Rouge, LA

J. Kenneth Reynolds  
Baton Rouge, LA

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Date: Thu, 17 OCT 2002 00:42:35 +0000  
From: "Darlene Wardlaw" <DW@aow.cpa>  
Subject: Upcoming Apollo Shoes Engagement  
Attachment: <<AudComMins—101502.doc>>

Well, first let me congratulate you on your recent promotion. Although we have not worked on an engagement together before, I have heard many good things about you. I look forward to working with you on the new Apollo Shoes engagement.

I understand that this is your first engagement to in-charge. Arnold Anderson (aka "Uncle Arnie") will be the engagement partner; he is pretty sharp so you'll have to stay on your toes. As engagement manager, I'll try to help out as much as I can. Understand, however, that I am managing four other busy season engagements, so my interaction time with you will be limited. For now, I want you familiarize yourself with Apollo Shoes and help me out by doing the following:

1. *SEC Filing*: I have asked Larry Lancaster, President and chairman of the Apollo Shoes board of directors, to send you a copy of last year's (2001) 10-K filing with the SEC. Review the information when you receive it, as it is one of the most important sources of information about a company.
2. *Audit Committee Meeting*: I have attached the minutes of an audit committee meeting that occurred earlier this year. Please **review the minutes and draft an appropriate engagement letter** (label it *GA-1*, for General and Administrative, page 1) addressed to Mr. Lancaster. (Since this is our first year on the engagement, you might want to check one of your old auditing textbooks for an example.) I'll review the letter before getting Arnold to sign it.
3. *Audit Team*: Based upon the information that you glean from 1 and 2 above, do you see any need for special business knowledge in regard to the basic type of business and products Apollo manages? Do you see any need for special audit or accounting expertise for any of the work that we have agreed to perform? In other words, since you'll be in the trenches, what kind of expertise do you want on your audit team? Just **write a brief audit staffing memo (GA-2)** telling me what expertise you need to complete the audit and I'll see if I can get them assigned to the audit team.
4. *Scheduling*: We are going to have to work around your other engagements, but we have you tentatively scheduled for one week in October (next week) for bringing you up to speed on Apollo and its industry, and five straight weeks beginning the last week in December for engagement planning, internal control evaluation, and substantive testing.

Finally, since most of our interaction will be by e-mail, please forgive me if I give you too much detail. Since we haven't worked together before, I'd rather give you too much than too little until we get used to working together.

DW

**Minutes of the Audit Committee, Apollo Shoes**  
**October 15, 2002**

Present at Meeting: Arnold Anderson, CPA (partner in charge of the audit); Darlene Wardlaw, CPA (engagement manager); Eric Unum (Apollo's vice president of finance); Mary Costain (Apollo's treasurer); Samuel Carboy (Apollo's controller); and Karina Ramirez (Apollo's director of internal audit). The three members of the audit committee of the board and the corporate secretary also were present, but they did not enter into the conversation.

**Mr. Unum (VP finance):** Well, I want to welcome the auditing firm of Anderson, Olds, and Watershed, CPAs to what we call the "Apollo Shoes Experience." After our old auditors, Jones and Douglas, CPAs, unexpectedly withdrew from the engagement, we were very happy to have a firm of your quality to come aboard.

**Mr. Anderson (partner on the audit):** Well, we are always looking for high quality clients. By the way, why did your previous auditors resign?

**Mr. Unum (VP finance):** I'd rather not talk about it. Arnold, will Darlene be in charge?

**Mr. Anderson (partner on the audit):** Yes, and she will be assisted by several of our best staff, including a tax specialist and a computer systems management consultant. We need to keep up to date on your computer systems. Back to your previous auditors, with your permission, we would like to contact them.

**Mr. Unum (VP finance):** Well, we'd rather you didn't. There may be some litigation since they withdrew from the engagement with so little notice. Is it necessary for you to speak with them to accept the engagement?

**Mr. Anderson (partner on the audit):** No, not really, but it does raise some concerns for our firm.

**Ms. Costain (treasurer):** In the past, we have never had any unpleasant discoveries of embezzlement or theft, but we always want to be vigilant. Will you plan enough in-depth auditing to give us assurances about errors and frauds in the accounts?

**Ms. Wardlaw (manager on the audit):** We will follow audit standards and base our audit work on samples of transactions. We plan the work to look for major errors and frauds in the accounts, but cleverly hidden schemes might not be discovered. We will give you the usual separate management letter on our internal control evaluation and other related findings.

**Ms. Ramirez (internal auditor):** Darlene, I agree, it's hard to uncover clever schemes. While I am new to Apollo, none of the projects that I have undertaken this year shows anything amiss, other than normal human error types or mistakes.

**Ms. Costain (treasurer):** This year, we want to add some work to the audit. I am short on staff time and need to have you prepare the state franchise tax return as well as the federal tax returns.

**Ms. Wardlaw (manager on the audit):** Our tax staffperson can do the state and federal returns, and I will have them reviewed by Maria Olds, our tax partner.

**Mr. Anderson (partner on the audit):** I assume you also want us to review the 10-K filing material?

**Mr. Unum (VP finance):** Yes. Will you need any staff help from us?

**Ms. Ramirez (internal auditor):** Last year, Apollo was able to save on audit fees when my staff prepared a stack of schedules and analyses that our previous auditors needed.

**Mr. Wardlaw (manager on the audit):** Yes, Karina, I will give you a list of schedules for various accounts. I will appreciate your having them ready when we start fieldwork in mid January.

**Mr. Carboy (controller):** Speaking of being ready, we will be able to give you a trial balance the day after December 31.

**Mr. Unum (VP finance):** How much is this going to cost us?

**Mr. Anderson (partner on the audit):** It is difficult to give you a fixed fee deal, but my estimate, considering the additional work this year, is \$750,000. Darlene will let you know immediately if problems arise to cause the work to be more extensive.

**Mr. Unum (VP finance):** Thank you. This has been a productive meeting of the minds. We look forward to your getting started next month.

Meeting ended 5:30 P.M.

/s/ Jeff Chesnut, Secretary

C:/AudComMins—101502.doc/

Date: Fri, 18 OCT 2002 4:43:17 +0000  
From: "Larry Lancaster" <LLancaster@ApolloShoes.com>  
Subject: Attached 10-K Filing  
Attachments: <<Shareholder Letter.doc>>, <<10K.doc>>,  
<<ApolloShoesOrgChart.xls>>

I am sorry that you were unable to attend the audit meeting earlier this week, but Darlene Wardlaw said that you were busy with another client. She asked that I forward a copy of our 10-K directly to you. I've attached one that we sent out to all shareholders with the Letter to Shareholders attached.

I've attached a copy of Apollo's organizational table. Please let me know what my staff or I can do to help the audit go smoothly for you. I will have Karina Ramirez, our Director of Internal Audit, contact you to provide you with any other information that you need.

Larry

P.S. Do you play golf?

**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.**



## Letter to the Shareholders

Dear Fellow Shareholders,

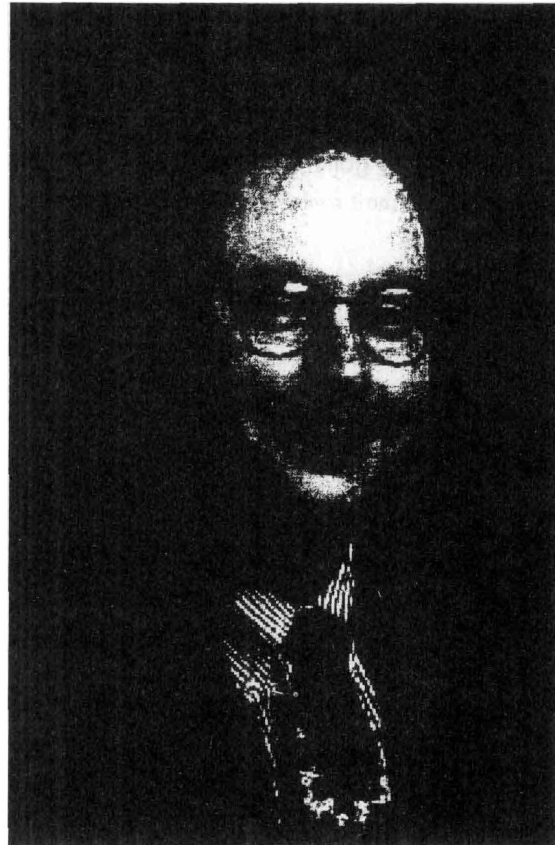
You may have noticed our competitor's focus on earth-bound activities and athletes. Our focus is in exactly the opposite direction. In actuality, the technological superiority of our products is at the point where our sales are limited only by the technological inferiority of other scientific fields (specifically, current transportation means). As space exploration continues, we intend to be among the first to market our products in new worlds. It is there that our technological advances in light and sound can combine with our rugged footwear to propel all galactic sports participants to their fullest potential.

Back here on earth, the past year has been one of the most dynamic and exciting years since I began my tenure at Apollo Shoes. From the beginning, Apollo Shoes, Inc. has adapted itself to meet the needs of all its galactic customers and to take advantage of all opportunities supplied by exploration of new frontiers. After a record year when most companies may have wanted to relax and play it safe, we have decided to use this excitement to reach out further in our continuing mission: to make a difference in this galaxy.

Our product lines, led by the flagship products **SPOTLIGHT** (for athletes who like to compete at night) and **SIREN** (designed specifically for police officers working the graveyard shifts in our nation's most dangerous cities) have met widespread acceptance. We have signed with some of this world's premier athletes as spokespersons for our products, including a recent winner of the grueling Alaska Iditarod who used his **SPOTLIGHTs** to guide his dogs to a late night finish line. We are currently negotiating with a soccer league to exclusively use our **SIRENs**; the shoe's flashing lights are designed to go off after every team goal!

Our strategic management plans have allowed us to maintain a positive trend in income over the past several years, and this was no easy task, given the state of the galactic economy. Our net income for the year has been the best since we began operations four years ago. Next year appears even better!

The strength of our results for the past year should not be confused with the truth of the times. This was a uniformly difficult year for all businesses. Due to the conflicts in foreign countries, and uncertainty with the Federal Reserve's adjustments of interest rates, consumer confidence has been negatively affected; therefore, fewer earth consumers are buying our state-of-



the-art athletic equipment. All of our operating divisions were severely tested. I am proud of their responses. Although sales were not as strong as we had anticipated, our marketing plans will allow us to bounce back next year. With the advent of significant new breakthrough technology by Apollo Shoes, Inc.'s research and development team, Apollo Shoes, Inc. now has the possibility to take a leadership role in the galactic athletic footwear market. Apollo Shoes, Inc. has always been known for its leadership position in electronic shoe technology, but we are now committed to expanding our marketing focus. With new applied technologies, Apollo Shoes, Inc. can maintain its tradition of high tech electronic performance and style. We continue to work on and improve the **SPEAKERSHOE**, an athletic shoe with an amplified loudspeaker, originally designed for the international recording group "Mythic Meathook." We are hard at work on new ideas, such as the **PHONESHOE**, the sneaker with a cellular phone for those executives who like to simultaneously combine exercise with work. We anticipate that the **PHONESHOE** will capture a significant piece of this quickly expanding market.

At Apollo Shoes, Inc., we like to briefly acknowledge achievement and then proceed to new challenges. This year was great only because it provided us with resources to expand operations and further technological progress. As we continue into this century of "more, faster, better," it is critical to continue this tradition because production, speed, and quality are critical elements for future success. We look forward to the challenge.

*Larry Lancaster*

Chairman, President and CEO

<<Shareholder Letter.Doc>>

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SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
-----

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, 2001

COMMISSION FILE NUMBER 1-9Z40

APOLLO SHOES INC.  
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

MAINE  
(STATE OR OTHER JURISDICTION OF  
INCORPORATION OR ORGANIZATION)

X8-061325  
(IRS EMPLOYER  
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 ☒ 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. ☒

As of March 8, 2002, 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, 2002, 8,105,000 shares of the registrant's Common Stock were issued and outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Definitive Proxy Statement dated 12, 2002 for the Annual Meeting of Shareholders to be held on Tuesday, February 29, 2002 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 300 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, the credit manager, 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 local area network (LAN) multiserer 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 2001, 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, 2002. 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, 2001, 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 2001 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 SHUBZ. The following table, derived from data supplied by STUDS, sets forth the quarterly high and low sale prices during 2001 and 2000.

	2001		2000	
	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, 2001, was \$3 1/4 per share.

As of December 31, 2001, 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.

ITEM 6. SELECTED FINANCIAL DATA.

APOLLO SHOES, INC.

*in thousands (except per share data)*

**Income Statement Data**

	Year Ended December 31			
	2001	2000	1999	1998
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,			
	2001	2000	1999	1998
Working Capital	\$20,482	\$6,602	(\$1,951)	(\$2,356)
Total Assets	\$36,794	\$21,040	\$6,754	\$6,062
Long-Term Debt	\$0	\$0	\$0	\$0
Shareholders' Equity	\$22,119	\$17,748	\$5,470	\$3,880



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

### 2001 Financial Results

Net sales for the year ended December 31, 2001 increased 2% to \$240,575,000, when compared to the same period in 2000. The sales growth was primarily due to new products introduced during the 2000 fiscal year. The average selling price per product in the year ended December 31, 2001 increased approximately 2% from the year ended December 31, 2000.

Gross profit for the year ended December 31, 2001 was 41% of sales compared with 49% for the year ended December 31, 2000. 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, 2001 was 30% of net sales as compared to 26% for the year ended December 31, 2000. The increase of 18% to \$73,273,000 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, 2001 were 5% of net sales and increased by 10% when compared to the year ended December 31, 2000. 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.