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AUDITING PRINCIPLES

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AUDITING PRINCIPLES

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PREFACE

This book, on the principles of auditing, has been written primarily as a text for college students. It represents a distillation of the author's experience as a practitioner and as a teacher.

In each chapter relating to assets or equities, the major objectives of the examination of the account are set forth. This is done so that the student may relate the detailed procedures and techniques that follow to these objectives. The procedures thus should become more meaningful to the beginning student.

The purpose underlying each procedure has been emphasized, in an attempt to make it become a part of the student's background and to permit him to apply the proper techniques to specific situations. At the end of each chapter the major procedures are summarized. This should remove the necessity of learning by rote long lists of audit steps.

The premise has been taken that the student who is ready to study auditing has been well indoctrinated in accounting theory and valuation principles. Although it is impossible to ignore these areas completely in any discussion of auditing, their treatment has been minimized.

A sufficient number of audit working papers has been included to illustrate the principles of working paper development and preparation. It is assumed that the instructor will supplement these basic papers with his own ideas and variations, either through problems or through the use of an audit practice case.

Internal control plays such an important part in the structuring and programming of any audit that, in addition to over-all coverage in a separate chapter, each chapter includes a section relating internal control to the specific area covered by the chapter. In this way, the student may apply general principles to specific accounts and observe the manner in which controls are effected.

The book is written in simple, easily understandable language. While it is necessary to expound in detail at some points, generally there is a brevity of treatment which permits retention by the student of major procedures.

The questions and problems provide a helpful stimulus to the student. Many of the questions included are based on the text material so that the student may quiz himself on his grasp and understanding of the material. Some of the questions and problems require the exercise of judgment and should present a challenge to the better students. Other problems present situations in which the student must choose from alternatives. Solutions to these problems will depend on the circumstances assumed.

The author wishes to express his gratitude to Professor Joseph E. Hampton, Cornell University, and Professor Arthur Wyatt, University of Illinois, for their painstaking reading of the draft and for their many suggestions which added materially to the worth of the text. Professor Richard V. Northrup, The Ohio State University, has cooperated with the author in the use of the material in the classroom and has made many valuable suggestions.

The author will be grateful to users of the text who care to submit critical comments.

W. B. Jencks

CONTENTS

Preface v

1. The Auditor's Function 1
2. Beginning the Audit and Internal Control 38
3. The Audit Program and Audit Working Papers 61
4. Auditing the Records of Original Entry 88
5. Cash 113
6. Accounts Receivable, Sales, and Bad Debts 147
7. Notes Receivable and Related Income 188
8. Inventories and Cost of Goods Sold 202
9. Prepaid Expenses 235
10. Investments 254
11. Tangible Fixed Assets and Depreciation 284
12. Intangible Fixed Assets and Deferred Charges 317
13. Notes Payable 337
14. Accounts Payable and Other Current Liabilities 349
15. Long-term Debt and Contingent Liabilities 380
16. Proprietorship Accounts 394
17. Revenue and Expense 426
18. Completing the Audit; the Financial Statements 452
19. The Auditor's Report (Short Form) 469
20. The Auditor's Report (Long Form) 485

Index 515

Chapter 1

THE AUDITOR'S FUNCTION

MEANING OF AUDITING

Auditing, per se, is the examination of the financial and related records of a business, an individual, an institution, or a governmental body. It is as old as commerce, trade, and taxes. Records dating back to 2000 B.C. indicate that auditing was a necessary part of the internal control of the government of that day. The examination is concerned not only with accounting records but also with many of the data and papers that comprise the nonfinancial records of the organization. Any document that reflects the conduct of the business is of interest to the auditor.

Technically, anyone who examines business records for the purpose of ascertaining their accuracy is an auditor. Many individuals perform this audit function in their day-to-day routine tasks. Although it must be admitted that this is auditing in the broadest sense of the word, it does not coincide with the common connotation accorded the term. The usual concept of auditing assumes that the original record keeping has all been done and that the auditor's task is to review and test the accuracy of this work.

CLASSES OF AUDITORS

Auditors may be classified into two broad categories, internal auditors and public accountants. The distinction between the two classes is primarily one of the relationship between the auditor and the management of a company.

The internal auditor is part of the management team. As such he is an employee of the company and, from the public point of view, unable to express an independent opinion as to the fairness of the company's

financial statements. Internal auditors are employed by industry, by the federal, state, and local governments, and by other nonprofit organizations. A large number of internal auditors have been drawn from the ranks of public accountants.

The public accountant sets himself forth as an auditor whose report attached to financial statements represents the considered opinion of an independent professional accountant. He is completely divorced from the management for whom he works and presents his opinion not only to management but to owners, labor, government, and prospective investors.

The Internal Auditor

Prior to the Second World War little recognition was given to the profession of internal auditing. Although some of the large firms utilized an internal auditing staff, there was little general recognition of the scope, duties, and responsibilities of such a staff. In too many instances the duties of these auditors, particularly the traveling auditors, were restricted to the police function. Since 1940 many factors have led to the rapid growth and recognition of this branch of the auditing profession. The increased size of corporate structures, the widespread geographical locations of plants, and the inability of top management to oversee operations directly, have all served to increase the usefulness of internal auditing. The internal audit function will probably continue to expand as its usefulness to management becomes better known.

According to a statement issued by the Institute of Internal Auditors,[1]

> The over-all objective of internal auditing is to assist all members of management in the effective discharge of their responsibilities, by furnishing them with objective analyses, appraisals, recommendations and pertinent comments concerning the activities reviewed. The internal auditor therefore should be concerned with any phase of business activity wherein he can be of service to management.

In seeking to attain this over-all objective, the internal auditor engages in two types of auditing. One phase covers the general police function. This includes the protection against loss of company assets, the general amount of reliance that management can place on statements reaching it, and the compliance or lack of compliance with company policy. In the other phase the internal auditor delves into actual operations of the company in order (1) to review and appraise operating policies, procedures,

[1] "Responsibilities of the Internal Auditor," The Institute of Internal Auditors, New York, 1957.

and records, and (2) to review and appraise the performance under these plans, policies, and procedures.

Under most company organization plans, the internal audit department is strictly a staff function. The internal auditor reports to top management and depends upon top management to take corrective or remedial steps for any findings that he makes. The auditor's position is weakened and his work is made more difficult if he attempts to force into effect at the operating level those recommendations he thinks necessary.

The internal auditor should be independent of the various departments or divisions of the company. This independence may be achieved only if the individual to whom the internal auditor reports is of equal or higher rank in the organization than any of the heads of departments which he audits. It is only in such situations that the recommendations of the internal auditor will be certain to receive serious consideration. The exact title of the person to whom the internal auditor reports is of little moment as long as the necessary rank is present.

The basic position of the internal auditor, like that of the independent accountant, is as a reviewer. It follows then that the internal auditor, if he is to be independent within the organization, should not perform work of a constructive nature. That is, he should not be asked to perform current operating tasks as a part of the line function of the organization. In emergencies the internal audit staff often is called upon to carry out current routine operations. However, in these instances its work should be subject to the same appraisal and review that is accorded the work of other line personnel. Obviously, this appraisal and review must be performed by members of the internal audit staff who had no part in the constructive activities. Only in this way will the internal auditors maintain their independence in the eyes of company employees.

In summary then, the internal auditor performs many of the same tasks as the independent accountant, but he is part of the management team. He is independent, as between the different parts of the company, and reviews the work that has been done. His activities are broad and may carry him out of the office and into the factory or to branch locations. His work is part of the system of internal control and, as such, is of great importance to the independent public accountant.

The Independent Auditor

As opposed to the internal auditor, the independent auditor offers his services to all who need them. In most of the United States independent auditing may be performed either by noncertified public accountants or

by certified public accountants. The only real restriction placed upon the noncertified public accountant is that he must not title himself a certified public accountant or use the initials CPA. In most jurisdictions he performs the same types of services as does the certified public accountant. In some states where public accounting has been carefully defined, further restrictions have been placed upon the noncertified public accountant and in a few states noncertified public accountants are being legislated out of existence.

There are many noncertified public accountants who are just as capable, just as conscientious, just as highly considered, and just as aware of their responsibilities as are most certified public accountants. In many cases the only reason that these men do not have certificates is that they have not spent the necessary time in preparing for and taking the CPA examination. It is also true, however, that on the whole, noncertified public accountants do not command the respect nor do they have the ability of the certified men, since an individual need not meet any requirements of education, training, or experience to set himself up as a public accountant.

The author believes there is a place in our economic structure for both noncertified and certified accountants. However, it does seem that if these two classes are to work alongside each other successfully, there must be a specific definition of public accounting and some restriction as to the work of the noncertified accountant. Since one of the major responsibilities of the certified accountant is to the world at large through his expression of opinion on accounting statements, it would appear that one of the restrictions to be imposed on the noncertified man is that he must not express an opinion on statements. This would leave within his sphere of activity the large amount of bookkeeping services that many noncertified public accountants perform, tax work (although there is some question here, particularly if at some future date the signature of the certifying accountant must carry heavy weight with treasury department officials), systems work, and work of similar nature. If, however, the noncertified accountant is to express opinions on the fairness of statements, then it would seem only just that he be bound by the same restrictions that guide the professional conduct of the certified accountant. Since noncertified public accountants serve a useful function in the variety of services they offer to small businessmen, it would be unfortunate if they were put out of business completely. For there is no one else, at present at least, who is willing to offer this service to the small businessman for the fee he can afford to pay. At some future date

FUNCTIONS OF THE INDEPENDENT AUDITOR

The independent auditor makes examinations for a fee at the request of clients and offers to his clients a variety of functions. Foremost among them is the annual examination. The end result of most examinations is the expression of an independent, professional opinion as to the fairness of the financial statements, by an independent accountant who sets himself forth as an expert. However, there are other purposes for which accountants' services are desired, and examinations for reasons other than the rendering of an opinion.

In discussing the auditor's functions it is often convenient to classify the examinations as to the size of the business operation—small, medium, or large. For the purposes of this classification, it does not matter whether the client is engaged in business for profit, is a nonprofit charitable, religious, or educational institution, or is some governmental unit.

Small Businesses

In one classification there may be included all units that have a very small ownership group, or a small volume of business transactions, or a small or inadequately trained accounting staff. These are the characteristics usually associated with small business.

When the auditing profession was in its infancy, auditors usually were called upon only for two purposes. The bookkeeper might have made an error and the books did not balance, or fraud might have been suspected. The auditor, who was little more than an expert bookkeeper, was requested to find the error and put the books back in balance. If fraud were suspected, the auditor was engaged to make a detailed examination to determine whether or not fraud existed, and if so, the extent of the loss.

Today the auditor expects to find the client's records in error-free condition. This expectation usually is modified in the case of the small business where the bookkeeping task may be only a part-time affair or where the bookkeeper is inadequately trained. Here errors of mechanics as well as of principle may occur. Hence, one important purpose of the examination of small businesses, and large ones as well, is to determine that the record keeping has been performed correctly and that the statements reflect accurately the financial position and the operating results.

The auditor holds himself ready at all times to help in analyzing and preparing entries for unusual or complicated transactions. While the client's bookkeeper may be competent in recording day-to-day transactions, some may occur which are too complex for him to handle. Many

auditors help in these situations by making monthly visits to the client's office and reviewing the work. In this way the audit is kept up to date and both the auditor and the client are assured that no major errors have been made.

It may also be that the bookkeeper is able to record the routine transactions as they occur but is not able to prepare the accounting statements. The auditor then may be called in to prepare monthly statements. Although intended solely for management, these statements should be marked "Prepared from the books without audit," even though the auditor may have applied some audit procedures and made some monthly adjustments. Wherever a complete examination has not been made, this fact must be stated, so that no one reading the statements will be misled by assuming that they are the result of an examination.

The auditor may also be called upon to adjust and close the client's books at the year end. It is still common to find persons keeping records in small concerns who are not able to accomplish this task. Consequently the auditor performs a professional service, even though it is not strictly auditing work. In some cases it is possible for him to train the record keeper to do these elementary bookkeeping chores, and he will then merely supervise the work instead of performing it.

An expanding field of activity for the professional accountant lies in the area of business consultation. The owner of a business is usually qualified in one particular field, such as selling or producing, but often he is weak in other phases of his business. The auditor usually is experienced in business organization, finance, taxes, costs, and systems. Many of the businessman's problems will be in one or more of these areas. As taxes take a continually larger share of net income it is only common sense to plan transactions to take advantage of alternatives that will result in a lower tax. If such planning is to be successful, the client must be educated to consult the auditor before the transaction is consummated, for it is necessary that the tax impact be studied before any action is taken. In many fields of endeavor errors may be corrected at a later date; taxwise, however, once a transaction has occurred there is no retroactive action that can undo what has been done.

In areas other than taxes the auditor is also well equipped to help the businessman in the solution of business problems that arise. Such questions as how best to obtain additional capital, the possible results of adding a new product or dropping an old one, the profitability of replacing an old machine with one which is more productive, or the advisability of mechanizing some of the office operations, are just a few of the situa-

tions wherein the auditor is qualified to advise management. The experience and judgment of the trained auditor supply small business with skills and abilities which it otherwise might not be able to obtain.

In many instances in which the auditor is serving a client with a small business there is no need for certification of the financial statements. The owners are close enough to the business to know generally the results of operations and there are no outside parties involved. The auditor, through his intimate contact with the client and his records, knows that there are no major discrepancies in the financial statements. As a consequence, management places reliance on the statements that have been prepared without asking for an opinion.

It may well happen that in certain circumstances an expression of opinion may be needed for credit purposes or for some other reason. The auditor must then ask himself whether he is too intimately connected with the business to be able to express an opinion. There are three possible courses of action. If he feels that he is, in fact, still independent, he may express an opinion. In all probability he will have to expand the scope of his work to bring it into accord with generally accepted auditing standards. Secondly, he may feel that while he may still express an opinion, his connection with the client is so close (for example, a directorship or a minor stock ownership) that he must disclose the relationship in his report.

Finally, there are extreme cases in which the auditor may be a salaried officer or a major stockholder. He then may feel that his independence would be questioned if he were to make the audit. In these cases he will probably advise his client to engage another auditor to examine the records and express an opinion. This is a problem that each auditor must solve for himself. Independence must be maintained at all costs. This problem may arise with large clients, but it is more prevalent with small clients where the relationship between auditor and client is very close.

In summary, then, for this first group of clients the major functions of the auditor may be: (1) to aid the bookkeeper on accounting matters, (2) to adjust and close the books, (3) to prepare monthly accounting statements, (4) to provide consultation with respect to various business problems that arise, and (5) in rare cases, to express an opinion as to the fairness of the accounting statements.

Medium-sized Businesses

The second class of clients with whom the auditor has contacts is composed of owners or managers of medium-sized businesses. It is normal to

expect that the accounting departments in this group will be adequately trained to handle all accounting transactions as they arise, to adjust and to close the books, and to prepare the financial statements. The auditor's service to his client, and the purposes for which the auditor is engaged, must be found in areas other than these.

It is common to encounter in this group companies that have stock listed on exchanges or listed with brokers by stockholders for over-the-counter sale. Hence a public interest is evidenced here which was not present in the case of the smaller clients. The auditor's position of independence now becomes paramount. He is in a situation where not only the owner but outsiders also are going to place reliance on his judgment and opinion.

In this situation the verification of the financial statements and the expression of an opinion thereon becomes one of the major purposes of the audit. In many instances no audit would be made if it were not required by the Securities and Exchange Commission (for those companies whose stock is listed on an exchange), the stock exchange itself, or some other regulatory body. The auditor's report on the examination of these companies is closely examined by investors, analysts, and others who are aware of its significance.

Another important purpose of the audit is to review the accounting system and its inherent system of internal control, a matter which will be considered at some length at a later point. Suffice it to say here that internal control is composed of all the techniques and procedures used by management to safeguard the assets entrusted to it and to obtain the greatest possible return from the use of those assets. The review is intended to disclose weaknesses in the accounting procedures that might imperil the operation of checks and balances included in the system of internal control. The auditor does not expect to find fraudulent transactions existing. His assumption is that the client's staff is honest, but it is his responsibility to satisfy himself that the system of accounts and the controls therein are conducive to the *prevention* of fraud. Prevention is much better and much cheaper than detection. The mere fact that an audit is being made is a psychological deterrent and preventive of fraud. The review of the accounting system becomes an important part, then, in the over-all system of internal control. Weaknesses, with recommendations for their correction, are brought to the attention of management.

Usually clients in this second category have become large enough that management (or owners) have become somewhat separated from the active sphere of operations. The owner here has lost the personal control

that he exerted when the business was small. It now has become essential for him to rely on others, not only for the correctness of the information that comes up through the business, but also to see that the policies he formulates are followed throughout the concern. By his examination the auditor is able to provide management with reasonable assurance as to both of these matters.

With this group, also, the auditor plays an important role in counseling management. As business problems arise throughout the year the advice and counseling may be done in conference, or it may be done through the medium of the audit report. Many auditors, in writing the long-form report, review the year's transactions and discuss weaknesses and problems revealed by the examination. The auditor may be able to supply his client with many important data that the client is not able to provide for himself because of staff inadequacy. Obviously, if the client's staff can prepare such information, there is no value in repeating it in the audit report. The auditor may also suggest changes in accounting procedures which have a strengthening effect on the system of internal control. The preparation of federal, state, and local tax returns is another service offered by the auditor. The client may have staff men competent to prepare these returns, but in many cases the auditor is requested to prepare them. Thus, for this group, the major services offered are (1) the certification of the financial statements, (2) the review of the client's system of internal control, (3) consultation on business problems, and (4) the preparation of tax returns.

Large Businesses

The emphasis in the audit is almost completely changed when the auditor is making an examination for a large enterprise where a professional management group is in control of the business. Here the task of major importance is the verification of management's representations through the accounting statements. Management itself is very interested in making certain that the statements, which reflect the flow of transactions through the records, have been correctly prepared. While it may be assumed that management attempts to make a fair and reasonable report to the owners, there is always the possibility that errors of principle may be included in the statements. These may be intentional or unintentional. It is the purpose of the examination to determine that such misstatements are corrected and that the final statements fairly present the financial position and operating results of the business.

In many cases business has reached such a very large size and has be-

come so complex that the stockholders know little if anything about the business that they own. Even the elected representatives of the owners, the directors, find it too large a task to satisfy themselves personally that the policies determined by the stockholders and by the board of directors have been carried down through the operating echelons and are being enforced. The auditor acts as a representative of the board of directors and the stockholders in satisfying them that company personnel is acting in compliance with these policies. Where an internal auditing staff exists it will partially perform this function for top management and complement the work of the independent accountant. Where there is no internal auditing staff the independent auditor must broaden the scope of his responsibilities to include a review of compliance with established policy.

It is also the auditor's responsibility to see that the accounting statements that have been prepared comply with the rules and regulations of the various governmental regulatory bodies to whom this client must report. Since many of these bodies have diverse and sometimes contradictory regulations, it is obvious that the auditor must keep up to date and be familiar with what is required for each of the agencies.

While it is expected that large businesses normally will have a good system of internal control, the very size of the business makes it difficult to oversee all the employees to determine that the various checks and balances are being properly used. Another purpose of the audit, then, is the determination by the examining accountant that the system of internal control is working effectively. The auditor will report on weaknesses that he finds in either the system itself or in the lack of compliance on the part of any of the personnel. Unless there is constant review of the system by both the internal auditors and the independent accountants, over a period of time changes in procedures may slip into the system and thus lessen the effectiveness of the control mechanism as a guard against fraud and error. Although fraud is an ever-present possibility, the auditor should be more concerned with the chance of errors arising in the accounting records and thus resulting in unreliable data. As management becomes further and further divorced from the general operations of the business, it becomes more dependent on internal reports. Hence it is important that the reports and data reaching them be reliable. The auditor's review of the system of internal control and his verification of the accounts both tend to assure management that the reports are reasonably correct.

The final major purpose of the auditor's examination of these large firms is his expression of opinion on the fairness of the financial state-

ments. Here the auditor has in mind not so much the management as the directors, the stockholders, interested governmental agencies, creditors, and the public at large. The auditor says in effect, "These are the statements of the management of this business. They are in my opinion fair representations." This statement is addressed to anyone who is interested in the business, and it is on this statement that the auditor rests his reputation and his responsibility to the public at large.

The expression of opinion may take any form the auditor wishes. The American Institute of Certified Public Accountants has suggested a standard short-form report which is rather generally accepted. This report is reproduced at this point.

> We have examined the balance sheet of X Company as of December 31, 19__, and the related statement(s) of income and surplus for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.
>
> In our opinion, the accompanying balance sheet and statement(s) of income and surplus present fairly the financial position of X Company at December 31, 19__, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles, applied on a basis consistent with that of the preceding year.

It is largely this report—this expression of opinicn—for which the client pays the auditor's fee. From the point of view of the large client this report is in many instances the major purpose of, and in some cases the only reason for, the examination. There are many companies, including all those listed on stock exchanges, that are required to have their statements examined and an opinion expressed as to their fairness. There is some doubt as to whether all these companies would consider the expense of an audit necessary if this requirement were not in effect. It may be said that governmental regulations have increased the work of the independent accountant to some degree. It is fair to assume, though, that most managements recognize the value of the other aspects of the examination and would continue having their books audited even though it were not required.

Thus the points of emphasis in the examination of large businesses include (1) the auditor's position as a representative of the directors, owners, government, and management, (2) the review of the system of internal control, accounting system, and procedures, and (3) the certification of the financial statements. Ordinarily the client's staff is capable

enough to provide the answers to most business and tax problems that arise. The auditor, however, may be called in when an independent opinion on a specific problem is desired.

THE CERTIFIED PUBLIC ACCOUNTANT

Regulation is provided by all states over the activities and actions of the certified public accountant. The granting of the certificate is a state right and each state sets up its own code of regulations. As a consequence there is a great diversity of rules governing experience and education requirements.

At present two types of legislation exist, restrictive and permissive. Under the restrictive type of legislation either the noncertified man is licensed, with no new licenses being issued, or there are no noncertified public accountants. Under the permissive legislation anyone may set himself up as a noncertified public accountant. In consequence, there is no regulation whatsoever over such accountants. They have no fear of their certificates being revoked since they have none. This makes for an almost impossible policing problem. When noncertified public accountants run afoul of the law the odium is cast over all public accountants, certified and noncertified alike.

Since the certification of the accountant is a right exercised by the individual state, it is to be expected that there would be a diversity of requirements pertaining to this certification. In general, there are four types of requirements found in most state laws. These requirements deal with (1) the moral character of the applicant, (2) his education, (3) his experience, and (4) the passing of a written examination.

Most state laws require that the applicant be of high moral character. The state accountancy boards attempt to determine whether or not this is the case by requiring letters of reference from those who know the applicant. It is also customary to find in most state laws the requirement that the applicant be a resident of the state in which he wishes to take the examination. This latter requirement is rather loosely applied in some states.

With respect to the educational requirements, the minimum is found in those laws which say nothing at all about education and the maximum is found in laws similar to those of New York and New Jersey which require the applicant to be a college graduate from a recognized school of business with a major in accounting. Since a constant effort is being made to strengthen all the requirements, any specific requirements

written for a book such as this are apt to be out of date before the book is printed. Therefore, no effort will be made to set forth the requirements of a particular state. The state board of accountancy of any state will furnish the requirements of that state on request.

The experience requirement varies from none in a few states to three years, which is the most common experience requirement. Some state laws are specific that this experience must be gained in the office of a public accountant or in the practice of public accounting. Other state laws are silent on that point but the state boards of accountancy incline to interpret it as being public accounting experience. In many states some credit is given for accounting work of other kinds.

In 1956 a committee composed of leading educators and professional accountants produced a report dealing with proposed educational and experience requirements for entering the public accounting profession. The report was the result of several years' study of this problem. The committee made recommendations for both short- and long-range objectives. These recommendations are summarized here.

Transitional Goal

1. College graduation, including completion of an accounting major as part of the undergraduate program, or college graduation supplemented by completion after graduation of the equivalent of an accounting major
2. Satisfactory completion of the Uniform Certified Public Accountants Examination
3. A minimum of two years' practical experience in public accounting under the guidance of a CPA

Long-range Goal

1. College graduation
2. A qualifying examination
3. A professional academic program
4. An internship program
5. The Uniform CPA Examination

This is a very ambitious program and represents a considerable change from conditions as they exist today. Further, the program quite naturally considers only the training and experience of those students planning on entering the public accounting profession.

In the past the CPA certificate has generally meant that the individual

holding the certificate had proved himself by experience, training, and passing the examination, to be capable of holding himself out as an expert. Under the proposed program the passing of the CPA examination will merely signify that the individual is ready to enter the public accounting profession. There is considerable doubt in the minds of many accountants that this is the meaning that should be imputed to the CPA certificate.

Since 1952 the same certified public accountant's examination has been given to all candidates taking the examination in the United States and its territories. This examination is divided into five sections: accounting theory, business law, auditing, and two sections on practical problems. In some states an additional section is given in economics or a kindred subject. The American Institute of Certified Public Accountants, which prepares the examination, also provides a grading service which now grades the bulk of the examinations. It is to be hoped that in the future more and more states will take advantage of this service so that there is not only a uniform examination but also uniform grading. Uniformity in the questions asked is not of too great value unless there also is uniformity in the solutions and methods used in grading the examinations.

The examination is difficult and many failures are recorded. At the end of the two and a half day meeting most candidates are very fatigued. However, it is not nearly so difficult as the poor results would indicate. There are two major factors contributing to the large number of failures. One is the fact that many persons simply are not qualified, by training or experience, to take the examination. Some state boards apparently are rather lax in screening candidates. The other reason is that many persons who are qualified to write the examination do not spend the necessary time in preparing for it. This is understandable because most of these people are practicing accountants who are very busy with their day-to-day activities. However, failure to prepare often results in failure to pass. That the examination is not too difficult is proved by the fact that a number of persons each time pass all parts of the examination at the first attempt. Proper preparation plus a proper mental attitude aid in giving the candidate a better than even chance of passing the examination the first time. The retaking of the examination for those who do not pass all or any part of it is again a matter of local jurisdiction. Suffice it to say that under most state laws portions or all of the examination may be retaken a stipulated number of times without additional charge. However, it is also true in most states that if the examination is

not passed completely after a stated number of attempts the applicant loses all the credits he has gained and must start over again.

Periodically, the American Institute of Certified Public Accountants makes an award for excellence in passing the examination. The award is made to the candidates who pass all parts of the examination the first time and receive the highest grades for that particular examination. Many state societies of certified public accountants follow the same practice and make an award to the successful candidates having the highest grades in their states.

The pride and elation of the candidate on notification that he has passed the examination should be tempered by the realization that he must also assume grave responsibilities, which should control his relations with his clients, with his fellow practitioners, and with that portion of the public which is interested in the results of his work as an independent practitioner. These responsibilities will be discussed in detail in later sections dealing with professional ethics and legal liability.

QUALIFICATIONS OF THE PROFESSIONAL AUDITOR

It is assumed that if an individual today expects to enter public accounting he will have an adequate educational background. To be successful the auditor must be well versed in all phases of accounting theory and practice. The technical proficiency of his work must be beyond question. Adequate training in the theory of accounts, supplemented by on-the-job training and the acquiring of experience in the practical aspects of business, will provide the auditor with the background necessary for this proficiency. Whether or not he will successfully utilize his training and experience depends primarily on other characteristics of the individual.

Accuracy is essential, with attention to detail a requisite for obtaining it. At the same time, the auditor must be able to forget details and consider entire situations from a broad point of view. He must be able to visualize the effect of assumed facts on the business as a whole. He must be able to take at least as comprehensive a viewpoint as does top management.

Since much of the work of the professional accountant is analytical in nature, it follows that he must possess the ability to analyze what he finds in the client's records. As opposed to the constructive work of the industrial accountant, that of the auditor consists in taking what has been done and breaking it down to determine if it has been done

correctly. This work is of such importance that unless the auditor has the ability to analyze accurately and quickly he is almost doomed to failure.

The successful auditor must be a tactful person and a persuasive one. He must at times convince a client that his treatment of certain transactions is incorrect and persuade him of the desirability of treating them differently. He will encounter some situations in which the client or some of his staff will be antagonistic. Here the auditor must call forth all his tact. Preferably he should overcome the antagonism, but if he cannot he still must be able to obtain the information necessary to complete the examination satisfactorily without further alienating the client.

Leadership qualities are necessary if the auditor is to be successful in leading and training the men who work under him. He must be able and willing to take time to explain how he wants work done and why it should be so done. He should take a reasonable amount of time to answer questions and to explain how the work done fits into the audit. The junior just starting in public accounting should receive rather complete instructions as to how to approach and carry through his assignment. Any other policy is shortsighted, since it probably will require a greater expenditure of time to correct and complete the work to the satisfaction of the senior than it would have taken to give complete instructions and have the task done right originally.

In addition to his thorough knowledge of accounting, the auditor must be well versed in taxes, both federal and local. Businessmen are recognizing the importance of obtaining tax advice prior to the consummation of important transactions. The accountant must be prepared to advise as to the tax implications and as to alternative procedures that might lessen the tax impact.

In the field of communications, a sound knowledge of English is of prime importance. Both orally and in writing the auditor must be able to so express himself that the listener or reader has no doubt as to what he means. Practicing accountants report that inadequacy in the art of communication is one of the most serious deficiencies of the accounting graduate. By reading good literature in his spare time the young auditor can make a start in overcoming this lack in his training. Constant striving in all the written work that he does is another aid in mastering the language. The speakers clubs of various kinds found in most cities will afford an opportunity for training in oral expression.

The auditor must be conversant with the principles of economics,

business law, corporation finance, and business organization. As he assumes more and more responsibility he will find that his knowledge of these fields will be put to constantly increasing use. The experience that he gains through his practice will broaden his base of knowledge so that he becomes each year of greater value to his clients.

Personal qualities of loyalty, willingness to serve, and integrity are essential. The auditing profession basically is a service profession and unless the work done is actually of service to the client it is useless. If the auditor thinks first in terms of how he can best serve his clients and what he can do for them, rather than placing primary emphasis on the fee to be gained, it follows almost without exception that his financial rewards will increase. The best advertising is to have a client tell his friends about how well the auditor has served him.

The confidential nature of the auditor's work is such that his integrity must be above reproach. Since his reports are read and used not only by his clients but by other interested groups, the auditor must maintain an independent attitude at all times. He must be extremely careful not to favor one group over another, and he must never use the information he obtains from clients to benefit his personal financial condition.

Finally, the successful auditor must have sound business judgment and common sense. Much of auditing is merely the application of common sense to a situation in an endeavor to obtain an answer. Correct theory must at times give way to the practical considerations. Preplanned programs must often be revised as the audit progresses. Only through the application of sound business judgment, along with auditing principles, can the auditor adjust his program and plan new procedures that will advance the audit with a minimum of time and effort. Many situations are not covered by the program and the auditor must devise his own techniques to fit the situation. Judgment is as necessary as a knowledge of auditing principles in the work of the professional accountant.

PROFESSIONAL ORGANIZATIONS

As a professional man the accountant should engage in the activities of the organizations of his profession. Membership in these groups offers opportunities for keeping abreast of current developments. New problems are constantly arising in the ever-expanding field of accounting. Study and research play a part in keeping up to date, and participation in the discussions and activities of professional groups stimulates the growth of the accountant. Such associations broaden his perspective and increase

his general fund of knowledge. Membership also offers the opportunity to become acquainted with leaders in the profession on a state and national basis, as well as to make lasting friendships with local practitioners.

The American Institute of Certified Public Accountants is the national society that represents the certified public accountant. Organized in 1916 as successor to an earlier organization of public accountants, the Institute has played an important role in the development of the accounting profession. The objectives of the society are to represent certified public accountants, to unite the public accounting profession, to promote high professional and ethical standards, to assist in maintaining high standards for the certified public accountant's certificate, and to promote accounting research and education. Membership is open to those who hold a valid certified public accountant's certificate and who have had two years' experience in public accounting.

The Journal of Accountancy, with a current circulation of over 70,000 copies, is the official monthly publication of the American Institute of Certified Public Accountants. It also publishes *The CPA*, a newsletter for members. As official spokesman for the public accounting profession, the Institute also publishes bulletins dealing with current problems in accounting and auditing, and other material dealing with matters of interest to the accounting profession. As noted previously, the Institute prepares the examination used by all states in examining candidates for the CPA certificate.

Societies of certified public accountants have been organized in most states. In some states the organization is divided into sections or chapters. While there is no formal organizational link between the national group and the state societies, there does exist a very close working arrangement. All presidents of state societies serve on the governing body of the Institute.

Most of the state societies publish newsletters or bulletins for the presentation of articles on accounting and for the dissemination of information to members. Membership in a state society normally is restricted to those holding a valid certificate granted by that state. Associate memberships often are available for individuals holding valid certificates issued by other states. The objectives of the state societies are similar to those of the national group, with the added purpose of safeguarding the worth of the certificate issued by the state through advocating or opposing legislation affecting the certificate.

While the national and state groups mentioned above should be of

primary importance to the public accountant, there are other organizations which are of interest and whose memberships include many certified public accountants. The National Association of Accountants (successor to the National Association of Cost Accountants) is the largest accounting organization, with more than 35,000 members. Membership is open to all persons interested in accounting matters. The more than one hundred chapters provide monthly meetings for the discussion of current topics and the interchange of ideas. The *NAA Bulletin* is a monthly publication. Its articles are of primary interest to the industrial accountant.

The American Accounting Association originated as an association of accounting instructors. Although its membership now contains a majority of nonteaching accountants, its major objectives remain in the educational area, including research and the development of new thought. *The Accounting Review,* published quarterly, contains articles and departments of interest to educators and to other accountants.

Other organizations of more restricted interest and membership are the Controller's Institute, the Institute of Internal Auditors, and the American Society of Women Certified Public Accountants. There is also the National Association of Public Accountants for those public accountants who do not hold a certificate as a certified public accountant.

HISTORY OF THE PUBLIC ACCOUNTING PROFESSION

Public accounting has been in existence since the seventeenth century. The first public accountants were little more than expert bookkeepers. Some served different clients as bookkeepers. Others were engaged to use their skills to discover errors made by bookkeepers. Audits, as they are known today, did not exist.

By the end of the eighteenth century there were enough people engaged in public accounting to merit a separate classification in some city directories. Sufficient interest was evidenced in the practice of accountancy for some restrictions to be placed on those who could engage in it. For example, in 1790 Charles Emanuel III, of Italy, recognized "chartered" accountants as the only ones qualified to discharge the duties of public accountants; and in 1805 Napoleon of France decreed that an accountant would not be permitted to practice until he had passed a required examination and had served three years with an approved accountant.

The title "chartered accountant" was adopted in Edinburgh in 1853

and in England in 1880. In this same year the Institute of Chartered Accountants in England and Wales was organized. This Institute soon began to require the passing of an examination, after an extended period of apprenticeship, as a condition of membership and use of the title chartered accountant. By this time many English companies were having their books audited by independent accountants.

In the United States the American Association of Public Accountants was formed in New York in 1887. Nine years later the legislature of New York passed the first CPA law. This bill was used as a model by many other states. By 1921 all the states had passed acts regulating use of the title certified public accountant.

In 1916 the American Institute of Accountants was formed as successor to the American Association of Public Accountants. In 1957 its name was changed to the American Institute of Certified Public Accountants. It has become the official voice of the public accounting profession. Its pronouncements carry great weight not only with the practicing accountants but also with the various governmental bodies affected. However, the value of any pronouncement must be measured by its adoption in practice.

Although the public accounting profession had made a place for itself by the beginning of this century, its field was very limited in scope. Much of the work was for the purpose of detecting errors or fraud. Although some companies had certified statements prepared for publication (United States Steel, for example, has published certified statements since its organization in 1901), most managements regarded the accounting statements as being private information and not for public consumption. Consequently, there was no particular incentive to have audited statements prepared. As business expanded, auditors were called in to make examinations primarily as an assurance to management that the accounting work was being properly done and that the statements were dependable.

The introduction of the federal income tax law provided a stimulus for the accounting profession. Not only was the preparation of the tax return considered a proper task for the public accountant, but in an increasing number of cases the auditor found it necessary to make an examination of the accounts as a first step in the preparation of the return.

The tremendous increase in productive facilities caused by the First World War brought with it increasing problems in accounting. Companies turned to the public accountants for help in establishing account-

ing systems that would help solve these problems and handle the increasing flow of paper work necessitated by the further divorcing of top management from operating levels. As a natural consequence many of these companies requested the auditors to make annual examinations of their accounts and records.

The next factor causing increased demands on the public accountant was the large number of security issues brought forth in the 1920s. Many companies sought capital from the public for the first time. Many others greatly increased their capital stock issues. In most cases, prior to the issuance of the securities, there was a demand for certification of the balance sheet. Relatively little attention was paid to the income statement.

Gradually, however, during the 1930s, there was an increasing demand for an expression of opinion on the income statement as well as on the balance sheet. This further increased the pressure on the accountant's time. The many regulatory laws passed by Congress during this period also added to the accountant's work.

In the next decade, the Second World War caused a still further increase in the amount of accounting work to be done. At the same time accounting firms were depleted by the entry of their staff members into the armed forces. During this same period the scope of auditing work had been increasing. Extended audit procedures were being applied to accounts receivable and inventories. All these demands on the limited time of auditors brought sharply into focus the subject of internal control and the part it should play in the auditor's examination. Greater emphasis was placed on the auditor's appraisal of internal control. Where it was found to be effective, tests of transactions were limited. Attempts were made to strengthen weak situations so that the auditor could place more reliance on the internal control and thus reduce the amount of time necessary for test checking. The auditor thus was able to concentrate more on problems of greater magnitude and significance.

In light of the constantly increasing demands mentioned above and in view of the country's constantly expanding national product, it is not surprising that the number of persons engaged in all phases of public accounting work has increased from approximately 1,000 in 1900 to 90,000 in 1951, according to a recent estimate.[1]

The auditor is faced in the future with such challenges as the increased use of mechanical and tabulating equipment, the use of elec-

[1] CPA Handbook, Vol. I, American Institute of Certified Public Accountants, New York, 1952, pp. 3–4.

tronic equipment by the larger companies, and the constantly expanding demands of governmental regulatory bodies. The question has recently been raised as to the effect of electronic equipment on the accounting profession. Some have feared that these marvelous machines would supplant accountants, both industrial and public. Such fears appear to be groundless. It is true that much bookkeeping work will be done on this type of equipment. But the whole history of mechanical equipment suggests that as the equipment is developed, more uses are found for it, requiring more accountants rather than fewer. Further, while claims have been made for some electronic equipment in the judgment-making area, certainly at present there is no satisfactory substitute for the application of human judgment. It should also be realized that these electronic masterpieces are so costly and so large that they can be used economically only by the largest corporations. The hundreds of thousands of other business concerns must still rely on well-trained accountants for the accumulation and interpretation of their business data.

The public accountants must learn new approaches and new techniques for the auditing of records produced by mechanical and electronic equipment. These machines will do only what they are told to do. The auditor then must be prepared to look for errors on the part of the personnel instructing the machine. It must also be recognized that the machines sometimes break down and give incorrect answers. The auditor must know enough about the mechanical equipment to recognize these shortcomings and to devise audit techniques that will disclose such errors.

THE PUBLIC ACCOUNTANT'S OFFICE

Organization

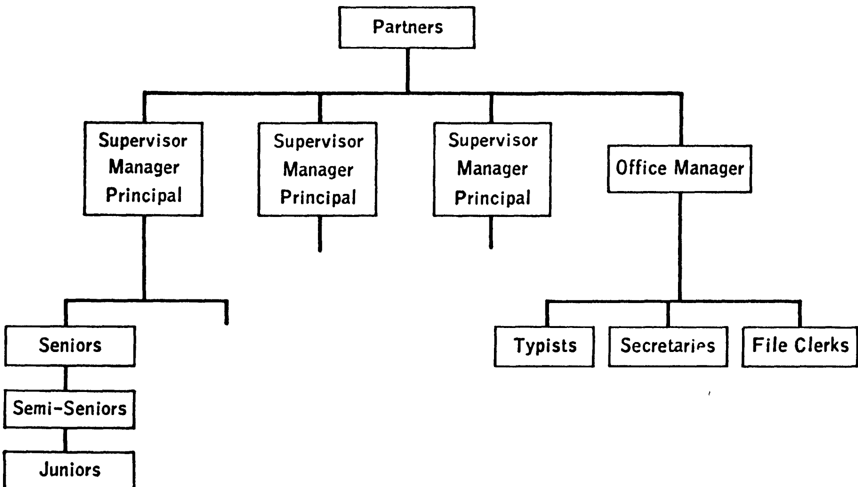
The internal organization of the accountant's office will vary with the size of the staff. Many differences will also arise because of individual habits and policies. However, it is possible to build a hypothetical organization that will be reasonably typical of many office organizations. The chart shown in Exhibit 1-1 indicates generally the strata of personnel. Titles of ranks vary as between firms.

The partners (or principal, if a sole proprietorship) initiate policies, are responsible for supervision of all engagements generally, talk with prospective clients, discuss with clients major problems arising during the audit of their records, and administer the affairs of the firm. Theirs is the ultimate responsibility for all audit reports issued. Theirs is the

liability for all transactions carried on in the firm name, and to them the profits or losses accrue. Many firms have adopted a policy of sharing these profits with employees through some bonus or profit-sharing plan.

In many firms there are enough partners that some degree of specialization can be gained. One partner may be particularly skilled and experienced in audits of public utilities, another may have special knowledge of oil and mine accounts, while still another may have particular skills in tax matters. Although this type of specialization may occur within a firm, rarely does it extend to the entire firm. That is, almost all firms want, and have developed, a diversified clientele, not

Exhibit 1-1



only as to industrial classification but also as to the size of the client. This is just a matter of prudent business management and a recognition of the proverb about not putting all the eggs in one basket.

The partners delegate a considerable amount of authority concerning the supervision of audit engagements to those in the next rank. These men, called principals, managers, supervisors, or some similar title, have charge of a number of concurrent engagements. It is the responsibility of the supervisors to see that these engagements are proceeding properly, and it is to them that the seniors turn for answers to questions or problems for which they do not wish to take complete responsibility. Similarly, the supervisors will discuss with partners those problems which they feel require a top-level decision.

One of the responsibilities of supervisors, in most firms, is the review

of the audit working papers prepared by the staff auditors. This review should be conducted at the client's office. In many cases, it is a periodic review, with the supervisor reviewing on each visit the work that has been done since his last visit. However, there is merit in waiting to begin the review until the audit is completed, or almost so. All the papers may then be reviewed at one time and the component parts related to each other. By making the review near the completion of the examination, before the report is written, any changes required will cause a minimum of friction and confusion. The supervisors are the top personnel who have an intimate knowledge of the audit engagements.

Below the supervisory rank are the staff auditors: the seniors, semiseniors, and juniors. Here again titles may vary, but the groups range down from seniors who are ready to move into the supervisory level to the novice who is ready to start his first day in public practice. The work and responsibilities of these men vary according to their ability, experience, and the size of the engagement. Normally, a senior has complete responsibility for the progress of the audit. It is his task to plan the audit program, to supervise the work of his staff, to instruct his staff, to assign work and review its progress, and to review the papers prepared by the staff. On large engagements a sizable portion of the senior's time will be spent in these administrative tasks. On smaller audits the senior will have more time to spend in the actual performance of the examination. Semisenior accountants and junior accountants aid the senior in his examination of the books and records of the client company. The part that each man plays in the engagement depends upon his ability and the size of the engagement. These men work under the direct supervision of the senior in the conduct of the examination.

The well-organized accounting office needs typists, secretaries, file clerks, mechanical duplicator operators, and other personnel for the proper administration of the office. Many of the larger firms have one person in charge of personnel. Depending on the size of the firm, this may be someone trained in personnel problems, it may be a partner, or it may be a staff member who handles this function on a part-time basis.

Types of Audits

Some accountants feel that it is necessary to distinguish between different kinds of audits. It seems to the author that there are only two types of examinations worthy of the name. One is the examination in which an opinion is given as to the fairness of the statements; the

other is the special or partial examination of a specific portion of the records or an examination in which no opinion is reported. In the first class we have what are commonly called balance sheet examinations and general audits. The difference between these two types of examinations is one of degree, with additional work being done in the general audit.

A balance sheet audit is an examination in which each balance sheet account is verified and those operating accounts directly related to the balance sheet accounts are also examined. In the balance sheet audit the auditor expresses an opinion only on the balance sheet or statement of financial position. This type of examination is becoming rare.

A general audit is one in which, in addition to the balance sheet audit, a more intensive examination is made of the operating accounts. In the general audit the auditor expresses an opinion upon the statement of operations and the statement of surplus, as well as the balance sheet.

In some cases the client may want to have only a certain account or accounts examined. He may suspect fraud and want a detailed examination of the cash and receivables accounts. He may want some other account such as plant and equipment examined, with a report giving the scope and results of the examination but with no opinion expressed. The client may not even want an examination; he may merely want statements prepared from his records as they now exist. The auditor must be extremely careful to present these statements in such a way that there is no question in any reader's mind as to just how much work he has done on them and how much responsibility he is willing to take with respect to the fairness of the statements.

Billing the Client

Basically, there are three methods of determining the final charge that is made to the client. In the first of these methods the auditor charges a flat fee for making the examination. This is advantageous to the client in that he knows beforehand exactly what the audit cost is going to be. It may not be good for the auditor, particularly in first engagements, since it is easy to underestimate the costs of the engagement. This results in underpayment or in an examination that is not as complete as it should have been.

Under the second method, the auditor charges a straight per diem rate according to the abilities of the various men who work on the engagement. That is, a partner may be charged to a job at $300 a day, a supervisor may be charged at $150 a day, a senior in charge may be

charged at $100 a day, semiseniors at $60 a day, and juniors at $30 a day. Under this method of billing the client does not know exactly how much his bill is going to be until after the job is completed. It has the advantage to the client, of course, that he pays the auditor only for the amount of time that he has spent on the engagement.

A third method is one which attempts to use the advantages of both of these types. Under this method the auditor gives to the client a guaranteed price. At the same time he indicates to him that the final charge will be based on the per diem rates regularly used by the firm and that, should the total charges be less than the maximum fee, the client will be charged on that actual basis.

Of these methods, the per diem method is by far the most advantageous from the accountant's point of view. The client knows that he is getting an examination that has been carefully made and on which there has been no hurrying or cutting of corners. He must depend on the accountant to make certain that no unnecessary procedures are being followed that tend to lengthen the job beyond what it normally should be.

Regardless of the method used in billing the client, the method used in building up the time reports and building up the costs of the job is much the same for all accounting firms. As a man is placed on the staff a basic rate is set for which his work is charged. This may be from two to three times his salary rate. As he works on different engagements he keeps a record of the time he spends on each and reports either weekly or semimonthly the amount of time spent on each engagement. The method of reporting this time will vary considerably from firm to firm and in some instances will be shown in much greater detail than in others. Basically, all time in the regular work week must be accounted for and classified as to time spent productively. The time reports prepared and submitted by the auditors are then costed and posted to cost sheets for the individual engagements. The total cost of the engagement is thus accumulated. While this cost becomes a basis for the charge against the client, it is subject to modification. In some cases the fee is intentionally reduced drastically because the work has been done as a semipublic service. Even though the auditor knows that for one reason or another the fee will not be based specifically upon his accumulated time, nonetheless it is his responsibility to make certain that he accounts accurately for all the time that he spends on the engagement. In some firms this time allocation is kept to no less than a quarter of an hour; in others no less than one-half an hour is charged.

ETHICS OF THE PROFESSION

Like people in other professional organizations, public accountants have, over the years, built up a code of ethics for self-discipline. The American Institute of Certified Public Accountants has been the leader in the development of this code. It has been rather closely followed by most state societies of certified public accountants and by many state boards of accountancy.

Professional ethics are of such importance to the profession as a whole that it is considered worthwhile to list all these rules of conduct and to add explanatory material at some places. The reader will note that most of the rules deal with problems arising within the profession. There are some others that deal with the relationship of the auditor to his client, and still others that deal with the relationship of the accounting profession to the general public. The rules have been regrouped here to show the composition of these three classes, but they are numbered as they appear in *By Laws—Rules of Professional Conduct*.[1] The rules dealing with accountants themselves are:

1. A firm or partnership, all the individual members of which are members of the Institute, may describe itself as "Members of the American Institute of Certified Public Accountants."

2. A member shall not allow any person to practice in his name who is not in partnership with him or in his employ.

3. Commissions, brokerage, or other participation in the fees, charges, or profits of professional work shall not be allowed directly or indirectly to the laity by a member. Commissions, brokerage or other participation in the fees, charges or profits of work recommended or turned over to the laity as incident to services to clients shall not be accepted directly or indirectly by a member.

4. A member shall not engage in any business or occupation jointly with that of a public accountant, which is incompatible or inconsistent therewith.

8. Direct or indirect offer of employment shall not be made by a member to an employee of another public accountant without first informing such accountant. This rule shall not be construed so as to inhibit negotiations with anyone who on his own initiative or in response to public advertisement, shall apply to a member for employment.

10. A member shall not advertise his professional attainments or services.

11. A member shall not be an officer, director, stockholder, representa-

[1] Copyright 1959 by the American Institute of Certified Public Accountants, New York.

tive or agent of any corporation engaged in the practice of public accounting in any state of the United States or District of Columbia.

14. A member shall not make a competitive bid for professional engagements in any state, territory, or the District of Columbia, if such bid would constitute a violation of any rule of the recognized Society of Certified Public Accountants or the official board of accountancy in that state, territory, or District.

15. A member of the American Institute of Certified Public Accountants engaged in an occupation in which he renders services of a type commonly rendered by public accountants, must observe the by-laws and rules of professional conduct of the institute in the conduct of that occupation.

17. A member in his practice of public accounting shall not permit an employee to perform for the member's clients any services which the member himself or his firm is not permitted to perform.

18. A member who receives an engagement by referral from another member shall not extend his services beyond the specific engagement without consulting with the referring member.

Rules which have to do with the general public:

5. In expressing an opinion on representations in financial statements which he has examined, a member may be held guilty of an act discreditable to the profession if

a. he fails to disclose a material fact known to him which is not disclosed in the financial statements but disclosure of which is necessary to make the financial statements not misleading; or

b. he fails to report any material misstatement known to him to appear in the financial statement; or

c. he is materially negligent in the conduct of his examination or in making his report thereon; or

d. he fails to acquire sufficient information to warrant expression of an opinion, or his exceptions are sufficiently material to negative the expression of an opinion; or

e. he fails to direct attention to any material departure from generally accepted accounting principles or to disclose any material omission of generally accepted auditing procedure applicable in the circumstances.

6. A member shall not sign a report purporting to express his opinion as the result of examination of financial statements unless they have been examined by him, or an employee of his firm, a member of the Institute, a member of a similar association in a foreign country, or a certified public accountant of a state or territory of the United States or of the District of Columbia.

12. A member shall not permit his name to be used in conjunction with an estimate of earnings contingent upon future transactions in a manner

which may lead to the belief that the member vouches for the accuracy of the forecast.

13. A member shall not express his opinion on financial statements of an enterprise financed in whole or in part by public distribution of securities, if he owns or is committed to acquire a financial interest in the enterprise which is substantial either in relation to its capital or his own personal fortune, or if a member of his immediate family owns or is committed to acquire a substantial interest in the enterprise. A member shall not express his opinion on financial statements which are used as basis of credit if he owns or is committed to acquire a financial interest in the enterprise which is substantial either in relation to its capital or his own personal fortune, or if a member of his immediate family owns or is committed to acquire a substantial interest in the enterprise, unless in his report he discloses such interest.

19. A member shall not permit his name to be associated with statements purporting to show financial position or results of operations in such a manner as to imply that he is acting as an independent public accountant unless he shall:

(1) express an unqualified opinion, or (2) express a qualified opinion, or (3) disclaim an opinion on the statements taken as a whole and indicate clearly his reasons therefor, or (4) when unaudited financial statements are presented on his stationery without his comments, disclose prominently on each page of the financial statements that they were not audited.

The rules which deal with the relationship of the accountant to his client are:

7. A member shall not directly or indirectly solicit a client by circulars or advertising, nor by personal communication or interview not warranted by existing personal relations, and he shall not encroach upon the practice of another public accountant. A member may furnish service to those who request it.

9. Professional service shall not be rendered or offered for a fee which shall be contingent upon the findings or results of such service. This rule does not apply to cases involving federal, state or other taxes, in which the findings are those of the tax authority and not those of the accountant. Fees to be fixed by courts or other public authorities, which are therefore of an indeterminate amount at the time when an engagement is undertaken, are not regarded as contingent fees within the meaning of this rule.

16. A member shall not violate the confidential relationship between himself and his client.

The American Institute of Certified Public Accountants has a trial board which sits in hearings when complaints are brought before it. The board may recommend suspension or expulsion from the Institute if the

member's actions are flagrant. A member may write to the Committee on Professional Ethics requesting a ruling on a particular ethical situation. Many of the state societies of public accountants also have professional ethics committees. The national board ordinarily will await the ruling of the state body or the courts before making a ruling. State societies also consider seriously any action taken by the national committee.

The accountant must be ever alert to live within the rules set up for his professional well-being. In connection with rule 3 it should be noted that one member may do work for another member, for which the second member may receive a commission or "forwarding fee." For example, an auditor in New York, examining a client's records, finds that a branch has been opened in St. Louis. If the auditor does not have a branch in or reasonably near St. Louis, he may arrange with a St. Louis auditor to do some work at the branch. The St. Louis auditor may bill the New York auditor at his regular rates, less the forwarding fee of 10 to 20 per cent. The New York auditor will include the full amount in his bill to the client. Since neither auditor is a member of the "laity," the rule has not been violated. However, consider this example. A client is considering a pension plan. An insurance agent approaches the auditor and says "Convince this client that he should accept our plan and I will pay you $1,000." It is unethical for the auditor to accept the fee even if he is convinced, and convinces the client, that the agent's plan is the best plan.

Rule 8 is provided to prevent "pirating" of staff members. The disadvantages of such a practice are obvious, particularly in times when work is heavy and accountants are scarce.

Rule 10 is similar to rules in the codes of other professional bodies. Advertising is considered suitable for business but not for professions. Probably the most important reason for this is the intimate personal contact the professional man has with his client. He sells services, not commodities. The service is based on his professional skill and ability, which are difficult to appraise in advertising form.

The same reasoning underlies rule 11. The close personal relationship between the auditor and his client rules out the concept of the cold, impersonal corporation. Further, the professional man should be in a position where he personally can be held liable for his errors and indiscretions. The use of the corporate form of organization might protect him against such liability.

Rule 5 deals with the auditor's professional work. It is probably the most important rule of the entire code; certainly it is the one which constantly touches the everyday acts and practices of the auditor. In every

report that he issues the auditor must consider whether or not he has conformed to this rule. It is under this rule that the most stringent penalties are applied. It is through failure to comply with these general concepts that auditors are brought to trial in court. Ignorance of the provisions does not excuse the auditor. Most of the material in this text deals, directly or indirectly, with the basic concepts of rule 5. The proper application of the procedures and techniques included in this material should satisfy the auditor that he has conformed to the primary requirements of this rule.

Rule 13 deals with one facet of the auditor's independence, which is his greatest asset. No one will place much faith in the auditor's report if he feels that the auditor is biased. The provisions of this rule indicate what might be construed as a lack of independence. It is difficult to measure accurately what has been described as a "mental attitude." The ownership of securities is only one means of attempting to make such a measurement. It is the auditor's clear responsibility to conduct himself in such a fashion that no one will raise the question of bias.

There are two basic situations covered in this rule. If the client's stock is sold by public distribution, implying a wide distribution of ownership, the auditor must not have a substantial financial interest in the enterprise. Most firms solve the question of substantiality by making certain that none of the partners own *any* stock in client companies whose stock is sold in public markets. If, however, the company is a small, closely held company and the statements are to be used in obtaining credit, a substantial interest in the company may be held by the auditor if it is disclosed in his report.

Another situation that leads to the question of bias occurs when the auditor is a director of the client company. The auditor may be a director without having a substantial financial interest in the company. Where there is a public distribution of securities it is fairly obvious that this situation should not exist. It is much more common to find the auditor as a director in a small, closely held company. Here again the question of mental attitude is all-important. Disclosure of the relationship in the audit report is imperative. Since the question of the auditor auditing his own work is ever present, the proper solution is to refuse to serve as a director. This should not prevent the auditor from attending the directors' meeting for purposes of consultation and advice.

Almost as important as the independence concept is the confidential relationship between the auditor and his client, covered in rule 16. The client bares to the auditor all his records and data. If the auditor fails to keep this material confidential it is a foregone conclusion that he will

lose his clientele in short order. It is immaterial whether he releases the information to others or uses it for his personal benefit. Several states have written into the accountancy law a "privileged communication" clause which excuses the accountant from being forced to testify in court regarding information obtained from his client. This indicates the importance of the matter. Prior to the widespread publication of financial statements it was common for auditors to refuse to disclose even the names of their clients. This practice is still general with respect to clients whose statements are not published.

The Accountant's Liability

The accountant is being held to constantly higher standards of examining and reporting. A cursory examination of cases reported in the past few years—cases brought by the Securities and Exchange Commission or by third parties—bears out this statement. It is, therefore, of growing importance that the accountant's work be performed in such a way that it will always stand up under court examination. No auditor wants or expects to become involved in litigation, but the number of cases that have been heard by courts indicates that the possibility certainly exists.

The accountant's liability has developed under common law and also through statutory legislation. Under the common law the accountant's liability is of three basic types: (1) breach of contract, (2) simple negligence, and (3) gross negligence (fraud).

Breach of contract occurs in instances where the auditor agrees to make an examination and then for some reason fails to complete it. His liability extends only to the client. A breach of contract might occur in which the client would not bring suit. This would happen where the client is dealing with some illegal matter, and the auditor refuses to complete his contract when he discovers the illegality.

Simple negligence occurs in cases where the auditor makes a mistake—not an error of judgment but a mistake—in accepting what should not be accepted; or in not doing what should be done; or in failing to do what should be done in a manner in which most public accountants would do it. For example, the auditor might accept the inventory listings his client hands him without making any tests of the accuracy of the listings. Such acceptance would certainly constitute negligence by the auditor if the inventory is material and he gives an unqualified report. In simple negligence the client is again the only person to whom an auditor would be liable. Privity of contract is set up here as a defense against third parties.

However, in those cases where negligence is so great as to constitute constructive fraud, the auditor's liability has been extended to innocent third parties who have been damaged by his gross negligence. It is almost inconceivable to visualize a case of gross negligence where the client is not also at fault, either actually or constructively. Hence, it is only logical, reasonable, and just that the liability extend through the client to the third parties. In cases of fraud the auditor must know that he is making a misstatement. He must also be aware of the fact that this statement is to be used to the detriment of some third party and he must then also be aware of the fact that that statement was so used. If such is the case and the third party is damaged by his reliance on the auditor's report, the courts have held that he can collect for the damages he has suffered.

Statutory liability has arisen mostly through the Securities Act of 1933 and the Securities Exchange Act of 1934. Under these laws the public accountant is held liable for the financial statements that he certifies. If there is any material misrepresentation in those statements, any plaintiff who has suffered loss and can prove that the loss came about because of misrepresentation may sue the accountant. The best defenses against suits brought under the statutory laws are

1. Proof that the statements as presented in the auditor's report or in the registration statement were at the time of presentation honest, truthful, correct statements
2. Proof that the copies presented in the registration statements are not fair copies of the statements that the auditor prepared
3. Proof that the plaintiff possessed knowledge of the incorrect statements at the time that the securities were purchased
4. Proof that the loss of the investor was caused by reasons other than the accountant's error
5. Proof that the auditor acted in good faith in conformity with a regulation of the Commission
6. Proof that the accountant relied upon a technical expert for some phases of the financial statements and that he had no reason to question the accuracy of the figures of that technician.

AUDITING STANDARDS AND PROCEDURES

While there has been a considerable amount of material written on the technical phases of auditing and on the specific procedures and techniques for making an examination, relatively little has been written

about auditing standards as such. In 1948, the Committee on Auditing Procedure of the American Institute of Certified Public Accountants prepared a special report titled "Tentative Statement of Auditing Standards, Their Generally Accepted Significance and Scope." In 1954, this statement was revised and issued under the title of "Auditing Standards." This was the first serious effort to reduce to black and white what had been vague generalities and very broad measurements of intangible and nebulous qualities. However, it was becoming apparent that there was an accumulation of demands on the part of the public and of the regulatory bodies for a method of qualitative measurement of accountants' work. It is probable that unless the profession had made such a start, it would have been done by some regulatory body. It is to the credit of the accounting profession and of the regulatory commissions in this country that in almost all instances the profession has been able to make sufficient progress to satisfy the regulatory bodies. There have been relatively few dogmatic dicta pronounced by these commissions with respect to professional accounting work.

One of the objectives of this special committee was to make a distinction between auditing standards and auditing procedures. *Standards* may be defined as broad over-all gauges by which the quality of the performance of the examination may be measured. *Procedures* are those technical steps and processes by which the auditor fulfills the auditing standards. These procedures are composed of such things as reconciliations of various types, analyses, work with books of original entry, proof of footing and posting accuracy, and other similar techniques. It is around these audit procedures that the major portion of this book is built, and it is these audit procedures which fill the everyday work of the practicing accountant.

General Standards

1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.

2. In all matters relating to the assignment an independence in mental attitude is to be maintained by the auditor or auditors.

3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

Standards of Field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.

2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.

3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmation to afford a reasonable basis for an opinion regarding the financial statements under examination.

Standards of Reporting

1. The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.

2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.

3. Informative disclosures in the financial statements are to be regarded as reasonably adequate, unless otherwise stated in the report.

Materiality in Auditing

One of the most important things to which the auditor must daily give careful thought is the materiality of the items with which he deals. *Materiality,* as it is used in auditing, may be defined as the relative importance of a procedure, omission, error, or item under review, in a particular situation. Materiality is applied to the field work and to the reporting. The most difficult task is the determination of what is or is not material. There are a number of guides which the auditor may use to help him make a judgment as to whether or not an item is material. Some of these are listed below:

1. Percentage of item to total of the group
2. Percentage of item to total assets
3. Percentage of item to net profit
4. Percentage of item to net worth
5. Absolute dollar amount of the item

These, however, are merely guides. No one of them should be used as a conclusive factor. It is only when all these guides are added together and the auditor has had an opportunity to observe the effect of each on the total picture that he may make an intelligent judgment as to the materiality of the item. From the point of view of the reader of the statement, if the omission of an item, when judged in all its ramifications, would have an effect on an intelligent reader's opinion, then the item is material.

Materiality also plays a part in the differences that arise between the auditor and his client. It is recognized that many honest differences of opinion will arise. The auditor must realize that the client has spent considerable time in arriving at the decision to treat the transaction as he has on his books. Before he takes up the matter with the client, the auditor must prepare his own case carefully and satisfy himself that he is treating the transaction in the best possible manner. Even with care shown on both sides, the proper treatment of a transaction may be in dispute. In this situation, the auditor must make a judgment, based primarily on three elements, as to the disposition he wishes to make of the item. He must consider the theoretical correctness or incorrectness of the treatment as recorded, the practical effect of the current treatment, and the materiality of the item, as it affects the financial statements. From these factors he must make a decision and stand by it.

QUESTIONS AND PROBLEMS

1. What is the major difference in the end result of an audit of a small business as compared with an audit of a very large business?

2. What factors have caused the tremendous growth of the public accounting profession?

3. What implications are there in the auditor's short-form report when it states that the examination was conducted in "accordance with generally accepted auditing standards"?

4. What advantages of specialization are gained in the large public accounting firm, as compared with a single proprietorship?

5. It is common to find in a business organization an individual called auditor or internal auditor whose function is to examine and make final approval of invoices before they are paid. Is this auditing? Explain.

6. What services does the independent auditor offer to his clientele, other than auditing?

7. What is the law in your state with respect to the practice of public accounting?

8. What methods are there for billing clients? Which is preferred?

9. What are the requirements in your state for obtaining a certified public accountant's certificate?

10. What are the major national accounting professional organizations? Which have chapters in your city?

11. A certified public accountant has for a client a small, closely held company. Discuss the ethical points involved if he

1. Is a director of the company.
2. Is a director and a major stockholder of the company.

3. Is a director, a major stockholder, and a salaried officer of the company.

12. Would the situation be different if the client were a large company with many widely distributed stockholders?

13. Why is competitive bidding for accountants undesirable?

14. A prospective client asks you to cut your fee 10 per cent in exchange for a five-year contract to examine the books. Would such an arrangement be ethical? Explain.

15. A prospective client asks you to compute your fee as 10 per cent of all net profit above $100,000. Why is this considered unethical?

16. Distinguish between auditing standards and auditing procedures.

17. Define *materiality* as it is used in auditing.

18. What is the difference in the auditor's liability between simple negligence and gross negligence?

19. Your current examination of the Abel Company indicates that it is virtually insolvent. Later, in examining the Blue Company you find that it has large amounts due from Abel and is not aware of Abel's financial difficulties.

How will you handle this situation, in light of your ethical obligations to each client?

20. If engaged to make a balance sheet audit to determine only the financial position at a given date, would you consider it necessary to examine the income and expense accounts?

21. Discuss the independent accountant's responsibilities to (1) his client, (2) his fellow accountants, and (3) the public.

22. You are asked to audit the accounts of a company which has thus far been audited by another accountant in good standing. Will you accept the engagement? Give reasons.

Chapter 2

BEGINNING THE AUDIT AND INTERNAL CONTROL

BEGINNING THE AUDIT

How Auditors Are Selected

Ideally, auditors for a corporation should be chosen by an impartial, independent committee selected from the nonofficer directors. The selection of this committee should then be submitted at the stockholders' meeting for ratification by the stockholders. Actually, in many instances, the auditors are selected by an officer of the company, either the president or the treasurer. There can be no great complaint about this method as long as the size of the company is such that the interests of the selecting officer are inextricably bound up with the affairs of the company. That is, where the auditor reports to top management and where top management represents the substantial ownership of the company, such a method may be satisfactory. Wherever there is a substitution of professional management for owner management, then there should be a divorcing from management of the selection of the auditor so that the interests of the owners are fully protected.

Businessmen are sometimes requested by their banks to have audits made as a prerequisite for loans. The banker may suggest the name of an auditing firm that he knows. In effect the banker selects the auditor, although the depositor usually has the right to select some other firm.

Many auditors are chosen for engagements because the businessman has heard from some of his business friends of the fine work the firm does. Satisfied clients constitute the best advertising the auditor can have.

Interview with the Client

The first interview is one of the most important meetings that the auditor will have with his client. It is essential that a full understanding be reached in this meeting on the essential points of the engagement.

One of the first questions to be asked of the prospective client is the purpose of the audit. Why is an audit needed? Is it because of a demand by a bank in connection with granting credit? Because the owner of the business feels that there is a possibility of fraud taking place within his company? Because the owner of the business feels that the business is getting so large that he cannot keep track of all the details himself and wants to be assured that everything in his company is in good order? There are any number of reasons why an owner might want an audit made. The auditor, of course, is interested in determining just what that purpose or reason is, so that he may pay particular attention to that point. It may well be that the auditor may have a little difficulty in determining the purpose of the audit. This might be particularly true if the owner suspects some fraudulent transaction but does not have proof and is reluctant to make accusations. In any event, it is important that the auditor understand what the client expects in so far as the examination is concerned.

If this is not a first audit, it is wise to determine, if possible, why the client is changing auditors. Some companies follow a specific policy of rotating auditors every two or three years. Others, having once found an auditor who is satisfactory to them, may not change auditors for many years. There are instances in which an auditing firm has made annual examinations of a company for fifty years or more. This being true, it is of interest to the auditor to determine why the client was dissatisfied with his predecessor and why he has been approached. In fact, it might not be amiss, after negotiations have been fairly well settled, for the auditor to contact the preceding auditor to determine, if possible, whether or not there is anything questionable about the client or the examination. In some instances the auditor might be interested in setting up a rotating arrangement with the predecessor for the exchange of permanent-file information with respect to this and other jobs.

The scope of the examination should be discussed in some detail. It should be determined whether this is to be a general examination or just a review of certain accounts for some special purpose. If it is to be a general examination, is an opinion desired? If the client expects to place certain limitations on the auditor's work, they should be considered at this point. The auditor should indicate clearly the results of these limitations particularly as they might affect his opinion of the reasonableness of the financial statements.

While the examination usually covers a period of one year, it is essential at the first meeting that the auditor determine the exact period of

time to be covered. If this is a first audit for the client it may well be that the period to be covered will be for more than one year. On the other hand it may be that the client wants only a quarter or a half year covered. It is important that this matter be determined and set down in the auditor's notes so that no question will arise at a later date.

The auditor should indicate to the client the condition that the records are to be in before the examination is started. That is, the books should be in balance, although not necessarily closed. Subsidiary records should be in agreement with control accounts, and reconciliations of such accounts as cash in bank should have been made. A trial balance of the general ledger should have been made. In other words, the clerical staff should have completed all the routine work and the records should be in such condition that the accounting statements can be prepared. When this is agreed upon the client can then indicate to the auditor approximately at what date the records will be ready for examination.

It is important that the auditor determine when the client must have the audit report. The client may want the report in such a short period of time that the auditor is required to work a considerable amount of overtime in order to meet the deadline. This not only increases the cost of the examination but also is apt to give poorer results than would be true if overtime were unnecessary. Some engagements require that the audit report be in the client's hands within ten or fifteen days after the end of the fiscal year. Fortunately, most companies now recognize the unsatisfactory position of the auditor in this situation and are changing the dates of their annual meetings so that there is not quite such a rush at the end of the year. In any event, in order to plan his work properly, the auditor should determine just when the client must have the finished report.

The auditor should come to an understanding with the client at this point as to just where he is to work. For the ordinary audit, the auditor certainly would want to work in the client's office. For the very small audit, he may take the books and records to his own office and work on them there, although such a situation is not usually the most satisfactory. If he is to work at the client's office, he should determine exactly what space is to be made available to him. This is done so that when he does come to work, there is not a lot of time wasted trying to find a place for him.

Usually at the first interview the client will be very happy to conduct the auditor through his plant. The auditor needs the tour of the plant to give him necessary background for his examination. He will learn on

this trip what kind of machinery the client uses, what kind of raw materials are necessary, where they are stored, and the flow of materials through the plant. He will also gain an understanding of the type of labor that is used and the amount of skills necessary in producing the client's product. He should at this time also absorb information with respect to the type of product produced and the possibility of any over-all proofs that might be made in terms of units or product rather than in dollars. He should gain a very general understanding of papers and documents used for information and control in the plant. Intelligent questions asked at this point should also aid him in his understanding of some of the problems with respect to inventories. He might even discuss with the client, as they examine the warehouse, what the inventory problems are, how often an inventory is taken, and what provisions are being made for an inventory at the audit date.

As the visit reaches the office, the auditor should be introduced to the key personnel with whom he will be working. In many cases it is helpful to draw a rough floor plan of the office, inserting thereon the desks of these key personnel, their names, and the books for which they are responsible. This chart may later be integrated with the organization chart. The auditor should gain a general idea of the flow of paper work through the office. He may also determine roughly what books of accounts are kept.

The client will be anxious to determine how much the audit is going to cost him. As indicated in the preceding chapter, there are various ways of determining the total charge. The auditor should explain these methods and should attempt to satisfy the client with the use of the per diem rate basis. If he will not be satisfied with this, obviously some other method must be chosen. It is important for the client to understand that if a per diem rate is used, the daily charge is based on the client's normal working day. In many instances it is necessary for the auditor to work overtime. The client should understand that if his office works a regular seven-hour day and the auditor puts in fourteen hours in that particular day, then the client will be billed for two days' time.

It is also important for him to understand that not all the work will be done in his office. Much of the final portion of the audit may be done in the auditor's office. In all cases the report will be typed in the auditor's office. Whether or not the auditor charges typing time to the client is a matter that varies with firm practice. Certainly if such time is to be charged to the job and billed to the client, the client cannot hope to keep track of such costs. It is, however, not unusual for clients to keep track

of the number of days that the auditors work and then to try to correlate the days worked with the final billing.

In some instances the fee charged by the auditor does not represent a proper fee for the amount of time and professional ability used in the examination. It is, of course, natural for the young accountant to be tempted to take an engagement at almost any price in an effort to build his practice. This is a shortsighted policy which will boomerang to his later dissatisfaction. One exception occurs where the client also is just starting in business. Here an agreement may be reached where the auditor bills at a low rate until the client is making satisfactory progress. Rates should then be adjusted upward.

Another point that should be settled during the first interview is the auditor's observation of inventory taking. It is assumed that this initial interview with the client takes place prior to the end of the client's year. In those instances in which the year has already ended, the auditor must explain to his client the necessity of qualifying his audit report with respect to the inventory observation. The auditor might also explain at this point that it is possible to take inventories at some date other than the balance sheet date. This probably will not be necessary in the usual medium-sized examination, but as the size of engagement increases the auditor and the client may find it helpful if the inventory is taken at some date prior to the balance sheet date. If the inventory has not yet been taken, the auditor should review the inventory instructions which have been set up for the inventory crews. If none have been set up, he may well want to make suggestions to be incorporated in those instructions.

A generally accepted auditing procedure requires that the auditor request a direct statement from customers as to the amount they owe the client company. This request for confirmation of customers' balances should be explained to the client if he is not familiar with it. The confirmation of accounts receivable has now become so widespread that there usually is little question by the client as to the advisability or the necessity of requesting confirmations. The client may then determine whether or not he will want any of his staff to help in the preparation of the confirmation requests.

The auditor will also want to explain to the client that it will be necessary for him to send confirmation requests for various other items, including cash, notes receivable, and accounts payable.

By the time this stage of the interview has been reached, the auditor should have a fair idea as to whether or not he is going to make the ex-

amination. If he is, one important matter to be considered now, at least generally, is the system of internal control. A complete study is much too large a task to be attempted during this preliminary interview, but the auditor may obtain now broad outlines of the plan that is in effect. It may well be the client has set down on paper the elements of internal control existing in the firm. The best way to start on this review is to obtain a copy of the client's organization chart. If such a chart is not available, the auditor can prepare one in rough form. With this chart he should be able to sketch out the accounting responsibilities and to visualize fairly well the checks and balances that are, or should be, in use to afford the necessary controls. In many companies where there is no internal control, or where it is weak, there also will be no formal organization chart. This may be because the company has grown so rapidly or so haphazardly that no one has bothered to give any attention to this particularly important item. The development of an organization chart will stress or point out the responsibilities that each person should have and the ways in which these responsibilities may be made to dovetail with those of other individuals. In this way it is very simple to set up an elementary system of control that will provide some safety factors.

The auditor will want to determine whether or not the client is interested in receiving comments about the strengthening of his accounting system. Some persons believe that any changes in the accounting system necessarily indicate a reduction of personnel, and it may well be that the client will want to avoid disturbing his staff by having such suggestions made. During the study of the system of internal control the auditor may find opportunities for making suggestions with respect to changes in the accounting system.

Another point to be covered in this preliminary interview is the work to be done by the client's staff. It is to be assumed that the client's staff will have completed the routine work. The amount of work that may be done in addition to this bookkeeping work, as an aid to the auditor, will depend largely on two factors. One of them is the willingness of the client to have his staff spend their time doing work for the auditor. The other is the auditor's concept of the abilities of the clerical staff. It is to be understood, of course, that the work the client's staff may do is all of a clerical nature. There are many such tasks that the office force can perform. Any work that can be done by them serves to reduce the total number of hours that the auditor works and thus to reduce the total charge to the client. Although it would seem to be an economical move to have the staff do this work, in some cases the client feels that

his staff is already overburdened and that there is no great gain to be made. In cases in which the client wants his staff to help, the following list of tasks is suggestive of the work that may be done:

1. The preparation of a working trial balance for the auditor. This is not a substitute for the regular trial balance that the client's staff prepares as a part of its regular accounting work.
2. The preparation of a bank reconciliation for the auditor. Here again, this reconciliation is for the auditor's working papers and is not a substitute for the reconciliation prepared by the staff for its own purposes.
3. The preparation of a schedule of investments owned.
4. The listing of accounts receivable on aging schedules, or the actual aging of the accounts.
5. The listing of notes receivable.
6. The preparation of a schedule listing all the insurance policies held during the year.
7. Analysis of any of the other prepaid expense accounts which the auditor wishes.
8. Schedules of any long-term investments.
9. Analyses of fixed asset accounts and of the related accumulated depreciation accounts. The analyses should be accompanied by all the primary documentary evidence necessary to support the changes made during the year. This is one of the most timesaving tasks that can be done for the auditor if there has been any volume of changes.
10. The scheduling of any deferred charges.
11. The preparation of a listing of open accounts payable.
12. A scheduling of the notes payable.
13. Analyses of any accruals, together with the documentary evidence supporting them.
14. For those companies which keep their own capital stock records, a listing of the certificate holders and the number of shares owned.

This list will indicate to the reader the type of tasks that may be performed by the client's staff. In each case the auditor must satisfy himself that the work has been done accurately. He must accept nothing at face value but must test and check until he is satisfied as to the accuracy of the final result. The client's staff should use paper supplied by the auditor so that the work may be filed in his working papers. There is nothing professional in the nature of the work that the client's staff has done. It is purely copy work, filing work, or searching—tasks that the office

help can do just as adequately as the accountant and in some cases more quickly because of their familiarity with the filing system and records.

A final point to be discussed is whether the auditor may come in to do preliminary work prior to the year end, assuming of course that the interview takes place prior to the year end. Much of the necessary detailed work may be done at some interim date, and if this is to be a first audit, most of the investigative work dealing with prior years may be done early. It is advantageous to both the auditor and the client if arrangements can be made to start the examination before the year end.

When the auditor has returned to his office from this preliminary interview with the client he probably will want to make some formal notation of the results of his conversation. In many instances these notes are written up in a document called an engagement memorandum. An illustrative memorandum is shown in Exhibit 2-1.

If the client has agreed to engage the auditor and the auditor has agreed to accept the engagement, it may be that the auditor now will want to formalize the agreement to some extent. Here again practice varies according to the accounting firm. In some instances a formal contract will be drawn up and signed by both parties. In other cases, the auditor will write a letter to the client covering in general the points made at the time of the preliminary interview, specifically covering the type of audit, the date it is to be started, the date it is to be finished, and the fee to be charged. In some cases the client is asked to sign a copy of this letter and to return it to the auditor. In many repeat engagements the only contact made is when the client calls to say that the books are ready and that the auditors may come in any time.

Summarizing, these points should be discussed with the client in the initial interview.

1. The purpose of the audit
2. Why a change of auditors is desired
3. The scope of the examination
4. The period the examination is to cover
5. The condition the records are to be in
6. When the audit report must be completed
7. Where the auditor is to work
8. Tour of the plant
9. The audit fee
10. Inventory observation
11. Requests for confirmation of various accounts

Exhibit 2-1

ENGAGEMENT MEMORANDUM

Client (exact name)	*Hoffman Manufacturing Corporation*
Address	*1102 Fourth Street* *Pickerington, Ohio*
Telephone	*Halifax 7-4123*
Service desired	*General audit, year ended 12/31/61* *Federal and city income tax returns*
Starting date	*January 20, 1962*
Contact	*Mr. J. E. Hoffman (Treasurer) or* *Harry Jonas (Controller)*
Address report to	*Board of Directors and Stockholders*
Report needed by	*March 18, 1962*
Number of copies of report	*Five long form; ten short form*
Men needed	*1 senior, 3 juniors*
Estimated time	*Senior 4 weeks, 2 juniors 2 weeks, 1 junior 3 weeks*
Per diem rates	*Partner $200, senior $75, juniors $40*
Account to be charged	*Hoffman Manufacturing Corporation*
Type of organization	*Ohio corporation*
Type of business	*Manufactures electronic devices*
Books located at	*Above address*
Client interviewed by	*J. O. Hanscomb*
Staff assigned: In charge	*John Leary*
Assistants	*Harry White, Joe Green, James Black*

12. Work to be done by the client's staff
13. Whether any preliminary work may be done

BEGINNING THE AUDIT

When the year's work has been completed by the client's staff and the books are ready for audit, a senior is appointed to take charge of the examination and the necessary staff men are designated to help him. If this is a new job for the senior, he should review the preceding year's working papers, audit report, and permanent file. If it is a return engagement, he should review the correspondence between the client and the firm for the year under review. If the client is one of an industry with which the senior has had no contact previously, he should make some study of the basic problems of the industry. Only with this background may he make an intelligent examination.

Having familiarized himself with the client's record and correspondence and with the specific problems involved, the senior next proceeds to the obtaining of the necessary supplies for the engagement. He should take worksheets of various sizes and ruling. Working paper may be obtained in columnar pads in almost any number of columns from two to fifty-six, or even more. For most small or medium-sized engagements, pads of two-, four-, six-, thirteen-, or fourteen-column paper will suffice. Horizontally ruled paper for making notes and drafting reports should also be included. In addition, the auditor will need scratch pads, a supply of letterheads and envelopes, confirmation requests, colored pencils, erasers, paper clips, seals, tape, ruler, and rubber bands. In most cases, the client will furnish any postage needed.

If this is a return engagement, the senior should also take with him last year's working papers, a copy of the report prepared last year, last year's tax returns, and the permanent file, containing papers of long-time interest. All this material along with the current working papers should be kept locked in a brief case when not required for immediate use. If this is a new job for the senior, it is probable that the partner who had the preliminary interview will write for the senior a letter of introduction to the client. For a return engagement he will need no such letter. All that will be necessary is that the firm arrange with the client the date on which the examination may be started.

Having arrived at the office, the question always arises as to just how the examination is to get started. Probably the most important task is to lay out the work assignments for the assistants. There are listed below

some tasks that may be started immediately, many of which are often assigned to junior staff members.

1. Count the petty cash.
2. Count the cash on hand.
3. Prepare accounts receivable confirmation requests.
4. Prepare bank confirmation requests.
5. Age the accounts receivable.
6. Foot the cash books.
7. Trace postings from cash books to ledgers.
8. Prepare the general ledger trial balance.

This last item is included to illustrate a point. One of the most important tasks of the senior is the training and supervision that he accords to the men under his direction. The senior must determine for himself the junior's ability and should assign to him tasks which will use that ability to the fullest degree. It is the senior's responsibility to train the junior in such a way that he is able to accomplish work of greater and greater responsibility. Hence, it might well be in this situation that this particular junior had advanced to where he was able to schedule the trial balance and start analyzing the accounts. In assigning tasks the senior, however, should remember that it is cheaper for the client if the necessary detailed work is done by auditors of the lowest pay level.

The senior should always take time to spell out clearly just what it is that he wants his assistants to do and just how it fits into the audit. The junior staff members should feel that they are contributing something to the examination. It is the senior's responsibility to explain to the junior that the work that he is doing, even though it does appear to be monotonous and wearisome, is of benefit and is an important part of the examination.

After he has started the junior on one of the above tasks, the senior is ready to go to work. Probably one of the most satisfying ways that he can spend the first part of this first morning is to talk with some of the men in top management positions. Certainly he will want to spend some time with the controller of the organization, discussing with him any changes in the accounting system or changes in internal control that have taken place during the year. He might also want to talk with the treasurer or the president about any conditions that have developed that were not present at the time of the preceding audit. In this way the auditor can gain a considerable amount of information that will be useful to him as background material in his examination of the records. Having concluded his conversations with the officers, the senior may then turn to any of a half-dozen tasks that require his attention early in the audit.

One of these is the reading of the minutes. This should be done at an early enough stage so that the senior is familiar with the important transactions and actions that have taken place during the year under review. The senior might reserve to himself the task of taking off the trial balance. This is advantageous from several points of view. First, the senior is thus able to obtain quickly a broad picture of what has happened to the company during the year. Obviously, there will not be enough detail here to lend a meaningful translation to the picture, but at least he can see what major changes have been effected during the year. Secondly, the senior will be interested in any accounts that have been opened and closed during the period. Also he is interested in any new accounts that now appear in the trial balance. For these reasons many auditors prefer to take off the trial balance themselves. If the client has already prepared the trial balance for the auditor, he then compares the trial balance with the ledger accounts to satisfy himself that all are included, that the balances shown on the trial balance are those in the accounts, and finally that the trial balance is in balance.

If this is a first examination, early in the audit the senior will want to examine the articles of incorporation and the bylaws of this company. He will also want to start a permanent file for this client and will summarize the pertinent data in the charter and the bylaws. After he has accomplished all these things, the next step will be to start the verification of account balances and the operational review.

INTERNAL CONTROL

Internal control may be defined as all the techniques, procedures, and measures used by management (1) to establish maximum reliability for the accounting and other statistical data relating to operations, (2) to protect and safeguard company assets and reduce potential losses, (3) to encourage adherence to prescribed managerial policies, and (4) to increase plant and worker efficiency. This is a considerably broader definition than is usually visualized when many accountants refer to internal control. Generally they are thinking of the part of the over-all system that applies specifically to financial data and to the checks and balances included in the accounting records. While these are an important part of the system, they do not constitute all of it. Controls and safeguards existing in the plant, for example, the internal security force, are also a part of the system.

Although the system of internal control is exceedingly important to the auditor, basically it is a managerial tool. Management is charged with

the responsibility of safeguarding the owner and creditor interests and of producing correct financial statements. Good internal controls are a means of accomplishing this end. The independent auditor, however, is interested in the system of controls as its effectiveness is a consideration in determining the extent of his tests in arriving at an opinion as to the fairness of the statements.

Basic Principles of Internal Control

The basic principles of internal control relate to the physical custody of assets, the separation of custody and accounting, the subdivision of functions, and the assignment of accountability and responsibility. These principles are set forth in the statements listed below. The auditor must bear them in mind as he makes his examination of the internal control system and of the accounts.

1. No person should have complete control of a business transaction.
2. There should be a separation of physical custody and record keeping.
3. All cash receipts should be deposited intact, daily.
4. All disbursements (except for petty cash) should be by check.
5. All employees in positions of financial responsibility should be bonded.
6. All employees in positions of financial responsibility should be required to take an annual vacation, with their work being performed by some other employee.
7. Functions should be divided and subdivided as much as is reasonable and practicable to provide cross checks.
8. Authority must accompany responsibility.
9. Mechanical equipment providing automatic proofs should be used wherever feasible.
10. Control accounts and subsidiary ledgers should be used as much as possible.

The Auditor's Review of the System of Internal Control

The auditor's review of the system of internal control should have two major objectives. First, the review should indicate to the auditor whether or not he is justified in placing any reliance on the representations of management, as they are reflected in the books of account. In other words, is the actual operation of the system proceeding satisfactorily enough so that the auditor may express an opinion on the statements as a whole, based upon his usual examination?

Second, the review should disclose to the auditor those points at which the internal control is not functioning as prescribed, or where the control could be strengthened. It is the auditor's duty to make recommendations to management for strengthening the system. In fact, particularly in smaller concerns, this is one of the fields where the auditor can be of great service to his client. The auditor's experience in the field of internal control will enable him to point out rather quickly those areas in which a further development of the control system is needed. Conversely, he is able to indicate any situation in which an unnecessary amount of control is exerted. The auditor should point out the weaknesses and recommend the steps necessary for their correction. Management may then decide whether or not his recommendations should be adopted. The strengthening of the internal control and, as a corollary, the increasing operating efficiency may result in a much greater service to the client, from a managerial standpoint, than does the certification of the statements. Particularly for smaller companies the auditor's role as a consultant and advisor is just as important as is his role as an examiner.

The first review of the system of internal control should be undertaken at a date prior to the examination. The laying out of an audit program, with a consequent expansion or contraction of the normal audit procedures, is dependent on the findings with respect to internal controls. At the time of this review, the auditor must of necessity apply some audit procedures. It is not enough to inquire into how things are done and to review the prescribed features of the system as set forth in the accounting manual. To satisfy himself as to the adequacy of the system, the auditor must review actual transactions and determine whether or not they are handled in accordance with instructions. These tests will be augmented at the time of the examination by additional tests and observations. Where the client company is very large or has a widespread geographical structure, it is impracticable to review the entire system at one time. A rotating plan is usually followed, with the expectation of a complete review every two or three years. However, for the smaller client, the entire system should be studied prior to the beginning of the examination. The completion of the review will usually be made in connection with other phases of the audit program.

Ordinarily, the review of the system of internal control is undertaken through the use of an internal control questionnaire. Many accounting firms have standardized these questionnaires to a point where they may be used for most engagements. The questionnaire shown below is typical of those used. There are many excellent treatises available on the subject

of internal control and on the related internal control questionnaire. Hence, it is felt that in this text it is necessary to note only the importance of the review as an over-all audit standard and the use of the questionnaire as a tool for accomplishing this objective. It is to be further noted that each of the chapters concerned with assets and equities will contain a separate section devoted to the internal controls relating to that particular phase of the examination.

INTERNAL CONTROL QUESTIONNAIRE

A. General matters
1. Does the company have an internal audit staff?
2. If so, do we review and test their work?
3. Do we have a current organization chart?
4. Are responsibilities and accountabilities clearly defined by the organization chart?
5. Are all officers and employees required to take vacations?
6. Are their duties performed by other employees while they are on vacation?
7. Are all general journal entries authorized by a responsible employee?
8. Are all general journal entries properly substantiated?
9. Is there prompt comparison monthly of budgeted and actual operations?
10. Are major variances promptly investigated?
11. Are all employees in positions of trust bonded?
12. Are securities kept in a lockbox, locked safe drawer, or by an independent custodian?
13. Is there joint responsibility for the physical control of securities?
14. Does a third person keep a record of securities, including a record of certificate numbers?
15. Must all securities transactions have board of directors' approval?
16. Is a periodic proof made of income actually received relative to income that should have been received?
17. Do the internal auditors make surprise counts of the securities and cash funds?

B. Sales, accounts receivable, cash receipts
1. Is the credit department divorced from the accounts receivable and sales departments?
2. Are all orders approved by the credit department before acceptance?

3. Are invoices prepared for all sales?
4. Are invoices prenumbered?
5. Are all numbers accounted for?
6. Is a second independent check made of prices and extensions used on invoices?
7. Is there a proper proof that all invoices are shipped and that all shipments are billed?
8. Do the routines provide for the same treatment for partial shipments as for complete shipments?
9. Are the routines for miscellaneous sales (scrap, fixed assets) the same as for regular sales?
10. Is there a proper distinction of these sales in the accounts?
11. Is a proof of sales (independent of the accounting department) regularly prepared and checked to recorded sales?
12. Is the keeping of accounts receivable divorced from the credit-granting, sales, shipping, and cash-receiving functions?
13. Are statements sent to all customers each month?
14. After the statements have been prepared, does an independent employee prove the statements to the individual accounts and to the controls?
15. Does this same employee mail the statements?
16. Are customer complaints routed first to this employee?
17. Are subsidiary ledgers proved to control accounts monthly?
18. If not, how often is this done?
19. Are the accounts receivable aged periodically and passed to the credit department for review and follow-up?
20. Are credit memoranda prenumbered?
21. Are credit memoranda numbers accounted for?
22. Must all credit memoranda be approved by a responsible executive?
23. Must bad-debt write-offs be approved by a responsible executive not in the accounting or credit department?
24. Are adequate allowances for doubtful accounts maintained?
25. Is adequate control maintained over accounts that have been written off?
26. Do the subsidiary ledgers contain other than trade accounts receivable?
27. Are the subsidiary ledger posting clerks rotated periodically?
28. Are the duties and functions of the person receiving cash sep-

arated from the work of the accounts receivable and billing departments?

29. Are cash register tapes controlled by someone other than those responsible for the cash?
30. Is incoming mail controlled and opened by employees who have no responsibility for recording or depositing cash?
31. Do these employees prepare duplicate lists of receipts?
32. Is one copy of this list sent to an employee (independent of the cashier's office) who periodically compares the list with the details of the cash receipts book?
33. Are deposits of all receipts made daily?
34. Is a duplicate deposit ticket stamped by the bank?
35. Is this ticket returned to the employee who received the list of receipts (question 32)?
36. Are all bank accounts properly authorized?
37. Is an independent control established over such miscellaneous receipts as dividends, interest, scrap sales, etc.?

C. Purchases, accounts payable, cash disbursements, petty cash

1. Are all purchases made by the purchasing department?
2. Are all purchases supported by properly authorized requisitions?
3. Are limits of authority observed with respect to requisitions?
4. Are requisitions routed through a financial officer for financial control?
5. Is there enough separation of function that collusion between requisitioner and purchasing department is improbable?
6. Are prenumbered purchase orders used?
7. Are all purchase order numbers accounted for?
8. Are all purchase orders properly approved?
9. Are company policies relating to competitive bids followed?
10. Are "emergency" purchases supported by regular purchase orders?
11. Are emergency purchases excessive?
12. Is there any evidence of favoritism in purchasing?
13. Are receiving reports prepared for all shipments received?
14. If not, is the purchasing department notified by some other means of the receipt of goods?
15. Does the purchasing department compare the receiving report (or other notification) with the purchase order?
16. Are purchase returns controlled so that the accounting department is automatically notified of all returns?

17. Are all invoices received directly in the accounting department?
18. Are supporting documents received and compared with invoices in the accounting department?
19. Is the distribution of charges from invoices independently checked?
20. Are all invoices checked for extensions and footings?
21. Are invoices for services approved by a responsible employee?
22. Is there proper approval for payment of all invoices?
23. Are routines so arranged that all invoices are presented for payment before the discount date?
24. Does the company use a discounts lost account?
25. Are open invoices totaled and compared with the control account periodically?
26. Are monthly statements from creditors compared with balances in the subsidiary payables record?
27. Are discrepancies reported to a responsible employee (other than the accounts payable clerk) for investigation?
28. Does a responsible official periodically review invoices for the necessity and reasonableness of the purchase, and the existence of the vendor?
29. Are checks prepared only on presentation of invoices, properly supported and approved?
30. Are blank checks ever signed for emergency purposes?
31. If so, does the check signer later satisfy himself as to the supporting evidence?
32. Are the functions of check writing and check signing separated?
33. Are two signatures required?
34. If so, does either of the cosigners ever sign checks in advance?
35. Does the check signer examine the supporting evidence for propriety and approvals?
36. Are the invoices stamped or perforated as checks are signed, by the check signer or an assistant, to prevent reuse?
37. Are signed checks sent directly to the mail clerk for mailing?
38. Do all supporting documents remain attached to the invoice when it is filed after payment?
39. Are spoiled checks properly voided and retained for accounting by check numbers?
40. Is a check-writing machine or other protective device used?
41. Is a check-signing machine used?

42. If so, is the signature plate controlled by the person whose signature is on it?
43. Are bank accounts reconciled regularly?
44. Is the employee who does this someone independent of the person receiving cash and/or writing checks?
45. Does this employee receive bank statements directly from the bank?
46. Is the imprest system used for petty cash?
47. Is there a maximum limit for individual disbursements from petty cash?
48. Are reimbursements of petty cash approved by someone other than the petty cashier?
49. Are surprise counts of petty cash made by persons independent of this section?
50. Is complete responsibility for each petty cash fund vested in one person?
51. Are other funds ever mingled with petty cash?
52. Are petty cash vouchers perforated or stamped PAID at the time of reimbursement?

D. Payroll

1. Are personnel placed on and removed from the payroll only on written authorization?
2. Are these authorizations approved by an executive?
3. Does the personnel department keep records of employees' wage rates?
4. Does the internal auditing department make tests of authorized rates against rates paid?
5. Are all changes in wage rates noted on employees' records along with the authorizations therefor?
6. Are clock cards (or time sheets) the basis for the preparation of the payroll?
7. Do responsible employees supervise the punching of clock cards?
8. Are "floor checks" made reasonably often?
9. Are clock cards compared with labor charges (job tickets)?
10. Does a separate payroll department make up the payroll register?
11. Is the gross payroll proved against total labor charges?
12. Is there written authorization for all payroll deductions?
13. Is a proof made of all payroll calculations?
14. Are specimen signatures of employees on file?
15. If so, are these signatures tested against payroll check endorsements?

16. If payroll is paid in cash, are employees required to give receipts?
17. Is payroll distributed by an employee who did not participate in its preparation?
18. Do the internal auditors make surprise distributions of pay checks?
19. Are unclaimed wages returned to a responsible employee not in the payroll department?
20. Must employees produce proper identification and give a receipt to obtain unclaimed wages?
21. Do the internal auditors make audits of unclaimed wages on a surprise basis?

When the initial review of the internal control system has been completed, the auditor should be in a position to evaluate its effectiveness. He can tell, from the answers to the questionnaire and his tests of the answers, which areas of the audit need expansion or which may be contracted. He may feel that the entire system is so effective that a severe contraction of the audit program is possible. Conversely, the systems of controls may be so weak, or even nonexistent, that a considerable expansion of all areas of the examination is required. The student should realize that it is possible to make an audit even when there are no internal controls. The existence of a system of contrcl is not essential to an examination and the expression of an unqualified opinion, but the work necessary for such an opinion is greatly increased where there are no controls.

Forms of Fraud

One purpose of a system of internal control is to prevent or control fraudulent practices. If the auditor is satisfied as to the effective operation of the system he may lessen his watchfulness for evidences of fraud. Most cases of fraud occur because there is no internal control or because some phase of the system has been circumvented.

Modern audit programs are based on an extensive use of tests. They are not designed to disclose all fraudulent practices but place reliance on the internal control system to prevent fraud. While the detection of fraud is not the major purpose of an examination, the auditor knows that fraud may occur at any time and in any of several forms. He must be constantly alert to notice signs which may indicate fraudulent practices and he should know the methods commonly used. It is essential that

he be able to recognize these signs or clues as he performs his regular work.

Most fraud takes place in the cash, accounts receivable, and accounts payable areas. Some common practices used and methods of disclosing the practices are shown below.

Practice. Fail to ring up a cash sale on the cash register and keep the cash received.

Disclosure. This is generally difficult to disclose at the time. It may show up through a lower than normal rate of gross profit. Use of spotters may disclose if the practice is general.

Practice. Overstate cash discounts and abstract the cash. A variation is to allow a cash discount when none was taken.

Disclosure. This practice is disclosed by making individual tests of the discounts granted. Application of the discount rate to the amount credited to accounts receivable will disclose the practice immediately if the cashier has been too greedy. It is necessary to know the firm's practice with respect to late discounts and to compare sales invoices with cash receipts to disclose the variation.

Practice. Underfoot the cash column of the cash receipts book and some credit column other than accounts receivable. Abstract cash by the amount of the underfooting.

Disclosure. Foot the cash receipts book, preferably all columns.

Practice. Lapping. This is a method of deferring credits to customers' accounts, withholding cash in the amount of credit deferred. For example, A pays $100. The cashier keeps the money and makes no entry. B pays $129.42. The cashier credits A $100 and either keeps the balance or credits B.

Disclosure. Obtaining statements from customers as to the amounts they owe the company is the best means of disclosing this practice. A clue may be provided if a scanning of the customers' accounts indicates an unreasonable number of odd credits posted to the accounts. Most customers will pay by invoice, by monthly balance, or in round amounts. If there are many odd credits, relative to the debits, the investigation should be extended.

Practice. Overfoot the cash column and an uncontrolled debit column in the cash disbursements journal.

Disclosure. Foot the cash column and all uncontrolled columns of the cash disbursements journal.

Practice. Present fictitious invoices for payment. Present actual invoices for payment a second time.

Disclosure. Normally this method requires collusion with an outside party. The auditor should demand supporting documents (in addition to the invoice) for checks written. He should also satisfy himself as to the existence of the creditors.

Practice. Kiting. Two bank accounts are necessary. A check on bank X, preferably located in another town so that the time lag is longer, is deposited in bank Y shortly before the year end. No entry is made on the books either for the check drawn or for the deposit. Thus, the cash balance in banks is increased by the amount of the deposit. This device is used to cover an existing shortage.

Disclosure. All bank transfers near the year end should be verified. Cutoff statements from both banks should be requested, as well as direct advice of all charge-backs.

Practice. Payroll padding. This may take the form of fictitious employees, excessive payments to actual employees, or retention of an employee's name on the payroll records after he has been separated.

Disclosure. Review the internal control as it relates to the payroll procedure. Observe the distribution of payroll checks on a surprise basis. Obtain the list of employees from the personnel department and compare it with the payroll sheet.

The practices listed above are typical of fraudulent activities encountered by the auditor. The list certainly is not exhaustive and is included only to indicate to the student some of the devious ways in which cash disappears, and how the auditor applies his techniques to disclose the irregularities. It should be recognized that where an adequate system of internal control exists these methods would be difficult if not impossible to put into practice. However, where collusion exists almost any system of control may be defeated.

QUESTIONS AND PROBLEMS

1. How should a company's auditor be selected?

2. Name ten points that should be covered in the first interview with the client.

3. Name ten things that the client's staff may do to aid the progress of the examination.

4. What supplies should the auditor take with him when he starts an engagement?

5. You are starting an engagement tomorrow, on which you worked last year as a junior. This year you will have one experienced junior to assist

you. Outline your program for the first morning's work for yourself and for your junior.

6. Define *internal control.*

7. Who has the primary responsibility for the maintenance of an effective system of internal control? Why?

8. Why does the auditor review the system of internal control?

9. How does the auditor proceed to review the internal control system?

10. Outline a system of internal control for a small store, club, fraternity, or other business with which you are familiar.

11. In auditing the accounts of a small manufacturing concern you find that the manager (who is not a stockholder) has a contract with the company which provides that he is to receive, in addition to his salary, a commission on all the company's sales in excess of $400,000. The books show net sales of $850,000. You also note that the sales manager acts as office manager, supervising the accounts and the granting of credits.

Under these conditions what matters would receive your special attention during the audit?

12. List five methods of obtaining cash fraudulently from cash receipts, and indicate the audit method necessary to disclose each.

13. Four situations are shown below. After examining each one as to the internal control, or lack thereof, indicate where you would expand or contract your audit program in each case.

1. The cashier records cash receipts and posts to the accounts receivable subsidiary.

2. The cashier records cash receipts and disbursements. He does not have access to the receivables ledger but does control the paid and unpaid voucher file.

3. Cash receipts are listed in duplicate by mail clerks. The cash, checks, and original listing are sent to the treasurer's office where the daily deposit is made up. The duplicate list goes to the cashier and from him to the accounts receivable clerk. The monthly bank statement goes directly to the treasurer's office and is reconciled there. The cashier writes but does not sign checks in payment of vouchers. The checks go from the check signer directly to the mail room for mailing to the payee. Vouchers are stamped PAID after the checks are signed.

4. The payroll is computed from time cards and entered in the payroll book by a payroll clerk. This clerk also computes the amount of cash necessary for the payroll, obtains a payroll check from the cashier, cashes it, prepares the pay envelopes and pays off the employees.

14. Why should the auditor make a tour of the plant?

15. What are some of the basic principles of internal control as it applies to the financial aspect of operations?

Chapter 3

THE AUDIT PROGRAM AND AUDIT WORKING PAPERS

THE AUDIT PROGRAM

When the study of the system of internal control has been completed and the auditor has evaluated its efficiency and determined the weak and strong areas, he is ready to prepare an audit program for the examination. The audit program is a map or guide for the conduct of the examination. It is preplanned and in some cases set down in detail, but it is always subject to revision in light of the circumstances encountered. Its use as a check list is valuable provided the auditor does not feel that he is restricted to the steps on the program or needs to go no further when his curiosity about a particular item or area is aroused by what he finds.

There are accountants who claim that they would not think of using a program of audit. Probably what they mean is that they would not use a formalized printed audit program. Every auditor who starts to make an examination must have some idea as to how he is going to approach the task. There must be some plan in his mind as to his general approach, otherwise his time used in completing the task would be excessive.

Most firms of any size have found that it is advantageous to have a preplanned guide. In some instances this is not set down in any great detail but contains only the broad scope and characteristics of the work to be done. In other cases, the audit program is a detailed schedule of audit procedures to be followed. There are advantages to each of these types of program, but the greater flexibility and other advantages of the detailed schedule favor its use. It is conceded that the program must be flexible and that seniors in charge must have full authority for

making necessary changes. If these factors are present, the advantages well outweigh the disadvantages. The use of some type of formalized audit program results in the following advantages:

1. The program serves as a guide for the engagement. Its use results in a minimum of lost time in the following out of the routine procedures.

2. It aids in the division and assigning of work to be done. This is particularly true on the bigger jobs where a rather large staff is used. With a detailed audit program available the senior can go through the program and make the assignments. He thus is able to get a better diversification for his staff. Through preplanning he can also do a better job in assigning work at the different levels to proper personnel, with respect to experience.

3. It is an aid in the placing of responsibility for work done. Many firms use the audit program in this manner by having the auditor who does the work initial the program to indicate that fact. Much of the work done does not result in the preparation of audit working papers. For these tasks, responsibility is thus indicated specifically. For those situations in which working papers are prepared, the signature of the auditor on the working paper places the responsibility for that portion of the work.

4. The use of an audit program enables a man coming on the job to find his place quickly. It sometimes happens that the senior in charge of an engagement is called off that job to start a new one. To the new man taking charge the audit program is very helpful in enabling him to determine what has been done and what remains to be done.

5. It is useful as a guide in planning the succeeding audit. The proper time for planning next year's audit is at the close of the current audit. All the information is fresh in the auditor's mind, and he has ideas at that time as to changes that should be made in the audit program. However, it is unusual to find an audit program being made up at this time. The senior on the job usually is busy writing his report and looking forward to the next engagement. Hence, the succeeding engagement is usually planned shortly before the first work is done on it. At that time, the audit program plus the "notes for next year's audit" worksheet provide a basis for making the plans for the current examination. In extremely large engagements there may be a plan for rotating the examination of the various units of the business. Here the audit programs for the preceding two or three years will aid in determining what phases of the business should next be examined. In many situations of this nature there is a master plan covering a period of many years, showing

the component parts of the organization which are to be audited in specified years. This master plan is also subject to revision as circumstances change.

6. The program enables the reviewer to make a better review with respect to standards and procedures. An audit program is helpful in determining the scope and adequacy of the procedures followed in the examination.

There are some disadvantages alleged for the use of an audit program. Some auditors claim that the audit program results in restricting the man in charge to the items that appear on the program, and as a result his initiative is minimized. It must be recognized that the program must be flexible, and that the senior should expand or contract the audit steps as circumstances require. This alleged disadvantage will depend more on the auditor than on the use of a program. If the auditor is a mechanical auditor and is without initiative, the examination will reflect it whether an audit program is used or not.

There is illustrated in Exhibit 3-1 a section of an audit program, which is indicative of the type of direction usually employed in setting forth the audit steps to be followed. The parts of the audit program having to do with the examination of specific accounts will be developed in the related chapters.

Exhibit 3-1

AUDIT PROGRAM

Petty Cash

Secure or place under seal all cash and negotiable securities.
Count and list all cash and noncash items found in the petty cash fund.
Have the client's representative observe the count.
Obtain agreement from the client's representative as to the total count.
Remove by journal entry all noncash items.
Return fund to custodian and obtain release.
Make a second count on a surprise basis if deemed necessary.
Vouch petty cash transactions for test periods.

AUDIT WORKING PAPERS

In making an examination the auditor prepares or fills in many types of worksheets, schedules, analyses, extracts, questionnaires, and related papers. These records comprise the audit working papers and represent a summary of the auditor's work on the examination. Their importance

to the auditor will be developed below in relation to the purpose they fulfill. Their major objective is to substantiate the audit report that is made to the client. Sample working papers will be included in the following chapters so as to give the student a fair idea of the part that they play in the examination of a business.

Purposes of Audit Working Papers

As the basis for writing the report. The audit working papers are prepared during the course of the examination. They contain summaries of the transactions reflected in the client's records and they contain a record of the work performed by the auditor in the various phases of the examination. They are devised in such a fashion that they accumulate the information which the auditor needs for forming an opinion as to the fairness of the financial statements and for writing the formal report. If the papers are deficient or poorly prepared, the difficulties encountered in writing the audit report are increased tremendously.

As a basis for reviewing the report. As the engagement progresses, a rather detailed review of the audit working papers is usually made by the individual next in rank above the in-charge senior. This may be a supervisor, a manager, or a partner, depending upon the size of the engagement and the size and structure of the audit firm.

It is through a review of the audit working papers and the audit program that the reviewer determines whether or not the engagement was carried out in accordance with generally accepted auditing standards. These standards have now become fairly well formalized and it is up to the individual practitioners and accounting firms to make certain that their examinations conform.

After the engagement has been completed and the audit report written, there must be a review of the report to determine that the material it contains is supported by the information included in the working papers. The accounting firm takes full responsibility for the audit report and it is only natural that there be some review of the report before it is issued. This review is made either by an individual in the upper echelon of the firm or by a report department, to determine not only that all statements made are supported by the working papers but also that the report has been prepared in accordance with the practices and policies of the firm.

An incidental use of the working papers is that the reviewer gains an impression of the abilities of the various men who work on the job. The working papers constitute one measure of the quality of their work.

Complete and carefully prepared papers usually are an indication of thoroughness in the conduct of the examination. Where two men are equal in other abilities, the one who prepares the better working papers will certainly forge ahead more rapidly. The ability to prepare good working papers must be developed in the field, but certainly a start may be made at the college level.

As a defense in case of litigation. While no auditor looks forward to spending a day in court because a client or an investor has suffered a loss and is suing for recovery, such an eventuality may occur. These suits often claim that the auditor's report was misleading or that the audit was deficient. The auditor's best defense is that he has made a proper audit and that in his opinion the client's financial position was fairly presented. The proof of his defense lies in his working papers. The papers should indicate clearly the audit procedures followed, the points in dispute, the decisions made, and the work done. Then, in the light of the generally accepted auditing standards and procedures in force at the time of the audit, a decision may be reached by a judge or a jury as to the adequacy or inadequacy of the examination. Obviously, if the auditor's papers are in such poor shape that they do not support his claims, he must avail himself of such other defenses as he can and attempt to prove his point without the aid of these papers. Since the auditor is constantly held to higher and higher standards and responsibilities, it is of growing importance that the working papers be of such character that they will stand up under judicial examination and scrutiny.

As an aid in future examinations by Internal Revenue agents. Again, if the papers have been properly prepared, the auditor will be able to answer quickly many of the questions asked by the examining agents. This is true particularly with respect to income tax returns. Since most of the questions that arise are of the accounting nature, most of the answers should be in the working papers. Even where the client has prepared the tax return, the auditor should have reviewed it and should have taken note of any questionable items, satisfying himself that the items are proper and noting in his working papers the basis for the inclusion or noninclusion. The ability of the auditor, aided by his working papers, to provide satisfactory answers to the questions raised by the agent is a service to the client that inures, indirectly at least, to the auditor's benefit. If the auditor has prepared the tax return, he should have a special set of working papers that will include most of the material that may be questioned.

As an aid in succeeding examinations. In repeat examinations, one of the auditor's first steps is to review the preceding year's working papers. This review refreshes his memory as to the basic problems he is apt to encounter on the engagement. It also reminds him of any special characteristics of peculiarities of the client's business and will enable him to recall their treatment. His review of the "notes for next year's audit" will recall to his mind the special points which he wants to take up during the current examination. If the examination is a new one for the auditor, the preceding year's working papers will supply him with a vast amount of background material which will enable him to proceed with his work without asking many time-consuming questions. While most clients are happy to answer the auditor's questions, they do get tired of answering the same questions year after year. The working papers should contain most of the basic information relating to the examination.

At the same time the auditor should not rely too heavily on last year's working papers. This initial review of the papers should be made with the thought in mind that they may be improved. Each year the auditor should attempt to prepare better papers than the preceding set. This does not necessarily mean more papers. It may well be that some papers should be revised or eliminated. The best set of working papers is the one which presents the most information on the least number of pages without confusing the issue. A different type of working trial balance or a different method of scheduling certain accounts may result in the elimination of several working papers and a net saving of time. Certain papers may have lost their significance and should be discontinued. As each paper is prepared, the auditor should ask himself, "What is the purpose of this working paper? Is it necessary to a complete, truthful reporting of the account? Or is it prepared only because it was prepared last year?" Only a critical and continuing analysis will result in improved working papers.

As source material for other services. The expansion of public accounting into the field of management services is increasing. This is particularly true for clients with small businesses. The advisory service that the auditor can furnish the client on managerial problems is constantly expanding. The auditor's wide experience enables him to bring to the client abilities that most small clients could not hope to engage on a full-time basis as an integral part of their organizations. Preparation of budgets, development of different types of cost systems, the application of machine accounting, the new field of electronics, methods of

financing, the tax aspects of anticipated transactions represent just a few of the managerial problems for which the auditor can render valuable services to the client. Many of the basic data necessary for a studied opinion should be included in prior years' working papers.

As indicated earlier, many clients wish to have recommendations made with respect to changes in their accounting systems. The working papers should include information necessary for recommendations as to changes in policies, procedures, or systems. Where a complete reorganization of the accounting system is desirable, much of the necessary background information should be found in the working papers of prior years and in the permanent file.

Contents of the Completed Set of Work Papers

The completed set of work papers is composed of the following materials:

Pencil draft of the audit report and financial statements. The auditor's pencil copy of the report and of the accounting statements should be filed with the working papers. Presumably, this set has been used as the rough copy from which the final report was typed. After the typing has been completed, the copy should be returned for filing with the working papers.

Index. For easy reference and review, an index of the working papers should be prepared. This index is essentially a table of contents, showing in brief outline the major categories and subdivisions in which the papers are filed.

General information about this and future audits. Ordinarily, the next section of the papers is devoted to general information with respect to the current audit and to future audits. Exhibit 3-2 is typical of the general data sheet. There will also be included here the agenda sheet (Exhibit 3-3) on which the auditor has raised questions of particular problems that were not answerable at the moment or problems on which he feels some record is necessary to point up a decision that has been made.

There should also be a sheet dealing with the succeeding audit. All points on which the auditor wishes to comment with respect to changes in audit program, changes in the make-up of working papers, or other phases of the examination for the ensuing year should be included. This sheet is one of the most helpful that can be prepared, particularly if a different staff member is given the engagement the next year. If a formal audit program has been used, it should be included here.

Exhibit 3-2

AUDIT PROGRAM

General Data

Report data
- Client____________________
- Title of report____________________
- Date of report____________________
- To be addressed to____________________
- Number of copies____________________
- Report needed by____________________

General data
- Exact name of client____________________
- Address: Home office____________________
  - Branches____________________
- Scope of examination____________________
- Date of starting____________________

Type of organization____________________
- Date organized____________________
- Officers and key employees____________________
- Attorneys____________________
- Directors, trustees, partners____________________
- Personnel making examination
  - Partner____________________
  - In-charge senior____________________
  - Assistants____________________
- Who reviewed post-balance sheet events____________________

Many firms file the internal control questionnaire with the permanent file, but in those instances where it is filed in the current working papers, it may be included with this section of the papers.

Working trial balance. Most auditors will use a preclosing trial balance as the basis for their working trial balance. There are many forms that this trial balance may take. A typical one is shown in Exhibit 3-4. The auditor should develop a form to suit the particular circumstances of the engagement. Some examples of different types of trial balances are shown in Exhibits 3-5 and 3-6.

The working trial balance is the auditor's most important working paper. He may measure the progress of his examination through controls set up on the working trial balance; he reviews much of the

Exhibit 3-3

NO. 5400

Aaronson Mfg. Corp.
Agenda Sheet
December 31, 1961

Questions	Answers
Why is the Jones Corp. not consolidated?	Not in the same general industrial pattern.
M. James, treasurer, has borrowed $10,000. No approval.	President signed our analysis of the account in approval.
Control over unclaimed payroll checks is poor.	Discussed with treasurer. We should suggest better procedure in our letter re internal control.
Client insists on showing treasury stock purchased this year as an asset. Refer to supervisor.	Supervisor convinced client that it should be shown in capital stock section.

operational work through the operating columns of the working trial balance; and finally he prepares the accounting statements from figures developed on these sheets. Consequently, this particular worksheet should be prepared early in the engagement.

Regardless of its design, the working trial balance should include a

trial balance of the preceding year. Most auditors are content to include only the balance sheet accounts. Some, however, insert also the operating account balances. The inclusion of the preceding year's balances serves several purposes. Of most importance to the auditor is the fact that, having taken these figures from the client's books, he may now compare them with the amounts reported in the last year's audit report, either by referring to the report itself or by comparing the amounts with those shown in his last year's working papers. This comparison enables the auditor to make certain that the adjusting journal entries of the preceding year have all been recorded by the client. He will also be able to determine whether or not any additional changes of which he was unaware were made prior to the closing of the client's records. Of more importance, the preparation of the beginning and ending trial balances in contiguous columns enables the auditor to make a quick comparison to determine the major changes which have taken place during the year. A review of the two trial balances will give him some idea of what to expect to find in his examination of the records.

Each sheet of the trial balance should contain the client's name, the date of the audit, the initials of the auditor who prepared the sheet, and space for the proper referencing of the working papers. Where many sheets are included in the working trial balance the auditor usually will save time if he totals each sheet separately and on the last sheet recapitulates the page totals to arrive at the grand totals. Unless the auditor is very familiar with the accounts, it is good practice to enter the accounts from the ledger on every other line. This method may waste a few lines, but it is better to have a few vacant lines than to have to crowd the items on the worksheet. In fact, for such accounts as cash and accounts receivable, where numerous adjustments are anticipated, it is well to leave additional lines blank. Regardless of the way in which the general ledger is set up, the auditor should list the accounts on his trial balances in statement order. Further, there should be separate sheets for assets, liabilities and net worth, income, and expenses. This makes easier the preparation of the financial statements. In extremely large engagements the auditor may very well find that the general ledger is composed only of control accounts, with subsidiary ledgers supporting these accounts. In such instances the auditor will want to prepare a trial balance of each of the subsidiary ledgers to support the general ledger trial balance.

Exhibit 3-4

Aaronson Mfg. Corp.
Working Trial Balance
December 31, 1961

Account	Trial balance, January 1, 1961 Dr.	Trial balance, January 1, 1961 Cr.	Trial balance, December 31, 1961 Dr.	Trial balance, December 31, 1961 Cr.	Adjustments Dr.	Adjustments Cr.	Manufacturing Dr.	Manufacturing Cr.	Profit and loss Dr.	Profit and loss Cr.	Balance sheet Dr.	Balance sheet Cr.	W/P
Petty Cash	600.00		600.00			(1) 482.12					117.88		C1
Cash on hand	1,846.50				(A) 1,813.25						1,813.25		C2
Cash in bank	32,551.10		46,212.90			(A) 1,213.25 (2) 321.50					44,678.15		C3
U.S. Securities	50,000.00		20,000.00								20,000.00		D1
Accrued interest	263.13		263.13			(4) 154.80					108.33		D2
Accounts receivable	41,452.50		54,112.20		(7) 2,150.00						56,262.20		E1
Notes receivable	51,000.00		15,000.00								15,000.00		E3
Accrued interest on notes receivable	51.00		51.00		(9) 99.00						150.00		E3
Allowance for doubtful accounts		3,860.10		515.21		(12) 4,152.12						4,667.33	E6
Raw materials	22,415.10		22,415.10		41,510.20	41,510.20	22,415.10	41,510.20			41,510.20		F1
Work in process	6,215.50		6,215.50		11,251.00	11,251.00	6,215.50	11,251.00			11,251.00		F1
Finished goods	30,312.25		30,312.25		28,316.80	28,316.80			30,312.25	28,316.80	28,316.80		F1
Inventory in transit	8,152.50		8,152.50				8,152.50						
Interest income				481.20	(4) 154.80	(9) 99.00				425.40			S1
Discount on sales			2,210.51						2,210.51				S2
Loss on sale of securities			141.50						141.50				H1
Interest expense			3,128.20						3,128.20				S3
Federal income tax					(12) 3,350.00				3,350.00				O4
Totals – page 3			648,720.20	4,121.20	37,461.35	416.72	242,467.18		96,421.50	5,278.91	—	—	
2	32,363.20	301,303.79	214,812.15	1,105,208.54	33,607.83	38,756.43	—	—	13,278.13	364,615.75	39,414.22	70,416.37	
1	327,462.12	58,521.53	310,512.81	64,715.42	91,560.75	123,456.78	36,783.10	51,761.20	30,312.25	28,316.80	338,422.14	276,609.49	
Grand totals	359,825.32	359,825.32	1,174,045.16	1,174,045.16	162,629.93	162,629.93	279,250.28	51,761.20					
Cost to manufacture								227,489.08	227,489.08				
							279,250.28	279,250.28	367,400.96	398,211.46	377,836.36	347,025.86	
Net income									30,810.50			30,810.50	
									398,211.46	398,211.46	377,836.36	377,836.36	

Adjusting journal entries and reclassification entries. As the examination progresses the auditor may find it necessary to make entries to adjust or correct the accounts as they appear on the general ledger. These entries should appear in two or three places in the audit working papers.

1. Each entry should appear on a chronological listing of journal entries.
2. The entries should be posted to the working trial balance.
3. In all cases where there is a supporting schedule or analysis dealing with the account involved, that portion of the journal entry applying to the account should also appear on that schedule or analysis.

As the auditor encounters situations where adjustments are necessary, he sets up these adjustments on a chronological list of journal entries. The entries that he makes should use the account titles preferred by the client so there will be no question as to the meaning of the entries. At the end of the engagement the auditor will give to the client the complete list of journal entries so that they may be recorded. It should be remembered that the auditor is not responsible for the preparation of the accounting statements but merely submits an opinion as to their fairness. Thus it is essential that the adjustments he makes be incorporated in the books prior to the issuance of the statements. Only if this is done will the accounting statements reflect the accounts shown in the ledger. Each entry should contain a concise explanation so that the client will be able to set up the entries without calling the auditor for assistance. In some situations the client puts the entries on the books as soon as the auditor prepares them. Obviously, the client must agree to the entry before the auditor makes it.

In addition to adjusting entries, it may be necessary to make reclassification entries for statement purposes, which the client probably will not want to put on his books. Illustrative of this type of entry would be a reclassification of vendors' debit balances as accounts receivable. In recording these reclassifying entries, it is good practice to use a different identifying system. If the regular entries are numbered, these may be lettered, or vice versa.

The adjusting and reclassification journal entries should be posted to the working trial balance as they are set up on the list of entries. Some type of posting mark should be placed against the amounts in the list of entries as they are posted. A different mark may be used to indicate

Exhibit 3-5

Abel-Manning Co.
Working Balance Sheet
December 31, 1961

Line	Account title	Trial balance December 31, 1960 (Dr.)	Trial balance December 31, 1960 (Cr.)	Trial balance December 31, 1961 (Dr.)	Trial balance December 31, 1961 (Cr.)	Adjustments Dr.	Adjustments Cr.	Balance sheet (Dr.)	Balance sheet (Cr.)	W/P
1	Petty Cash	1000.00		1000.00				1000.00		C1
2	Cash in bank	58462.21		49452.12				49452.12		C2
3	Accounts receivable	81516.42		114721.60		(A) 4267.15		118988.75		D1
4	Reserve for bad debts		5141.95		1112.21		(B) 6842.14		7954.35	D4
5										
6	Notes receivable			4250.00				4250.00		D5
7	Accrued interest on					(10) 35.82		35.82		D7
8	notes receivable									
9	Merchandise inventory	92151.42		98179.63				98179.63		E1
10										
11	Prepaid insurance	2498.76		4119.47			(12) 2089.50	2029.97		F1
12	Supplies inventory	1040.51		6721.46			(16) 5161.40	1560.08		F3
28	Capital stock		250000.00		250000.00				250000.00	S1
29	Retained income		101268.71		76268.71				76268.71	S2
30	Net income		—		48755.96	8162.71			40591.25	
31	Totals - page 2	—	456721.60	—	512471.89	9471.15	4445.47	—	512270.15	
32	1	567945.95	111224.35	618743.43	106271.54	8456.52	13482.20	639682.31	127412.16	
33		567945.95	567945.95	618743.43	618743.43	17927.67	17927.67	639682.31	639682.31	

whether or not the item has been posted to a supporting schedule. Two types of adjusting journal entry working papers are illustrated in Exhibits 3-7 and 3-8.

Analyses, schedules, etc., relating to each phase of the examination. The bulk of the working papers will be composed of this group of papers. Included therein will be such items as analyses of the balance sheet accounts, bank reconciliations, accounts receivable aging schedules, confirmations of various types, inventory schedules, investment schedules, fixed assets and depreciation schedules, expense account analyses, and all the other papers that support the final account balances. There is illustrated in Exhibit 5-9 (page 139) a summary schedule for cash, and in Exhibit 5-6 one of the supporting schedules, in this case a bank reconciliation.

Abstracts of minutes, contracts, and other documentary evidence. This section of the papers contains abstracts of various nonfinancial documents which will be needed during the examination. Copies of minutes, leases, contracts, royalty agreements, and other such documents may be made available to the auditor for inclusion in his working papers, saving copy time. If duplicated minutes are provided the auditor should ask the secretary of the company for a statement certifying that the duplicates received are true copies of the original minutes.

Preparation of Working Papers

Working papers may take any of many forms as they are developed to fit particular situations. While there is a natural flow of material that tends to dictate the form to be used for the particular working papers, the auditor should be constantly alert to develop his papers along lines that will give the most information with a minimum of effort. To a degree, the type of paper and the form it takes are dependent on the type of service that is being rendered. If the audit being made is strictly a balance sheet audit a particular working paper may take one form, but if a general audit is being conducted it may need some expansion or revision. The important fact to remember is that the working papers should contain the information necessary to support the report and opinion.

Regardless of the particular form that the various working papers take, each sheet should incorporate certain desired information. While there may be a variation among particular firms as to the spacing or

Exhibit 3-6

Antaz-Viking Co.
Working Operating Statement
December 31, 1961

Operating accounts	Trial balance, December 31, 1961		Adjustments, dr.	Adjustments, cr.	Manufacturing, dr.	Trading, cr.	Selling expenses, dr.	Administrative expenses, dr.	Temporary items, dr.	W/P
Sales		738562.14		(31) 2850.00		735712.14				T1
Sales returns	815.00					(815.00)				
Sales allowances	421.20					(421.20)				
Materials purchases	212573.50				212573.50					H3
Freight in	4761.12				4761.12					
Direct labor	178575.45			(35) 1254.25	177321.20					H7
Superintendence	23462.00									
Salesmen's salaries	71451.25		(38) 1462.00				72913.25			
Travel and entertainment	12561.80						12561.80			
Sales supplies	3957.50						3957.50			
Depreciation, sales equipment	3650.00						3650.00			K10
Taxes, sales department	2265.20						2265.20			K4
Advertising	25057.70						25057.70			H9
Officers' salaries	90000.00							90000.00		H7
Telephone and telegraph	874.25							874.25		
Miscellaneous office expense	2120.18							2120.18		H13
Interest income		1762.20		(12) 107.80					(1870.00)	H16
Purchase discounts		4018.52							(4018.52)	H17
Interest expense	270.00			(32) 60.00					210.00	H18
Inventory adjustments:										
Raw material				(9) 3416.20	(3416.20)					I1
Work in process				(9) 2115.50	(2115.50)					I1
Finished goods				(9) 2871.46		2871.46				I1
Federal income taxes			(41) 44206.20						44206.20	P7
Net income per books	40368.15		41320.01							
Totals	1634715.50	1634715.50	11418.52	11418.52						
Cost of goods manufactured					403728.56	(403728.56)				
Gross profit						329318.78	(329318.78)			
Net selling profit							(203412.20)	(203412.20)		
Net operating profit								(86211.51)	(86211.51)	
Net income									47683.83	

Exhibit 3-7

Agamemnon, Inc.
Adjusting Journal Entries
December 31, 1961

Line	Account / Explanation	Debit	Credit
	(1)		
1	Due from employees	50.00	
2	Freight in	14.72	
3	Miscellaneous office expense	12.14	
4	Petty cash		76.86
5	To remove noncash items from petty cash.		
6			
7	(2)		
8	Cash in bank	740.00	
9	Bank service charge	10.00	
10	Notes receivable		750.00
11	To record collection by bank of A. J. Malik note		
12			
13	(3)		
14	Bank service charge	5.86	
15	Cash		5.86
16	December service charge		
17			
18	(4)		
19	Loss due to market decline of securities	248.75	
20	Provision for loss on U.S. Securities		248.75
21	To recognize loss on market value of		
22	temporary investment		
23			
24	(5)		
25	Accrued interest on U.S. Securities	87.50	
26	Interest income		87.50
27	To accrue interest on securities to		
28	December 31, 1961		

Exhibit 3-8

Agamemnon, Inc.
Adjusting Journal Entries
December 31, 1961

Line		Balance sheet accounts		Operating accounts		Line
		①	②	③	④	
1	Net income per books				42481 57	1
2						2
3	①					3
4	Due from employees	50 00				4
5	Freight in			14 72		5
6	Miscellaneous office expense			12 14		6
7	Petty cash		76 86			7
8	To remove noncash items					8
9	from petty cash					9
10						10
11	②					11
12	Cash in bank	740 00				12
13	Bank service charge			10 00		13
14	Notes receivable		750 00			14
15	To record collection by bank					15
16	of A. J. Malik note					16
17						17
18	③					18
19	Bank service charge			5 86		19
20	Cash		5 86			20
21	December service charge					21
22						22
23	④					23
24	Loss due to market decline					24
25	of securities			248 75		25
26	Provision for loss on					26
27	U. S. securities		248 75			27
28	To recognize loss on market					28
29	value of temporary					29
30	investments					30
31						31
32	⑤					32
33	Accrued interest on U.S. securities	87 50				33
34	Interest income				87 50	34
35	To accrue interest on					35
36	securities to December 31, 1961					36
37						37
38				291 47	42569 07	38
39					291 47	39
40	Net income carried forward				42277 60	40

placing of this material, its inclusion is almost universal. Somewhere on each sheet there should be shown the following:

1. The name of the client (or a number)
2. Date of audit
3. Title of the particular sheet
4. The body of information
5. Explanation of audit marks used
6. Program of work done
7. Auditor's signature or initials
8. Reference or cross-reference marks

The reader should examine Exhibits 3-9 and 5-6 to see where and how these eight items are shown on the working papers. The client's name or number is essential to the working papers in case some of them are separated from the bulk of the papers. Because of the very confidential nature of these papers, some auditing firms elect to use a number instead of the client's name, so that if the papers do fall into unauthorized hands, the information shown will be meaningless. The date of the balance sheet should also appear on these sheets as further identification. Each worksheet should contain a title descriptive of the material it bears.

As the auditor makes his examination it is customary for him to place various marks against the amounts shown on the schedule. The purpose of these audit marks is primarily to indicate work performed. Some firms use a series of standard marks. Others leave this to the auditor's ingenuity. Where there is no standardization it is essential that the auditor explain on each sheet the meaning of the marks that he has used. It may be necessary at times to make audit marks on the client's books. These marks should be so small that they do not deface the records. In some cases the position of the marks is meaningful to the auditor. For example, a small *a* under a total may mean that the auditor has proved the total. If it is placed to the left of the total, it may mean that he has crossfooted a series of totals. Where many marks are made in the client's books and there is no standardization, a separate worksheet should be prepared for inclusion in the working papers showing the symbols used and the meanings to be attached to them.

Many of these marks, particularly as shown in the working papers themselves, will mean that certain audit procedures have been followed. Unless there is a full explanation of the meaning of these marks, their value is lost. Oftentimes, additional audit steps will be taken which are not identified by any particular marks. In these cases, a separate listing

of the steps taken should be filed with the papers relating to the account examined.

The auditor who prepares the working paper should take responsibility for that portion of the examination. He should initial or sign each sheet as an indication that he performed the work and assumes the responsibility therefor. Even where one auditor makes the complete examination himself he should initial the papers so that there will be no question at any future time as to who made the examination.

Since the working papers are of such importance, care should be taken in their preparation. The following qualities are characteristic of a well-prepared working paper:

1. It should be neat. Not only does this result in a pleasing appearance, but also it makes the paper easier to read and understand.

2. The writing should be legible. It does not make much difference how valuable the information on the sheet is if it cannot be read. Since time is such a factor in auditing, it is easy to get into the habit of writing hurriedly, which sometimes results in illegibility.

3. The paper should be understandable; that is, the information should be so arranged that there is a logical development of the data. This makes the paper much easier to review and understand.

4. The paper should be complete. All the various data and explanations discussed above should be included. More important, the information shown in the paper should be informative and complete enough so that the reviewer does not have to ask for additional information concerning the account.

5. Finally, in the interest of legibility and clarity, only one side of the paper should be used.

In developing working papers the auditor should give thought to the design and form of the sheet before he starts. Nothing is more time wasting than copying working papers because they were not arranged correctly the first time. The time taken in developing the paper mentally before a start is made is time well spent.

The Account Analysis

One of the most commonly used audit papers is the account analysis. The purpose of such an analysis is to disclose the component parts that make up the final balance of the account and to indicate the sources of the entries. The data in the account may be set down in different ways, according to the auditor's wishes. In Exhibit 3-9 the information is

Exhibit 3-9

The Hall Company
Automobiles
December 31, 1961

	Dr.		Cr.	
Balance, December 31, 1960	22462.18	"		
3/15/61 License plates	82.00			
4/15 Two-door Chevrolet sedan	2851.50	V		
6/30 Sold 1955 Chevrolet			250.00	T
10/1 Four-door Mercury sedan	3425.00	V		
	28820.68		250.00	
	250.00			
Balance per ledger, December 31, 1961	28570.68			
AJE (17) To expense license plates			82.00	
AJE (18) To remove balance of cost of car sold			1640.18	
	28570.68		1722.18	
	1722.18			
Balance per audit	26848.50			

" = Traced to last year's working papers. Examined minutes for authorization of purchase and sale.
V = Vouched purchase of cars.
T = Traced to cash receipts book. Examined repairs account

WBJ

shown as it appears in the account. Another auditor might want to list all debits first, then all credits. Regardless of the precise form of the analysis, there should be an agreement with the ledger balance before any audit adjustments are applied. It is the client's account that is being examined, not the auditor's concept of a correct statement of the account.

Indexing the Working Papers

The working papers should be completely indexed for ease of reference, permitting quick access to any paper desired. Several different methods are in common use today. The audit firm sets the pattern or, if the auditor is working for himself, he chooses that method which seems to him most applicable. One complete indexing system is shown below and portions of other methods are shown to illustrate them. No one method is preferred, but the auditor should be consistent in his application of the method chosen. The index symbol may be inserted in the upper or the lower right-hand corner of the worksheet. Ordinarily, colored pencil is used so that the symbols will stand out clearly.

First method. This method employs capital letters as category symbols, with arabic numerals and small letters as needed to complete the file. This method is possible of infinite expansion.

- A General matters
  - A1 Data with respect to client
  - A2 Notes for next year's examination
  - A3 Agenda sheet
  - A4 Audit program
- B Trial balances
  - B1 Balance sheet accounts
  - B2 Operating accounts
- C Adjusting journal entries
  - C1 Adjusting journal entries
  - C2 Reclassification entries
- D Cash—Summary
  - D1 Reconciliation—First National Bank
    - D1a List of outstanding checks
    - D1b Bank confirmation
  - D2 Reconciliation—Second State Bank
    - D2a List of outstanding checks
    - D2b Bank confirmation
    - D2c Proof of disbursements with bank clearings
    - D2d Proof of receipts with deposits

- D3 Reconciliation of payroll bank account
- D4 Petty cash

E Securities

- E1 U.S. securities

F Accounts and notes receivable

- F1 Accounts receivable retail
- F2 Accounts receivable wholesale
- F3 Notes receivable
- F4 Allowance for doubtful accounts
  - F4a Retail bad debts written off
- F5 Accrued interest receivable

G Inventories

- G1 Inventory summary
- G2 Finished goods inventory
- G3 Work-in-process inventory
- G4 Raw materials inventory
- G5 Test of salability
- G6 Inventory on consignment
- G7 Inventory certificate

H Prepayments

- H1 Unexpired insurance
  - H1a Insurance calculations
- H2 Supplies inventory

J Long-term investments

- J1 Investment in affiliate
- J2 Deposits

K Fixed assets

- K1 Machinery and equipment
- K2 Allowance for depreciation, machinery and equipment
- K3 Furniture and fixtures
- K4 Allowance for depreciation, furniture and fixtures
- K5 Leasehold improvements
- K6 Office equipment
- K7 Allowance for depreciation, office equipment

L Current liabilities

- L1 Accounts payable
- L2 Notes payable
- L3 Customers' credit balances
- L4 Officers' salaries accrued
- L5 Accrued payroll taxes

- L6 Federal income tax withheld
- L7 Estimated federal income tax payable
- L8 Liability certificate

M Equity accounts
- M1 Capital stock
- M2 Premium on stock
- M3 Retained income

N Operating accounts
- N1 Sales summary
- N2 Payroll data
- N3 Interest income
- N4 Selling expenses
- N5 Administrative expenses

O Minutes
- O1 Minutes of stockholders' meetings
- O2 Minutes of board of directors' meetings
- O3 Minutes of finance committee meetings

In cases in which the accounts are so numerous that the alphabet is exhausted, double letters may be started. In one variation of this method of indexing, single letters are used for asset accounts and double letters for liability and equity accounts. Triple letters, or P/L, or XX may be used for operating accounts.

Second method. In this method roman numerals are used for category classification and letters are used for detailed sheets within that category. Where additional subdivision is necessary, arabic numerals may be added for the detailed sheet giving supporting data. This method also is capable of indefinite expansion but at times may be difficult to read.

I General matters
- Ia Data with respect to client
- Ib Notes for next year's examination
- Ic Audit program
- Id Agenda sheet

II Trial balances
- IIa Working balance sheet
- IIb Working operating statement

III Journal entries
- IIIa Adjusting journal entries
- IIIb Reclassification entries

- IV Cash
  - IVa Petty cash fund
  - IVb Change funds
  - IVc Reconciliation—First National Bank
    - IVc1 List of outstanding checks
    - IVc2 Bank confirmation
  - IVd Reconciliation—Second State Bank
    - IVd1 List of outstanding checks
    - IVd2 Bank confirmation
  - IVe Proof of receipts with deposits
  - IVf Proof of disbursements with bank clearings
  - IVg Cash items for further investigation
- V Temporary investments—summary
  - Va Analysis of investments account
    - Va1 Schedule of stocks owned
    - Va2 Schedule of bonds owned

A third method sometimes encountered consists of a straight numbering of the papers as they are prepared. The chief disadvantage of this method is that in many cases the auditor wishes to rearrange his papers before they are finally filed. This means either that the numbering must be rearranged or that the indexing must wait until the job has been completed. If the auditor waits to index until the job is completed, he may have difficulty during the examination in finding papers that he needs.

After the papers have been completely indexed, the major analyses or summary sheets should be referenced to the working trial balance. Each account shown therein should have a reference opposite the final balance showing the number of the worksheet page which supports the balance. Then one can quickly find the support for any amount shown in the working trial balance.

There are many important cross references from one portion of the papers to another. The cross referencing aids in the review of the working papers and adds much to their value. Failure to make cross references means that an incomplete job has been done. In many cases this referencing is deferred until the final steps of the engagement, but it should never be omitted. Referencing and cross referencing are illustrated in Exhibit 3-10.

The auditor should also reference the minutes of the stockholders

Exhibit 3-10

Horace Chocolate Co.
Working Balance Sheet
December 31, 1961

	Trial Balance, December 31, 1960	Trial Balance, December 31, 1961	Adjustments, Dr.	Adjustments, Cr.	Adjusted balance sheet	
Cash on hand and in bank	26741.50	28122.52	3826.45	1154.40	30794.57	C

Horace Chocolate Co. — C
Cash Summary
December 31, 1961

		Per books	Adjustments Dr.	Adjustments Cr.	Per audit
Cash in bank	C1	26622.52	26.45 3800.00	8.20	30440.77
Petty cash	C3	500.00		285.20	214.80
Payroll advance fund	C4	1000.00		861.00	139.00
		28122.52	3826.45	1154.40	30794.57
					T/B

Horace Chocolate Co. — C1
Bank Reconciliation
December 31, 1961

		Per books	Per bank
Balance, December 31, 1961		26622.52	28972.13
Deposit in transit			5403.12
Check charged in error			2000.00
Note collected by bank		3800.00	
		30422.52	36375.25
Less outstanding checks	C2		5960.93
Bank service charge		8.20	
Reconciled balance		30414.32	30414.32
AJE (5) Write off of old checks		26.45	26.45
		30440.77	30440.77
		To C	

Horace Chocolate Co. — C2
Outstanding Checks
December 31, 1961

Date	Check	Payee	Amount
7/16/60	4214	Jones Supply Co.	11.16
10/12/60	4921	J.B. Smith	2.78
10/29/60	4998	James Anderson	12.51
3/6/61	5251	Powers & Co.	49.20"
8/14/61	5713	Long Bros.	271.50"
11/21/61	6064	Hobson & Glass	2412.48"
12/3/61	6131	Lyle & Son	1821.21"
12/28/61	6192	H.C. Miles	791.00"
12/31/61	6218	Wiggins Supply	589.09
			5960.93
			To C1

and board meetings to the proper accounts. This is usually done by placing in the abstract of the minutes the worksheet index number applying to the particular transactions. After the engagement is completed, the auditor should then review the abstract to make certain that there is a worksheet number for all major transactions reported.

Filing the Working Papers

The filing of the completed working papers constitutes a major problem for most accounting firms. Working papers are bulky and filing space is costly. Nonetheless, the papers must be kept where they are easily available and some of them must be retained permanently. Practice will vary between auditing firms as to the filing of papers, but the following system has been found practicable.

For even the small client the auditor should prepare two sets of working paper: the current file and the permanent file. Included in the permanent file will be all papers having to do with the long-term aspects of the client's organization. Matters of company policy, organizational data, historical information, data with respect to internal control, and running analyses of long-term accounts comprise the bulk of these papers. Each year there is also prepared a set of working papers for the current examination.

The basic division of filing space should be threefold. There should be one file containing current working papers, another for the permanent files, and a third for copies of the reports which have been issued. For larger clients it may be desirable to have a separate file for tax working papers and tax returns. There will also be a correspondence file containing all correspondence with the clientele.

Ultimately, the time may come when the auditor feels that working papers may be destroyed. It may be that the past years' working papers are of such an age that the auditor feels no benefit will be had by retaining them any longer; or it may be that the client has gone out of business, or for some other reason no longer is his client. In any event, until the papers have been completely destroyed, the auditor must maintain the confidential relationship that exists between himself and the client. This means that there must be a careful guarding of the papers and a supervision of their destruction.

The microfilming of working papers to conserve limited filing space is a rapidly growing practice. A minor problem brought about by this practice is the necessity of eliminating colored pencil marks since the film does not distinguish colors. This is not too serious a problem but one that the auditor must bear in mind in the selection of his audit marks.

Ownership of Working Papers

The working papers are the property of the auditor. A court case in 1927 decided this problem, and it has not been seriously questioned since. Though the client does not have the right to demand the working papers, most auditors certainly are willing to cooperate with their clients in furnishing them with any information they desire from the working papers. Again, the auditor must maintain control over the working papers. He should be present when they are examined or get the information himself for the client. As a general rule, no one but the auditor or the client should examine the working papers without specific authorization from the client.

QUESTIONS AND PROBLEMS

1. You have completed an examination and are on your way back to the office to write the report. During the trip back to the office you lose the working papers. Discuss the effect and consequences of the loss.

2. Outline the qualities you believe to be necessary to a good worksheet supporting a balance sheet account.

3. List the contents of the ordinary set of audit working papers. To whom do they belong? Why?

4. What type of audit working papers may be included under the heading of permanent file papers?

5. Give five reasons for the preparation of complete, legible working papers.

6. What is an audit program? When is the audit program prepared and by whom?

7. What are the advantages of an audit program?

8. Adjusting journal entries are recorded in three places in the audit working papers. Explain this statement.

9. What information should appear on each working paper prepared by the auditor?

10. Why should each journal entry contain an explanation?

11. Distinguish between adjusting entries and reclassification entries.

12. What is the purpose of indexing and cross-indexing the working papers?

13. Why are the preceding year's balances set up on the working trial balance?

14. Why should the auditor's audit marks be explained?

15. Differentiate between an audit program and a program of work done.

16. What is meant by an *agenda sheet* (otherwise known as a "to do sheet" or a "followup sheet")?

Chapter 4

AUDITING THE RECORDS OF ORIGINAL ENTRY

EXPLANATION OF AUDITING TERMINOLOGY

Within the accounting profession certain words have been assigned specialized meanings. Many of these words have other meanings in other professions. Even in the accounting profession some of these words are used in varying ways and some of them are used interchangeably. Some of the auditing terminology is explained below.

Voucher. A voucher is any written evidence underlying or supporting a business transaction. This definition is considerably broader than the one to which most students are accustomed. Using this definition, a voucher might be a minute book, a vendor's invoice, a clock card, a job order, or even correspondence.

Vouching. Vouching may be defined as the examination of underlying documentary evidence in order to verify the entries which are based upon that evidence.

Analyzing. The word analyzing is usually used by the accountant in connection with a ledger account. In this sense, analyzing means determining the composition of the items within the ledger account so that they may be more easily verified.

Footing. Footing means verifying the total of a column. Crossfooting means verifying the cross adding of columnar totals to arrive at a grand total.

Posting. Posting means tracing entries from the books of original entry to the ledger, or vice versa. The purposes of this test are to determine that all journal items have been entered in the correct accounts for the correct amounts and to determine that there are no entries in the ledger not arising from a journal entry.

Extending. Extending means multiplying one number by another to

determine the accuracy of a total. The term is used in reference to such things as invoices, inventory sheets, payroll records, and cost records.

Scanning. Scanning means reviewing fairly rapidly the major components of an account or a schedule in order to determine any variation from normal. As an example, the expense accounts are often scanned.

Verifying. Verifying is determining the correctness or truth of an item by competent examination.

Confirmation. A confirmation is the verification of some item from an outside independent source. Confirmations are received from banks, customers, suppliers, and lenders. In some instances, confirmations are taken from officers and employees, but the normal usage of the term envisages the receipt of a written document from an outsider.

Testing. Testing is verifying certain selected portions of a whole. Based on the result of the tests, the auditor forms an opinion as to the correctness or adequacy of the whole.

Check. The word "check" is used in so many diverse ways and has so many meanings attached to it that its use is eliminated from this text, except as meaning a written order to pay an amount on demand to a payee.

TESTING TECHNIQUES

The entire public accounting profession has been built on the assumption that selected tests of the correctness of a mass of material will substantiate the correctness of the mass. It would be most uneconomical to have the accountant examine all transactions in detail. The value of such work to the client certainly would not be worth the cost involved. Past experience has proved the validity of the testing techniques if the tests are properly applied. The major problem then is what to test, and more particularly, how much to test.

Attempts have been made to establish definite quantities that should be tested. Such attempts are doomed to failure because of the varying circumstances and the necessity to exercise judgment. It is true that most programs will be started with some preconceived notion as to the amount of testing to be done. However, as the job progresses factors arise which cause the auditor to extend or contract his testing program. The auditor's experience and judgment must, in the final analysis, determine for him just how much is to be done. The mass of transactions available for testing will also have a direct bearing on how much is to be done, as will the effectiveness of the internal control.

The most widely used type of sampling is the block sample. Under this method a block of items, on either a time or a numerical basis, is chosen for examination. This group of items is then given a detailed examination. It should be understood clearly that the word "test" applies only to the mass of transactions and not to the individual transactions examined. Each item in the block is examined thoroughly. If discrepancies are found, they are traced out to determine the correct answers. It may well be that the auditor will decide, after reviewing the item, that the error is too minor to correct, and he will ignore it. But before he can do this, he must first have all the facts before him. The error may be one of arithmetic or it may be, even though only small numerically, an error in principle which is so grave that corrective steps should be taken. The auditor should list the errors that he finds, so that when he has completed his test he will have before him factual data as to the number and magnitude of the errors. He should also indicate on this worksheet the disposition of the items. Some will be corrected and some will be ignored. Each item should be clearly marked, with the reason for the particular disposition.

For most medium-sized engagements the auditor probably will be willing to start with one-month blocks of transactions. The number of months he chooses to test will be determined on the basis of the factors discussed above. It is fairly common to test three months' transactions. In almost all cases the first month and the last month of the fiscal year will be examined. It is in these two months that any covering or uncovering of fraudulent practices will probably take place. In some cases it may be satisfactory to work with periods of less than one month. Then it probably will be desirable to use more than the normal three test months in order to extend the periods of time covered. In most situations it is better to use the full month for testing since most companies post their books of original entry monthly. This permits the test of the particular month to be intensive and complete, whereas if a shorter period were used, certain procedures, for example, tracing postings, would have to be omitted.

Thus, if January is to be one of the test months, all the work that the client has done in January should be examined in detail. It seems to the author that it would be manifestly unsatisfactory to examine, say, cash receipts for January, cash disbursements for February, accounts receivable for March, and sales for April. The objective of the test is to see that all the factors entering in the final balances in the accounts for any particular test period are in agreement. Unless all the

work is examined, there can be no satisfaction as to the make-up of these final balances. Where a system of internal control is highly developed, it may be satisfactory to test selected groups of transactions within the test month. Or, where a company makes postings for a shorter period, it would be perfectly satisfactory to use such a shorter period for a test period. The important point is to see that all entries and factors are integrated and examined to make certain that the final items entering into the ledger accounts are correctly stated.

Another type of sample used by auditors applies to accounts rather than books of original entry. The auditor analyzes the account, setting forth individually all significant items. All remaining items are included as one amount. The auditor examines, vouches, and reviews all the significant items. He either ignores or makes only isolated spot tests of the remaining items.

Thus, the auditor works both forward and backward. He makes concentrated tests of original evidences through the books of original entry and traces the results into the books of final entry. He also works from the books of final entry back through the books of original entry to the supporting documentary evidence.

Another sampling method that is receiving an increasing amount of study is known as "statistical sampling." This method uses in a more scientific manner the theory of mathematical probability. In any sampling method the auditor uses the probability theory. In statistical sampling the size of the sample drawn, the percentage of error for acceptable or rejection, and the level of probability of drawing an unrepresentative sample are much more closely defined than is true in other types of sampling.

The advantages claimed for statistical sampling are that it supplies the auditor with a much more objective basis on which to form his opinion, that it is considerably more effective in disclosing errors, and that, in many cases, the size of the sample necessary will be much smaller than that ordinarily drawn by the auditor. Where the sample is larger than that ordinarily taken, it means that the auditor has not previously used a broad enough base from which to form his opinion.

The difficulty of applying statistical sampling to the usual audit areas lies in several problems which have not yet been solved. In other fields where statistical sampling has proved effective, particularly in the field of quality controls, there is a homogeneity of samples to be tested. This is rarely the case in auditing. No two invoices are identical. Rarely are two sales invoices exactly the same.

There has not as yet been any general agreement as to what acceptable levels of probability of drawing unrepresentative samples should be, nor has an allowable percentage of error been determined and universally accepted. Perhaps the biggest problem to be solved is the definition of what constitutes an error for audit purposes. Of equal importance is the materiality of the error. Statistically, an error is an error regardless of the amount, but this obviously is not satisfactory for audit purposes.

While studies are going forward for determining the applicability of statistical testing techniques, their use to date has been limited mainly to such areas as the testing of accounts receivable aging, inventory work, and to a lesser degree some of the books of original entry. It should also be indicated that these statistical techniques are used only for clients of the largest size. The student should keep abreast of this field by readings in current periodical literature. It is presumed that at some future date the problems in statistical sampling will be solved and the method will become more generally accepted than it is at present.

Regardless of the final size of the sample determined, certain requirements must be fulfilled if the sample is to be valid. The items selected, whether they be a block of transactions or items taken at random, must be representative of the group as a whole. The auditor's judgment is of prime importance here in determining the representativeness of the sample. The sample must show stability. That is, the results must be approximately the same despite any increase in the number of samples taken. In other words, the number, type, and seriousness of errors found in 500 items must be roughly one-half of the number found in 1,000 items if the sample is to show proper stability. The sample must be adequate. There must be enough items tested to assure that the sample is large enough to be representative and also large enough to have the necessary stability. Here again, the auditor's judgment as to the adequacy of the sample is all-important.

While the representativeness and stability of the sample are important factors in determining its adequacy, other factors have equal importance. Perhaps the one to which most accountants would grant first place is the effectiveness of the client's system of internal control as it applies to the record keeping. The larger the mass of data handled, the better the system of control is apt to be. The reason for this is that as the transactions multiply in volume, controls must be exerted if the work is to be done properly, or done at all. Because of these controls, there generally is relatively less sampling necessary where there is a large mass of data

available. More extensive work is required in those situations where there is a smaller number of transactions and, consequently, a smaller number of personnel. Here the controls are apt to be fewer or looser, or even nonexistent, and the accountant must extend his examination of details in order to satisfy himself that the work is being handled properly. As a second factor, the auditor will be greatly influenced by the quantity and type of errors that he finds. His interest in these errors is twofold. First, he wants to know what the error is and how important it is, with respect to the accounting statements. Secondly, he is just as interested in attempting to determine how the error was caused and why it was not disclosed through the normal checks and balances within the accounting system. Every error in the books indicates that somewhere along the line there is some weakness in the system of control. The auditor is extremely interested in determining where those weaknesses are and how they may be corrected.

Obviously, if the auditor encounters a great number of errors in his test, he will extend the test until he satisfies himself either that the sample chosen was not representative or that the books, as a whole, are replete with errors. If the latter situation arises, he should confer with the client and indicate what he has found. In this way, the client will be notified that the accounting system is not functioning properly and that additional work is necessary which will increase the auditor's fee. Conversely, in those situations where the auditor finds no errors in the work that he examines, he is apt to consider contracting his program. The possibility of timesaving must be balanced against the possibility of sizable errors or even fraud. Here again the auditor's judgment, his knowledge of the client's personnel and of the over-all situation will aid him in determining which way he should move. Even where the control is good and the auditor finds no errors, enough work must be done to make up an adequate sample.

For medium-sized clients, many firms will use a two- or three-month period as the base point from which to start their sampling. This then may be expanded or may in some instances be contracted if warranted by the circumstances.

EXAMINATION OF NONFINANCIAL RECORDS

In addition to the regular books of account, there are many corporate business records of a nonfinancial nature which are of interest to the auditor. Some of these records will reveal actions that have been taken

which should be shown on the books, and others will reflect actions that may have been authorized but which have not yet transpired. They may, nonetheless, have a bearing on the final statements.

On a first examination, the auditor will want to review the corporate charter, or the partnership contract, to determine the basic organization of the business. The auditor will want to abstract the important points from the articles of incorporation or the partnership agreement as one of the important papers for inclusion in the permanent file. He should also review the bylaws of the corporation and abstract the important or unusual sections for the permanent file. If the client is a single proprietorship, he must, of necessity, obtain most of this beginning information from the owner of the business and from the books of account.

One of the most important nonfinancial records that the auditor encounters is the record containing the minutes of the governing body of the organization. For a corporation this would include the minutes of the stockholders' meetings, the minutes of the board of directors' meetings, the minutes of the executive committee meetings, and the minutes of any other groups to whom authority and responsibility have been delegated and whose actions may have an important effect on the organization. Unless the auditor can get duplicated copies of these minutes, he should abstract from the original sheets the important information that will have an effect on the examination and include the abstract in his working papers. It should be arranged in such a way that the auditor can easily cross-reference the pertinent items therein to the audit working papers.

It is important that the auditor read these minutes early in the engagement, for most of the important actions taken or authorized will be reported in these minutes. Such things as the declaration of dividends, the election of officers and their compensation, authorizations for purchase of fixed assets, the purchase or sale of securities, and the entering into leases or other contracts, are usually recorded in the minutes. The minutes may also indicate authorized limits for certain types of expenditures. In making his examination the auditor should be certain that these limits have not been exceeded. The minutes of the annual stockholders' meeting will indicate to the auditor the duly elected directors and other items of major importance. Proposed new stock issues, merger proposals, stock splits or recapitalizations, and similar transactions will be noted in this record. The major purpose in reviewing *any* set of minutes is to determine that the actions authorized by the various groups have been accomplished. Where the auditor finds that any such actions have not taken place, he

must investigate to determine what the status is, why they have not been put into effect, and what the future plans are. It may well be that in some instances he may find it necessary to qualify his report because of a refusal to effect some transaction that has been authorized, either by the stockholders or by the board of directors.

Throughout the text mention is made of the fact that the auditor should trace a particular transaction to the minutes. The student should understand this to mean that he should refer to his abstract of the minutes, not to the minutes book itself. Having once made his abstract he should not need to refer again to the formal minutes.

Such documentary evidence as leases, union contracts, royalty agreements, and trust agreements, should also be reviewed by the auditor and the pertinent information abstracted. In some instances these papers will go into the permanent file and in other cases into the current working papers. In all cases the purpose in making the review is first to place before the auditor the terms that have been agreed upon, and secondly, to enable him to determine whether or not those terms have been followed faithfully.

THE SALES FUNCTION

One of the best methods of auditing the books of original entry is to examine them on the basis of functions. As a means of becoming thoroughly familiar with the organization and methods of operations, the functional audit is unexcelled.

Logically, the examination of the sales function should begin in the order department where orders are received. The auditor should examine the method of taking orders, whether by mail, by telephone, or by salesman. He should recall that this is one of the weak points of any system of internal control. Until the order has been recorded little control can be exerted over it.

The auditor should move next to the credit department to determine just how credit is established or granted and to watch the flow of paper work from the order department through the credit department. The next move would be to the inventory department where the order is filled. Here the auditor should examine the method by which the orders flow from the credit department. He should also look into the method of filling the order, determining what is done with partial orders and back orders. He should also investigate to see that orders are filled as they are received or that customers are promptly notified of inability to fill the

order. While he is in this department the auditor should determine what physical controls are placed over the merchandise. If perpetual records are kept in this department, he will also want to investigate to see how information for receipts and shipments flows into these records, and what controls are placed over them.

From here the normal flow of the paper work would be to the billing department. Here the auditor is interested in the promptness with which invoices are prepared and mailed, and with the controls that are placed over them.

The invoices should then flow to the accounts receivable department where they will be posted to the customers' accounts. Here an investigation of the posting process and of the relationship between the controls and the subsidiary ledgers is warranted. The auditor is also interested in what information is developed from the subsidiary ledgers and what use is made of this information. For example, do the clerks watch for accounts that are becoming out of date and promptly forward such information to the credit manager? Are the customers' cards or ledger sheets set up in such a way that accounts are automatically "flagged" when they reach a certain age? Are the subsidiary ledgers regularly proved to the control accounts? Are the customers' statements assembled and mailed by some person other than the person who does the posting? Are customers' statements mailed promptly at the end of each billing period? These are just some of the questions that the auditor will want to keep in mind as he makes his review of the posting process.

He next will want to investigate the credits to accounts receivable. These will come mostly from the cash receipts record keeper. He should investigate the controls that are placed over the cash receipts, noting whether or not the function and responsibility have been so divided that it will be difficult to have fraudulent transactions without collusion. Particular attention should be paid to noncash credits. Ordinarily, the source records for these credits will be the general journal or a sales return and allowances journal. Of particular interest at this point is the investigation of the method of authorizing returns and allowances and other noncash credits.

Examination of Sales Records

Having made his over-all review of the sales function, the auditor is now in a position to make an examination of the detailed sales records. The first step will probably be an examination of sales invoices. The number examined will depend on the mass of transactions. If the

auditor is going to examine sales transactions for a month, a logical step at this point would be to run a tape of the sales invoices and prove it to the ledger total. If there is a distribution of sales by product or by department, the auditor will have to make his tests conform to that distribution. The examination of the invoices should include a test of extensions and footings. Again, if the client distributes his sales by product or department, the auditor must see that the individual invoices are properly distributed. He should also make some tests with the clients' price lists to see that the proper amounts have been charged on the sales invoices. If the invoices are recorded in a sales journal, he should make a comparison to see that they have been properly entered in that record. This should include a comparison of the invoice number, the date, the customer's name, the total sale, and the distribution.

The auditor should also make some tests of the shipping records to determine that all invoices recorded have actually been shipped. For the last week or so of the fiscal year he should make a detailed comparison of the shipping records and the sales invoices to be certain that all sales included in the period under review were shipped during that period. In making his examination of the sales invoices the auditor should see to it that all are accounted for. Since in all firms of any size the sales invoices are sequentially numbered, it is a simple matter to leaf through the invoices and make certain that all numbers are in place. If a sales journal is used, the accuracy of the totals is determined by footing and crossfooting the sales journal. If the monthly distribution is made from a summary or standard journal entry, the auditor must then foot the individual invoices and trace the footings into the summary. Then the totals from the sales journal or from the summary should be traced into the general ledger to determine the accuracy of the posting process.

A similar review should be made of the sales returns and allowances for the test months. The auditor is interested primarily in the authority for the return or allowance, as well as in the mechanical work that has been done. The procedures of footing and posting will be the same for these credit memos as they were for sales. As another test, the auditor will want to see that there actually was a receipt of merchandise where credit has been given for a sales return. If inventory cards are maintained, he should investigate the record keeping to determine that this merchandise gets back into the perpetual records.

Some tests should be made of the postings of the individual invoices to customers' accounts. A sufficient number of these tests should be

made to determine that the work is being done satisfactorily. At the same time, tests should be made of the postings of the credits to the customers' accounts. While the majority of these entries will come from the cash receipts records, most of the tests should be made against the noncash credits.

Cash Receipts

In most audits little can be done in examining primary documentary evidence related to cash receipts. While a number of companies now use remittance advices, many do not. In almost no instance will there be evidence for *every* cash receipt taken into the records. Other tests may be made which will indicate in general the satisfactory nature of the cash receipts, but it is difficult indeed to make certain that every receipt has been recorded. One of the auditor's major problems in connection with cash receipts is the attempt to determine that all cash actually received has been recorded.

The cash receipts book should be footed. Some auditors feel that the only satisfactory method is to foot the cash book completely for the entire year. Others feel that a proof of the normal test months is satisfactory but that the book should be completely footed for those test months. Still others feel that the penny column is insignificant and that the footing may start with the dollar or even the ten-dollar column. In these cases estimates are made of the amounts to be carried over, based on the type of cash entries included. Usually it is fairly safe to divide the total lines by two and carry over that amount to the next column. After the book has been footed it should be crossfooted. Then all totals should be traced into the general ledger.

For the test periods the cash receipts as shown by the cash receipts journal should be compared with the deposits shown on the bank statement. An audit mark should be made against these items on both the cash book and the bank statement. The unmarked items in the cash journal at the end of the period represent the deposit in transit. Tests should also be made of the details shown on the deposit ticket with the details shown in the cash receipts book to detect lapping.

Substantial tests should be made of postings to customers' accounts. This should be done as part of the series of tests that prove the reliability of the record keeping, and also as a possible means of discovering the presence of lapping. Lapping is a method of fraud through deferred postings. The actual method is illustrated in the accounts shown in Exhibit 4-1. Most customers pay by one of three methods. They pay

either by invoice or by monthly balances or, if they are in poor financial shape, they may pay by a series of partial payments. Normally, these partial payments will be in round amounts. In his examination of the accounts receivable subsidiary records through the tracing of postings of individual credits from the cash book, the auditor should notice whether or not the cash payments fall into one of these three categories. In instances in which they do not, he should be alerted for the possibility of lapping. Additional tests then should be made of the accounts in

Exhibit 4-1

		Actual transaction		Cash recorded as being received from	
July	7	Received and pocketed from James Moor	$385.25	Not recorded	
	9	Received from John Eden	86.40	James Moor	$ 86.40
	12	Received from Robert Charles	415.00	James Moor	215.00
		Pocketed $200			
	15	Received from William Roberts	252.10	James Moor	83.85
				John Eden	86.40
				Robert Charles	81.85
	22	Received from Paul Nobel	188.12	Robert Charles	188.12
	28	Received from Harry Gomer	250.00	Robert Charles	145.03
				William Roberts	104.97

Robert Charles

6/14	SR	415.00	7/15	CR	81.85
			7/22	CR	188.12
			7/28	CR	145.03

John Eden

6/8	SR	86.40	7/15	CR	86.40

Harry Gomer

6/18	SR	172.89			

James Moor

6/2	SR	385.25	7/ 9	CR	86.40
			7/12	CR	215.00
			7/15	CR	83.85

Paul Nobel

6/20	SR	188.12			

William Roberts

6/10	SR	252.10	7/28	CR	104.97

which these odd credits occur. An extended comparison of duplicate deposit tickets, remittance advices, if any are available, and the cash receipts journal may bring further indication of lapping. The auditor may feel that a complete circularization of the accounts may then be necessary to prove or disprove his suspicions. Confirmation of the account balances is the most satisfactory method of determining whether or not lapping exists. In preparing the confirmation requests the auditor should make certain that all accounts are included, otherwise the bookkeeper may withhold those in which he has made his most recent lapping entries. Where the confirmation requests returned indicate any sizable discrepancies which cannot be satisfactorily reconciled, it may be necessary to have further correspondence with these customers requesting dates and amounts of payments made. This procedure should complete the picture.

The example of lapping in Exhibit 4-1 shows the incongruities that may appear. Such discrepancies should be notice to the auditor that lapping may exist.

The results of the lapping procedure leave the following customers with balances that actually have been paid.

William Roberts	$147.13
Paul Nobel	188.12
Harry Gomer	250 00
	$585.25

This total represents amounts stolen on the following dates:

July 7	$385.25
July 12	200.00
	$585.25

Obviously the cashier must be in control of the customers' accounts and of the sending of statements. He must also keep a supplementary record showing the actual receipts so that he will know to whom statements should be sent and those which should be omitted. Given enough time, if continued thefts are made, the lapping process will break down. The auditor's interest is to uncover the process as early as possible so that losses will be minimized. A better step is to improve the internal control so that lapping is not possible.

In those rare cases where documentary evidence is available to support the cash receipts, such evidence should be traced into the cash receipts book. As an example, in retail stores the cash register tapes may be

used as support for the entries in the cash receipts book. If sales tickets are written up on all sales, then additional tests should be made of the sales tickets for isolated days to determine that the tickets total the same amount of cash as is shown by the cash register tape. In some instances the auditor will find that a posting medium is prepared for each cash receipt. While this may be of some assistance in making his tests, the posting medium actually is not primary documentary evidence and should not be treated as such.

A final important part of the mechanical work with cash receipts is the testing of the discounts granted. Extraction of cash through the use of these false discounts is a common method of defrauding employers. By considering the terms which the client allows to his customers and the proportion of customers who ordinarily take the discount, an over-all test may be made to prove the reasonableness of total discounts allowed for any month. Then detailed checks should be made for the test period. In making these tests, it is necessary to work with the original invoice to be certain of the date of sale and to determine the client's policy with respect to the taking of discounts by customers after the due date has passed. Some companies are rather firm in their insistence that full payment be made once the deadline has passed. Others will accept discounted payments for a day or two after the discount period. Such a policy opens the door to easy manipulation of the records and makes the auditor's task of testing the discounts much more difficult. Where controls are loose, a thorough test of discounts allowed is advisable.

THE PURCHASING FUNCTION

As with sales, the best approach to an examination of purchasing and its related accounts is a survey of the entire purchasing function. The survey should be started at the level of the purchase requisition. As a preliminary to this study the auditor should obtain the names of those persons authorized to requisition material or other assets and the limits of their financial responsibility. In many organizations a definite limitation is placed upon the various ranks of employees as to the maximum amount for which they may commit the company. It is not possible to make a complete examination of purchases unless the auditor has this information available. One of his duties is to see that the policies set down by management are followed and that the limits are not exceeded.

After his study of the requisitioning procedure, the auditor should then

move into the purchasing department. The auditor should determine that all purchases, with the exception of such services as rent, utilities, and advertising, are made through the purchasing department. One other exception to this general rule is the purchasing of small items paid for through the petty cash fund. Other than these, the purchasing department should have the authority and responsibility for all purchase transactions.

In making his examination the auditor must know what the company's policy is with respect to the placing of orders. Some companies require the use of bids when the amount exceeds a stipulated level. One of the points to be examined is whether or not sufficient controls are placed around the requisition to reduce the possibility of collusion between the requisitioner and the purchasing agent. An investigation should also be made to determine whether or not purchases ordered are being placed with no supporting requisition. The auditor should also examine to see that there is a clear division of responsibility between the purchasing department and the receiving department.

In his tests of the paper work the auditor should compare the requisition and the receiving report with the purchase order. He should also investigate the system in effect for returning purchases for credit.

An important point that is rather difficult to tie down is the matter of vendor favoritism. The auditor should be alert for any indication of this situation. This may be disclosed through comparison of purchase orders with catalogues and price lists. It should, of course, be remembered that price is only one factor entering into the satisfactory purchase of material. Where the auditor is convinced that there is vendor favoritism, he should report to his supervisor or partner who will then determine whether or not the client's management should be consulted.

The auditor should next move to the vouchering department where he should study the system set up for recording the liability to vendors. His study should include investigation of the authority for recording invoices, the method of filing invoices so that all discounts are taken, and the authority for final approval of the invoices for payment.

The next move would be into the check writing department where a study should be made of the control over writing checks and handling papers. As a final step in the study of the purchasing function, the auditor should trace the checks into the check signing department and see what controls there are to eliminate the possibility of vouchers being sent through for payment a second time. A major principle of internal control is that after the check has been signed it should immediately

be placed in the envelope and mailed to the vendor without retracing any of the steps it has followed. At the same time the vouchers should be perforated or stamped PAID, and returned to the voucher department for filing.

Accounts Payable

Having become familiar with the entire purchasing function, the auditor now is in a good position to make some detailed tests of the accounts payable. A discussion of the different methods of recording the liability for purchases will be given in the chapter on accounts payable. Regardless of the method in use, the basic mechanical work remains the same.

The first step is the examination of the invoices or vouchers and the comparison with the written records. There should be gathered together all the invoices for the test month and the purchase journal, voucher register, or other book in which they have been recorded. If the invoices have been filed numerically or by date of entry, this is a fairly simple procedure. If, however, the invoices are filed alphabetically, the auditor will have to work from the voucher register to the voucher rather than from the voucher to the book.

The examination of the invoice should reveal that it is made out to the client, that the items purchased are reasonable purchases for use in this type of business, and that the mathematical portion of the invoice is correct. It should also be noted that proper authorization has been recorded on the invoice. The next step is to make a comparison of the invoice with the entry in the journal. This should include a comparison of the date, the name, the voucher number, the amount, and the distribution. The auditor may not be able to determine for himself whether or not the distribution shown is correct. He will, however, be able to ascertain that the amount shown in the columnar sections of the journal has been transcribed from the invoice correctly in the proper columns. He also should be able to detect any flagrant errors in classification of items. Having completed the comparison of the invoices with the entries, the auditor should prove the totals in the book of original entry and trace the totals into the general ledger. If a vendor's ledger is maintained, tests of postings to the vendors' accounts should be performed.

It is not unusual to find that some invoices are missing. When this occurs the auditor should make a listing of those which cannot be located. A copy of the list should be turned over to the voucher clerk

who should be asked to locate the invoices. In those cases where the clerk is unable to locate the invoice, the auditor must then see other documentary evidence that will satisfy him as to the genuineness of the purchase. He may examine correspondence, purchase orders, receiving reports, purchase contracts, and similar documentary evidence tending to corroborate the entry made. In extreme cases he may ask the client to request duplicate invoices for the missing items.

Cash Disbursements

The detailed work in connection with cash disbursements deals primarily with an examination of the checks that have been written. Most companies of any size will file their checks in numerical order. Others merely place the checks in the statement in which they were received from the bank and file them by month. In such cases the auditor should request the client's staff to remove the checks from the statements and place them in numerical order. This task is certainly not one that should be performed by the auditor.

The examination of checks should include a comparison of the payee, the date, the check number, and the amount, as shown on the check and in the check register or cash disbursements book. There should be recorded in the permanent file the names of the individuals having the authority to sign the checks. The auditor should note that all checks are signed by one or more of these authorized signers. Ordinarily a *test* of the endorsements is sufficient in cases where the checks have been written to business concerns. For payroll checks and other checks written to individuals a more detailed examination of endorsements is necessary. As the auditor examines the checks, he should mark them in some inconspicuous manner to prevent their being accepted again as evidence. He should also tick the entry in the check register. At the completion of the task, all unmarked items in the check register will represent uncleared checks that should appear on the bank reconciliation.

The comparison of checks with the entries in the cash disbursements book should be made for the test periods which have been decided upon. As a part of the examination the auditor should account for all check numbers. The safety feature of prenumbered checks is dependent to a degree on the relations that exist between the company and the bank. If it is a very close relationship, undoubtedly checks other than those of the regular check series could be cashed. In this case the prenumbering of checks would be of little significance except as a convenience to the clerical staff. An unnumbered check could be written, cashed, and

destroyed without affecting the numerical sequence of checks recorded in the disbursements book. In most cases, as long as an authorized signature appears on a check, the bank does not question the form of the check. In those companies where a checkbook is used the auditor should always examine the back of the book to determine whether or not any checks have been removed. Particularly in smaller companies, where the auditor has not convinced the client of the undesirability of this habit, it is the practice to remove checks from the back of the book to replace spoiled or voided checks. The auditor should insist that all spoiled checks be retained for his examination.

As a part of his examination of checks the auditor should list for further investigation all checks made out to "Cash," to "Bearer," or to banks. All checks made out to employees other than payroll checks should also be listed for further investigation. The auditor should be rather adamant in his demand for proper supporting evidence for such checks and should make strong representations to the client as to the poor business practice involved.

When the examination of the checks and the comparison with the entries in the cash disbursements book has been completed, the next step is to prove the total of this record. The author believes that the best method for such proof is a complete verification of all totals and all columns for the test periods involved. Other auditors feel that such a complete proof is not necessary. In some cases the penny column will be ignored, an estimate being made of the necessary carry-over. In other cases only uncontrolled columns will be totaled, the assumption being that totals posted to control accounts are automatically proved by the necessity of agreeing the subsidiary with the control. Depending on the size of the company there is merit to both of these suggestions; for the medium-sized and smaller concern, however, it is the author's opinion that there is no substitute for a complete footing of all journals of original entry for the test periods.

The next step is to trace the postings from the journal to the ledger accounts. The footing and tracing of postings should be performed for the same test periods that were used for the examination of checks.

The comparison of checks with the check register is of little worth unless the checks (or register entries) are also compared with the invoices. Where a voucher register or purchase journal is used, the invoices may be compared with the journal and later this journal compared with the checks (or cash disbursements journal). If the system does not provide for a purchase journal or voucher register, the actual

invoices must be compared with the checks. Unless this procedure is followed the cash work done will fail to disclose situations where a check was written in payment of an invoice but made payable to an incorrect (and possibly fictitious) vendor. The importance of making this final cross check cannot be overemphasized.

PAYROLL EXAMINATIONS

The examination of payroll records should start in the personnel department. Here the auditor expects to find a list of employees, with the proper authorization for employing, for separating, and for changes in wage rates. The list of authorized personnel, with the proper rates, should then be proved into the original evidence from which the payroll sheets were prepared. This evidence may be in the form of clock cards or time sheets. The examination of this primary evidence should include computations of time worked during the day and the week, and of the rate paid, if this information is available. All changes in rates of pay should be authorized in writing, either by way of union contracts or by individuals. When he has satisfied himself as to the propriety of this evidence, he should then trace it into the payroll register for the selected test period. The payroll register should then be extended for verification of total hours, straight time, overtime, gross earnings, and net pay.

The auditor should review the client's system with respect to deductions made. There should be written evidence of one sort or another for all deductions against gross pay. These evidences may be in the form of withholding exemption slips, union contracts, withholding authorizations for savings bonds, or other like evidence. Selected tests should be made of the accuracy of the deductions made. The payroll register should then be footed and crossfooted and the totals traced into the ledger accounts. Where there is an independent distribution of the employees' time on a job or other basis, this evidence should be examined to see that there is a correlation between the hours worked per the payroll register and the hours charged per the time tickets.

Where the payroll is paid in cash a comparison should be made of the receipts given by the employees with the specimen signatures on file in the personnel department. Where checks are used to pay the payroll the regular check examination should be made but with particular emphasis on endorsements. It is normal to find several endorsements on many of the payroll checks. A careful examination should be made to determine that the payee endorsed his check, as many instances have occurred

where checks have been cashed without the payee endorsing them. If such checks are found they should be turned over to the client with the request that the proper endorsement be obtained.

OTHER SPECIAL JOURNALS

In many companies a petty cash journal will be used as a book of original entry. Where an auditor finds such a book in use his examination would include a comparison of the petty cash vouchers for the test period with the entries made in the journal. He should examine for the accuracy of the entry in the journal and for the propriety and authority for the petty cash voucher. He should also satisfy himself as to the correctness of the distribution of the charges. As a final step he should foot the journal for the test period and trace the totals into the general ledger.

Many companies have special journals of a nature peculiar to that particular company. Where these are encountered the auditor should determine the basis for the entries in these journals. He should then make a comparison of the original evidence with the entries, should prove the totals of the journal, and should trace the totals into the ledger accounts.

THE GENERAL JOURNAL

Under ordinary circumstances, the general journal is the book in which are recorded the nonrecurring, unusual transactions of the business. For this reason the auditor has a great interest in it. His major interest is in who cintrols the general journal and who has the authority to make or approve entries for inclusion in this book. The answers to these questions usually are determined through his review of the system of internal control. Where the general journal is well controlled the auditor may be satisfied with examining the same test periods he uses for other books. Where there is a weakness evident, he probably will want to extend his examination and may even make a complete examination of the general journal entries. Whether or not this procedure is followed will depend chiefly upon the number of transactions placed in the general journal. In some instances the auditor may find a great number of *recurring* entries. In these cases he may wish to recommend the institution of an additional special journal to take care of this repetitive type of transaction.

Since the entries in the general journal are of an unusual nature, it is probable that they do not fall within the scope of the normal controls placed around most of the business transactions. As a consequence there is a greater possibility for fraudulent transactions to be hidden through general journal entries than in the other books of original entry. Also, because of the unusual nature of the transactions that are recorded in the general journal, the auditor may expect to find more errors of classification and principle.

For these reasons the auditor is especially interested in obtaining supporting evidence for all general journal entries. The examination of these entries then should include a review of the primary evidence, a review of the accounting principle involved and of the classification, a check as to the mathematical correctness of the journal entry, and a tracing of the entry into the books of account. In reviewing these entries the auditor looks specifically for authorization for each entry. Unauthorized entries to accounts receivable, cash, or accounts payable should immediately put him on guard as to the possibility of fraudulent transactions.

Occasionally, the auditor still encounters a private journal and private ledger. These books must come under the same scrutiny as the other books of account. The accounts in the private ledger should be added to the general ledger trial balance with the reciprocal accounts offsetting. The use of these private books is now encountered so rarely that no further attention will be given to them in this text.

THE GENERAL LEDGER

Certain basic audit procedures are applied to the general ledger. It has already been noted that early in the examination the auditor should prepare a working trial balance. This sheet should include columns for both the beginning and ending trial balances. The amounts in the beginning trial balance should be compared with the amounts shown in the preceding year's audit report.

Where the trial balance has been prepared for the auditor by the client's staff, the amounts shown therein should be compared with the ledger account balances and then refooted by the auditor. Then he should trace the beginning balances into the working papers or report of the preceding year.

An advantage of the senior's tracing the amounts into the ledger accounts or taking off the trial balance himself is that he is able to

determine in his review of the ledger any accounts which have been opened and closed during the period. Although no balances show in these accounts the auditor normally will want to analyze the accounts to determine the reason for their existence and the uses to which they have been put. He will also want to determine to his own satisfaction that the closing of the accounts was done properly, that is, that the showing of no balance in that particular account is correct. Explanation by the client's staff of the reasons for opening and closing the accounts oftentimes is all that the auditor needs to satisfy himself.

After the amounts have been traced from all books of original entry to the general ledger for the test periods, an examination should be made of the ledger accounts for those periods to determine that all items entered have been checked off. The discovery of unmarked items means one of two things. Either the auditor has been careless in his work and failed to mark an item that should have been marked, or more important, an entry has been made in the ledger that did not arise from a book of original entry. If the latter is true the best procedure at this point is to make a note of the discrepancies in the working papers. Later on in the engagement he may encounter additional information that will tend to explain the item or will strengthen his convictions that something is wrong. An attempt to get an explanation from the client's staff at the time the entry is discovered may serve only to alarm the staff member and to give him time to attempt to cover his tracks in other ways. Naturally a thorough search will be instituted, and the auditor will not be satisfied until he has received complete and adequate explanations as to the origin of the item under investigation.

As a part of his examination the auditor will make an analysis of many of the accounts. These analyses will support the ending balances of those particular accounts and aid in the auditor's verification of transactions. For all accounts not analyzed the auditor should prove the footings and the balances. By this means he is certain that the amounts shown on the trial balance represent the actual account balances. A common type of analysis is shown in Exhibit 3-9 (page 80).

In the course of his examination the auditor has many occasions on which he wishes to make a mark of some kind on the client's records. Clients recognize the necessity of this and in most cases permit the accountant to make the marks he deems necessary in the books of account. The accountant on his part should make these marks as small and unobtrusive as possible. The less information the client's staff can gain from these marks the more effective they are. Thus if they are so

small or are placed in such a spot or in such a manner that only the accountant knows where to look for them and what they mean, their value will be enhanced.

QUESTIONS AND PROBLEMS

1. You are auditing the accounts of a corporation for the first year of its existence. What records and documents would you expect to examine in addition to the books of accounts and vouchers?

2. What information should the auditor obtain from the minutes of the corporation that would be of importance in his examination?

3. Define *voucher, scanning, confirmation, testing.*

4. You have examined all the balance sheet accounts of the Clarwood Company. Your examination did not include an audit of all the operating accounts. Nonetheless you prepared an unqualified opinion as to the fairness of the statements.

How can you justify this?

5. What factors influence the auditor in his determination of the amount of testing to be done on any engagement?

6. What is a *block sample?*

7. Why should the minutes be read early in the engagement?

8. During an examination your early attempts to read the minutes were put off. You finally complete the examination and make a final request for the minutes. The president states that there is nothing of importance in the minutes, that you were retained "to examine the books," and that he is not going to produce the minutes.

What position will you take?

9. In examining sales invoices what disposition would you make of errors that you find?

10. What are the requirements of a sample?

11. What is the auditor's interest in errors that he discovers?

12. Why does the auditor review leases, contracts, royalty agreements, etc.?

13. What is the importance of the sales cutoff?

14. It is customary to examine sales returns and allowances for the first week or two of the new year. Why is this done?

15. How would you treat each of the following items discovered in your test of sales cutoff? The audit date is December 31.

1. Invoice for $3,000 included in sales, shipped December 31, f.o.b. the customer's plant.

2. Invoice for $2,500, shipped January 8, excluded from sales. Sale was made on December 28, but customer requested a deferred shipping date.

3. Invoice for $4,000, shipped f.o.b. client's plant, December 30, included in sales.

4. Goods sold December 24 included in sales, but you find the merchandise still on hand in the warehouse, "set aside" for the customer.

16. In examining vouchers payable for the Jones Company you are unable to find some of the vouchers. What procedure should you follow to complete the task?

17. In examining checks for the Jasper Corporation you find a check that has five endorsements, none of which is that of the payee. What procedure should you follow?

18. You are examining the payroll checks of the Manning Company. You find several checks on which there are two endorsements, the second being that of a plant foreman. What possible reasons are there for the second signature? How will you treat this situation?

19. You are examining the Clayton Company general journal. You find the following entry:

	Debit	Credit
Dr. Repairs and maintenance	350.00	
Cr. Accounts receivable		350.00

What might be the reasons for such an entry? How will you vouch it?

20. You have been assigned to examine the records of Harrison Bros. Inc., a new client. In taking off a trial balance of the general ledger you find an account called private ledger. How will you audit this account?

21. You have traced postings from all the books of original entry into the general ledger for the test months. You now examine the ledger accounts to make certain that all the items have been checked off. You find a debit and a credit for $2,000 in two widely separated accounts not checked.

What are the possible reasons for this? How would you proceed?

22. What points should be observed by the auditor in examining paid checks?

23. Briefly state the purpose of the examination of accounts payable vouchers and entries thereof in the voucher register.

24. The automobile account of the Jasper Corporation appears as shown in Exhibit 4-2 at December 21, 1961.

Exhibit 4-2

Automobile

Date	Item	Ref.	Amount	Date	Ref.	Amount
1/1/61	Balance	x	2,162.50	7/15	CR90	650.00
3/1		V81	10.00			
7/8		V85	2,816.00			

Your examination reveals that the $10 charge was for a license tag, the $2,816.00 represents the invoice price of a new Pontiac, and the $650 represents the cash received from the sale of the 1953 Chevrolet which cost $2,162.50 and had been fully depreciated.

Prepare a working paper analyzing the account, including thereon any adjustments you think necessary.

Chapter 5

CASH

THE IMPORTANCE OF THE CASH AUDIT

Most fraudulent transactions take place in the cash area because (1) cash is difficult to identify as belonging to any particular owner, (2) it is the common medium of exchange and thus is more desirable than most other assets, and (3) there is no conversion problem. It is also easy to conceal about the person. Further, almost all business transactions begin or end in the cash account. Although there may be a time lag of months or years, cash is received or disbursed sometime during the transaction. For these reasons the examination of cash often consumes a proportionately large amount of the total audit time. The auditor must be particularly alert in working with the cash records to make certain that nothing slips by him which might be indicative of fraud.

Most beginners in public accounting are given some phase of the cash work to do. Many take it for granted that they are started in cash because the work may be monotonous, dull, and of not much importance. The junior who allows the repetitive nature of this work to dull his curiosity falls into a serious error. The mechanics of examining checks are such that the job may quickly become routine. Unless the auditor keeps alert and constantly looks for irregularities, he may overlook something that might lead to the discovery of fraud or serious error. The importance of the cash audit is so great that no beginning (or experienced) accountant should permit himself to be lulled into a sense of false security by the monotony of the task. Furthermore, he must be ever-conscious of the fact that some people are always looking for new methods of circumventing existing controls.

INTERNAL CONTROL AND CASH

Many of the checks and balances incorporated in modern accounting systems deal, directly or indirectly, with cash control because cash is the most elusive of all assets. Since cash is so desirable and so easy to handle, much attention has been paid to making unwarranted removals as difficult as possible. While it is true that the auditor does not normally expect to find fraud, he must at all times be aware of the possibility of its occurrence. It has been estimated that the total annual loss from fraud amounts to one-half billion dollars. This is enough to make any auditor realize that his task is one that constantly requires the exercise of vigilance.

The disclosure of fraud is much less desirable than is its prevention, hence the auditor's interest in internal control as it applies to the accounting system. With particular reference to the cash area, the auditor is interested in the following control points.

The division of functions is of basic importance in any system of controls. A review of the client's organization chart, which lists the duties and responsibilities of the personnel, should indicate whether such a division exists on paper. The auditor should note whether or not the responsibilities are known and accepted, and whether or not the corresponding authority has been granted to the personnel to permit the discharge of their responsibilities.

Petty Cash

The petty cash fund may be small in many companies. This sometimes leads to the belief that it is unimportant and that no particular attention need be paid to controls over it. This is fallacious because not only the size of the fund but also its volume of transactions must be considered to obtain the total effect of its importance.

The following procedures should be observed with respect to petty cash funds. The imprest cash system is the best control device for handling petty cash as it establishes accountability for a definite amount of company funds. Other types of petty cash funds are more difficult to control and often invite peculation because of this lack of control and lack of accountability.

1. The responsibility and authority for petty cash should be assigned to one person who should be held accountable for all moneys advanced to him. Whether or not he is charged for petty cash shortages is a matter of company policy.

2. The petty cash fund should be kept under lock and key with the custodian controlling the key, for he can be held responsible only if no other person has access to the fund.

3. Since petty cash is designed to pay only for small purchases, a maximum for any transaction should be established by the company. The auditor should see that there are no expenditures in excess of this amount.

4. All petty cash vouchers should be perforated or stamped PAID when the fund is reimbursed. All vouchers should be approved by someone other than the petty cashier.

5. In most cases the amount in the fund should be sufficiently large to handle one month's transactions and should be reimbursed at the end of the month. Surprise counts of the fund should be made intermittently by an officer or by the internal auditor.

Cash in Bank

For ease in discussion, the internal control principles affecting cash in bank will be treated as they apply to receipts and payments. Here, as in other areas of control, the basic control principle involved is the division of function. No one person should have complete control of any business transaction. Even where there is limited personnel this principle may be applied to provide some element of control.

Cash receipts. The weakest control point in most cash situations is the point where cash has been received but as yet no record has been made of its receipt. Once the receipt is recorded, a series of accountabilities and releases may be set up to control its movement and ultimate disposition. Until this first recording has been made there is always danger that cash may be withheld and not find its way into the accounts or the bank.

In retail establishments this weak point is the point of sale. Commonly used devices to prevent unauthorized withholdings are central cashiers, duplicate sales tickets, signs reminding customers to request cash register receipts, store detectives, and independent "spotter" services. The prime objective of all these devices is to ensure the proper recording of cash received.

In other types of establishments where most or all cash receipts come through the mails, other methods are used. A common method is to use two persons for this function, with one opening the mail and calling the name of the sender and the amount, and the other making a record of the receipts. Where only one person is used in opening

mail, a device enabling others to watch him without his knowledge as to when he is being watched is sometimes used. For this method to be effective the mail opener must know that he can be observed.

The listing of cash receipts should be prepared in duplicate by employees who have no responsibility for recording or depositing cash. The cash with the original listing should be routed to the person, other than the cashier, who prepares the bank deposit. After proving total cash against the listing, the original should be filed with the treasurer, controller, or some other employee independent of the cashier. Periodic comparisons should be made of the original listing and the detail of the amounts recorded in the cash receipts record. The duplicate listing should be sent to the bookkeeper who prepares the cash receipts record. After this has been done the same list may be routed to the accounts receivable clerks for posting to customers' accounts.

All cash receipts should be deposited intact daily. The deposit should be prepared and made by an employee who has no contact either with the opening of the mail or with the recording of cash receipts. Duplicate deposit tickets should be prepared and, when properly stamped by the bank teller, should be returned to the employee who has final custody of the original listing of cash receipts. Failure to make daily deposits may result in having large amounts of cash on hand, which presents a temptation that should be avoided. Laxity in handling cash deposits may lead to laxity in the record keeping. No disbursements should be made from cash receipts. If it is necessary to make expenditures by cash rather than by check, an imprest fund should be established for this purpose. All checks received should be endorsed for deposit only.

Cash disbursements. As with cash receipts, cash disbursements are best controlled by a division of responsibility and function. The use of a voucher system is the most satisfactory plan for effectively controlling the flow of expenditures. The controls consist of cross checks between the purchasing department (for commitments made), the voucher department (for unpaid invoices), the check writing department (for invoices paid), and the vouchers payable account (for balancing purposes). Under this system, except for petty cash expenditures, all disbursements are made by check.

Each check written is supported by a voucher. The voucher is supported by an invoice or invoices, and the other underlying evidence. The approved purchase requisition, purchase order, and receiving ticket should be matched and compared with the invoice in the vouchering department, vouchered when approved, and filed by date of payment.

There should be proper separation of duties between the purchasing department and the vouchering department.

On the payment date the vouchers should be pulled from the file, given a final examination, and approved for payment. They should then be sent to the check writing department for preparation of the checks. No check should be written unless there is an approved voucher in support. All spoiled or voided checks should be retained for accounting by check numbers. Particularly in smaller companies the auditor may encounter the practice of removing checks from the back of the checkbook to replace spoiled checks. Where this occurs the spoiled check is usually discarded. Normally a few words of explanation from the auditor are all that is necessary to indicate the folly of this practice.

Prepared checks, with all the supporting evidence, should then be routed to the check signer. Whether the check signing is done manually or mechanically, there should first be a final examination of the check and documentary evidence for propriety and approvals. If a check signing machine is used, the person whose name is on the plate should control it, keeping it under lock and key.

As a further means of control many companies require two signatures on checks. The auditor should note whether or not either signer signs blank checks. This is very poor practice, but in emergencies, particularly in smaller companies, checks are signed in advance of their preparation. The auditor should note whether or not the check signer later is supplied with the documentary evidence supporting the check. The author is familiar with one situation where control is supposedly achieved by requiring two signatures on all checks. However, the treasurer presigns checks in advance in large batches and a bookkeeper is permitted to sign the other individual's name, per the bookkeeper. Here then is a situation in which a sound control feature has broken down. The bookkeeper has complete control of all parts of the purchasing–cash-disbursing function. Hence the audit scope must be extended in consideration of the weakness in control.

After the checks have been signed they should be placed in envelopes and mailed without retracing any of the steps in the routine. At the same time the evidences supporting the checks should be marked, perforated, or stamped in such a way that no part of them may be resubmitted as support for additional checks. These documents should then be returned to the voucher department for filing in the paid voucher file.

Bank accounts should be reconciled monthly by an employee independent of the cash section and of the check signer. All checks and state-

ments returned by the bank should be sent directly to this employee. The reason behind these divisions of duties is to prevent any misappropriation of funds by making it necessary to involve at least one other person to avoid prompt disclosure.

Mechanical devices should be used wherever practicable. This not only results in more accurate results but also usually permits additional automatic controls to be used. Cash registers, bookkeeping machines, check writers and signers, and punched card equipment all aid in maintaining control over the record keeping.

A strong psychological preventive is attained by bonding all employees who handle cash. In addition to the insurance against loss, bonding acts to deter the employee from making the false step. He knows that where the employer might be persuaded to overlook a slip, the insurance company is much more likely to prosecute. Further, the insurance company's investigation of the applicant in some cases discloses information that indicates the undesirability of placing the applicant in a position of trust.

In all situations dealing with internal control the auditor must recognize the client's right to take a calculated risk. It may well be that the client feels that the cost of following the auditor's recommendations will be more expensive than the possible losses that may be incurred. Wherever the auditor finds points of weakness in the system of control, he should make formal, written representations and recommendations for overcoming the deficiencies.

MAJOR OBJECTIVES IN THE AUDIT OF CASH

In addition to reviewing the internal control as it affects cash, the auditor has three major objectives in the examination of cash. These are (1) the verification of the year-end cash balances, (2) satisfaction as to the quality of the clerical work performed by the client's staff, and (3) the proper classification of the cash balances for balance sheet purposes.

The verification of the cash balances is obtained by the use of cash counts, reconciliations, cutoff statements, and confirmations. By using these aids the cash balance is authenticated. The quality of the clerical work is determined by making various tests of recordings, footings, and postings, as explained in the preceding chapter. The classification of the cash items for balance sheet purposes is determined by the application of generally accepted accounting principles. The strict application of these principles is modified by the auditor's judgment as to the materiality of the items. While the problem of materiality permeates the audit

engagement, one of the more important applications is that of dealing with classification.

AUDIT PROCEDURES AND TECHNIQUES

The audit program should list the audit procedures to be followed in any particular engagement. The audit steps discussed below represent the major steps normally followed. They are not applied indiscriminately to all situations. The auditor preparing the audit program chooses those procedures which he thinks will fulfill the audit objectives for the particular engagement. The following list is not intended to be all-inclusive and it should be recognized that special situations may call for the application of additional specifically designed procedures.

The student should not attempt to memorize the steps by rote. He should attempt to gain an understanding not only of how, but especially of why, the particular procedure is applied. Then in any given situation he is much more apt to be able to determine judiciously which procedures to use. Experience is a vital factor in building judgment, but lack of understanding negates the value of the experience.

Simultaneous Count of Cash and Negotiable Securities

Although it is no longer considered essential to make cash counts at the close of business on the final day of the fiscal year, it is important that when the count is made, control should be exerted over all cash funds and negotiable securities. Control is necessary so that there may be no switching between funds until all have been accounted for. If there are not enough staff men to make simultaneous counts, all funds and securities should be sealed and not released until completion of the count. Gummed seals bearing the message that the box is not to be opened except in the auditor's presence may be used to seal the boxes or registers.

Securities may be held in the office, or they may be in a safe deposit box. If they are on hand, the same sealing procedure may be used. If they are in a bank vault and it is inconvenient to make the count at this time, the auditor may have the client write the bank asking the bank to refuse admittance to the box unless the individual seeking access is accompanied by the auditor. If this has not been done the auditor should make a note of the date of the last visit to the deposit box, as shown on the entry card held by the bank. If the last visit took place before the year end it is acceptable. If the box has been opened since the year end

extreme caution must be used in accounting for the balance at the year end.

Petty Cash

1. Count cash funds. At a time convenient to the auditor and the client the petty cash fund should be counted. It is better practice to make

Exhibit 5-1

Brown and Jones
Petty Cash Count
December 31, 1961

	Number	Denomination	Amount	Total
Currency	2	100	200 00	
	2	50	100 00	
	22	20	440 00	
	38	10	380 00	
	30	5	150 00	
	1	2	2 00	
	168	1	168 00	
Coins	1	1 00	1 00	
	94	50	47 00	
	128	25	32 00	
	242	10	24 20	
	105	05	5 25	
	276	01	2 76	
Total currency and coin				1552 21
Checks Date Drawn by Payable to			Amount	
12/28/61 Brown and Jones Henry Jones			142 82 (1)	
12/31/61 John Jones Cash			300 00 (1)	
Total checks				442 82
Vouchers Date Paid to Charge				
12/31/61 Railway Express Co. Freight in				4 97
Total fund per ledger and per audit				2000 00

(1) Checks were deposited January 2, 1962

Counted in my presence and returned intact 1/2/62
W. C. Brady, Cashier

WBJ

the count as soon as possible after the year end. Assuming that the fund was properly reimbursed at the year end, it will contain mostly currency and coins and thus will be easier to count. The custodian of the fund should observe the count so that he may discharge the auditor of all responsibility at the completion of the count. Some auditors prefer to observe the custodian make the count. In this way the auditor has no responsibility for the fund since it is not in his custody at any time.

The auditor making the count should insist on the custodian remaining with him until the count is completed. If the custodian must leave, the auditor should return the fund to him and arrange to make the count at another time. At no time should the auditor allow himself to be left alone with the fund, as he would then have no protection against claims that he had stolen some of the funds.

A common form of count sheet is shown in Exhibit 5-1.

Currency and coins should be separated for convenience in counting. After all the cash has been counted the items should be extended and footed, for often this sum will be the amount that appears on the balance sheet as petty cash. The student should become familiar with the amounts of wrapped coins shown in Exhibit 5-2.

Exhibit 5-2

Denomination	*Number of coins*	*Amount*
$0.01	50	$ 0.50
0.05	40	2.00
0.10	50	5.00
0.25	40	10.00
0.50	20	10 00

It is not customary practice to break rolls of coins for counting. A little practice will enable the auditor to gauge the weight of the various rolls. If he is suspicious, breaking and counting may be necessary. Nor is it customary to break packages of currency if there are only one or two packages. However, in a large fund, the auditor is justified in testing one or more of the packages, especially in the larger denominations. Again, the principle of materiality is involved.

After the cash has been counted, any checks in the box should be listed. Checks may be of three types. There may be good current checks, bank drafts, or money orders awaiting deposit. These are considered to

be cash, as shown in the illustration. There may be checks which have been returned by the bank for any number of reasons, and which have been cashed by the petty cashier to counter the charge back made by the bank. The cashier will hold such checks until they are made good by the drawers or until they are considered bad and are written off. Finally, the checks may be postdated checks which for business reasons have been accepted by the client and cashed by the petty cashier so that the customers' accounts may be credited. These latter two types of checks do not represent bona fide orders to pay as at the balance sheet date. They should be removed from the petty cash fund by journal entry and charged back to the customers' accounts.

The auditor should be suspicious of large currently dated checks drawn by officers or key employees. The preceding year's working papers should be examined to determine if a check for the same amount, then currently dated, was included in petty cash. If so, this may represent permanent borrowing. In any event, it is good practice to insist that all current checks included in petty cash be deposited immediately. The bank should be requested to notify the auditor directly if any of the checks are returned for nonpayment.

The auditor should next examine the vouchers included in the petty cash fund. If the count is made a few days after the beginning of the new year, it is possible that vouchers for both years may be included in the fund. If the fund was reimbursed at the balance sheet date, all vouchers in the count should be current-year vouchers. At the balance sheet date these were cash and should be so considered for audit purposes. The vouchers should be examined for validity and authorization. The account to be charged for the expenditure should be scrutinized for the propriety of the debit.

IOUs, bulk postage stamps, prepaid-sales-tax stamps, or other items of a similar nature are sometimes found in petty cash funds. They should be removed from the fund and charged to the proper accounts.

In making the count the auditor should list everything that he finds in the fund. He may find that the cashier uses the fund as a personal safekeeping device. Nonetheless he should examine everything that is in the box to satisfy himself that he has listed everything that belongs to the client. After he has made certain that everything has been listed, he should total the sheet and obtain the cashier's agreement as to the total count. The total should then be proved to the general ledger accounts. If there is a shortage, the amount short should be added to the total count to make it agree with the control. The auditor should obtain the agree-

ment of the cashier as to the existence of the shortage. The fund may then be returned to the cashier, after he has signed the release for the auditor. This release, shown in Exhibit 5-1, is necessary to protect the auditor against claims of theft while the fund was in his possession.

The question arises as to how to handle shortages and overages. Normally, if the amount is insignificant it may be disregarded. If it is considered material either because of its size or because of the poor record keeping, it should be adjusted to a cash over and short account, or if none exists to a miscellaneous office expense account.

Theoretically, all vouchers should be cleared from the petty cash fund as at the year end and be charged to the proper expense accounts. In the cash count illustrated above, the voucher for freight in was considered not significant in light of the total fund and the total freight-in account. When adjustments are to be made they should be included on the count sheet after the total fund has been established. The student should remember that a primary purpose of audit working papers is to support the amount shown in the balance sheet. Consequently, the final worksheet for any account should include all the adjustments pertaining to that account.

When the fund is counted at such a late date that one or more reimbursements have been made, in addition to making the count the auditor should reconcile the fund back to the balance sheet date. This includes a review of all reimbursements made during the current year to make certain that no vouchers pertaining to the year under review are included.

Since it is customary not to make a surprise petty cash count at the beginning of the audit, the same result may be had by making a second count just prior to closing out the examination. Such a count would be made only in those cases in which the petty cashier is suspected of some irregularity. A second count will provide the surprise element necessary to disclose the fund being out of balance.

In many large examinations there will be funds in many widespread locations. In such cases it may not be necessary to count all the funds. The auditor may accept certifications of the funds not counted, preferably received from someone superior to the fund custodian. Here, again, the testing principle is used. If the funds which are counted are in order, the funds not counted may be accepted at face value, after being certified to by a responsible official.

2. Examine details for test periods. In addition to examining vouchers in the fund, the auditor should examine the petty cash records for

the test periods. The book of original entry may be a petty cash journal, from which postings are made to general ledger accounts. If so, the original petty cash vouchers should be reviewed for validity and authorization and compared with the entries in the journal. This step should include a comparison particularly of dates, amounts, and accounts charged. The journal should then be footed and crossfooted for the test periods, and the totals traced to the ledger accounts.

If a voucher system is in use, entries may be recorded in a book, but more often than not, the voucher is the only record of entry. The supporting petty cash vouchers should be attached to the reimbursing voucher. A summarizing sheet may also be attached. In any case the auditor should review the underlying vouchers and invoices and prove them into the distribution of the reimbursing voucher. The comparison and posting then become a part of the detailed work done on the voucher register. In reviewing these vouchers care should be taken to see that the account distribution is in line with generally accepted accounting principles. Oftentimes many of the petty cash disbursements are not carefully classified but are included as miscellaneous expense when a more exact distribution could easily be made.

Summarizing, the examination of petty cash should include a count of the fund in the presence of the custodian of the fund. A release should be obtained from the custodian when the fund is returned to him. Non-cash items should be journalized out of the fund and charged to the proper accounts. Details of the petty cash record keeping for the test periods should be examined. This examination should include a review of the correctness of the arithmetic, propriety and classification of accounts charged, authorization, and postings.

Cash in Bank

1. Count cash on hand awaiting deposit. At the same time that petty cash is counted, the day's receipts awaiting deposit should also be counted. If the client is a retail organization and the deposit has not yet been prepared, it may well be that a change fund is mingled with the receipts. The auditor should ask about this and account for the fund separately. If the count is made at the year end, the cash on hand should represent the deposit in transit. The duplicate deposit ticket, stamped by the bank, should be examined and compared with the total shown on the count sheet. The same precautions should be observed in counting this cash as were indicated in the description of the petty cash count.

2. Request confirmation of the bank balance. A considerable amount of evidential material is received by the auditor from sources outside the organization being audited. This information usually comes in the form of letters to the auditor or answers to questions raised by the auditor. Normally these letters are called confirmations, since they confirm statements appearing on the client's books.

One of the first tasks in the examination of cash is the preparation of the bank confirmation request. The request may take the form of a letter written by the auditor and countersigned by management, or it may be written by the client on his own letterhead. The auditor composes the letter in either case. Many auditing firms have their own printed requests that require only filling in the name of the bank and the client's signature. The American Institute of Certified Public Accountants, in cooperation with the National Association of Bank Auditors and Examiners, has prepared a standard bank confirmation request which it offers for sale to accountants. This form is shown as Exhibit 5-3.

Regardless of the form the request takes, the following basic information is sought: the client's cash balance per the bank's records, as at the audit date and perhaps at a later date; details of any direct liabilities that the client owes the bank, with the details of any collateral held by the bank as security for the loan; and information relating to liabilities on which the client is contingently liable. The request to the bank should be mailed in an envelope bearing the auditor's return address. This is done to ensure the return of the request to the auditor and not to the client in case the letter is sent to a fictitious bank. Normally a stamped envelope, addressed to the auditor, is enclosed to ease the bank's task in complying with the request.

When the confirmation is returned the balance shown should be compared with the balance per the bank statement held by the client. The purpose behind this procedure is to make certain that no one has tampered with the bank statement.

When a standard printed form is used it is not unusual to find that the bank has provided the balance requested but has ignored the space concerning liabilities. The auditor should examine the confirmation carefully to see that all questions are answered. If some answers are missing the confirmation should be returned to the bank with the request that the missing information be furnished.

3. Prove footings and postings. The cash receipts and disbursements books should be added for the test months and the totals traced to the

general ledgers, as explained in the preceding chapter. Where controls are loose this procedure should be followed for all months. The purpose of this procedure is to determine that the entries in the account are supported by the books of original entry.

4. Prove receipts against deposits. For the test periods the cash receipts should be traced into deposits on the bank statements. Some book-

Exhibit 5-3

[illegible]

STANDARD BANK CONFIRMATION FORM - 1953
Approved 1953 by
AMERICAN INSTITUTE OF ACCOUNTANTS
NATIONAL ASSOCIATION OF BANK AUDITORS
AND COMPTROLLERS

ORIGINAL
To be retained by Bank

______________19____

Dear Sirs:

Your completion of the following report will be sincerely appreciated. IF THE ANSWER TO ANY ITEM IS "NONE", PLEASE SO STATE. Kindly mail it in the enclosed stamped, addressed envelope direct to the accountant named below.

Report from

(Bank)______________________

____

____

Yours truly,

____

By______________________
Authorized Signature

Name of accountant

Bank customer should check here if confirmation of bank balances only (item 1) is desired ☐

Bank should check whichever is applicable:
This report covers all accounts
1. with this office ☐ or
2. with this office and all other domestic offices ☐

Dear Sirs:

1. We hereby report that at the close of business on______________ 19____our records showed the following balance(s) to the credit of______________________

AMOUNT	DESIGNATION OF ACCOUNT	REMARKS: IS BALANCE SUBJECT TO WITHDRAWAL BY CHECK?	REMARKS: DOES ACCOUNT BEAR INTEREST? GIVE RATE
$			

2. We further report that the above mentioned depositor was directly liable to us in respect of loans, acceptances, etc., at the close of business on that date in the total amount of $______________, as follows:

AMOUNT	DATE OF LOAN OR DISCOUNT	DUE DATE	INTEREST		DESCRIPTION OF LIABILITY, COLLATERAL, LIENS, ENDORSERS, ETC
			RATE	PAID TO	
$					

3. Said depositor was contingently liable as endorser of notes discounted and/or as guarantor at the close of business on that date in the total amount of $______________, as below

AMOUNT	NAME OF MAKER	DATE OF NOTE	DUE DATE	REMARKS
$				

4. Other direct or contingent liabilities, open letters of credit, and relative collateral, were

Yours truly,

(Bank)______________________

Date______________19____ By______________________
Authorized Signature

If the space provided is inadequate, please enter totals hereon and attach a statement giving full details as called for by the above columnar headings.

keepers have a separate column for amounts deposited, while others show deposits in pencil to the left of the cash column. Some make no indication of deposits in the cash receipts book. Regardless of how this information is shown, the auditor should prove the amounts deposited to the books. This may be done by adding the items in each individual deposit, or it may be done by adding all the deposits and comparing the total with the total cash receipts. Amounts shown in a deposit column, or to the left of the cash column, should not be accepted at face value because they may be underfooted. The purpose of this procedure is to prove that all recorded receipts actually get into the bank.

In cases where deposits are not shown it is a simple task to make a block proof of receipts and deposits. This proof, shown in Exhibit 5-4, will establish that the bank's records and the client's records are, or are not, in agreement as to total cash received and deposited. It does not prove the accuracy of any individual deposit. The first step is to run a tape of deposits per the bank statement. Adjustment for in-transit items should, except for items recorded by the bank but not by the client, bring the total to an amount equal to the cash receipts total.

Exhibit 5-4

Total deposits in December per bank statement	$42,685.12
Less: Beginning deposit in transit	3,591.50
Total received by client and deposited	$39,093.62
Add: Ending deposit in transit	4,140.17
Total per cash receipts book	$43,233.79

The last receipts of the fiscal year probably do not appear as a deposit on the bank statement. Hence it is necessary to prove that the deposit reached the bank to complete the proof of receipts. This may be done in several ways. The bank confirmation request may include a request for certification of the first few deposits of the new year; a separate letter may be sent to the bank asking for confirmation of these deposits; or a cutoff statement may be requested (see step 12). By one of these methods the auditor satisfies himself that the last day's receipts were received by the bank. The auditor should also request the bank to notify him directly of any protested checks or other unusual charges made to the client's account for the first week or ten days of the new period. By these means any kiting (explained in Chapter 2) will probably be revealed.

5. Examine detail of deposits. In most cases of fraud the employee stealing funds tries to cover his tracks by the year end so that the auditors will not become suspicious. After the year end he will uncover what he has covered. In an effort to disclose any fraud the auditor should compare the detail of the deposit tickets with the detail shown in the cash receipts book for a few days preceding and following the year end. The auditor should request certified copies of these deposit tickets from the bank. This procedure will have no value if the client permits cashing checks from receipts as a convenience to customers and employees. Such a practice would permit the inclusion of checks on the deposit ticket for which no entries would be made in the cash journal. The major purpose of this procedure is to detect the lapping of receipts from customers (explained in Chapter 4).

6. Test for discounts granted. As a part of the work done on cash receipts, the auditor should make tests of cash discounts granted to customers. Extractions of cash by using the discounts column is a common fraudulent method. By considering the terms usually granted to customers and by approximating the proportion of discounts normally taken, a rough over-all proof may be derived for any test period, indicating the reasonableness of total discounts granted. Then tests should be made by scanning the cash receipts book to determine whether individual discounts are within the allowable percentage.

Where these tests indicate possible fraudulent activity it may be wise to extend the test to cover the time period involved. This requires working with the sales invoices to be certain of the dates of sales. It is also necessary to determine the client's policy with respect to the taking of discounts by customers after the due date has passed. Some companies insist that no discounts be taken after the discount period has passed and return checks which represent net payments. Other companies accept the discounted amount at almost any time. If this latter situation exists it is almost impossible for the auditor to prove the propriety of discounts taken. He must rely on remittance vouchers or comparisons of duplicate deposit tickets with the cash receipts book listings to satisfy himself as to the correctness of recorded amounts. Neither of these methods is very satisfactory. Where controls are loose it is wise to extend the scope of the discounts tested.

7. Trace out oustanding checks at the beginning of period. In a first audit the auditor should reconcile the bank account as at the beginning of the year. In recurring audits this work has been started but probably has not been completed. Most clients write enough checks toward the

end of the year that not all checks written will clear the bank even at a second reconciliation date. Thus, in most cases, last year's reconciliation will include some checks, outstanding at the audit date, that have not been examined by the auditor. One of the first steps in working with disbursements is to go back and pull these unaudited checks and subject them to the regular examination. This step is also necessary to determine whether or not any of these checks are still outstanding. If they are, they will become a part of the current reconciliation.

8. Examine checks for test periods. The auditor should begin his examination of checks written by securing a list of authorized signatures. If the examination being made is of a small company, the auditor should obtain all the checks written during the year. In this way he does not disclose the test periods he is examining. If there is a large volume of checks written he should obtain access to the file of cleared checks and remove those that he wants to examine.

In examining the checks the auditor should compare the data on the check (check number, date, payee, and amount) with the entry in the cash disbursements book or check register. Any variances from normal should be pointed out to the senior in charge. The auditor should be keenly alert to detect any erasures or changes in checks. The purpose in examining the checks is to determine that they have been correctly recorded in the books of account and to see that the correct individual received the money. For this latter purpose, the endorsements should be examined. Cases have occurred where a check was mismailed and the company receiving it endorsed and deposited it even though the recipient was not the payee. And banks often do not uncover such an error. Where the checks are payable to business concerns it is often considered satisfactory to make only spot tests of endorsements. Endorsements on checks payable to individuals should be examined completely.

Many auditors like to use a block proof for checks written, either for the test period or for the entire year. In this type of proof the total of the debits on the bank statement(s) is determined in the following manner. Deposits on the bank statement are footed. To this total is added the beginning balance per the bank statement. From this total the ending balance is deducted. The result is the sum of all debits made by the bank. Adjustment is then made for beginning and ending outstanding checks. The final answer should be the total disbursements per the company records for the period covered by the proof. Any variances indicate entries made by the bank but not yet recorded by the company. One other possibility for difference exists where the bank corrects for its errors

by making an offset on the other side of the account. For example, if the bank charges a check to the account in error, it will correct the error by making an addition in the deposits column. Where many bank errors are noted on a statement the auditor should compare the client's copy of the statement with the bank's record to determine that all the indicated errors are valid. Such items are usually clearly marked on the bank statement and are easily discerned by the auditor. Exhibit 5-5 illustrates one method of making a proof of bank debits and disbursements.

Exhibit 5-5

Balance per bank statement, December 1		$174,711.70
Add: Deposits per bank statement		231,681.20
		$406,392.90
Less: Balance per bank statement, December 31		126,246.90
Total charges on bank statement		$280,146.00
Add: Outstanding checks, December 31	$81,681.90	
Less: Outstanding checks, December 1	60,458.90	
Net outstanding checks not cleared		21,223.00
		$301,369.00
Less: Bank service charges (or other items charged by bank but not recorded on books)		97.00
Total checks written per check register		$301,272.00

This proof would disclose a situation where a check has been written, cashed, and later destroyed without ever having been entered in the cash disbursements journal. As part of his examination of paid checks the auditor should account for all check numbers, in order to disclose the possible destruction of checks, whether authorized or unauthorized.

While it is conceded that the prenumbering of checks would not, in many cases, prevent the cashing of unauthorized checks, nonetheless the accounting for check numbers is psychologically a good audit step. The auditor should arrange with his client to have all spoiled and voided checks saved until they have been examined and an accounting has been made of all check numbers. Where a bound checkbook is used the auditor should look at the last checks in the book to determine that none have been removed and used improperly.

9. List unusual checks for further investigation. As the auditor makes his examination of checks he should list for further investigation all checks made out to cash, bearer, individuals, or banks. He should discuss with his client the inadvisability of making checks payable to cash or

bearer, which is nonetheless a fairly common practice. The auditor should examine each check and endorsement critically and obtain a satisfactory explanation from officers as to the purpose for which the check was written. Cases have occurred where there was no supporting evidence for such checks and the officers were vague in their explanations of the purpose, at the same time insisting that the checks were properly drawn and approved and were for business purposes. In these cases the auditor must use considerable judgment in deciding whether or not to accept the proffered explanation. The alternative is to note the situation in the report.

Checks other than for payroll which are made payable to officers, employees, and other individuals should be carefully investigated and traced into the records. If the checks have been charged to officers' or employees' accounts receivable, it is proper to ask these individuals to confirm the year-end balances due from them. If the checks have been charged to expense accounts, satisfactory documentary evidence should be examined in support of the debit.

10. Investigate old outstanding checks. Most businesses have established policies for the treatment of checks not cashed by the payees. It is customary to set a time limit after which the checks will be written back to cash. Probably the most common time period is one year. All checks outstanding written more than one year ago will be removed from the list of outstanding checks and an entry made increasing cash and miscellaneous income. If checks written off are later presented for payment, two alternatives are possible. Most banks refuse to cash a check more than a year old without specific authorization of the depositor. If this takes place the payee will probably return the check for replacement with a current check, which should be charged to miscellaneous income. If the bank does not notice the date and cashes the check in routine operations, the client's bank account is not reconcilable until an entry is made reversing the write-off. The auditor's interest in this problem is to see that the client company follows a consistent policy. If the old checks have not been written off the auditor should prepare an adjusting journal entry to provide for this corrective action, assuming that the company has such a policy. He should also review the attempts the client has made to have the payees cash the checks, and, in case of large checks outstanding for a long period of time, review the original transaction. He may also attempt to determine, by means of the block proof indicated above, whether or not the check has actually cleared the bank.

For the two or three months prior to the year end the auditor should

review the list of outstanding checks and examine the large checks, long outstanding, which cleared in those periods. They may not have cleared but may have been dropped from the list of outstanding checks (without entry) to cover a theft.

11. Reconcile the bank account. After the auditor has performed the above steps he is in a position to prepare reconciliations of the bank balance with the book balance. The purpose of any bank reconciliation is to determine that the bank records are in accord with the book records, or that they are adjusted to be in agreement, and to determine the correct cash balance for balance sheet purposes.

There is illustrated in Exhibit 5-6 a form of bank reconciliation in common use. This form is advantageous in that it results in an adjusted cash balance for balance sheet purposes. It also results in confining to the "per books" column any adjustments that need to be recorded on the books, which aids the auditor when he is ready to prepare adjusting journal entries. The determination as to the effect of any reconciling item needs to be made only once. The reconciling factors appearing in the "per bank" column represent transactions already recorded on the books, or items that have no effect on the client's records. There is also illustrated in this reconciliation the effect of the client's policy of writing off old outstanding checks.

The student should note the use of various audit marks and the manner in which they are explained. If the outstanding checks are too numerous to fit into the body of the reconciliation, a separate schedule should be prepared. If there is a very large number of checks outstanding, an adding machine tape may be run and pasted to the reconciliation or to a supporting sheet. If certified checks have not cleared they should be listed as outstanding checks. The debit memo for the certified checks should then be deducted from the total. The purpose of this procedure is to keep before the auditor the fact that the certified check has not cleared.

12. Reconcile the bank account at a later date. On most engagements it is wise to request a cutoff statement from the bank and reconcile the bank account with the book balance at an interim date. This statement should be sent directly to the auditor by the bank. A cutoff statement is the usual bank statement for a period shorter than a month. Usually ten or fifteen days' transactions are sufficient. The purposes of obtaining this partial bank statement (with paid checks) are threefold.

1. The deposit in transit used on the first reconciliation is traced to the bank statement to see that it actually was deposited.

2. Many if not all of the checks that were outstanding on the first reconciliation will have cleared the bank by the cutoff date and will be returned with the bank statement. This permits the auditor to examine these checks, thus coming closer to a complete examination of all the items appearing on the reconciliation.

Exhibit 5-6

Horace Chocolate Company
Bank Reconciliation
December 31, 1961

C 1

Line		Per books	Per bank
1	Balance, December 31, 1961	26622 52	28972 13 C
3	Add:		
4	Deposit in transit		5403 12 T
5	Check-Horace Engineering Co. charged in error		2000 00
6	H R Jones note collected by bank	3800 00	
7		30422 52	36375 25
9	Less: Outstanding checks:		

Date	Check	Name	Amount
7/16/60	4214	James Supply Co.	11.16
10/28/60	4921	J. B. Smith	2.78
10/29/60	4998	James Anderson	12.51
3/6/61	5251	Comer + Co.	49.20 "
8/14/61	5713	Long Bros.	271 50 "
11/21/61	6064	Harris + Glass	2412.48 "
12/3/61	6131	Lyle + Son	1,821.21 "
12/28/61	6192	H. C. Miles	791 00 "
12/31/61	6218	Waggener Supply	589.09

Line		Per books	Per bank
20			5960 93
22	Bank service charges	8 20 ④	
24	Reconciled balance	30414 32	30414 32
26	Add: AJE (5) Write-off of old checks	26 45	26 45
28	Balance per audit	30440 77	30440 77
29		To C	

C = Confirmed by bank
T = Traced to cut-off statement
" = Returned with cut-off statement
④ = Examined bank debit memo

WBJ

3. The auditor obtains direct notice of any checks charged back to the account and is able to determine that any corrections to be made by the bank discovered during the first reconciliation have been made. The charging back of checks for nonpayment is important, as it may affect the December 31 bank balance (see step 14).

The reconciliation at the cutoff date may be made in the same way as the first reconciliation, or it may take the form of a proof of cash transactions for the interim period. Such a proof is illustrated in Exhibit 5-7.

Exhibit 5-7

HORACE CHOCOLATE COMPANY

Proof of Cash Transactions

January 1 to 10, 1962

	Balance December 31, 1961	*Transactions January 1–10, 1962*		*Balance January 10, 1962*
		Deposits	*Withdrawals*	
Transactions per bank	$28,972.13	$23,158.38	$25,629.81	$26,500.70
Deposit in transit, December 31	5,403.12	(5,403.12)		
Deposit in transit, January 10		4,151.50		4,151.50
Check charged in error	2,000.00	(2,000.00)		
Note collected by bank	(3,800.00)	3,800 00		
Outstanding checks, December 31	(5,960.93)	26.45	(4,583.84)	(1,350.64)
Checks written in January, outstanding at January 10			2,009.10	(2,009.10)
Bank service charge	8.20		8.20	
Transactions per books	$26,622.52	$23,733.21	$23,063.27	$27,292.46

It is necessary to add the receipts and disbursements books for this interim period and to apply to the cash balance any adjustments that have been made thus far in the examination.

In the first column the year-end bank balance is reconciled to the balance per books. Instead of using subtotals, black and red figures are used to permit an uninterrupted flow of the reconciling factors. From the cutoff statement, deposits are inserted in the second column and checks cleared (plus other bank debits) are inserted in the third column. Cross-footing should produce the balance per the bank statement at the cutoff

date. Since the December 31 deposit in transit is included in the deposits per the bank, it is shown in red in the second column as the first step in working toward the cash receipts per the books. The January 10 deposit in transit is added in this column and in the final column. Presumably the bank will have credited the client with the check erroneously charged. This must also be deducted from the bank deposits. If the bank has not yet made this correction, the $2,000 would be added in the final column. Since the collection of the note presumably has been added to the client's cash, it is added to the deposits as an additional reconciling factor between deposits and receipts. The old checks that were written off are added to the deposits because the adjustment has added them back to the cash balance. This column should now foot to the total of the January cash receipts book plus the additions by adjustment to the December 31 balance per books. Any discrepancies should be promptly and completely investigated.

The third column starts with the total of the checks cleared by the bank during the cutoff period. A comparison of these checks with the list of checks outstanding at December 31 will disclose those which have cleared. These checks should be ticked off on the outstanding list and footed, with an appropriate deduction shown in the third column. The effect of this deduction is to cancel out from the total checks cleared those drawn before the beginning of the cutoff period. Checks written in January and outstanding at January 10 are added to the total that have cleared. The service charge is included in this column because, either through an adjustment or through an entry in the January cash book, cash has been credited. The total of the third column should now equal the cash disbursements book total for the ten-day period plus any adjusting journal entry credits to cash.

The final column represents the reconciliation from the bank to the books at the cutoff date. Outstanding checks are shown in two amounts, those written before the year end and those written in January. It would be just as satisfactory to clear out all the 1961 checks in the third column and in the fourth column include *all* outstanding checks at January 10. However, the audit trail is a little more satisfactory when the checks are handled as shown in the illustration. Where separate proofs are made of cash receipts and disbursements, this form is often used as the basic bank reconciliation.

13. Determine that the cash cutoff is proper. While the practice of holding open the cash books is not as common as it once was, the auditor must keep alert to the possibility of this happening. Normally, the worse

the client's financial position, the more chance there is of the books being held open in an attempt to present a better picture than actually exists. Either the cash receipts journal or the disbursements journal or both may be held open. The effect of holding open the receipts book is to present a better cash and receivables picture. The effect of holding open the disbursements record is to present a better current ratio.

The holdover of cash receipts is disclosed in the tracing of receipts to the bank statement. Unless circumstances are unusual, there is no reason to expect that the December 31 receipts should be much in excess of those for the previous day or days. So, where the auditor finds a relatively large deposit in transit on the bank reconciliation, he should be put on notice. If the deposit in transit appears as separate deposits in the first few days of the new year as shown on the cutoff bank statement, it is prima facie evidence that the receipts book has been held open. Any true deposit in transit should be deposited on the first business day of the new year. Unless the client can provide convincing proof that these receipts all actually were received in the old year, the auditor has no recourse other than to have the client reverse the entry for all deposits beyond the first business day.

It is more difficult to detect the holding open of the cash disbursements journal. If the auditor is suspicious that this might be apt to happen, he may take preventive action by visiting the client's office at the beginning of business the first day of the new year and making a record of the last check number used.

Where this is not done the following method may be used. This is based on the premise that most businesses deposit each day's receipts promptly and completely. Checks written the last day of the period should be mailed the same day. Checks to local concerns should be delivered on the first day of the new period and deposited that day or the next day. When the cutoff statement is received the auditor may examine the bank clearing date of the checks written on the last day of the period. If many of these checks are not deposited until late in the cutoff period, his suspicions should be aroused. Then, if necessary, he may correspond with the vendors (always with the client's permission) to determine when the checks were received. In this way the auditor can build a case indicating clearly that the checks were not written until after the first of the new period.

Evidence may also be found to indicate that checks were written on the last day but were held for some days before mailing. Checks should not be considered as outstanding until the client has lost control over

them. When the checks are mailed control is lost. The auditor's reaction in this situation should be the same as though the checks were not written until after the close of the period. The amounts should be returned to cash and the appropriate liability increased.

However, it is common practice for many concerns to write a large number of checks in the last few days of the month. This is an unconcealed effort to reduce payables for balance sheet purposes and is proper if there is a timely mailing of the checks. This practice is encountered so often that it is difficult for the auditor to determine whether or not there has been an attempt at "window dressing."

14. Test for kiting. Whenever more than one bank account exists, the auditor should watch carefully at the year end for any signs of "kiting." If bank accounts are in different cities, the opportunity for kiting is enhanced. Although kiting may occur during the year, it more often takes place at the year end to cover a shortage which has developed. The kiting procedure is as follows. A check is drawn on the out-of-town bank and deposited in the local bank close enough to the last day so that it will not reach the paying bank before the end of the year. Usually there is not enough on deposit in the paying bank to cover the check, but this is not material to the fraud. No entry is made in the books either for the deposit or for the withdrawal. The shortage is covered by the deposit of the check. If the check does not reach the bank on which it is drawn before the year end, the balance of that account will not be reduced. The amount of the check is thus included in two balances at the year end and the usual bank certification will not disclose it.

When cutoff statements are requested along with direct notice of any protested checks, this type of manipulation is easily detected. As an additional step a schedule of bank transfers should be prepared covering the last week or ten days of the old year and the first week of the new year. This type of schedule is shown in Exhibit 5-8.

Each transfer should appear on the schedule in four places. If it does not an immediate and complete investigation should be made. Any unusual delay between deposits and bank charges on the one hand and the book entries on the other should excite the auditor's curiosity.

15. Search for unrecorded receipts. A continuing task in the examination is an inquisitiveness about the possibility of unrecorded receipts. At this point in the program there should be a positive review of possible sources of miscellaneous receipts. Oftentimes this type of transaction does not lend itself to the usual controls governing normal transactions. For this reason it is a fruitful area for the perpetration of fraud. There is no

easy standard program to follow in searching for unrecorded receipts. A review should be made of the possible sources of miscellaneous receipts that the particular business might have. These should then be followed out to determine whether or not, this year, there should have been some receipts. If it appears that there should have been some, questions should be raised as to where they were recorded. Often such receipts have been miscredited and will appear in some account not yet examined. For example, sales of scrap may be included in the regular sales account.

This is a task that exercises the auditor's ingenuity. He must find the answers without exciting suspicion. Block proofs such as the gross profits

Exhibit 5-8

AMBROSE JONAS & CO.

Bank Transfers

December 31, 1961

	New York bank				*Chicago bank*				*San Francisco bank*			
	Deposits		*Withdrawals*		*Deposits*		*Withdrawals*		*Deposits*		*Withdrawals*	
Amount	*Bank*	*Books*	*Bank*	*Books*	*Bank*	*Books*	*Bank*	*Books*	*Bank*	*Books*	*Bank*	*Books*
50,000					12/23	12/22					12/27	12/22
20,000	12/29	12/27									1/2	12/27

test may be used to advantage, or it may be possible to translate raw materials into units of product manufactured. Allowing for inventory variances, the result should be units of product sold. This may be translated into dollars and compared with recorded sales. Both of these proofs are only rough approximations, but they should disclose any major discrepancies that might otherwise not become apparent for some time.

16. Prepare a cash summary. After the cash work has been completed it may be wise to prepare a summary statement, or leading schedule, for the accounts. The need for such a schedule is dependent on the number of bank accounts involved. If the client has only one petty cash fund and one bank account it would hardly be worthwhile summarizing them. As the number of bank accounts increases it is necessary to consolidate them so that one amount may be reported.

Exhibit 5-9 presents such a summary. It should be well noted that the summary is completely a copy of the supporting schedules to which it

makes reference. No new audit work or adjustments appear on the summary. Each supporting schedule must be complete in itself and should support the final amount shown for each account in the summary. The final total on the summary should support the amount shown on the balance sheet.

Exhibit 5-9

Horace Chocolate Company — C
Cash Summary
December 31, 1961

	W/P	Per books	Adjustments Dr.	Adjustments Cr.	Per audit
Cash in bank	C1	26,622.52	3,826.45	8.20	30,440.77
Petty cash	C3	500.00		285.20	214.80
Payroll advance fund	C4	1,000.00		861.00	139.00
Total cash		28,122.52	3,826.45	1,154.40	30,794.57
					B/S

17. Review the balance sheet presentation. Cash on hand and in bank normally appears as the first item on the balance sheet, but there are some situations that call for the exclusion of cash from the current asset section. To be known as a current asset the cash should be immediately available for current operating purposes. Any restrictions placed on a bank balance, whether or not self-imposed, should act to exclude the funds from the current section. The type of account in which the funds are placed does not automatically determine the classification. Some savings accounts may be more current than some checking accounts. The purpose behind the establishment of the account must be determined. Such items as cash in closed banks, cash in sinking funds for the payment of long-term debt, and cash in building funds, are by their nature not available for current operating needs and so should be excluded from the current group and classified in the investments section.

Overdrafts should be classified as current liabilities and should not be netted against other free bank balances. Here again, the matter of materiality affects accounting practice. If the overdraft is not material it may be offset. It should be remembered, though, that the dollar amount is only one of many factors used in determining the materiality of an item.

Summary

In summary, the major areas of verification of cash may be listed as follows:

1. Count all cash on hand.
2. Obtain confirmation of bank balances.
3. Examine the original evidences underlying the transactions.
4. Review the correctness of the bookkeeping work.
5. Reconcile the bank account.
6. Determine that a proper cash cutoff has been made.
7. Search for unrecorded receipts.
8. Review the balance sheet presentation.

QUESTIONS AND PROBLEMS

1. Why is cash a favorite source of fraud?

2. What controls should be placed over petty cash?

3. A petty cash fund amounted to $25. Since it was so small the auditor ignored it in his examination. Was he correct in so doing?

4. What principles of internal control should be employed in handling cash receipts?

5. Why should bank accounts be reconciled by some individual other than the one who writes the checks?

6. What are the major objectives in the audit of cash?

7. Why should there be a simultaneous count of all cash and negotiable instruments?

8. Why should the auditor insist that the petty cashier observe the counting of petty cash?

9. What are the underlying reasons for the following audit procedures?

1. Prove receipts to deposits.
2. Examine endorsements on checks.
3. Investigate old outstanding checks.
4. Reconcile the bank accounts at a cutoff date.
5. Examine the detail of deposits.

10. What principles should be observed in the presentation of cash in the balance sheet?

11. You are assigning an assistant to examine paid checks. There are certain types of checks about which you urge him to be particularly alert and inquisitive. Indicate what these types are and why they should receive special attention.

12. You suspect that your client has held open his cash receipts book after the closing date for window-dressing purposes. How would you proceed to prove or disprove this suspicion?

13. The Charles Company began business on January 4, 1961. At December 31, the list of accounts and balances (except cash) shown in Exhibit 5-10 is taken from the general ledger.

Exhibit 5-10

Accounts payable, trade	$ 2,436.28
Capital stock	20,000.00
Customers' accounts	5,423.23
Expenses	4,530.00
Furniture, buildings, and land	22,500.00
Inventory of merchandise	9,312.09
Mortgage bonds issued	20,000.00
Notes payable, banks	4,000.00
Notes payable, trade	2,000.00
Salaries	4,622.89
Sales	8,469.10

The balance per bank statement at December 31 was $2,197.50. Miscellaneous bank charges amounted to $4.64. Checks outstanding totaled $200. The cost of merchandise sold was 97 per cent of sales. Cash of $300 received on December 31 was deposited January 1.

Construct the cash account and bank reconciliation.

14. Your client's payroll clerk has forged eight payroll checks, each for

$74.25. Seven of the checks had been cashed when the clerk decided his health required a different climate. The eighth check has not been cashed. As an auditor, how will you handle this situation?

15. You and a junior arrive at the client's office at 8:55 A.M. this morning to start the examination for the year ended July 31, 1961. You decide to start by counting cash. This client has a petty cash and a change fund in the offices and ten cash registers, each with a change fund, in the store. The store opens for business at 9:30.

Explain your procedures for counting the cash.

16. Your client has a monthly payroll of about $500,000, payable on the last day of the month. Checks are written during the latter part of the month. By arrangement, some checks are mailed to the payee's bank. The balance are distributed to the employees personally. It is normal practice for the client to borrow to meet this payroll. Depending on the dilatory nature of people, the client borrows $150,000 the last day of the month, $150,000 the first of the new month, and $200,000 the third day of the new month.

As of the end of the fiscal year, what program would you follow in auditing the payroll cash account? What balance sheet problem arises?

17. Your client has three major bank accounts in the home office (two general and one payroll). There are 214 branch bank accounts, which are used by store managers to deposit each day's receipts. Withdrawals are made only by the home office. All bad checks, bank charges, etc., are sent to the home office where they are reimbursed from the general bank account. All bank accounts are reconciled monthly.

Lay out your program for the audit of cash in banks.

18. You have been assigned a junior, just graduated from college, who has been hired by your firm. You put him to work on petty cash. Outline for him just what you want him to do to complete the audit of petty cash.

19. For what purposes is a cutoff bank reconciliation prepared?

20. In the examination of an educational fund-raising organization, you find this situation. Many donors wait until December 31 to mail in their contributions. In order to get all contributions into the year for which they were intended, the organization keeps its cash receipts book open until January 5 of the new year. There is no secrecy about this.

How will you audit cash receipts for the year end? How will you treat this situation in your report?

21. Your client is a small grocery chain. All purchases are made by the home office. The owner signs all checks (about 300 a year). The cashier keeps the cash receipts book, the cash disbursements book, and the general ledger. Of the cash receipts, 99 per cent are from cash sales, the other 1 per cent coming from miscellaneous sources. Each morning the cashier visits each store, picking up the cash for the preceding day's sales.

Set up a program for the verification of cash in bank.

22. You count the petty cash fund of Johns, Inc., of $1,100 at 9 A.M. on January 5, 1962. December 31, 1961, is the audit date. Petty cash count was witnessed by Joe Ash. Exhibit 5-11 shows your findings.

Exhibit 5-11

Cash

Description	*Number*	*Denomination*
Currency	2	$50
	7	20
	13	10
	28	5
	79	1
Coins	1	1.00
	38	0.50
	86	0.25
	62	0.10
	80	0.05
	170	0.01

Checks

Date	*Payee*	*Amount*
12/27/61	Client	$100.00
1/10/62	Client (cashed 12/28/61 for customer)	50.00
1/ 2/62	Client's president (endorsed by him)	48.15
10/ 1/61	Client (from a customer, returned by bank, marked NSF)	25.00

Vouchers

Date	*To*	*For*	*Account charged*	*Amount*
12/22/61	Postmaster	Stamps	Postage	$ 9.15
12/26/61	Office boy	Carfare	Miscellaneous	0.30
12/31/61	Sales manager	Travel advance	Travel	75.00
1/ 2/62	Office Supply Co.	Office coats	Office supplies	50.00

Prepare a working paper for petty cash, showing adjustments necessary, if any.

23. You have been handed the following worksheet (Exhibit 5-12) by one of your junior assistants. Review the worksheet, then point out to him all the errors as to form, content, and procedure.

Exhibit 5-12

Bank Reconciliation

			Books	*Bank*
Balances			$12,041.26	$14,746.80
Deposit in transit				3,412.48
			$12,041.26	$18,159.28
Outstanding checks				
4612	Harry Jones	$ 123.45		
4721	Smith Company	1,481.39		
4767	Bispo Company	2,841 13		
4770	Harry Jones	123.45		
4771	Tom Smith	150.00		
4772	Sweet Brothers	1,250.00		
4773	O. B. Janey	400.00		
Total				6,370.42
				$11,788.86
Adjustments		$ 200.00		
		51.40	251.40	
			$11,789 86	
Discrepancy				1 00
				$11,789.86

24. Shown in Exhibit 5-13 are data concerning the cash accounts of the Harlock Corporation.

It is the policy of this client to write off to miscellaneous income, at each year end, all the checks outstanding more than one year. If such checks are presented at a later date, they are charged to miscellaneous income.

You requested and received bank confirmations as of 12/31/61; you also requested and received cutoff statements and paid checks from the commercial banks as of January 10, 1962. All outstanding checks were returned with the cutoff statements, except as follows: Nos. 1416, 1937, 2415, 2710, T564, 1742P, 4590, 7519, 7571, T1515, 5071P, T1590, 5128P, 5151P, 7939, 7951.

On December 29, 1961, a check drawn by the James Co. in payment of its account was deposited by Harlock Corporation. This check, for $1,497, marked NSF, was returned with the cutoff statement of the Third-fifth Trust Co.

Among the checks returned with the December 31 bank statement of the Fifth-third National Bank, which were charged to the Harlock Corporation,

Exhibit 5-13

Balances, December 31, 1961

	Books	*Bank*
Fifth-third National Bank	$28,972.13	$28,972.13
Third-fifth Trust Co.	13,520.20	21,979.10
Picktown Savings Bank (savings a/c)	50,000.00	45,000.00
Fifth-third National Bank (payroll a/c)	2,500.00	3,648.17

Additional Data

		Fifth-third	*Third-fifth*	*Picktown*	*Fifth-third (Payroll)*
Deposits in transit		$5,453 12	$2,121 21	$5,000 00	
Checks not returned by banks					
2/14/60	1416	2 78			
8/21/60	1937	1 42			
10/10/60	2415	7 12			
12/15/60	2710	4.13			
1/ 7/61	T 564		8.56		
2/12/61	3015	21.12			
3/14/61	1742P				14.20
4/ 6/61	4101	68 00			
4/18/61	2207P				12.16
5/12/61	T 915		19.19		
5/15/61	4590	2.00			
5/30/61	4617	21.50			
8/ 1/61	3412P				104.20
9/17/61	6101	141.10			
9/21/61	6148	168.15			
10/26/61	T1380		478.52		
10/28/61	T1383		111.50		
11/21/61	4689P				104.20
12/ 1/61	7519	1,462 78*			
12/ 2/61	7571	1,215.71			
12/ 5/61	4820P				104.20
12/ 7/61	7598	1,236.60			
12/12/61	4928P				104.20
12/15/61	T1515		2,125.00		
12/16/61	7682	2,176.44			
12/19/61	5071P				104.20
12/21/61	7725	77.25			
	7732	190.00			
12/22/61	7745	83.50			

* This is a certified check.

Exhibit 5-13 (Continued)

		Fifth-third	*Third-fifth*	*Picktown*	*Fifth-third (Payroll)*
12/24/61	T1590		412.50		
12/26/61	5128P				104.20
	5133P				86.52
	5136P				91.80
	5142P				118.12
	5151P				58.27
	5168P				141.90
12/28/61	T1593		2,427.81		
12/29/61	7921	210.40			
12/30/61	7928	10.14			
	T1600		5,000.00		
	7939	16.06			
12/31/61	7946	52.50			
	7948	17.49			
	7949	103.20			
	7950	72.72			
	7951	48.13			
	7952	13.47			
Bank charges not recorded		7.81	2.97	—	—

was one for $2,000 drawn by the Herlock Corporation. Also included with the bank statement of the Fifth-third National Bank was a notice indicating that the bank had collected a note for $1,500 made by H. A. Jones, due December 31, 1961, payable to the Harlock Corporation.

The savings account has been appropriated for a future building expansion program. The balances as of 12/31/61 and 1/10/62 were confirmed by the bank.

From the information given, and assuming that you examined the cash records for January, August, and December, 1961, prepare the audit working papers for cash in bank, including the following:

1. Individual bank reconciliations on separate working papers.
2. A leading schedule for cash.
3. A list of journal entries (if any) necessary to produce the correct cash balances.
4. A list of the audit procedures you used. These should appear on each reconciliation.

Chapter 6

ACCOUNTS RECEIVABLE, SALES, AND BAD DEBTS

For most companies accounts receivable comprise an important part of total current assets. These receivables will arise primarily from the sales function, but they also often arise from other sources. They may be due from customers, officers and employees, subsidiary companies and affiliates, and others such as common carriers.

It is normal balance sheet practice to segregate nontrade receivables from those arising from customers. This ordinarily is not the case as far as the receivables records are concerned. Usually all receivables will be maintained in the accounts receivable subsidiary ledger or ledgers. One of the tasks of the auditor as he goes through the subsidiary ledger is to question any items that appear to be other than trade accounts.

To make an adequate examination of accounts and notes receivables the auditor should study all the conditions surrounding the receivables. He should familiarize himself with the credit and collection policy of his client and should consider carefully the system of internal control as it affects receivables.

INTERNAL CONTROL AND RECEIVABLES

The auditor's survey of the existing internal checks and balances with respect to receivables must be sufficiently intensive to satisfy him as to the reliability of the resultant account balances. The first step in this study is to determine that there is a proper division of functional responsibility. The best proof that this division exists is to determine that all amounts entered in the accounts receivable control account originate in departments other than the accounts receivable department. Thus debits should be transmitted from the billing department, credits for cash receipts from the cashier, credits for returns and allowances

from the credit and collections department, and bad-debt write-offs from the person or department having the responsibility for the final decision as to the write-off.

Invoices received from the billing department should be accompanied by a tape of the total amount of the invoices presented. If this is not done, the tape should be run in the receivables department so that the total posting may be proved against this prerun total. There should be a daily proof of all postings against the entries in the control account.

Information with respect to cash receipts should come from the cashier in the form of a list of receipts or, in larger organizations where total receivables necessitate, in the form of a remittance advice. Here again a prerun total should be obtained to act as a proof against the sum of the credits posted to the accounts receivable account.

Management should have divided the functions in such a way that all noncash credits to accounts receivable are controlled by an officer or responsible employee who does not have access to or authority over the cash books. Credit for returns and allowances should be controlled by the sales department. Authority for write-offs of uncollectible accounts receivable should be controlled by the credit-granting department. All other noncash credits to customers' accounts should be authorized by the chief accountant.

Regular (monthly) balancing of the subsidiary ledgers with the control account is a most desirable feature. Failure to follow this balancing procedure is a weakness in internal control. It also means that if errors are made it will be much more difficult to locate them at a later date. Monthly balancing isolates the error on a time basis and thus reduces the time necessary for locating the error. In most instances, the time saved in locating errors more than compensates for the time spent in preparing a monthly proof of the subsidiary record.

Monthly statements should be prepared and mailed early in the month. This task should be done by some person independent of the cashier's, credit, or accounts receivable department. After the accounts receivable bookkeeper has balanced the ledger or subledger for the month he should have nothing more to do with it until the statements have been prepared and mailed. Where the statements are prepared as a part of the posting process an independent person should check the original statement to the ledger card. The control over these statements should continue until the individual has placed them in the mail. The routing of incoming mail should be such that any undeliverable statement and any complaints received about the statement should be channeled to the

person who prepared or checked the statements and mailed them. Again the point is to keep the statement out of the hands of the person who is responsible for the original postings on the accounts receivable cards.

The auditor should also determine what work is done in giving the collection department information about old accounts. The preparation of aging schedules or the listing of slow accounts should be a regular portion of the accounts receivable work. This information should then be forwarded to the credit and collections department. In his study of the accounts receivable subsidiary records the auditor should note whether or not the accounts are flagged in such a way that this information is easily available.

When accounts are ultimately determined to be worthless, the bad-debt write-off should originate in the credit department. Formal approval by some executive other than the credit manager, preferably the treasurer, should be required. It is only on the basis of such properly authorized write-offs that an entry should be recorded in the general journal. The accounts receivable that have been written off should be pulled from the subsidiary ledger and filed in a suspense file. This file should be under the control of some department other than accounts receivable. A logical place for the retention of these accounts is in the credit department. Collection efforts on the accounts written off should not cease with the write-off. The auditor should investigate the follow-up procedures that are made for the accounts that have been written off to determine that an adequate effort at collection is attempted.

In those companies having an internal auditing department the auditor should investigate to determine what confirmation procedure, if any, is followed. The sending of confirmation requests by internal auditors is a normal part of their work. Not only will the independent accountant want to evaluate their performance in terms of its effectiveness as a part of internal control, but he will also need to take their confirmation practice into consideration in planning his own confirmation of accounts receivable.

MAJOR OBJECTIVES IN AUDITING ACCOUNTS RECEIVABLE

There are four major objectives in auditing the accounts receivable. These deal with (1) the existence and accuracy of the accounts, (2) the validity of the accounts, (3) their collectibility, and (4) the balance sheet presentation. There is a certain amount of overlapping in some of the procedures used in auditing receivables, but they all tend to support

one or more of these major objectives. As the student considers the procedures discussed below and determines the reason for their application, he should attempt to determine also which specific objective they help to fulfill. It is important to reiterate that memorizing auditing procedures is a poor way to study. Once the underlying reason for the use of the procedure is understood, its applicability in varying situations is easy to understand and employ.

AUDIT PROCEDURES AND TECHNIQUES

It is to be understood that the following procedures and techniques do not apply indiscriminately to every situation. After reviewing the specific situation the auditor must choose those procedures which he believes will be most effective in fulfilling the major objectives. The effectiveness of the internal control system will also play a part in determining not only how much to test but also which techniques to use.

1. Prove the subsidiary ledger to the control. There are three basic situations that the auditor may find for applying this procedure. Some clients will have few enough accounts receivable, with balances sufficiently large, that the aging of the receivables does not present an unduly burdensome task. Here the auditor will probably prove the subsidiary ledger against the control by setting up the account balances on an aging sheet. The aging schedule (Exhibit 6-1) is an important worksheet for the auditor in those cases in which it may be used. It accumulates from several sources information which aids him in the over-all examination of receivables. If the auditor has arranged to have the client prepare this schedule for him, he will at this point compare the balances shown on the schedule with those in the subsidiary ledger and prove the total (net) against the control account balance. A more complete description and illustration of the aging schedule will be given in the section on collectibility.

Some clients will have so many accounts receivable with relatively small balances that neither the auditor nor the client wants to spend the necessary time to prepare an aging schedule. Furthermore, in most of these cases, the valuation of the accounts receivable is not dependent on an analysis of each account but is determined by some other method. In any case where the accounts receivable exceed 1,000 in number and the individual balances are relatively small, the auditor should give due

Exhibit 6-1

Central Manufacturers, Inc.
Accounts Receivable
December 31, 1961

	Name	Credit balance	Debit balance	Not yet due	1-30	31-60	Past due accounts 3-6 months	6-12 months	over 1 year	To be written off	To be reserved	Collections to Jan. 15, 1962	Remarks
1	Abbott Mfg. Co.		1,416.20 c	884.60	531.60							531.60	
2	Barney - Black, Inc.		2,350.00 c	1,280.00	862.80	107.20						970.00	
3	Buckeye Supply		1,261.00 c	350.00	740.00	171.00						911.00	
4	Carroll & Carroll		65.00						65.00	65.00			Out of business
5	Conkle Corp.		948.00 c	624.50	323.50							948.00	
6	Fuller Parts Co.		1,961.45 c	1,442.25			519.20					1,442.25	Claims 519 [illegible]
7	Goodell Central Supply		3,850.41 c	180.52	1,750.48	1,919.41						1,919.41	
8	Holman & Montry		4,864.15 c	2,380.65	2,483.50								
9	Hurlbut Parts		2,052.80 c	2,052.80								2,052.80	
10	Ireman and Baldwin		1,788.54				1,141.20	647.34					Doubtful. Reserve 50%
11	H. X Jones Co.	62.80 c											
12	Juratch and Co.		3,842.50	3,842.50									
13	Kenilworth Corp.		5,412.18	5,412.18								5,412.18	
14	Kellam Supply		6,660.74 c	4,824.68	1,836.06								
15	Knapp & Knapp		1,868.20				318.20	841.20	708.80		934.10		Contractor [illegible]
16	Lee and Crane, Inc.		5,710.91 c	4,221.60	1,489.31							1,489.31	
17	Leidenroth Corp.		2,213.11 c	2,213.11									
18	McKee Supply		5,463.78 c	5,463.78									
19	Mirandor Glass Co.	181.52 c											
20	Nesbitt Mfrs.		14,715.28 c	1,281.51	2,248.75	8,141.50	3,043.52					3,043.52	Slow but good
21	O'Connell Vendors		8,066.93			1,281.50	4,362.81	2,416.62			2,015.23	500.00	Now on C.O.D. Reserve 25%
22	Rasor, D. L.		462.81						462.81	462.81			All attempts to locate
23	Roach Construction		3,469.71 ©	3,415.71				54.00		54.00			have failed. [illegible]
24	Satterlee & Jones, Inc.		12,413.10	8,260.20	4,152.90							4,152.90	54 [illegible] disputed item [illegible]
25	Seigel Steel Co.		51.21	51.21								51.21	
26	Tenafly Contractors		496.76				496.76				496.76		Doubtful
27	Waters Supply Co.		1,287.00 c	1,287.00								1,287.00	
28	Zeuss Parts Co.		8,984.44	6,520.00	2,464.44							2,464.44	
29	Total (101,570.21 − 244.32 = 101,325.89)	244.32	101,570.21	55,988.80	18,883.34	11,620.61	9,881.69	3,959.16	1,236.61	581.81	3,446.09	27,135.62	
30	AJE (17) To write off bad a/cs		(581.81)					54.00	(527.81)	(581.81)			
31	AJE (18) Allow credit memo		(519.20)				(519.20)						
32	Totals	244.32	100,469.20	55,988.80	18,883.34	11,620.61	9,362.49	3,905.16	708.80	-0-			

Sent positive requests to all customers.
C = Confirmed
© = Confirmed, except for $54. N/A
©* = Confirmed, except for $519.20 Credit memo found. Had not been entered.
Tested sales invoices for March, September, December
Traced invoices into accounts and shipping records for last week in December and first week in January

Confirmations requested - 28	101,125.89
" returned - 19	85,996.49
% returned - 68%	85%
Cash received to 1/15/62	
on unconfirmed a/cs	6,750.39

[illegible initials]

consideration to the cost of the preparation of the aging schedule as opposed to the value derived from it. Where an aging schedule is not appropriate the auditor should obtain a proof of the subsidiary ledger against the control account by taking a tape of the subsidiary ledger. Some judgment must be applied in deciding whether or not a complete tape should be run or whether tests will suffice. Where the client has broken down the subsidiary ledger into sections, each with its own subcontrol, tests of the subsections may suffice.

When accounts receivable are aged it is customary to show the credit balances in a separate column to the left of the debit balances. Similarly when a tape is run it is necessary to segregate in some manner the credit balances from the debit balances. While the major proof here is against the control account (or subcontrol) balance, the auditor also wants to know the number and amount of credit balances. Hence it is usually convenient to run the tape in some manner that will provide the auditor with the total debit balances and total credit balances rather than deducting the credits as they occur and arriving at a net balance. One method of handling this is to use the non-add key for credit balances. This results in a total of debit balances with all credit balances indicated by the non-add symbol. It is then a simple task to go back through the tape and pick up all the credit balances. The total of the credit balances is deducted from the total of the debit balances to arrive at the balance per the control. The possible reclassification of such credit balances is discussed under step 15. Exhibit 6-2 illustrates a summary worksheet of accounts receivable which might be used in this situation.

The third basic situation occurs where there are so many accounts receivable that the auditor finds it satisfactory to test the accuracy of the subsections of the subsidiary ledger. For example, if the client has 150 subledgers, each with 1,000 accounts and each with its own control, a footing of perhaps from 20 to 25 per cent of the ledgers should be a satisfactory test. It would then be necessary, of course, to list or take the totals of the 150 subcontrols to tie in with the over-all control. The determination as to how much testing is to be done is dependent on the auditor's evaluation of the internal control system. This will be further modified by the number of errors that the auditors find in the tests that they do run. As a general rule it is true that a greatly increased volume of transactions requires an increased effectiveness in the system of control. Hence it would be anticipated that a client with this number of receivables would have the controls set up in such a fashion that there would be constant cross checks. It would be expected that relatively few

errors would be made that would not be caught through the application of the cross check. However, the auditor must in each instance modify his prearranged plan by what he actually finds as he makes his tests. It is also reasonable to expect that, with 150,000 active accounts, there normally will be some errors that are not traced out but are charged or credited to an over and short account. The reasonableness of the net

Exhibit 6-2

Jones and Lamb, Inc.
Summary of Accounts Receivable Ledgers
December 31, 1961

Ledger	Total dr.	Total cr.	Net
A-D	32416 81	251 52	32165 29
E-H	22156 17	-0-	22156 17
J-M	33150 50	1461 15	31689 35
N-P	12586 40	320 00	12266 40
Q-S	17719 50	205 10	17514 40
T-Z	23914 38	290 86	23623 52
	141943 76	2528 63	139415 13
			C

C = Agrees with control.
Ran tapes of all ledgers. No employees accounts included.
Reclassification entry ② sets up credit balances as a liability.
Negative requests were sent to customers in first and last ledgers and about 5 per cent of the customers in the other ledgers. All returns were satisfactorily explained. No adjustments were necessary.

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balance in this account is some indication of the effectiveness of the internal control.

The auditor should be suspicious in situations where the client claims that because of the volume of accounts it is impossible to take a trial balance. The author is familiar with one such situation where a trial balance had never been taken. The auditors, however, insisted on attempting to prove the subsidiary against the control. As might be anticipated, the individual in charge of receivables was short many thousands of dollars in his accounts.

In one of these three ways, then, the auditor satisfies himself that there are individual accounts receivable aggregating the amount the client shows in the control account. The auditor must decide, in the light of all conditions surrounding the receivables, which method he is to use.

In some cases the subsidiary will not prove to the control account, at least on the first try. If the client has run a tape of the subsidiary ledger it may be obtained and checked against the auditor's schedule. The discrepancy should thus be brought to light quickly. No time should be wasted attempting to go back to prove the accuracy of the schedule if such tapes are available. If they are not, the schedule should then be checked with the subsidiary ledger again to make certain that all balances were taken off correctly. Schedules should then be refooted. If this procedure discloses no error, obviously the subsidiary was not balanced with the control when the work was started. The auditor's procedure at this point will depend somewhat on the circumstances. In most cases where the client has an adequate staff, he should turn back the subsidiary ledger with instructions that it is to be balanced before again being presented. This is pure bookkeeping work, which ordinarily should not be performed by the auditor. Presumably all subsidiary ledgers, as well as the general ledger, should be balanced before the auditor starts his examination. In those cases in which the client's staff is not able to find the errors, the auditor may be called upon to help out. However, the client should understand that this is bookkeeping, not auditing, and that the regular auditing fees will be charged.

The auditor is always interested in determining how the error arose and why it was not caught earlier. It is true, of course, that a subsidiary ledger out of balance may be an indication of fraud. The auditor then must be careful to judge at what point he wants to take over the job of finding the discrepancies. It may well be that he would rather do this work himself if there is any suspicion in his mind that illegal transactions are a possibility.

If the combined work of the client's staff and the auditor fails to dis-

close the discrepancy, a decision must be made as to whether or not the error is of enough significance to make an adjustment. The client is going to collect only those amounts for which he has bona fide accounts receivable in the subsidiary ledger. If it is decided that an adjustment should be made, the control must be adjusted to the total of the subsidiary ledger. This adjustment, however, should be made only after a serious attempt has been made to find the error. The client's staff should be impressed with the seriousness of permitting subsidiary ledgers to get out of balance. If monthly trial balances are not taken, the auditor should indicate that such a procedure would disclose the error in the month in which it occurred and would thus localize the differences and permit an early recognition and correction. He should also point out that the purpose of having a control account is lost if in fact it does not control and must be adjusted periodically to agree with the detailed ledgers.

2. Examine the control account. As part of the examination of the accounts receivable the control account should be scrutinized for unusual entries. It is not normal practice to prepare an analysis sheet of the accounts receivable, although in some cases it may be desirable. However, the auditor should follow up any unusual entries he finds in the control account. This would include entries from the general journal and from any other journals other than cash receipts and sales. In investigating these unusual entries the main point is to see that there is proper authorization for the entries and proper evidential material to support them.

His examination of the account should include a review of the pattern of entries from month to month to determine that all the normal entries have been made. In this review he should discern normal entries of abnormal size that should be investigated.

3. Test the sales record. In the majority of cases debits to the accounts receivable arise from sales transactions. As a step in proving the accuracy of the accounts receivable the auditor should make some tests of the sales transactions. If the sales invoices are recorded in a sales journal, a comparison should be made of the invoice with the entry in the journal. This should include a comparison of the invoice number, the date, the customer's name, the total sales, and the distribution. Tests should be made of the extensions and footings on the invoices. In many situations it is good practice to trace the unit prices used to the most recent catalogue or price list issued by the client. The sales journal should then be footed for the test months for which the comparison was made. If sales are recorded by departments, the comparison must include a testing of the distribution of sales.

Many companies do not use a sales journal. The sales invoices are

used as the book of original entry, with a summary entry being made in the general journal at the month end. In these situations a tape should be run of the sales invoices for the test periods. The same steps should be followed in the examination of the invoice as were indicated above, although the test may be smaller. Again, if there is a distribution of sales by product or by department, the auditor should take his tapes on that basis. As a further test, where prenumbered sales invoices are used, all numbers should be accounted for. If any of these invoices are missing the auditor should attempt to find them. All voided sales invoices should be retained in proper numerical order until the examination has been completed. The summary entry at the month end should then be proved and traced into the general ledger accounts.

Many companies, particularly those engaged in retailing, have so many sales transactions that summary entries are made daily and recorded in a sales journal. As might be suspected in such situations, the internal control is better than normal, and it is satisfactory to test some of the days of the month instead of an entire month. The footings and distribution of the daily tapes are then traced into the sales journal, with the journal being footed for the month. The monthly totals are then traced into the ledger accounts.

The purposes of this examination of the sales invoices are to furnish satisfactory evidence that the sales are bona fide transactions and that the amounts shown in the ledger accounts are supported by valid evidences which have been correctly summarized.

4. Test postings to individual accounts. A sufficient number of the sales invoices should be traced into the individual customers' accounts to indicate whether or not the work is being done satisfactorily. The mathematical accuracy of the balances of the individual customers' accounts should also be tested. The proof of the subsidiary ledger against the control is incomplete unless this is done. While it is not necessary to make a complete balancing of these accounts, enough balances should be proved to demonstrate that as a whole the balances are correctly stated. Only after this has been done is there any assurance that trial balance of the subsidiary ledger is an accurate one. The purpose of this test is to provide evidence of the accuracy of the charges to the customers' accounts and to prove the validity of these charges.

5. Review the sales cutoff. Sales invoices for the last week in the fiscal year and the first week in the new year should be traced into accounts receivable and into the shipping records. The purpose of this procedure is to determine that the sales recorded in the year under review

actually belong in that year. Since title ordinarily passes with delivery to the common carrier, the shipping records are important in determining whether or not the sale was completed. Attention must be paid to terms of sale also to ascertain whether or not there is passage of title. Sales in which material has been "set aside" for the customer are treated as sales for the current period, even though they have not been shipped. But it must be determined that the goods were also excluded from the client's physical inventory. The invoices for the new year should be examined to determine that no sales recorded there belong in the year under review. Another reason for tracing these invoices into the shipping records is to determine that a shipment was made and that the invoice is not a fictitious one.

6. Examine the sales returns and allowances. The sales returns and allowances memoranda should be examined for the same test periods as were the sales invoices. While the same scrutiny was made of the mechanical work on these memoranda, a more important part of the examination deals with the authorization. The procedure for handling sales returns and allowances should be studied and the proper authorization determined so that the examination of the memoranda will be meaningful. Where perpetual inventory records are maintained, some of the returns memoranda should be traced to the inventory records to determine that proper recognition was given to the material received. Customers' correspondence should be examined to determine the basis for the return or allowance.

The examination of the sales returns and allowances memoranda should be extended into the first week in January. The purpose of this step is to discover whether or not any unusually large returns were made during that period. The returns should be compared with returns for a comparable period of the preceding year or years. If the comparison discloses larger than normal returns it might be an indication that sales were padded at the year end. If suspicion is thus aroused an even more careful examination should be made of the customers' orders, sales invoices, inventory records, and shipping records for the week or ten days prior to the year end.

7. Circularize the accounts receivable. The circularization of accounts receivable is now firmly established as a generally accepted auditing procedure. The number of requests that are sent, the type, and the date chosen for the circularization all are a matter for the auditor's judgment. But the procedure is firmly fixed in all instances in which accounts receivable are material. The auditor must make some circularization or

disclose in the short-form report that he has not followed generally accepted procedures with respect to circularization. There are some instances in which it is necessary for him to make this disclosure because of other factors, as discussed below.

The completed confirmation request is basically an independent, outside verification of a balance shown on the client's books. As such it tends to support the auditor's opinion as to the fairness of the amount reflected in the ledger account.

Confirmation requests take two forms. In one a positive verification of an account balance is requested. The customer is asked to indicate the correctness or incorrectness of the balance shown by signing and returning the request. In the negative type, the customer is requested to write to the auditor only in case he disagrees with the amount shown on the client's books. Thus, in effect, the negative confirmation request is no confirmation at all. Examples of these requests are shown in Exhibits 6-3 and 6-4.

In determining his circularization procedure the auditor has a choice of either of these two forms; in many cases he will use both. However, certain factors arising in any situation tend to indicate the form that is best used in that particular situation. The positive form is used most widely in those instances where there are relatively few accounts receivable but each of the receivables has a relatively large balance. It is also used in situations where the auditor has some doubt as to the accuracy or validity of the account. The positive form is used also where an account is old and the auditor wishes to have the customer again recognize the debt. In other words, wherever the auditor wants a definitive answer as to the status of the account balance, he uses the positive type of confirmation request.

The negative type of confirmation request is used more often in those situations in which there is a mass of accounts receivable. Whenever there are tens of thousands or even hundreds of thousands of accounts receivable, the implication exists that the accounts have small balances relative to total accounts receivable and that the loss of any individual account receivable will not have a profound effect on total receivables. Thus, it is not as important that there be a positive confirmation of each of the balances. When there is a large number of individual accounts it is normal to find the negative request being used. As a further reason, the cost of recording the details of each of the positive forms sent out, and the answers thereto, would be prohibitive where there are so many accounts

These then are the normal situations in which the two types of confirmation requests are used. It is true, however, that there are certain situations in which the use of the negative form is prohibited. In any case in which there is no reasonable expectation that the confirmation request will be returned under any circumstances, the negative type of request should not be used. In such a situation, either the auditor must send the positive type of confirmation request, in the hope of getting a sufficient proportion of replies to satisfy him as to the validity of the accounts, or he must use alternative methods of establishing their validity. Where this is done, he must then disclose in his report that he has not complied with the generally accepted procedure of circularization of customers' accounts.

Exhibit 6-3

GENERAL MANUFACTURING CO.

1234 West High Street

Columbus, Ohio

January 5, 1962

Webster Parts Co.
2244 Tappan Avenue
Columbus, Ohio

Gentlemen:

Our auditors, Jones, Black & Co., are making their annual examination of our financial records. In connection therewith, we would appreciate your confirming to them the correctness of our accounts on your books. As at December 31, 1961, our books indicate that you are indebted to us in the amount of $2,005.69. If your records are in agreement, please so indicate by signing this letter in the space provided below and returning it to our auditors in the enclosed stamped, self-addressed envelope. If there is some disagreement about the amount owing us, please indicate what the discrepancy is on the back of this request, and mail it direct to our auditors. Thank you for your cooperation.

Very truly yours,

General Manufacturing Co.

To Jones, Black & Co.:

Our records are in agreement with the above statement.

By ______________________

There will be many situations in which it is desirable or necessary to use both types of confirmation requests. Even where there is a large number of accounts receivable it is normal to find certain of the accounts with large balances. The auditor will probably want to use a positive type of request for confirming large balances and to use the negative type of request for small balances. Negative confirmation requests are used to a large extent in situations where the client deals with the ultimate consumer. Most of these customers, being individuals, either wage earners or salaried or professional people, under no compulsion to keep a complete set of records, have little or no way of knowing for certain whether or not the amount billed to them is correct. Only in cases where the billing is recent or where the amount is unusually large would the customer be apt to recall any of the details of the transaction and thus be able to confirm positively the amount billed to him. In such instances, it would be rather useless to send out the positive form of confirmation request.

Once it has been determined which type of request is to be used, the next step is the preparation of the confirmation requests. The auditor should take control of the accounts receivable. Using the positive form of request, the letter may or may not be sent along with the monthly statement mailed to the customer. If it is, the statement balance should be compared with the balance per the ledger account or account card and the amount inserted in the confirmation request. Where the request is sent separately the balance shown on the account card or in the ledger account will be entered on a confirmation request. The name and address of the customer will then be inserted on the request and envelopes will be prepared and stamped. Unless a printed form is used bearing the client's signature, the request must now be submitted to the client for his signature. The auditor may watch the client's authorized representative sign the letters, but in many cases this is too time-consuming. Where he loses control of the confirmation requests by turning them over to the client and leaving them with him for signature, an additional check must be made to ascertain that he has received back from the client all that were given him. Having the requests back from the client and having proved that all are there, the auditor should next personally insert the statement and request, or just the request, as the case may be, in the envelope. Control over the confirmation requests should be maintained by the auditor from the time that he starts working with them until he places them in the mail.

Negative confirmation requests come in many forms, from a gummed

sticker to be attached to the customer's statement or a rubber stamp which is stamped on the regular monthly statement, to a printed form letter to be used when the customer's statement is not enclosed with the confirmation request. One form of negative confirmation request is shown in Exhibit 6-4. The import of all these forms is the same. The

Exhibit 6-4

PLEASE EXAMINE THIS STATEMENT CAREFULLY

If it does not agree with your
records, please correspond
directly with our auditors,

Jones, Black & Co.
26 North Main St.
Columbus, Ohio

THIS IS NOT A REQUEST FOR PAYMENT

customer is requested to reply only in those cases where his records differ from the client's records. The client's signature is not needed on negative-type requests. The process here is for the auditor to obtain the customer's statement, compare it with the account card to make certain there are no discrepancies, stamp or stick the request on the customer's statement, insert in the envelope, and mail. In all cases, the auditor's return address should be shown in the corner of the envelope. Where positive-type requests are used, ordinarily the auditor supplies a stamped self-addressed envelope for the customer's convenience in replying. This envelope too is addressed to the auditor's office. Since not many replies are anticipated when the negative type of request is used, it is not customary to enclose the prepaid envelope.

On many engagements it is not necessary to make a complete circularization of the accounts receivable. Instead reliance will be placed on a sampling. Where this procedure is followed, the sample must, of course, be representative. Accounts to be confirmed must be chosen from those that have current balances, from those that are delinquent, from those having large balances, from those having small balances. Accounts about which there is any question should always be confirmed, preferably through the use of the positive type of request. In addition to including individual accounts from the various categories mentioned, it is also customary to send requests to blocks of accounts. For example, requests may be sent to all customers whose last names begin with A, M, and W. The selection of the number of accounts and the particular groups

to be sampled is a matter for the auditor's judgment. The sample must, however, be adequate and representative.

The confirmation of accounts receivable may take place at some date other than the balance sheet date. For a calendar-year closing, the receivables may be confirmed at November 30 or even October 31. Where this is done it is then necessary for the auditor to make a careful review of the transactions intervening between the circularization date and the balance sheet date. All entries in the accounts receivable control account will be carefully scrutinized to ascertain that they are proper entries. Tests will be made at the year end of the details of the transactions in the intervening period. On the basis of the circularization and the tests, the auditor then is justified in accepting the book figures at the year end, although a few of the larger accounts might be again circularized at the year end.

While the general confirmation procedure is now accepted by most clients, it is still not unusual to find situations where the client requests that certain of the accounts not be circularized. In these situations, the auditor must disclose the fact that this circularization was not made. The materiality of the amount will indicate whether the disclosure should come in the short-form report or in the text of the long-form report.

In cases where the accounts, or certain of them, are not confirmed it becomes necessary to apply alternative procedures for establishing the validity of the account. Extended checks should be made of the customer's order, the filling of the order, the billing of the order, and the postings to the customer's account. Shipping records will also be examined to determine that the goods actually were shipped to the customer. The arithmetical accuracy of the account balance should be verified. While such steps tend to establish the accuracy and validity of the account balance, they cannot replace the satisfaction of a confirmed amount. In some cases, however, these alternative procedures are the only steps available to the auditor.

Where the positive confirmation request is used, it is customary to maintain a control over the number of confirmations sent and returned. This control may be achieved in any of several ways but it is always expressed and retained in the working papers. One common method of gaining control where requests are sent to all customers is to use the aging schedule as a control sheet. As returns are received, an audit tick mark may be made against the customer's balance on the aging schedule, indicating that the balance has been confirmed or that there has been a

question raised as to the correctness of the amount. This particular method is shown on the aging schedule illustrated in Exhibit 6-1.

Another method makes use of a separate column on the aging schedule, the column being headed "confirmations returned." A check mark is placed in the column as the returns are received. If there is some question about the balance, the complaint is entered in the remarks column of the aging schedule. In another method a separate sheet is set up as a control sheet. The requests are serially numbered and the control sheet contains just a listing of the numbers. As the confirmations are returned, the numbers are checked off. Where discrepancies arise a separate sheet is set up to record the discrepancy and the final disposition thereof.

These controls over the confirmation requests are also used as a guide by the auditor in determining when and to whom second requests should be sent. After a reasonable time has elapsed second requests should be sent to those customers who have not replied to the first request. A mark should be made against these names on the control sheet so that there is a record of the customers to whom second requests were mailed.

Where the negative form is used no attempt is made to control the outgoing confirmation requests. It is customary to indicate in the working papers the extent of the circularization. This may be expressed as the number of requests sent, and/or the blocks of accounts that were used. The important control aspect on the negative requests is the control over the complaints sent in as a result of the circularization. A worksheet should be set up on which may be entered the customer's name, the balance per books, the complaint that was made, the disposition of the complaint, and the adjustment that is necessary, if any.

As the confirmation requests come back, there will undoubtedly be some which indicate disagreement with the client's records. Where the positive type of requests has been used, the auditor will want to follow out these discrepancies. Because of the large amounts involved where positive requests are used, he should find out for himself just what happened to cause the difference and what is necessary, if anything, to correct it. The usual discrepancies that arise are as follows. The customer may have paid his bill just prior to the year end but the amount was not received until after the new year began. The client may have shipped goods right at the year end but the customer did not receive them until after the new year began and thus did not recognize the liability as of the year end. The customer may be disputing a bill

because of failure to receive the goods or because of poor quality of goods. An order or a credit may have been posted incorrectly to the customer's account, or one that should have been posted to his account was posted to another account in error. To determine the reason for these complaints the auditor will examine the cash receipts book for the new period, will examine shipping records at the close of the period, and will examine a subsidiary ledger card for posting to incorrect accounts. Wherever the discrepancy arises because of the time lag there is no adjustment necessary. If errors have been made in posting, they, of course, must be corrected. If errors have been made in shipping, if fictitious sales have been entered, if there is lapping going on, adjustment of the general ledger and subsidiary account is necessary.

It is essential that a distinction be made between valid confirmations and those which, in effect, are no confirmation at all. A duly signed confirmation request, with no discrepancy noted, is a valid confirmation. If the letter is signed but exception is taken to the amount, the confirmation is not valid until the discrepancy is satisfactorily resolved. When the letter is not signed, even if no discrepancy is noted, it is not a confirmation. Where differences are noted and the letter is not signed, the auditor should clear the differences, then resubmit the request. In some cases additional correspondence with the customer is necessary before he will sign the request.

The same types of errors take place regardless of what method of confirmation is used. However, when negative requests are sent out, with the usual implication that individual account balances are small, although the auditor is concerned about the errors, he is apt not to keep such a close control over them. In many instances, after having recorded the complaint, he is willing to turn the correspondence over to the client for investigation and disposition. He will, of course, want to determine what the final disposition is so that if any adjustment of the records is necessary he will have that information in his working papers. As is true with any errors, the auditor is concerned as to how the errors were made and primarily as to why they were not picked up earlier by the checks and balances in the internal control system. However, when working with accounts receivable subsidiary ledgers it is difficult to determine errors that have been made in posting to incorrect accounts. It is ordinarily the customer who brings such matters to the attention of the client. Since such an erroneous posting would not throw the subsidiary out of balance with the control account, there is no proof that would disclose such an error prior to the customer's complaint. It is

indeed another useful purpose served by the circularization of customers.

When positive confirmation requests are used the control exerted over the requests permits the auditor to report the results of the confirmation effort in a positive manner. Since the number and dollar value of the requests sent out may be determined from the control sheet, a comparison may be made of this information with the balances confirmed. For purposes of this comparison it does not matter whether the circularization was complete or only a test. Actual returns may be compared with the maximum to determine the validity of the procedure.

If the returns prove to be significantly less than 70 to 80 per cent or if the discrepancies disclosed are material, it may be judged necessary to expand the test. If requests were sent to all customers and a significant amount (both in number of requests and dollar amount) was not confirmed even after second requests were sent, the alternative procedures discussed earlier in this chapter should be applied to the unconfirmed accounts.

When negative requests are used, the greater the returns, the less satisfactory are the results. As the number of complaints increases the decision to expand the test becomes increasingly easier to make. A point is reached where the auditor decides that he cannot rely on the accounts receivable as they exist. Additional sections must be circularized to verify or disprove the results of the first group.

When positive requests are used, accurate statements may be made as to the percentage of accounts and dollar amounts circularized. This is not so true with negative requests. If a block is composed of a subledger, then dollar amounts are available. Usually no attempt is made to count the number of accounts in the subsection in order to compare it with the total number of accounts. Similarly, in indicating the results of the circularization, no attempt is made to compare the returns (number and amount) with the total. Instead, if the complaints are disposed of or adjusted satisfactorily, a statement similar to the following may be made in the auditor's long-form report. "We have circularized the customers' accounts to the extent considered necessary by us. All complaints have been adjusted satisfactorily."

Despite the fact that the request usually carries a statement indicating that it is not a request for payment, it is not unusual for the auditor's office to receive payments on account or in settlement of the statement. When this occurs the auditor should turn over to the client the statement and the money, being certain to take a receipt for the cash turned over.

8. Age the accounts receivable. The determination of the age of the individual accounts is the first step in determining their valuation. In some cases an aging schedule will be prepared; in others different means will be used for valuation purposes. Where relatively few accounts exist an aging schedule produces the best results. The decision as to whether or not this schedule is prepared, either by the auditor or by the client, is made on the basis of cost versus value to be received from its use. The aging process is time-consuming. Where easier means of evaluation are available they should be used, provided that the results are reliable either way.

An aging schedule is shown in Exhibit 6-1. The following principles should be observed in preparing such a schedule. Customers are entitled to indicate which charge they are paying. If no indication is made but the amount received is identifiable with one or more invoices, it should be applied to those invoices, even though prior invoices are left unpaid. If a receipt is not identifiable with specific charges, it is applied to the oldest open items.

In setting up the schedule it is wise to show credit balances to the left of the debit balances. It is better to segregate the credit balances, rather than including them in the debit balance column, so that the total is clearly set forth and its materiality may be quickly determined. It is the debit balances that should appear on the balance sheet as accounts receivable, unless the credit balances are insignificant. Credit balances are not distributed to the aging columns. Hence, if they are included in the debit balance column the schedule will not crossfoot. Showing the credits to the left of the debits also condenses the aging portion of the schedule.

If the accounts receivable are not aged it becomes necessary to follow other procedures to obtain information with respect to questionable accounts. As the auditor runs a tape of the receivables or of certain portions of them for the purpose of proving the subsidiary to the control, he may gather this information at the same time. In most cases, old accounts will be flagged or marked in such a way that they stand out. Hence, it will be no particularly difficult task for the auditor to list these accounts on a worksheet as he runs his tape. The following types of accounts should come under his scrutiny and be listed for later discussion with the credit manager.

1. Old accounts
2. Accounts where the credit terms have not been observed
3. Accounts with unusually large balances

4. Accounts where the balance is increasing even though payments are being currently made

5. Accounts where there is an old unpaid invoice even though current purchases are being paid

6. All accounts where anything unusual has happened which leaves the auditor puzzled

If the footing done is on a test basis, it may be necessary for the auditor to make further examination of the remaining accounts to accumulate the questionable receivables in those groups. With this information listed he then will be in a position to have a discussion with the credit manager.

Where the accounts are aged and a long-form report is written, it is customary to report the results of the aging and to compare these results with the results of the preceding year. There is shown in Exhibit 6-5 a

Exhibit 6-5

	1961		*1960*	
	Amount	*Per cent*	*Amount*	*Per cent*
Not yet due	$23,407.84	53.3%	$18,274.03	50.8%
Past due				
1–30 days	10,095.29	23 0	7,949.92	22.1
31–60 days	3,520.85	8.0	3,453.26	9.6
61–90 days	1,227.50	2.8	1,222.97	3.4
4–6 months	1,681.25	3.8	1,474.87	4.1
Over 6 months	4,005.95	9.1	3,597.45	10.0
Totals	$43,938.68	100.0%	$35,972.50	100.0%

tabular form of such a comparison. The breakdown, of course, should be on the basis of the client's billing and collection terms and should be shown in percentages as well as in dollars.

9. Examine cash receipts in January. As additional evidence of the collectibility of the accounts receivable, it is customary to examine the cash receipts book from the first day of the new fiscal year until the close of the auditor's examination. If the accounts receivable have been aged it is customary to provide space on the schedule for the accumulation of current receipts. Obviously, it is essential that only receipts pertaining to December 31 balances be picked up. In this way many accounts for which no confirmations were received are thus proved to be good collectible receivables. In rare cases where there are only a few customers it

is possible that all accounts will have been paid by the time the auditor makes his examination. In these instances it is doubtful whether the confirmation of the December 31 balances adds any weight to the auditor's opinion, although disclosure of the failure to confirm would then become necessary.

Where negative confirmation requests are used and the accounts are not aged, the problem of tracing cash receipts is a little more difficult. The cash receipts book may be examined to determine whether or not any of the accounts on the auditor's listing of questionable accounts have been paid since the year end. Total receipts may also be compared with receipts for the same period last year and the two amounts related to the total receivables balances at the corresponding periods to determine whether or not there is a major variation either way.

10. Discuss the results with the credit manager. Having aged the receivables and determined in this manner the old accounts, or having lifted from the ledger accounts the questionable items, and having reviewed the current cash receipts, the auditor is in a position to consider with the credit manager the general objective of the collectibility of the accounts receivable. The credit manager should have considerable data relating to the individual accounts which will be of value to the auditor in the formulation of his opinion. The credit manager's familiarity with the individual accounts should also enable him to answer the auditor's questions. The whole matter of evaluation now comes under the auditor's scrutiny. Here, as in other phases of the examination, the original work to be done on this particular portion should be done by the client. The auditor is again merely reviewing what has been done and satisfying himself that it is reasonable. Even though nothing has been done with respect to the adjustment of the allowance for uncollectible receivables and even though the auditor and the credit manager jointly reach a decision after a discussion of the situation, the final decision still is management's representation. The auditor may aid and abet the credit manager, but the final decision must be his.

11. Analyze allowance for uncollectible receivables. Particularly in those cases where an aging schedule is used and the allowance for uncollectible receivables is determined on the basis of specific accounts, the allowance account should be analyzed completely so that the action taken relative to the write-off of accounts may be clearly set forth. If the normal provision for doubtful accounts is made on the basis of a percentage of sales or of outstanding receivables, write-off of uncollectible accounts may be made directly to the bad debt account. The point here is that it is

necessary for the auditor to have at hand the information with respect to accounts written off during the year. Having completed his analysis of either or both of these accounts, the auditor should satisfy himself as to the propriety of the write-off. He should examine the basic documentary evidence available that resulted in the write-off. This may be correspondence with the customer, reports of collection agencies, notices of bankruptcy proceedings, or similar primary evidence. It should also be ascertained that the write-off was properly authorized. In some instances, the auditor may feel it necessary to list the accounts written off during the year and then to obtain the signature of the person authorized to make the write-off as a final proof of their propriety. As explained in Chapter 2, the unauthorized write-off of accounts is sometimes used as a means of covering fraudulent transactions. Hence, it is important that the auditor be certain that each account written off was properly authorized. The auditor should also investigate the method of handling the accounts once they have been written off. The credit department should continue its collection attempts even though the account has been charged to the allowance. The point of interest here is that control should be retained over these accounts so that any collections made on the accounts will not be diverted to unauthorized uses.

12. Review the provision for uncollectibles. On the basis of the discussion with the credit manager, the returned confirmations, the January cash collections, and the accounts written off, the auditor is ready to consider the necessary provision for doubtful accounts as at the year end. The function of the allowance for doubtful accounts is to evaluate the accounts receivable for balance sheet purposes, thus indicating the net amount expected to be collected from the customers. The method of determining what the proper balance should be is dependent on the type of business the client is operating. In those cases where it is appropriate to age the accounts receivable, the final decision as to the noncollectibility of individual accounts is the starting point in the determination of the balance necessary in the allowance for doubtful accounts. In this situation, the balance sheet approach is used. The attempt is made to evaluate as closely as is possible the net amount to be collected from customers. This is determined by attempting to decide which individual accounts will be never collected in part or in whole, or what percentage, based on past experience, of each age category will never be collected. After discussions with the credit manager a decision is reached as to the total amount that should be provided.

It should be noted that the determination of the bad debt expense is a

resultant of the determination of the necessary allowance. In this case, assuming a credit balance in the allowance for uncollectible receivables of $2,200 prior to adjustment, the computation is as follows:

Balance desired	$8,600
Less: Credit balance in account	2,200
Net to be added	$6,400

The following journal entry then is made to set up a provision on the books.

Dr. Bad debt expense	$6,400	
Cr. Allowance for doubtful accounts		$6,400

While this computation provides the best evaluating method for the balance sheet, it does not necessarily reflect correctly for operating statements the cost of extending credit. Where individual sales and account balances are relatively small the percentage-of-sales method is normally used for determining the bad-debt charge for the year. Based on an experience table, the use of this method tends to correlate more closely the cost of extending credit for a given period with the revenue produced from the sales of that period. Here, however, the balance sheet evaluation is not necessarily adequate. Also any balance remaining in the allowance for doubtful accounts is undisturbed by the adjustment. It is assumed that the current charge to bad debt expense represents the cost of extending credit for the sales made during the current year. The balance carried over is supposed to be adequate to cover any uncollected receivables remaining from prior years' sales.

The auditor should review the experience table that the client uses and correlate it with actual losses for a period of years to determine whether or not the percentage applied is reasonable. In any situation where there is, over the years, a constant increase or decrease in the allowance for uncollectible receivables, the percentage should be reviewed to determine if it is still reasonable.

In his discussion with the credit manager as to the adequacy of the allowance for uncollectible receivables, the auditor should consider factors other than the basic information that he has derived from the aging schedule or from the experience table. Such things as the current employment probabilities for the class of customer with whom the client deals, the general phase of the economy cycle, the ease or tightness of money, and all other outside economic factors which might affect the ultimate collectibility of the accounts should be reviewed. Only when all

these factors have been taken into consideration is it possible to make an adequate judgment as to whether or not the allowance is fairly stated. An analysis of the allowance for doubtful accounts, based on Exhibit 6-1, is shown on Exhibit 6-6.

In certain situations it may be found necessary to consider a provision for cash discounts. Normally the knowledge of and control over discounts

Exhibit 6-6

Central Manufacturers, Inc.
Allowance for Doubtful Accounts
December 31, 1961

Line	Description		Dr.	Cr.
1	Balance, December 31, 1960			4862 00
2				
3	3/18/61 Write off Harry [illegible], bankrupt		475 80 "	
4				
5	11/26 Schreiber + Son, out of business		3420 00 "	
6				
7			3895 80	4862 00
8				3895 80
9	Balance per ledger, December 31, 1961			966 20
10	AJE (17) To write off uncollectible accounts		581 81	
11	Carroll + Carroll	65 00		
12	O. P. Rasor	462 81		
13	Roach Construction	54 00		
14		581 81		
15	AJE (18) To adjust to necessary allowance			3081 70
16	Reserve needed	3466 09		
17	Balance	384 39		
18	Adjustment necessary	3081 70		
19			581 81	4047 90
20				581 81
21	Balance per audit			3466 09

" Traced to correspondence file.
Write-offs authorized by treasurer

W.B.J.

to be taken by customers is so small that there is no good method of determining the amount that will be taken. Hence, there is no fair way in which this allowance may be set up. However, wherever it is found that there is definite knowledge, consideration should be given to this fact. For example, the customers may be very few, and they may all have paid their year-end balances by the time the examination is completed. If it is found that discounts taken are material, there is no good reason for not reflecting them on the balance sheet.

13. Examine for consignment accounts receivable. Goods sold on consignment may be included in a customer's account as a regular charge sale. In many cases there is no indication on the customer's card that the sale is other than a regular sale. Hence, it is the auditor's duty to question the client as to whether or not there are any consignment accounts receivable. Where these are encountered the auditor should request confirmation from the consignee as to the balance of the merchandise on hand at the balance sheet date. He should then adjust the receivable, eliminating any profit and transferring the unsold goods to a merchandise on consignment account.

If the client regularly sells on a consignment basis, it is probable that special consignment accounts will have been instituted. If there is a great number of these confirmation may again be on a test basis. In this instance, the consignment accounts normally replace the accounts receivable and the confirmation requests must cover not only the amount due from the consignee for sold portions but also the confirmation of the unsold portions of the stock.

14. Segregate nontrade accounts receivable. Almost all companies have one or more accounts receivable due from others than regular trade customers. It is quite probable that these accounts will be included in the regular accounts receivable subsidiary ledger. Here again then the auditor must question the client as to the existence of such accounts. They may be due from affiliated or subsidiary companies, due from officers and employees, or due from others but arising out of transactions other than regular sales.

If such receivables are not kept in the accounts receivable subsidiary ledger but are shown separately or are kept by some other individual, it is important that particular attention be paid to them and a closer scrutiny be made of transactions therein. Since these accounts are apart from the regular receivables it is probable that they also are not subject to the regular checks and balances applied to trade receivables. Hence, the auditor must use more than ordinary care in proving the validity of

the transaction. Again, confirmations customarily are requested from the debtors in this class. Credits to their accounts are traced into the cash receipts journal and supporting documentary evidence is examined for the charges in the account.

Even though transactions with affiliated or subsidiary companies arise out of normal trade transactions, they should be segregated for balance sheet purposes if they are at all material. Other nontrade accounts receivable should also be shown separately if they are material in amount. On the other hand, receivables due from employees and officers, if they arise out of normal trade transactions and if the normal credit restrictions are applied to these accounts, are often retained in the trade accounts receivable category.

15. Investigate credit balances in customers' accounts. The auditor should investigate credit balances in customers' accounts to determine their cause. He should also seek confirmation of these balances. If the amounts are material, they should be shown in the current liabilities section. If, however, the amount is insignificant, it may be offset against the accounts receivable debit balances.

Summary

The major procedural techniques used in auditing accounts receivable may be summarized as follows:

1. Prove the total individual account balances to the control account balance.
2. Make proper tests of the detailed record keeping, including sales and shipping records.
3. Send confirmation requests to customers.
4. Evaluate the accounts receivable.
5. Examine bad debt expense.
6. Classify the receivables for balance sheet presentation.

QUESTIONS AND PROBLEMS

1. Your client has 50,000 accounts receivable. Most of the accounts have balances of under $5. About 200 have balances of from $5 to $500. There are twenty-three alphabetical controls.

List your audit steps with respect to confirmation; collectibility.

2. State the major objectives in auditing accounts receivable.

3. Distinguish between an acceptable confirmation and one which may not be considered as a valid return.

4. Distinguish briefly between a positive and a negative confirmation of an account receivable. Under what circumstances would an auditor use the one form? Under what circumstances would he use the other?

5. In auditing Company A you discover that an invoice from Company B for materials purchased from them reads $421.65, when it should read $4,216.50. The management of Company A refuses to do anything about the error. How will you handle this situation?

Later you are asked to audit Company B's financial statements. You accept the engagement. How will you proceed with the examination of B, keeping in mind all the ethical considerations involved?

6. You are examining a company that has 20,000 customers. You intend to send negative confirmation requests to selected portions of the customers.

1. What factors would you consider in making your selection of accounts to be circularized?
2. How would you control the confirmations? The returns?
3. What follow-up would you make of the returns?

7. You have sent confirmation requests to all the trade customers. One of the requests is returned by the customer with the notation that he does not owe any balance. Your investigation discloses that the goods were billed on December 10.

What steps would you take to prove or disprove the validity of the billing?

8. Under what conditions is the use of the negative confirmation request prohibited?

9. The accounts receivable control of the Harris Company shows a balance of $143,672.51. The auditor's first tape of the subsidiary ledger shows a balance of $140,567.12. State, in order, the steps you would follow.

10. During your examination of the Grimshaw Company you discover some employees' accounts receivable in the trade accounts receivable ledger. The credit manager indicates that the employees receive a 20 per cent store discount but that they must observe the regular credit terms.

How would you audit and classify these accounts?

11. You are doing interim work during November at one of your clients, who closes his books December 31. As part of the interim work you decide to confirm accounts receivable as of October 31. There are about 5,000 receivables. You send negative confirmation requests to about 4,000 of the customers and positive requests to the 200 customers who owe large amounts. All complaints are reconciled and you receive about 150 of the positive requests, confirming 83 per cent of the dollar value. You prove the subsidiary to the control.

When you return in January, what more would you do to satisfy yourself as to the December 31 receivables?

12. The treasurer of a company refused to permit you to circularize the accounts receivable. What steps would you take to satisfy yourself as to the

validity and accuracy of the receivables? How would you report this situation?

13. How would you treat credit balances in customers' accounts for balance sheet purposes?

14. You are the senior in charge of an engagement, with a new junior assistant. You want him to handle the confirmation of accounts receivable. You intend to send positive requests to all customers. State the complete instructions that you would give him.

15. Name some common reasons why accounts receivable confirmation requests are returned unsigned, or with allegations that the amounts indicated are not owed. State how you would satisfy yourself in each case.

16. You find in the accounts receivable ledger an account with the president of the company with a balance of $3,862.14. On investigation you find that this represents premiums paid by the company five years ago on personal life insurance policies. No credits appear in the account. The president receives a salary of $25,000 per year and annual dividends of $15,000 to $20,000.

How will you audit this? How will you show it on the balance sheet?

17. The Jones Company maintains a suspense ledger in which it keeps accounts receivable that have been written off. In your current audit, you find that at the year end there were accounts totaling $23,000 in this ledger and that many collections had been received on the accounts. Collections are merely noted on the cards, being credited to collections on accounts previously written off.

How would you audit this ledger? To what would you pay particular attention?

18. What are the generally accepted methods of recognizing credit losses? Under what conditions would you suggest that each be used?

19. What evidence would you examine in support of debit entries to the allowance for uncollectible receivables?

20. Your examination of the accounts receivable of Thompson Products, Inc., reveals subscriptions receivable from stockholders, $150,000. What audit procedures would you follow, and how would you classify the item?

21. The accounts receivable of The Happy Steel Company, as of December 31, 1961, are shown in Exhibit 6-7. Folio numbers of the 100, 200, and 300 series represent sales invoice numbers; 500, 600, and 700 series represent cash receipts advices. Credit terms are net 30.

Prepare an aging schedule of the accounts receivable. Aging column headings should read: Name, credit balances, debit balances, December, November, October, July–Sept., Jan.–July, prior to Jan. 1, comments.

Exhibit 6-7

Adams Pressed Metals Corp.

Date	*Folio*	*Debit*	*Credit*	*Balance*
Jan. 2	123	150.00		150.00
Feb. 3	551		150.00	0.00
Aug. 3	250	468.00		468.00
Oct. 15	678		468.00	0.00
Nov. 26	307	314.00		314.00

C. F. Bengtson

Date	*Folio*	*Debit*	*Credit*	*Balance*
Mar. 12	167	888.50		888.50
May 1	602		888.50	0.00
July 13	220	1,085.00		1,085.00
Aug. 7	251	1,452.50		2,537.50
Aug. 15	646		1,085.00	1,452.50
Sept. 20	269	3,115.00		4,567.50
Sept. 23	661		1,452.50	3,115.00
Oct. 3 JE	13		298.00	2,817.00
Oct. 10	679		2,817.00	0.00
Nov. 25	303	610.00		610.00
Dec. 21	321	852.00		1,462.00
Dec. 29	716		610.00	852.00

Bixby-Zimmer Engineering Co.

Date	*Folio*	*Debit*	*Credit*	*Balance*
Jan. 1 Balance	00	214.00		214.00

Exhibit 6-7 (Continued)

Butler Mfg. Co.

Date	*Folio*	*Debit*	*Credit*	*Balance*
Feb. 3	144	2,051.00		2,051.00
Feb. 25	554		2,051.00	0.00
June 5	204	1,287.20		1,287.20
July 22	632		1,287.20	0.00
Aug. 13	252	875.00		875.00
Sept. 4	270	954.00		1,829.00
Sept. 11	662		875.00	954.00
Oct. 1	286	681.50		1,635.50
Oct. 21	680		954.00	681.50
Nov. 15	699		681.50	0.00
Dec. 18	321	528.00		528.00

Caine Steel Co.

Date	*Folio*	*Debit*	*Credit*	*Balance*
Jan. 18	139	356.15		356.15
Feb. 20	159	585.00		941.15
Feb. 24	574		356.15	585.00
Mar. 30	592		585.00	0.00
May 2	203	404.00		404.00
June 3	630		404.00	0.00
July 7	235	772.20		772.20
Aug. 5	660		772.20	0.00
Oct. 7	301	481.25		481.25
Nov. 8	715		481.25	0.00
Dec. 9	336	282.20		282.20

Exhibit 6-7 (Continued)

D & D Machine Shop

Date	*Folio*	*Debit*	*Credit*	*Balance*
May 22	191	468.25		468.25
June 8	207	681.00		1,149.25
June 11	616		468.25	681.00
July 5	222	820.00		1,501.00
July 10	634		681.00	820.00
Aug. 10	648		820.00	0.00
Sept. 25	272	450.00		450.00
Oct. 15	682		450.00	0.00
Nov. 19	305	210.00		210.00
Dec. 4	323	420.00		630.00
Dec. 10	718		210.00	420.00

John Dalberg

Date	*Folio*	*Debit*	*Credit*	*Balance*
Jan. 5	121	285.00		285.00
Feb. 4	558		285.00	0.00
Apr. 24	177	60.00		60.00
June 13	207	240.00		300.00
July 3	223	450.00		750.00
July 10	635		240.00	510.00
Aug. 15	253	608.00		1,118.00
Aug. 17	649		450.00	668.00
Sept. 10	663		608.00	60.00
Sept. 19	273	126.00		186.00
Oct. 8	287	315.00		501.00
Oct. 10	683		126.00	375.00
Nov. 5	306	275.00		650.00
Nov. 20	700		315.00	335.00
Dec. 15	324	300.00		635.00

Exhibit 6-7 (Continued)

R. W. Fox

Date	*Folio*	*Debit*	*Credit*	*Balance*
May 3	192	580.00		580.00
June 10	617		580.00	0.00
Sept. 26	274	920.00		920.00
Oct. 10	684		920.00	0.00
Dec. 5	719		275.00	275.00–

Gullickson Building Co.

Date	*Folio*	*Debit*	*Credit*	*Balance*
Jan. 1 Balance	00	482.25		482.25
Jan. 17	128	1,000.00		1,482.25
Jan. 18	535		482.25	1,000.00
Jan. 21	140	428.00		1,428.00
Jan. 26	549		1,000.00	428.00
Feb. 10	559		428.00	0.00
Mar. 3	165	575.50		575.50
Apr. 10	179	2,419.00		2,994.50
Apr. 15	593		575.50	2,419.00
May 5	193	1,865.40		4,284.40
May 23	604		2,419.00	1,865.40
June 11	208	2,851.50		4,716.90
June 17	619		1,865.40	2,851.50
July 7	225	2,341.00		5,192.50
July 7	637		2,851.50	2,341.00
Aug. 11	254	1,943.50		4,284.50
Aug. 15	651		2,341.00	1,943.50
Sept. 5	276	1,642.50		3,586.00
Sept. 12	664		1,943.50	1,642.50
Oct. 18	288	729.00		2,371.50
Oct. 20	686		1,642.50	729.00
Nov. 1	307	820.30		1,549.30
Dec. 13	325	482.25		2,031.55

Exhibit 6-7 (Continued)

Illinois Power Co.

Date		Folio	Debit	Credit	Balance
Jan. 1	Balance	00	58.00		58.00
Jan. 9		130	812.25		870.25
Jan. 11		536		58.00	812.25
Feb. 12		561		812.25	0.00
May 5		194	1,260.50		1,260.50
June 8		621		1,260.50	0.00
Aug. 22		255	1,648.20		1,648.20
Sept. 15		665		1,648.20	0.00
Oct. 30		308	2,094.00		2,094 00

Intra State Telephone Co.

Date		Folio	Debit	Credit	Balance
Jan. 1	Balance	00	2,452.00		2,452.00
Jan. 15		136	1,005.00		3,457.00
Jan. 18		545		2,452 00	1,005.00
Feb. 1		157	1,502.80		2,507.80
Feb. 21		570		1,005.00	1,502.80
Feb. 26		162	2,151.50		3,654.30
Mar. 15		588		1,502.80	2,151.50
Apr. 3		600		2,151.50	0.00
May 7		201	737.00		737.00
June 13		217	740.00		1,477.00
June 20		628		700.00	777.00
July 7		233	799.00		1,576.00
July 10		644		740.00	836.00
Aug. 14		658		799.00	37.00
Aug. 21		266	805.00		842.00
Sept. 6		283	660.00		1,502.00
Sept. 15		674		805.00	697.00
Oct. 12		299	1,842.00		2,539.00
Oct. 15		695		660.00	1,879.00
Nov. 3		318	260.00		2,139.00
Nov. 15		712		1,842.00	297.00
Dec. 7		334	820.00		1,117.00
Dec. 10 JE		5		37.00	1,080.00
Dec. 15		725		260.00	820.00

Exhibit 6-7 (Continued)

Knox Steel Buildings, Inc.

Date	Folio	*Debit*	*Credit*	*Balance*
Jan. 1 Balance	00	2,450.00		2,450.00
Jan. 9	557		1,000.00	1,450.00
Feb. 8	149	1,853.50		3,303.50
Feb. 13	562		1,000 00	2,303.50
Mar. 6	167	2,146.80		4,450.30
Mar. 10	580		1,000.00	3,450.30
Apr. 3	181	1,246.50		4,696.80
Apr. 10	595		1,000.00	3,696.80
May 14	195	848.00		4,544.80
June 10	210	1,064 80		5,609.60
June 15	622		500.00	5,109.60
July 10	638		500.00	4,609.60
Aug. 4	256	1,275.00		5,884.60
Sept. 10	622		500.00	5,384.60
Oct. 8	638		500.00	4,884.60
Oct. 12	688		648.00	4,236.60
Oct. 13	289	648.00		4,884.60
Nov. 24	701		1,042.00	3,842.60
Nov. 26	309	1,042.00		4,884.60
Dec. 10	720		500.00	4,384.60

W. H. Mast & Sons

Date	*Folio*	*Debit*	*Credit*	*Balance*
Jan. 1 Balance	00	120.00		120.00
Jan. 10	558		120 00	0.00
Mar. 24	168	498.00		498.00
Apr. 20	596		498.00	0.00
May 29	196	280.00		280.00
June 25	623		280.00	0.00
Aug. 5	257	614.00		614.00
Sept. 20	667		614.00	0.00
Nov. 3	310	1,080.00		1,080.00

Exhibit 6-7 (Continued)

Midwest Sales Co.

Date	Folio	Debit	Credit	Balance
Jan. 1 Balance	00	1,456.00		1,456.00
Jan. 11	132	1,125.00		2,581.00
Jan. 12	559		1,456.00	1,125.00
Jan. 21	142	1,202.50		2,327.50
Jan. 24	143	610.15		2,937.65
Feb. 20	151	3,540 00		6,477.65
Feb. 21	564		1,125.00	5,352.65
Feb. 23	160	2,675.40		8,028.05
Feb. 24	575		1,202.50	6,825.55
Feb. 27	576		610.15	6,215.40
Mar. 11	582		3,540.00	2,675.40
Mar. 12	583		2,675.40	0.00
Apr. 2	182	2,050 00		2,050.00
June 30 note			2,050.00	0.00
Sept. 1 JE		2,050.00		2,050.00
Sept. 1 int.		20.50		2,070.50
Oct. 15	689		1,000.00	1,070.50
Nov. 30	702		1,050.00	20.50

Nystrom & Pierce

Date	Folio	Debit	Credit	Balance
Jan. 1 Balance	00	215.00		215.00
Feb. 16	575		215.00	0.00
Mar. 17	169	402.00		402.00
Apr. 23	597		402.00	0.00
June 16	211	640.00		640.00
July 8	639		640.00	0.00
Aug. 3	259	725.00		725.00
Sept. 8	668		725.00	0.00
Oct. 22	290	250.00		250.00
Nov. 20	703		250.00	0.00
Dec. 13	326	475.00		475.00

Exhibit 6-7 (Continued)

Ostrom & Maguire Construction Co.

Date	Folio	Debit	Credit	Balance
Jan. 1 Balance	00	350.00		350.00
Jan. 13	540		350.00	0.00
Feb. 11	152	158.20		158.20
Mar. 7	584		158.20	0.00
Apr. 10	183	286.50		286.50
May 15	606		286.50	0.00
July 28	226	841.20		841.20
Aug. 3	259	616.00		1,457.20
Aug. 10	652		841.20	616.00
Sept. 10	669		616.00	0.00
Oct. 6	291	456.25		456.25
Nov. 3	311	280.70		736.95
Nov. 10	704		456.25	280.70
Dec. 13	327	350.00		630.70

Pappemeier Engineering Co.

Date	Folio	Debit	Credit	Balance
Mar. 3	170	347.50		347.50
Apr. 14	184	401.00		748.50
Apr. 20	598		347.50	401.00
May 10	607		401.00	0.00
May 25	197	402.00		402.00
June 7	212	403.00		805.00
June 20	624		402.00	403.00
July 11	227	405.00		808.00
July 15	640		403.00	405.00
Aug. 9	260	406.00		811.00
Aug. 15	653		405.00	406.00
Sept. 19	277	602.00		1,008.00
Sept. 21	670		406.00	602.00
Oct. 1	292	603.00		1,205.00
Oct. 1	690		602.00	603.00
Nov. 2	312	604.00		1,207.00
Nov. 30	705		603.00	604.00
Dec. 15	328	616.00		1,220.00

Exhibit 6-7 (Continued)

Pearson Construction Co.

Date		*Folio*	*Debit*	*Credit*	*Balance*
Jan. 1	Balance	00	182.50		182.50
Jan. 12		133	456.00		638.50
Jan. 14		541		182.50	456.00
Feb. 12		153	550.85		1,006.85
Feb. 17		576		456.00	550.85
Mar. 27		585		550.85	0.00
Apr. 2		185	214.20		214.20
May 13		198	285.80		500.00
June 26		625		500.00	0.00
July 2		228	364.20		364.20
Aug. 9		261	210.00		574.20
Aug. 14		654		364.20	210.00
Sept. 2		278	1,800.00		2,010.00
Oct. 5		291	2,260 00		4,270.00
Oct. 11		691		210.00	4,060.00
Nov. 1		311	2,142.00		6,202.00
Nov. 15		706		1,800.00	4,402.00
Dec. 22		329	456.00		4,858.00

Exhibit 6-7 (Continued)

S & S Distributing Co.

Date		*Folio*	*Debit*	*Credit*	*Balance*
Jan. 1	Balance	00	3,110.00		3,110.00
Jan. 14		135	812.20		3,922.20
Jan. 15		542		1,585.00	2,337.20
Feb. 14		154	1,468.70		3,805.90
Feb. 19		578		1,525.00	2,280.90
Feb. 24		161	2,125.45		4,406.35
Mar. 6		171	1,142.50		5,548.85
Mar. 10		586		812.20	4,736.65
May 19		199	642.00		5,378.65
June 10		626		642.00	4,736.65
July 12		229	857.50		5,594.15
Aug. 3		263	916.20		6,510.35
Sept. 20		279	1,141.00		7,651.35
Sept. 25		672		857.50	6,793.85
Oct. 3		295	1,875.00		8,668.85
Nov. 6		314	250.00		8,918.85
Nov. 10		718		916.20	8,002.65
Dec. 11		330	420.00		8,422.65
Dec. 15		721		1,000.00	7,422.65

Sauter Supply Co.

Date		*Folio*	*Debit*	*Credit*	*Balance*
Jan. 1	Balance	00	1,600.00		1,600.00
Jan. 10		543		1,600.00	0.00
Mar. 12		172	1,050.00		1,050.00
May 1		609		1,050.00	0.00
June 5		214	624.00		624.00
July 15		642		624.00	0.00
Sept. 3		280	550.00		550.00
Oct. 10		692		550.00	0.00
Nov. 13		315	275.00		275.00
Nov. 19		331	380.00		655.00
Nov. 23		722		275.00	380.00

Exhibit 6-7 (Continued)

Schwartz Bros. Mfg. Co.

Date	Folio	Debit	Credit	Balance
Jan. 21	135	2,000.00		2,000.00
Jan. 31	544		1,960.00	40.00
Feb. 6	156	3,428.00		3,468.00
Mar. 9	173	2,562.00		6,030.00
Apr. 1	599		3,428 00	2,602.00
May 3	200	3,850.00		6,452.00
May 10	610		2,562.00	3,890.00
June 15	216	4,175.00		8,065.00
June 19	627		3,850 00	4,215.00
July 3	231	4,682.00		8,897.00
July 15	643		4,175.00	4,722.00
Aug. 10	656		4,682 00	40.00
Sept. 13	282	6,720.00		6,760.00
Oct. 7	296	8,121.00		14,881.00
Oct. 10	694		6,720 00	8,161.00
Nov. 17	317	6,261.00		14,422.00
Nov. 20	710		8,121.00	6,301.00
Dec. 4	332	4,972.00		11,273.00
Dec. 15	724		6,261.00	5,012.00
Dec. 29	729		4,972 00	40.00

Welders Supply Co.

Date	Folio	Debit	Credit	Balance
Jan. 1 Balance	00	540.00		540 00
Jan. 19	546		540.00	0 00
Apr. 18	189	822.00		822.00
May 10	612		822.00	0.00
June 3	212	850 00		850.00
June 30	629		850.00	0.00
Aug. 13	267	950.00		950.00
Sept. 6	284	808 00		1,758.00
Sept. 25	675		950.00	808.00
Oct. 9	299	811.00		1,619.00
Oct. 10	696		808.00	811.00
Nov. 27	319	815.00		1,626.00
Nov. 30	713		811.00	815.00
Dec. 16	334	820.00		1,635.00

Exhibit 6-7 (Continued)

Willis Steel Corp.

Date	*Folio*	*Debit*	*Credit*	*Balance*
Jan. 1 Balance	00	1,560.00		1,560.00
Jan. 17	122	1,084 20		2,644.20
Jan. 22	139	952.15		3,596.35
Jan. 25	548		1,560 00	2,036.35
Feb. 19	158	2,400.00		4,436.35
Feb. 23	572		1,084.20	3,352.15
Feb. 26	575		952.15	2,400.00
Feb. 28	163	1,845 00		4,245.00
Mar. 10	590		2,400.00	1,845.00
Mar. 20	591		1,845 00	0.00
Apr. 1	190	2,620.00		2,620.00
May 2	202	2,414.00		5,034.00
May 10	614		2,620 00	2,414.00
June 13	219	1,385 00		3,799.00
June 20	630		2,414.00	1,385.00
July 25	234	14,140 50		15,525.50
July 30	645		1,385 00	14,140.50
Aug. 5	268	2,265.50		16,406.00
Aug. 10	659		4,140.50	12,265.50
Sept. 6	285	3,081 00		15,346.50
Sept. 10	676		5,000.00	10,346.50
Sept. 20	677		2,265.50	8,081.00
Oct. 7	300	1,815 00		9,896.00
Oct. 10	697		5,000.00	4,896.00
Oct. 20	698		3,081 00	1,815.00
Nov. 8	320	1,120.00		2,935.00
Nov. 10	717		1,815.00	1,120.00
Dec. 13	335	1,265.00		2,385.00

Chapter 7

NOTES RECEIVABLE AND RELATED INCOME

A note receivable is a written promise to pay a specific sum of money on demand or at some definite future date. It differs from an account in that it is a written recognition of a debt, signed by the maker, while the account receivable is usually based only on an oral agreement. A note may or may not be interest-bearing.

If the holder of a note must take legal action to collect the note, the written document is prima facie evidence of the debt. If suit is brought to enforce the collection of an account receivable, the debt must be proved. This may make a note more attractive from the enforced collection point of view. However, it is not the primary business of the entrepreneur to engage in forced collection of debts. Ordinarily it is also easier and cheaper to discount notes receivable than it is to assign accounts receivable. From these points of view, then, notes receivable may be considered as being better than accounts receivable. However, it should always be remembered that the worth of any debt is based primarily on the debtor's ability and intent to pay.

With these exceptions in mind, the auditor's treatment of notes receivable should be much the same as that for accounts receivable. The mere fact that the debt is evidenced by a note instead of an account should not influence the auditor in his valuation procedure. In fact, circumstances surrounding the taking of the note might well indicate that it was taken only because the customer could not pay his debt when it came due.

INTERNAL CONTROL AND NOTES RECEIVABLE

With notes receivable as with other assets there should be a separation of physical control and record keeping. The physical custody of the notes

should be in the hands of a responsible employee or officer. The record keeping may be done by a clerical employee, but one who does not have access to cash receipts. The separation of functions here is designed to prevent unauthorized discounting of notes receivable. Physical safeguards such as safe deposit boxes should be employed to prevent, or at least to minimize, the opportunity for internal or external theft.

The accounting records for notes should be set up in such a way that there is no danger of failing to present the note for payment at its maturity date. The records also should provide a means of controlling interest income. This is particularly important for the type of note in which interest payments may be made in advance of the payment of principal, but the safeguard applies to other notes also. In addition to these points the internal control features applicable to the general control of accounts receivable set forth in Chapter 6 apply to notes receivable as well.

MAJOR OBJECTIVES IN AUDITING NOTES RECEIVABLE

The major objectives in auditing notes receivable deal with the auditor's attempts to verify the client's representations as to these notes. They may conveniently be segregated into steps aimed at proving (1) the existence and ownership of the notes, (2) the validity of the notes, (3) the collectibility of the notes, and (4) the balance sheet treatment of these claims. Again there is a certain amount of overlapping in some of the techniques, but taken together they serve to fulfill the objectives needed to satisfy the auditor as to the reasonableness of the account balance.

AUDIT PROCEDURES AND TECHNIQUES

1. Verify the beginning balance. The first step in auditing any balance sheet account is to prove that the beginning balance per the general ledger account is in agreement with the ending balance of the preceding year per the audit report. Where a schedule of notes receivable transactions for the year is prepared, the first columnar total is used for this purpose. If the schedule prepared is only of the notes outstanding at the year end, the verification of the beginning balance must be taken as a separate step. If this is a first audit, the beginning balance should be verified by a listing of the notes open at that date.

2. List notes and prove to the control. Two approaches may be used in listing the details of the notes receivable. The listing may show only the notes on hand at the year end (illustrated in Exhibit 7-1), or a

schedule may be prepared showing all note transactions for the year. The auditor's decision as to which type of listing to prepare will depend on the type of audit, the number of note transactions, and the value of the notes.

If note transactions are voluminous but of relatively small value, it may be satisfactory to list only those notes on hand at the year end. If the volume is not too great or if notes are of high value, it usually is preferable to schedule the activity for the year, as shown in Exhibit 7-2. The time required to prepare the larger schedule must be balanced against the utility of the additional information obtained. In situations where internal control is not good, the larger schedule supplies information valuable in proving the validity of transactions. If internal control is good to excellent, it may be judged not necessary to validate all the transactions for the year and the shorter schedule will be adequate.

The major purpose of the listing is to prove the total of the notes on hand to the control account at the year end. If a subsidiary ledger of notes receivable or a note register is maintained by the client, the schedule may be prepared from the ledger and proved to the control. Where no subsidiary ledger is maintained the schedule acts as a subsidiary and is proved against the control.

3. Examine notes on hand. After the schedule is prepared the notes should be obtained from the custodian. They should be examined and compared with the details shown on the schedule. As he examines the notes the auditor should determine their ownership, which may be shown in various ways. The note may be made payable to the client company. Most of the notes will be in this category. Or the note may be made payable to another who has assigned it to the client. Or the note may be endorsed in blank. In some cases the name of the payee is omitted, and the person holding the note at maturity date inserts his name in the payee space. In examining the notes the auditor should make certain that by one of these methods the client's ownership of the notes is indicated. Other procedures will substantiate this tentative claim to ownership.

The examination of the notes should include a comparison of the dates, interest rates, amounts, and signatures, with the details shown on the schedule. The purpose of the examination is to disclose the notes actually on hand and to verify the accuracy of the detailed record keeping.

If any notes are secured by collateral, full details of such collateral

Exhibit 7-1

Hampford and Co.
Notes Receivable
December 31, 1961

Name	Note	Date Made	Date Due	Interest rate	Amount	Accrued interest Dec. 31, 1961	Remarks
James Foundries	848	8/1/61	2/1/62	5%	5000.00	104.17	
George Nichols, Inc.	123	9/15/61	1/15/62	6	1253.00	21.91	
The Williams Co.	201	10/1/61	1/1/62	5	2000.00	25.00	
Lauren Booth	–	11/15/61	2/15/62	6	1200.00	9.00	
Paul's Supply Co.	417	11/15/61	3/15/62	5	640.00	4.00	
Walters and Walters	–	11/25/61	2/25/62	5	3000.00	14.58	{ 100 shares Blank Mfg. Co. stock held as collateral.
Horace Stoop, Inc.	–	12/1/61	2/1/62	6	2700.00	13.50	{ Market value approximately $4,000.
Daniels Corp.	107	12/15/61	2/15/62	6	2000.00	5.00	
Harry's Shoppe	519	12/20/61	6/20/62	6	465.82	1.55	
					18258.82	198.71	

Examined notes January 6, 1962.
Positive requests were sent to all makers.
All requests returned. No discrepancies.
Mr. J. T. Framer, Treasurer, is custodian of the notes.
All notes were controlled during the count.

WBJ

should be included in the working papers. The collateral should be segregated so that there is no possibility of including it as assets belonging to the client. The value of the collateral should be investigated and compared with the face value of the note. Collateral ordinarily is requested only in cases where there is some doubt as to the maker's ability to pay the principal amount of the note. Usually the value of the note is no greater than the value of the collateral.

4. Confirm notes not on hand. If the examination of notes takes place after the balance sheet date, it is possible that some notes may not be available for the auditor's inspection. These notes may be out for collection; they may be held by a bank either as discounted notes or as collateral for a loan; or they may have been paid. If notes have been paid, the cash receipts book should be examined to prove the receipt of cash, which should then be traced into the bank. If the notes are not yet due but are in the hands of others for any of the above reasons, written confirmation of the existence and details of the notes should be sought. This request for confirmation is not a substitute for the request to the maker of the note (see step 5). In the case of notes out for collection, a later examination of the cash receipts book should also be made to determine that they have been collected.

Notes discounted with the client's regular banks should be confirmed by the banks on the cash confirmation request. If notes have been discounted at other banks, separate requests should be sent for confirmation of the existence of the notes as at the balance sheet date. The notes receivable account should be examined to see that the proceeds from these discounted notes have been credited not to notes receivable but to notes receivable discounted. The contingent liability may be shown on the balance sheet as a deduction from total notes receivable, as a current liability if the note had been dishonored and the client was required to pay the amount to the bank (after the year end), or as a footnote to the balance sheet. The best disclosure is obtained by deducting the discounted notes from total notes receivable, but the liability is most commonly expressed in published statements as a footnote to the balance sheet.

5. Obtain confirmation from maker. Written confirmation should be sought from the makers of all notes, attesting to the correctness of details, the amount, and the validity of the debt. A more intensive effort should be made to obtain confirmation of notes than is normally made with respect to accounts receivable. Where the request is not answered

Exhibit 7-2

Federal Motors Corp.
Notes Receivable
December 31, 1961

	Makers	Dates: Made	Dates: Due	Balance, January 1, 1961	Notes taken	Notes paid	Balance, Dec. 31, 1961	Interest rate	Accrued interest, January 1, 1961	Interest earned	Interest received	Accrued interest Dec. 31, 1961	Remarks
1	Alum Creek Co.	9/1/60	1/2/61	4500.00		4500.00		6%	90.00	—	90.00		
2	Nelson and Sons	10/15/60	2/15/61	14700.00		14700.00		5	153.13	91.87	245.00		
3	Franklin Tile - Brick Co.	4/1/60	3/1/61	5653.34		5653.34		6	56.53	28.27	84.80		
4	Cornell Construction Co.	12/15/60	2/15/61	18340.00		18340.00		6	45.85	137.55	183.40		
5	Cole and Huddleston, Inc.	1/2/61	4/2/61		5431.95	5431.95		4		54.32	54.32		
6	Old Time Supply Co.	3/15/61	4/15/61		2626.00	2626.00		5		21.88	21.88		
7	Clemenger Corp.	3/1/61	5/1/61		5896.11	5896.11		6		58.96	58.96		
8	Ott Bros. Corp.	4/15/61	6/15/61		3800.00	3800.00		6		38.00	38.00		
9	House of Steel, Inc.	5/12/61	8/12/61		1567.00	1567.00		5		19.59	19.59		
10	Tomminy & Jones, Inc.	6/1/61	8/1/61		2348.00	2348.00		6		23.48	23.48		
11	Capital Supply Corp.	9/1/61	12/1/61		5860.00	5860.00		5		73.25	73.25		
12	Laura Booth	9/15/61	1/15/62		1481.40		1481.40 Ⓔ	6		25.93		25.93	
13	Federal Materials, Inc.	10/1/61	12/1/61		17000.00	17000.00		5		141.67	141.67		
14	The Williams Co.	10/15/61	1/15/62		7051.50		7051.50 Ⓔ	5		73.45		73.45	
15	Daniels Corp.	11/1/61	12/1/61		6065.00	6065.00		6		30.33	30.33		
16	State Builders Co.	11/15/61	2/15/62		7375.00		7375.00 E	5		46.12		46.12	
17	Paul's Supply Co.	11/20/61	3/20/62		3200.00		3200.00 E	6		21.33		21.33	
18	Alerts and Davis	12/1/61	2/1/62		2675.00		2675.00 E	6		13.38		13.38	
19	City Supply Co.	12/10/61	3/10/62		24115.00		24115.00 E	4		53.59		53.59	
20	Whipps and Son	12/15/61	2/15/62		8454.00		8454.00 E	6		21.13		21.13	
21				43193.34	104945.96	93787.40	54351.90		345.51	974.10	1064.48	254.93	
22				T	"	✓			T	Ⓒ	✓		

C - Confirmed by maker.
E - Examined January 12, 1962.
Ⓔ - Out for collection. Confirmed by bank.
T - Traced to last year's W/P
" - Traced back to accounts receivable. Authority for taking note examined.
✓ - Traced to cash receipts book.
Ⓒ - Computed interest.

within a reasonable period of time, a second request should be sent. A third request sometimes is sent, and the aid of the client may be sought in attempting to convince the maker of the desirability of confirming the debt.

As with accounts receivable a control should be maintained over the notes receivable confirmation returns. Since in almost all instances a schedule of notes on hand is prepared, it is relatively simple to use this schedule as a control sheet. As the requests are returned to the auditor he should indicate this fact on the control sheet (see Exhibit 7-2). Under certain circumstances it may be desirable to set up a separate control sheet for this purpose.

The positive type of confirmation request is normally used, with a self-addressed, stamped envelope enclosed. The precautions observed in controlling accounts receivable requests from start to finish should also be applied to notes receivable requests. There should be no opportunity granted anyone to change any amounts or to remove any of the requests. The auditor should mail the requests personally. A confirmation request for notes receivable is shown in Exhibit 7-3.

In cases where notes are taken at the time of the original sale and thus, in effect, replace accounts receivable, they may be so numerous that the confirmation technique and other procedures may be applied on a test basis. Here notes receivable, for audit purposes, become accounts receivable, and audit techniques and procedures for accounts receivable will apply.

6. Trace notes back to original transactions. As part of the examination of this account the note should be traced back through the account receivable to the original transaction. The authority for accepting the note should be noted, and the correspondence between maker and client reviewed. This is for the purpose of determining that an actual sales transaction underlies the note and to review, for valuation purposes, the circumstances surrounding the creation of the note. It is important to determine that the acceptance of notes is governed by a well-defined company policy, that authority to accept notes is limited to certain personnel, and that the notes actually accepted were taken in accordance with the expressed policy. This tracing of note transactions may be applied to all notes or it may be used on a test basis, depending on the volume.

7. Trace paid notes to cash receipts. Credits to the notes receivable account should be traced to the cash receipts record. This is done to make certain that cash was received and that the note was not merely renewed

Exhibit 7-3

ALLEN AND JAMES

Certified Public Accountants

1808 Northeast Boulevard

Columbus 42, Ohio

January 14, 1962

Smith and White, Inc.
1010 North Goodale
Columbus, Ohio

Gentlemen:

In connection with an examination of the financial statements of the Jones Manufacturing Co., as of December 31, 1961, we note that they hold a note signed by you, in the amount of $1,800.00, bearing 6 per cent interest, and maturing on February 15, 1962.

If the above details are in agreement with your records, will you please so indicate by signing in the space provided below, and returning this letter to us. If there is a discrepancy between the above details and your records, please use the back of this letter to describe and explain the discrepancy.

A stamped, addressed envelope is enclosed for your convenience.

Very truly yours,
ALLEN AND JAMES
By

Please supply the information requested.
JONES MANUFACTURING CO.

By ______________________________
Treasurer

The above information is correct.

____

or disposed of in some other way. If partial payments have been made, the note should be examined to see that the payments are indicated on the back of the instrument.

8. Make provision for notes of doubtful collectibility. The auditor should review the circumstances surrounding the taking of the notes in an effort to determine their probable collectibility. Wherever a note is taken because the customer was not able to pay his open account when it came due, the collectibility of the note should be questioned. Recent

credit reports should be obtained and reviewed, and the customer's general ability to pay discussed with the credit manager. Where the note is secured by collateral it is doubtful that the value of the note exceeds the value of the collateral.

Particular care should be taken where notes have been renewed. This is additional evidence of inability to pay, and while it may be only a temporary inability, it may also become permanent. The correspondence with the customer should be reviewed and the situation discussed with the credit manager to determine that proper provision for bad-debt losses is being made. The cash receipts record for the new year should be examined to determine whether any collections have been made since the balance sheet date. Such collections should be mentioned in the long-form report.

9. Vouch notes written off. Where notes have been written off as worthless during the year under review, a complete investigation of the transaction should be made. The investigation should start with the original sale to determine that the note was the result of a bona fide transaction. The credit rating reports for the maker should be reviewed, along with the correspondence between client and customer. Approval of the write-off should be obtained from the treasurer or other official charged with this responsibility. The customer's account should be investigated to determine whether or not the client is still advancing credit in spite of the write-off. Finally, a confirmation letter should be sent to the maker requesting confirmation of the debt. If the note was worthless, the debtor may well ignore the request. If, however, partial or complete payments have been made, and diverted, the customer will be quick to answer and to point out the payments made.

10. Examine treatment of dishonored notes. In cases where notes receivable have been dishonored, a complete investigation should be made to determine the proper balance sheet treatment. Some accountants prefer leaving the notes on the balance sheet as notes receivable dishonored. Others transfer such notes receivable back to accounts receivable. The method of showing the debt is not as important as is the provision made for its valuation. In some cases the note will have been paid by the completion of the examination, and it is appropriate to treat it as an account receivable at the balance sheet date. If it is shown as a dishonored note, its payment in the new year should be noted in the report.

If the note has not been paid it is best shown as a dishonored note, with proper provision for its doubtful collectibility. Of course, if it is

known for certain that the note will not be collected, it should be written off prior to the preparation of the balance sheet. The most important point in connection with these notes is to give full disclosure in the statements and/or the report.

11. Prove interest accruals and income. Accrued interest at the beginning of the year should be proved to the preceding year's working papers. The use of a working paper for notes receivable similar to Exhibit 7-2 enables the auditor to prove completely and easily the interest income for the year. From the data provided in the schedule, interest earned should be computed independently by the auditor. Interest received should be traced to the cash receipts records. Crossfooting the interest sections of the worksheet results in the accrued interest receivable at the year end. These results should then be proved by computation. If the accrued interest adjustments have not been made by the client they should be set up by the auditor. Then the interest earned per the schedule should be compared with the interest income account as adjusted. Here is an instance where the auditor makes an independent proof of the income that should have been received and then determines whether or not the client's records agree with his computations.

12. Segregate nontrade notes receivable. Notes receivable arising from other than normal sales transactions (or conversions of accounts receivable) may be included with the trade notes in the client's records. These notes should be examined carefully and the reasons for their existence reviewed. Since the notes are of a special nature, it is possible that the normal controls applicable to trade notes do not apply to them. It is necessary then to give particular attention to all the transactions affecting these notes to make certain that proper authority existed for their acceptance and that the transactions were properly handled.

Nontrade notes may arise from transactions with officers and employees, affiliates or subsidiary companies, or from special transactions not related to operations, that is, the sale of a fixed asset. For balance sheet purposes all such notes should be segregated from trade notes. Whether they are shown as current assets or as investments depends on the terms of the notes and whether or not collection of the notes is anticipated within the coming year. In some cases a delicate situation exists with respect to notes due from officers. The client ordinarily wants to classify such notes as current assets. Lack of payment in prior years may cause the auditor to question the intent of the officers to pay the notes within the coming year. Normally the auditor is willing to go along with the client's classification as long as there is any doubt or

question as to which way is proper. Often, however, it becomes apparent that the loan is in effect a long-term advance and as such should be reclassified as a long-term investment.

Summary

The following steps present in summary form the major procedural techniques used in auditing notes receivable.

1. List the notes and prove total to the control account.
2. Examine or otherwise account for the notes supposed to be on hand.
3. Prepare and send out confirmation requests. Follow up with second requests if necessary.
4. Test the details of the note record keeping.
5. Evaluate the notes.
6. Prove the interest transactions.
7. Classify the notes for balance sheet presentation.

QUESTIONS AND PROBLEMS

1. Your client is a finance company. The examination of notes receivable consumes about 25 per cent of the audit time. These notes (some secured by chattel mortgages, others with no security) run up to three years in time, with balances up to $1,000. There are approximately 1,000 notes.

Set up an audit program for this account.

2. On January 20 you arrive at the client's office to audit the calendar year just past. What special problems arise in connection with the verification of notes receivable?

3. Is a note receivable more collectible than an account receivable? Discuss.

4. Why are two confirmation requests necessary in the verification of some notes receivable?

5. What are the auditor's major objectives in the audit of notes receivable?

6. In what major points of internal control (as related to notes receivable) is the auditor interested?

7. What should the auditor look for in examining the actual notes?

8. How may notes receivable discounted be presented on the balance sheet?

9. If the auditor examines the note receivable why is it necessary to request confirmation from the maker?

10. Why should credits to the notes receivable account be traced back into the cash receipts journal?

11. You are examining notes receivable for the Action Company. As a final step you trace the interest income per your worksheet to the interest received account. After adjusting for beginning and ending accruals you find that your computed interest is several hundred dollars higher than the interest received account balance.

What might this lead you to suspect? How would you proceed to prove or disprove your suspicions?

12. In examining notes receivable you find a demand note signed by the president of the company for $5,000. The note is dated five years ago and is non-interest-bearing. Reference to the preceding year's working papers indicates that the senior in charge had discussed the note with the president and had been assured that it would be paid this year. He included it in the current asset section of the balance sheet.

How will you verify the note? How will you present it on the balance sheet?

13. You are examining the negotiable instruments of The Harvey Company. You find three 90-day notes, each for $10,000, complete in all

Exhibit 7-4

Maker	*Amount*	*Dates*	*Interest rate*	*Disposition*
The Crowder Corp.	$1,200.00	12/15/60– 2/15/61	6%	Paid when due
Cadman and Jones	850.00	12/ 1/60– 3/ 1/61	5	Interest paid in advance
Hartt and Shirley	2,400.00	12/15/60– 3/15/61	6	Paid when due
The Huntwork Company	8,000.00	1/ 2/61– 4/ 2/61	4	Paid when due
Tarsal Mfg. Co.	465.82	3/ 1/61– 5/ 1/61	5	Paid when due
Anmore Product Co.	2,000.00	4/15/61– 6/15/61	6	Paid when due
Cadman and Jones	385.00	5/12/61– 8/12/61	5	Paid when due
J. R. Albert's Sons	748.90	6/ 1/61– 8/ 1/61	6	Paid when due
Durstin Bros., Inc.	1,500.00	9/ 1/61–12/ 1/61	5	Paid when due
The Kroner Co.	2,700.00	9/15/61– 1/15/62	6	Paid when due
The Knowlton Company	5,000.00	10/ 1/61–12/ 1/61	6	Renewed 12/1/61
Hartt and Shirley	2,000.00	10/ 1/61– 1/ 1/62	6	Interest paid in advance
The Crowder Corp.	562.50	11/ 1/61–12/ 1/61	6	Paid when due
Cadman and Jones	640.00	11/15/61– 2/15/62	5	Paid when due
The Knowlton Company	5,000.00	12/ 1/61– 2/ 1/62	6	Interest paid in advance
Tarsal Mfg. Co.	1,200.00	12/10/61– 3/10/62	5	
Durstin Bros., Inc.	3,000.00	12/20/61– 2/20/62	5	

Exhibit 7-5

Maker	*Date made*	*Date due*	*Rate*	*Balance beginning*	*New notes*	*Notes paid*	*Balance ending*	*Interest accrued beginning*	*Interest earned*	*Interest received*	*Interest accrued ending*
Brown & Co.	11/ 1/60	2/ 1/61	5%	$10,000		$10,000x		$416.67	$208.33	$625.00	
Harris & Harris	12/15/60	2/15/61	6	2,000		2,000x		5.00	15 00	20.00	
Jones & Son	3/ 6/61	4/ 6/61	6		$ 500		$ 500				
Lawrence Bros.	8/12/61	10/12/61	6		4,000	4,000x			40.00	40 00	
Manson, Inc.	10/15/61	1/15/62	4		8,000		8,000		6.67		$ 6.67
Perry Pump Concern	11/ 1/61	12/ 1/61	6		3,000	3,000x			15.00	15.00	
Turvy and Co.	11/ 1/61	2/ 1/62	6		4,000		4,000		80.00		80.00
Harry Williams (sales mgr.)	12/15/61	1/15/62			1,000		1,000				
Totals				$12,000	$20,500	$18,000	$13,500	$421.67	$355.00	$700.00	$76.67

respects except that the line on which the payee's name is inserted is blank.

What procedure will you follow in verifying these notes? How will you classify them for balance sheet purposes?

14. From the data in Exhibit 7-4 relative to notes receivable held by Harper Bros. & Co., prepare a notes receivable working paper, as of December 31, 1961. All notes are payable to Harper Bros. & Co.

15. Shown in Exhibit 7-5 is a notes receivable work paper prepared by one of your juniors, as of 12/31/61. In answer to your questions, he says:

1. All notes except Jones & Son were confirmed by the makers.
2. No interest was accrued on the Jones & Son note since it will never be collected.
3. Williams is the client's sales manager. The loan was approved by the board of directors.

Review and criticize the worksheet. Point out all errors of omission or commission.

16. As of December 31, 1961, the notes receivable account of the Willey Corporation has a debit balance of $11,960. There was no balance at January 1. In analyzing this account, you discover that notes amounting to $42,250 were received from customers during the year under review, $20,800 of which were collected at maturity and $11,050 were discounted at the Jamestown bank, the credit being to notes receivable. Of the $11,050 notes discounted, $5,200 were paid at maturity. One note for $1,560 (Smith Supply Co.) was dishonored and was charged back to notes receivable.

Cash in the amount of $1,650 has been received as a partial payment on notes not yet due. These collections are shown as a liability on the balance sheet in an account entitled "partial payments on notes receivable."

The Willey Corporation has also pledged a $2,500 customer's note as collateral for the payment of a bank loan. The company is also treating as a cash item a three-month note for $400, given by an officer of the company, which is over a month past due.

1. What are the adjusting journal entries, if any?
2. Indicate how the facts regarding all notes discussed above should be disclosed in your client's balance sheet, including footnotes, if necessary.

Chapter 8

INVENTORIES AND COST OF GOODS SOLD

Inventories are composed of goods purchased for resale, materials purchased for use in creating a new or changed product, and the semifinished and finished products manufactured. Inventories also result from the extractive industries in the form of petroleum, ores, or timber. Goods for resale are set forth on the balance sheet under inventories, while stores of items to be used in the production, selling, or administrative processes, rather than becoming a part of the finished product, are classified as prepaid expenses.

It is difficult to stress too much the importance of the inventory audit. If the auditor is not reasonably certain of the inventory values, he usually is not in a position to express an opinion on any of the statements. For most companies inventories represent a material part of the current, and in some cases, total assets. Errors in inventory values also affect the cost of goods sold and net income. Failure to gain reasonable satisfaction as to the inventories thus may leave the auditor with a clouded picture as to the statements as a whole.

PRELIMINARY WORK

Review of Client's Inventory Instructions

It is now rather generally accepted that the auditors should be appointed early in the year. This early appointment enables the auditor not only to plan and execute certain interim work but also to participate in an essential phase of the inventory examination which occurs long before the inventory is counted. This has to do with the review of the inventory instructions. Many auditors feel that they should not take part in the actual preparation of the instructions to the inventory crews, that this is primarily a managerial responsibility. But it is certain that most

auditors do want to review the procedures before they are distributed, to determine that the instructions are clear, understandable, and complete. The following phases of inventory instructions should receive special attention.

Care with which work is to be done. The instructions should emphasize the importance of the inventory count and should point out that if the inventories are wrong, all the statements are wrong. They should also indicate that part of the auditor's task is to observe the care with which the inventory is being taken. If many errors should be found it might be necessary to make a complete recount. If this point is noted in the instructions, it usually has a good effect, since most people do not care particularly for inventory taking.

Use of proper units of measurement. Instructions as to units of measurement should be clear and definite. Fantastic errors occur when there is no clear understanding of what is to be used. The author recalls one situation where mimeograph paper was counted as sheets but priced as reams. The inventory was overstated some $35,000 because of this error in use of the proper unit. Errors often occur because the items are counted as units but are extended at some other measurement price, that is, units for dozens or hundreds, gallons for drums, pounds for tons, and so on. If the instructions are complete enough to cover the major types of measurements used by the client and to explain clearly where each is to be used, the problem is eased somewhat.

Inventory cutoff. There must be a point in time up to which all goods coming in must be included in the inventory and beyond which all incoming goods must be excluded. Similarly all goods shipped out of the plant prior to this time are excluded from the inventory while all goods shipped after this date are included. This point in time is known as the *cutoff date* and is the date at which the inventory value is established.

Some companies take inventory while the plant or store is closed for a holiday or vacation, but for most companies this is not feasible. Production and selling must go on during the period of inventory taking. Raw materials must continue to come in and be put into production. Work in process must be started and completed. Finished goods must be received in the warehouse and distributed to customers. This is good for business but it creates a problem as far as obtaining an accurate count of inventories is concerned. The problem is met in several ways. A department store, for example, using the retail inventory method, stocks enough goods in the department to carry it through the balance sheet date. This department is then inventoried at night. All sales made by

the department between the count date and the balance sheet date are then deducted from the inventory sales value before it is reduced to cost. Reserve stocks and warehouse stocks may be controlled and counted in a more leisurely fashion.

A manufacturer may instruct the receiving department to hold in the receiving room all goods received during inventory taking. Even here the receiving department must distinguish between materials received prior to and those received after the balance sheet date. In the stockroom the inventory count cards may be so arranged that receipts and removals are marked on the cards as movements take place.

If perpetual records are in use the situation is alleviated somewhat but not obviated completely. These records should show the movement of the inventory; the auditor can make test counts at any time to prove the accuracy of the records. But the problem of an accurate cutoff at the balance sheet date remains.

These various procedures indicate the complexity of the problem. The auditor's interest at this early date is to see that inventory instructions to all interested employees are clear and complete. This section of the instructions should be distributed not only to the inventory crews but also to all persons handling the materials.

A well-planned inventory is set up on a time schedule. Counts should progress through the plant in an orderly fashion. The auditor needs to know whether or not these timetables are clearly set forth in the instructions so that he may plan his observation schedule to coincide with the actual counting.

After the instructions have been carefully reviewed the auditor should consult with management on points which he thinks may be strengthened or which seem obscure. The planning and writing of the instructions should be done far enough in advance of the inventory date so that there is plenty of time for a studied review and for any modifications brought to light by the review. Following the timetable set forth in the instructions, the auditor must make his own plans for observing and testing the inventory. This, of course, may be done on a test basis. It may not be necessary to cover all departments, branches, or plants, but the tests must be properly planned so that there are enough qualified men at the right places at the right time.

Interim Work

In an effort to smooth the year-end peak of work that still holds for most accounting firms, two devices have been employed. One is the use

of a fiscal year other than the calendar year. Studies of a client's business activity may well reveal that some month end other than December 31 is a more natural time for the client to consider his year's business at an end. For example, many department stores use January 31 as a closing date, schools use June 30 or August 31, many meat packers use October 31, and so on. The auditor is ever-mindful of the advantages to be gained, by both the client and himself, if he can persuade the client to change to a natural business year.

The second device used by the auditor to spread his own work is known as *interim work*. This means that the client is visited at some time before the year end and much of the detailed work and testing is performed at that time. When the year-end visit is made, the remaining work is concerned largely with the verification of balance sheet accounts.

With respect to inventories, two possibilities exist as to interim work: (1) Tests may be made of the materials record keeping to a degree that will satisfactorily indicate their accuracy; and (2) the actual physical inventory may be taken at some date other than the balance sheet date. These devices may be used only if the client uses perpetual records that permit proof of book records against physical counts.

Tests may be made of the accuracy of the record keeping in many areas, some of which are listed below:

Examination of invoices for receipts
Examination of requisitions for withdrawals
Review of the method of applying burden
Review of standard costs
Review of the method of determining cost of goods sold

The procedures used in testing these areas will be discussed in the procedures and techniques section.

The client may find it advantageous to make his complete count of the inventory at some date prior to the balance sheet date. This may be done only if the inventory records are such that the transactions between the actual count and the balance sheet date may be readily traced. For example, a company that has no perpetual inventory or cost records would not be able to do this, for there would be no way of accounting for the inventory transactions during the intervening period.

Where an inventory is taken one or two months prior to the closing date, the auditor's work at inventory-taking time follows along the lines suggested in the techniques and procedures section. At the year end he should trace transactions through the records for the interim period.

It will be necessary to make certain additional counts and to prove them to the book records to be certain that actual counts are still in agreement with the book records. The next step would be to prove the subsidiary records to the control accounts. If these prove out, the control account balances may be accepted as representing reasonably accurate inventory values.

Costing Methods

It is assumed that the professional accountant is familiar with the various methods used in determining the cost of goods sold. He must have this knowledge well in mind to be able to determine whether or not his client is following generally accepted accounting principles. While this is not a text on accounting theory or cost accounting, it is felt necessary to review very briefly the major acceptable methods.

Actual or specific cost method. This method is used where unlike items of high unit value make up the majority of the stock. Here a careful record is kept of the cost of each individual item. As items are sold the actual cost of the specific items is charged to cost. This method is encountered primarily where the values are so high and sales relatively so few that it pays to keep individual costs. It is also used by clients such as art dealers, where only one of each item is on sale.

First-in, first-out method. Despite heavy inroads by the last-in, first-out method, the first-in, first-out method of costing is probably still the most common method in use today. Its simplicity and ease of operation make it the best system for small businessmen. The principle in use here is that the costs first acquired are disposed of first. This method tends to follow the physical flow of transactions but this is not, nor need it be, necessarily true.

Average costs. The moving average method of costing considers the cost of a particular item fixed until additional similar items are purchased. A new cost is then computed. Issues have no effect on unit cost, but each time a purchase is made, a new unit cost price is determined. While this method has some advantages, the difficulty of numerous cost computations works to its disadvantage.

When the weighted average is used, no computation of cost is made until the end of the accounting period, whether it be a week, a month, or a year. Then all purchases of an item are added together and an average cost determined. This method has the obvious disadvantage of not having any costs available until the end of the accounting period, when

many computations must be made and costs determined for each item in the inventory. This results in a delay of the financial statements.

Last-in, first-out method. This method, which has come into common usage since 1940, has the effect of charging against income the most recent costs. When prices are rising, this has the result of producing a smaller net income than would result if any of the above methods had been used. With a downward trend in prices the opposite effect would be obtained. Any business may change to the lifo method without obtaining permission of the Director of Internal Revenue. The change back from lifo to some other method, however, requires both the permission of the director and a recomputation of prior years' taxes.

Standard cost method. Standard costs are predetermined or estimated costs made in advance of the actual production and applied to all such items produced. Standard costs should be flexible and should be adjusted for substantial changes in any of the cost factors. This is not always done. It is not uncommon to find, at the year end, very large deviations from standard in one or more of the variance accounts. This means that actual costs are not correctly shown in the statements. An adjustment of cost of goods sold and of inventories should be made to conform the standard costs to costs incurred.

Direct costing. The direct costing method of inventory valuation is one in which only variable costs are charged to the product. Labor, material, and the variable overhead items are included in product costs. Depreciation, taxes, insurance, and all other fixed costs are charged to the period in which they are incurred. This method of costing is used by a number of companies for internal reporting but is not permissible for income tax reporting. Consequently, if a company has incorporated the direct costing method into its books of account, the beginning and ending inventories must be adjusted to include their fair share of the fixed burden charges.

These are the generally accepted methods of charging production or merchandise to cost of goods sold. Other methods may be used in unusual situations. The auditor must ascertain whether the particular method used by his client (if other than those listed above) is a generally accepted method. This is done by reference to accounting texts, current periodicals, and bulletins issued by the various professional accounting societies. The use of a particular method by a company or even by an industry does not per se make the method generally acceptable.

Valuation Methods

Just as with costing methods, the auditor must be familiar with the various methods of valuing an inventory. For purpose of review, the generally accepted methods are listed below, with a brief discussion of each.

Cost. Many businesses use actual cost as the inventory value. "Actual cost" may be determined by any of the costing methods indicated above. When a company uses lifo, it is prohibited from using any valuation method other than actual cost for tax purposes. And if it uses lifo for tax purposes, it is required to use it for reporting purposes. Hence, it must use actual cost in reporting inventory values.

Lower of cost or market. Most companies not using lifo still use the lower of cost or market in valuing all or a part of their inventories. Again, cost may be determined by any of the above methods (excluding lifo). *Market* is defined as being the price the business would have to pay for an item, purchasing in its usual quantities, on its usual terms, through its normal sources of supply.

The results of pricing the inventory at the lower of cost or market may be expressed as the sum of the individual decreases below cost, or as the net decrease, by department or other division. Thus, in Exhibit 8-1,

Exhibit 8-1

Item	*Cost*	*Market*	*Lower of cost or market*
A	$ 560 00	$ 560 00	$ 560 00
B	464 00	448 00	448 00
C	720 00	800 00	720 00
D	272 00	248 00	248 00
E	240.00	240 00	240 00
F	2,170 00	1,960 00	1,960 00
G	3,200 00	3,300 00	3,200 00
H	1,440 00	1,500 00	1,440 00
Total	$9,066 00	$9,056.00	$8,816 00

the inventory may be the total of the lower-of-cost-or-market column, $8,816, or it may be the total of the market column, $9,056. It would easily be possible to have a situation which would require adjustment of the inventory if the lower-of-cost-or-market total were used but which

would require no adjustment if the total of the market column were used.

The auditor should not let himself be carried away by the mechanics of the lower-of-cost-or-market principle. There are situations which would be excepted from the applications of this rule, even though it were generally used by the client. Obviously the purpose of this principle is to restate inventory values at an amount sufficiently less than selling price that a normal profit is permitted when a sale occurs. Where the normal profit is protected, it is improper to devalue the inventory. For example, a company bought 50,000 units of an item at $1 per unit. At the balance sheet date 30,000 units are on hand and the unit price has declined to 80 cents. Apparently the inventory should be reduced by $6,000. But suppose that the company purchased these units because it had a firm contract for the sale of the lot, over a period of time, at $1.45 per unit. Regardless of how much the market price drops the company is protected, so long as the purchaser does not breach the contract. There is, then, no need to decrease the inventory value in this case.

The same general reasoning may be applied where the company has not received all the units but does have a purchase contract for the 50,000 units. Ordinarily, the auditor would set up a reserve for future inventory loss. If the company is protected by the sales contract, it would not be necessary to do so.

Net realizable value. The lower-of-cost-or-market method is not applicable in certain situations because there is no market, as defined above, for the product to be sold. In these cases "net realizable value" or "net current market" is applied. These terms are defined as the estimated selling price of the product less the costs of bringing it to completion plus distribution costs. This definition is sometimes modified to permit inclusion of a normal profit. Thus the inventory value would be further reduced to permit the inclusion of normal profit.

The major premise of this series of principles is that no item should ever be included in inventory at a value in excess of the expected selling price. If additional costs must be incurred prior to the realization of the selling price, the inventory value should be reduced by the amount of the costs. The reductions should include any additional manufacturing costs and may include a portion of distribution and administrative costs and profit.

The problem posed is whether any profit should be anticipated. If this method is normally used by the client for the major portion of his inventory, as in the case of the meat packers, then it would seem reasonable

to value the inventory so that a normal profit may be produced in the future period. If, however, this method is being applied to some item in inventory that is, in effect, to be sold at distress prices, it hardly seems logical to insist that such a distress sale should be expected to produce a profit.

Retail inventory method. This method, as the title indicates, is used by retailers, and primarily by department stores. It varies from the other methods in that values are continuously maintained at both cost and selling prices. Adjustments are continuously made for markups and markdowns. Inventories are taken at retail. The primary inventory value is the book record, but it must be supported by a physical count. The continuous application of markups and markdowns results in a book inventory that approximates the lower of cost or market.

INVENTORY RESPONSIBILITIES

The importance of the final inventory amounts has been mentioned briefly earlier in this chapter. It has also been implied in the discussion of the various costing methods that costs are a matter of opinion, determined by the method in use. It has not seemed necessary to labor this point as the auditing student is assumed to have a thorough background of accounting theory. However, it is not amiss to mention again that the manufacturing statement, income statement, retained income statement, and balance sheet all are wrong if the inventories are misstated. Hence where inventories represent a material part of current assets, the auditor is justified in spending a considerable portion of the audit time on them. He has a heavy responsibility to the client, investors, and the public to satisfy himself that the inventories are reasonably stated. But the responsibility is not his alone; management also has some responsibilities for the inventory. In the next sections these responsibilities are discussed.

The Accountant's Responsibilities

The examination of the inventories is similar to the examination of the other accounts in that the auditor is reviewing what management has done. Management presents an inventory amount and the auditor expresses his opinion as to the fairness of that amount. To be able to express an opinion, he must assume the following responsibilities.

Observe the inventory taking. Prior to 1940, many auditors accepted certification from the client as to the physical quantities and condition of the inventories. The audit work was confined to the examination of

the book records and the testing of the clerical accuracy of the inventory sheets. As a result of the McKesson-Robbins case (in which there were nonexistent inventories in fictitious warehouses) this practice was changed. The membership of the American Institute of Certified Public Accountants voted to accept the extended auditing procedures recommended by its Committee on Auditing Procedure. These recommendations dealt primarily with the confirmation of accounts receivable and the observation of physical inventories.

In all cases where inventories are a material part of current assets, the auditor is required to observe the inventory taking. If it is reasonable and practicable to do this, yet the auditor fails to observe the count, he must disclose this fact in his short-form report.

It should be noted that the auditor observes and reviews the work of others. Unless specifically engaged by the client to do so, he does not supervise the inventory taking. The primary responsibility for the inventory rests with the client, who supervises and controls the inventory task. It is no more proper for the auditor to take charge of the inventory than it is for him to take charge of the posting of the general ledger. He observes, tests, and questions the work of others here as in other phases of the examination.

Look for obsolescence. The auditor is not an appraiser and is not expected to value the inventory. However, it is one of his responsibilities to keep his eyes open as he observes the counting and to question employees when he notices anything that appears to be at variance with the rest of the stock. He uses other techniques also to help in ferreting out obsolete items, but visual examination is one of the best methods. Old-appearing, dusty, or shopworn goods should be noted. In many instances, casual questioning of the employees making the counts will disclose items of doubtful value.

Check for consistency in pricing and valuation. Another of the auditor's responsibilities is to know the generally accepted costing and valuations methods. He must satisfy himself that his client is being consistent in the application of one or more of these methods. Consistency of application is more important than the method used, as long as the method is generally accepted. Where inventories are material, there must be disclosure in the audit report if a pricing or valuation method is used that is not generally accepted. Similarly, if there has been a change in the method used, it should be fully set forth in the audit report. It is quite possible that the auditor agrees with the change; he may even have suggested it. This does not mean that such approval obviates the necessity

of disclosure in the report. The statement in the report may well indicate the auditor's approval, but the disclosure must appear nevertheless.

Review the reasonableness of the inventory. As a final responsibility the auditor must satisfy himself generally as to the reasonableness of the inventory amount. He uses many techniques and procedures (explained later in this chapter) to gain this satisfaction. By various tests and checks he comes to an agreement with management's inventory representations as to quantities, clerical accuracy, and pricing and valuation. This ultimate responsibility must be fulfilled to the degree necessary to permit the auditor to express an opinion on the reasonableness of the inventory as a whole.

Management's Responsibilities

As indicated above, the primary responsibility for the inventory rests with management. The auditor is only expressing his opinion on the work which management has done. The following responsibilities are those of the management.

Have a good inventory taken. Management must arrange for a carefully taken, accurate inventory. The first step in this task is providing complete and adequate instructions for taking the inventory. Presumably the auditor will have reviewed these instructions and satisfied himself as to their completeness. The importance of providing the inventory crew with carefully drawn instructions can hardly be overemphasized. Not only does it make their task easier and more comprehensible, it also tends to assure a more accurate inventory. There is no substitute for a good set of inventory instructions.

Management also has the responsibility of providing serious, well-trained crews to make the actual physical counts. Training may come through printed instructions and/or through carefully planned staff meetings with the crews. Such meetings might well cover the reasons for inventory taking, the necessity of careful accurate counts, the reason for recounts, the arrangement of the stock, the necessity of counting everything, the various units of measurement to be used, inventory cut-off methods, and related topics. To accomplish the objective of a good inventory, the staff must be thoroughly indoctrinated in inventory-taking methods and techniques.

Provide the auditor with all the information he needs. As the examination of the inventory progresses, many questions concerning the stock will arise in the auditor's mind. It is management's duty to provide the answers to these questions and to provide such other informa-

tion as might have a bearing on the problem. In many situations management will provide an employee to stay with the auditor. The employee is to make counts at the auditor's request and to answer such questions as he is able to about the stock. This is an advantageous arrangement; the employee's knowledge of the stock is almost always of use in answering questions and in unrequested comments. Management also should provide the auditor with copies of the inventory summary sheets.

Provide the auditor with an inventory certificate. Finally, management has the responsibility of providing the auditor with a written representation concerning the inventories. This is commonly called the inventory certificate, a sample of which is presented later in the chapter. The purpose of the certificate is to impress further upon management its primary responsibility for the completeness and accuracy of the inventory amounts. It is also useful to call to mind some less common but important inventory problems that occasionally arise. The certificate does not excuse the auditor from any of his responsibilities, but it is an added assurance as to the fairness of the inventory amounts, status as to ownership, etc.

Joint Responsibilities

Working together, management and the auditor have joint responsibility for the solution of two problems.

Obsolescence. The auditor has, in his observation of the inventory taking, undoubtedly noted items that appeared to have some obsolescence factor. Through other audit procedures he will discover additional items that may be of doubtful salability. He will want to confer with management, and together they will come to some conclusion about these items. The auditor should acknowledge that the client knows much more about the inventory than he does. He should also recognize, however, that management cannot keep in close contact with all inventory items. Therefore he has the duty of raising questions about any items which to him appear to be of doubtful value. In joint discussion the client and auditor come to an agreement on the probable salability of the goods.

Valuation. Having come to an agreement as to the obsolescence factor, the next step is the valuation of the items. Here the auditor must rely rather heavily on the client's judgment as to the probable net realizable value of the items. The client is better informed as to possible alternative outlets and as to possible salvage values in case of a forced sale.

At the same time it should be recognized that the client may be somewhat optimistic about his ability to dispose of the goods without loss. The auditor should be less optimistic and should rely heavily on his past experience with this client. A review of prior working papers should disclose the client's claims. A follow-up of the items in question will reveal whether or not the client's claims were reasonable. On the basis of this past experience, the auditor will have some clue as to the reaction he should have to the client's surmises in the current situation. The conference should result in agreement as to the value to be placed on the old stock.

It may be that the auditor cannot convince the client that the items should be written down, nor be convinced that the cost of the items will be recovered in due time. If the items are material, he will have to take exception in the audit report to the inventory values.

These then are the responsibilities of the auditor, the client, and the two together in this very important matter of inventories. Both sides must perform their duties well if the resultant inventory figures are to be a fair presentation of the stocks on hand.

INTERNAL CONTROL AND INVENTORIES

Although inventories are not quite as susceptible to conversion as is cash, nonetheless several phases of internal control relating to inventories are of interest to the auditor. He must review these controls to assure himself that they are functioning properly. In instances where the client deals in jewels, precious metals, or similar commodities, the physical controls placed about the inventory are of prime importance. But in most audits the review of the inventory processes and procedures is of greatest importance in helping the auditor determine the effectiveness of the internal controls. His review of the controls relating to inventory processes should indicate what additional or alternative procedures he must apply before he can be assured as to the reasonableness of the physical inventory.

Receipt of inventories. The organization structure should be set up in such fashion that the receiving department is not a part of, nor responsible to, the purchasing department. The receiving department should receive, inspect, and report on all goods received, without prior knowledge of amounts ordered. "Blind" copies of the purchase order, which show all details of orders except the quantities ordered, may be routed to the receiving department so that they may anticipate receipts. The inventory

(warehousing) department should receive independent notices of receipts as proof against actual receipts and as an aid in planning warehousing space.

Disposition of inventories. All shipments out of the plant or to production should be properly requisitioned. Emergency orders should be routed to the inventory department for recording before being sent to the job. Test counts of stock items should be made periodically by the warehousing department, ordinarily when the items are close to minimum quantities. If discrepancies are discovered an attempt should be made to determine what caused them. If the differences are minor and a reconciliation is not easily made, the book records should be adjusted to the physical quantities. Thus with proper authorizations for receipts and dispositions and with current counting and balancing of records, the auditor has some assurance as to the dependence which may be placed on the inventory records.

As a part of his review of the inventory processes and procedures, the auditor should make tests of the various phases. He should satisfy himself that authorizations for receipts and releases are proper. Where there are authorization limits, he should note whether they are being observed. Failure to observe these limits tends to weaken this phase of the internal control.

Planning department. The most effective quantity control of inventories is obtained by having a planning department charged with the responsibility of maintaining balanced inventories. This department acts as a coordinator in determining future production plans and in planning inventory activities so that stock is always on hand when needed. It is responsible for the setting of minimum and maximum inventory quantities.

In making his audit tests, the auditor should note whether or not these minimum and maximum quantities are observed. Tremendous amounts of working capital are sometimes tied up in unused materials. The auditor should be alert to these possibilities and should note in his working papers when he finds apparent overstocking. These items should then be reported to management, along with the fact that control procedures are not being followed.

It has been assumed in this discussion that perpetual inventory records are maintained. Where the client depends entirely on periodic physical count, the control of inventories is haphazard at best. The auditor here is confined to his tests of the purchasing and receiving procedures and to a determination of what controls, physical or other, are placed over the

disposition of materials. Working from this information he should proceed to note where it is possible to strengthen the controls over the releasing of materials. This should then be transmitted to management.

MAJOR OBJECTIVES IN AUDITING INVENTORIES

The major objectives in auditing inventories fall in line pretty much with the earlier discussion of responsibilities. They are four in number. (1) The quantity and quality of the inventories are ascertained. (2) The clerical work of the staff compiling the inventory sheets is tested for accuracy. (3) The pricing and valuation of items are reviewed for accuracy and consistency. (4) The presentation of the inventory in the balance sheet is reviewed for propriety and consistency. Together these objectives give the auditor a basis for expressing or withholding an opinion on management's representations as to inventories.

AUDIT PROCEDURES AND TECHNIQUES

As a means of fulfilling the above objectives, the auditor applies the following audit procedures and techniques, some of which have been mentioned in earlier sections. They are now set down as a group so that the student may gain a total picture of the inventory work.

1. Observe the inventory taking. *Watch for obsolete or unsalable goods.* As mentioned previously, the observation of the inventory taking is a generally accepted auditing procedure. If the auditor does not make the observation he must qualify the report. The prime purposes of observing the work are twofold. First, there must be an assurance that the goods claimed to be on hand actually are on hand. Secondly, the auditor wants to assure himself, by actual observation, that the client's employees are taking a serious attitude toward their job and are making every attempt to have a good inventory count. Any variations from the written inventory instructions should be brought to the attention of the inventory supervisor immediately.

Obviously the auditor cannot be every place at once, nor does he need to be. He is not expected to watch all of the count. He should travel from room to room, department to department, or building to building, accumulating as he goes an impression of the care with which the work is being done. Where a company has many plants widely dispersed geographically, it is not essential that the inventory taking at each plant be observed each year. A master plan is usually set up that permits the

observing of the major warehouses each year and the minor ones on a rotating basis that ensures inclusion of all plants every four or five years. Certificates from plant managers are accepted for the plants not visited.

As he observes the inventory work, the auditor should keep alert to notice any materials, finished goods, or merchandise that may be obsolete, shopworn, or unsalable for any other reason. Where merchandise is boxed, he should open a few boxes to determine that old stock has not been repackaged in new boxes. He should look for dusty boxes or bins, indicating that the stock has not been disturbed for a long time. He may well question the employees doing the counting as to the turnover of the item being counted. Other tests of salability will be presented later, but there is no good substitute for a keen visual perception during the inventory observation.

2. Test the counts of physical quantities. At the time that he is observing, or after he has concluded the observations, the auditor should test some of the counts as a check on the reliability of the work. There is no standard as to how much of the inventory should be tested. Normally the high-value and large-volume items should be tested so that the count will include a large portion of the total dollar value of the inventory. He should question employees as to the location of the high-value, large-volume stock. In addition, scattered counts should be made of smaller items. A deciding factor as to the number of counts to make is the number of errors found. The more errors, the greater the tests should be. Even though the errors are minor, they indicate careless work and require the extension of the number of items counted. As a general rule, enough counts will be made to satisfy the auditor as to the reasonableness of management's representations as to inventory quantities.

Too many cases of empty cartons, of cartons filled with bricks or nailed to the floor have occurred to permit the auditor to accept at face value what he sees in warehouses. Cartons should be shoved, lifted, and on occasion opened to make certain they contain what is claimed for them. This calls for the exercise of judgment. The test counting must be done accurately, but rapidly. Too much time must not be spent in inquiry into packaged material, particularly where stated values are relatively small. At the same time enough must be done to satisfy the examiner that all is as it should be.

Oftentimes cartons are stacked from floor to ceiling over a wide area. The auditor must make certain that there are no gaps in the block—no holes in the center. He must be certain that he is dealing with a solid square. At the same time he needs to be sure that those on top of the

stock are filled, not empty cartons. The only way he can satisfy himself on these points is to crawl to the top of the stack and survey the situation.

In many cases the testing of inventory quantities is a dirty, disagreeable task. Some warehouses are unheated. In some places the heat is intense. In almost all cases the work is dirty. Before starting this phase of his task, the auditor should ascertain under what conditions he will be working and then dress for the job. Usually the senior will instruct new men on what to wear. If such instructions are not offered, the junior should ask his immediate supervisor.

Sometimes because of the type of inventory or the conditions in which he finds it, the auditor must resort to an estimate, instead of making an actual count. In other cases he will call in professional engineers, for example, to calculate the amount of material (coal, ore, scrap, etc.) stored in piles in company yards. In situations where the movement of material is rapid enough, a review of production records may be effective in testing the amounts claimed to be in piles. Through these various means the auditor satisfies himself as to quantities that are not subject to counting.

In some manner the counts made must be recorded. Just how this is done will depend on whether or not the client supplies the auditor with inventory sheets. One client may supply a prelisting of all inventory items along with complete recap sheets and summaries for the auditor's use and retention. Another may furnish him with only the final inventory summary sheets. In some cases the auditor may pick up one section of duplicate count cards, while in another he may get nothing at all.

If a prelisting is supplied, it may be used as the count sheet. In most cases, however, the auditor must make his own record of the counts. This record may follow the plan used in Exhibit 8-2.

When the test count does not agree with the client's count, the inventory supervisor should be notified. Presumably he will call for a recount. It is important that the recounts be made as quickly as possible so that there is little opportunity for any movement of the item before the final quantity is agreed upon.

It should be ascertained, when making test counts, that the items counted are all of those available, that is, that the auditor has been shown all of the items on hand. Otherwise, when he is tracing his counts into the final inventory sheets, he may find that the client has combined all of item X, located in two or three places, in one amount. This makes the test count worthless, for it is not traceable to the final record. Unless there is some assurance that the counts made are the same as those used

Exhibit 8-2

HARDWICK STEEL CO.

Inventory Test Counts

December 31, 1961

Location	*Description*	*Auditor's count*	*Client's count*
Warehouse #1	Part X-141	202	182
	V-216	408	400
	Q-312	22	25

in the final inventory sheets, the time spent test counting is almost completely wasted.

3. Compare counts with perpetual records. If perpetual inventory records are maintained, the auditor's counts should be compared with the inventory cards. Other items appearing on the client's final inventory sheets should also be traced into the cards to prove the accuracy of the record keeping. Where physical counts are not in agreement with the book records a determined effort should be made to discover why the variances occur. When there are many differences between perpetual record cards and the physical counts, the auditor should take it as an indication of weakness in the internal control. He may consider it serious enough to call for an expansion of the program relating to inventory processes. Obviously, if the errors cannot be found, the inventory cards should be corrected to agree with the physical quantities.

4. Prove subsidiary cards to control. Where dollar values are shown on the cards, a listing of amounts should be taken. This total should then be proved to the control account balance. Here, as in other areas, it may be satisfactory to use a test basis for the proof of subsidiary records against control balances. If subcontrols are maintained over subdivisions of the subsidiary records, it is permissible to prove totals of some, but not necessarily of all. A proof would then be made of the subcontrols against the top control.

5. Verify goods in transit and consigned goods. Industry practices vary as to the inclusion or exclusion of goods in transit in the balance sheet. Normal accounting principles require the inclusion of in-transit items where title has passed to the purchaser. The auditor should visit

the receiving department on the last afternoon of the fiscal period to note the provisions that have been made for handling the inventory cutoff. He might also note the last receiving report number. Early in the new year he should review the receiving reports that have been prepared since the number noted. These receipts should then be traced into the corresponding invoices so that the purchase terms may be determined. Normally, goods purchased f.o.b. the vendor's plant become the property of the purchaser when they are delivered to the common carrier. Hence, all items purchased f.o.b. vendor and shipped prior to the balance sheet date are the property of the purchaser at that date and should be included as goods in transit. Most companies leave it to the auditor to determine shipments in transit and to set them up for balance sheet purposes.

The two following special conditions should be noted. Goods may have been received prior to the year end that have a delayed billing date; as a convenience to the vendor the purchaser may have accepted the goods for storing much earlier than he needs them. Billing may be delayed until such time as they normally would have been shipped. The auditor should question for items of this nature and determine from the terms of the contract where title vests at the balance sheet date.

In some industries it is customary practice to disregard goods in transit. Where a client suggests the exclusion of this material, the auditor should make certain that it is a generally accepted principle for this industry before he accepts the suggestion. It should be remembered that exclusion of in-transit items results in a more favorable current ratio.

Inquiry should be made as to goods out on consignment. Some clients have separate records of goods consigned out; others treat these shipments as regular sales, adjusting for the unsold portion at the year end. Where it is determined that there are goods in the hands of consignees, written confirmations should be received from them as to the description and amount of goods on hand at the year end. Adjustments should then be made to the client's records to include these goods as inventory and to exclude them from accounts receivable.

Occasionally consignments in are encountered. Here the auditor is interested in several points. Primarily, of course, he wants to make certain that the consigned goods are excluded from his client's inventory. Since most inventory instructions stress the point that everything should be counted, it is probable that the consigned goods have been included in the original inventory counts. If so, they will now have to be removed.

The auditor should request a confirmation from the consignor as to

the quantities shown by his records. This is necessary to make certain that any liability for goods sold has been properly recognized. Furthermore, if the goods are raw materials it may be that the client has converted some to his own uses. In any event the client has an actual liability to the consignor for the quantity of material he is supposed to have on hand, even though the liability is not recorded. The auditor must prove to his own satisfaction that the records of the two parties are in agreement. As a final point of interest the auditor should note whether or not his client is abiding by the terms of the bailment as to proper care and segregation from his own stock. Where consigned goods in represent material values, it may be helpful to disclose their existence and dollar value in a footnote to the balance sheet.

6. Confirm goods in warehouses. Where the client has placed goods in public warehouses confirmations of their existence should be obtained. It should be noted that public warehouses give receipts for *what they have been told* has been stored. If there is a relatively large amount stored or if the auditor is at all suspicious of the existence of the inventory, he should visit the warehouse. He should make his own count of the cartons and should open a few to make certain that the contents are as described.

As a minimum the auditor should know of his own knowledge or satisfy himself that there actually is such a warehouse. The famous McKesson-Robbins case of fraud involved fictitious inventories in fictitious warehouses. If the warehouses are out of town, the auditor should seek proof of their existence.

7. Trace counts (or original tags) into final inventory sheets. It should be recognized that a period of time will elapse between the completion of the count and receipt of the final inventory sheets which have been written up, extended, footed, and summarized. During this period the auditor will be performing some other phases of the inventory work or some other part of the audit.

One of the important steps in checking the clerical accuracy of the inventory is to trace the counts made by the auditor from his record and from the original tags into the final inventory sheets. It is not uncommon to find grievous errors in the carry-over of these quantities.

As he traces his counts into these final sheets the auditor should make tick marks against the amounts so traced. Then he will be able to tell whether or not he has made a comprehensive test of the quantities that will include the greater part of the dollar value of the inventory. If he finds items with enough value to indicate that he should have counted

them but did not, he may want to take a look at the items even though it is three or four weeks after the count. If he has done a good, careful job, finding large uncounted items of high value on the inventory sheets may indicate erroneous original counts. While he may not be able to trace back exactly to the year-end balance, he should be able to satisfy himself generally as to whether or not the original count was highly incorrect.

Although client's inventory sheets vary in size and format, most of them contain the information shown in Exhibit 8-3.

Exhibit 8-3

Quantity	*Description*	*Gauge*	*Unit price*	*Amount*
1,000 #	Wire, copper, soft	16	0.56 #	$ 560.00
800	Wire, copper, soft	18	0.58	464.00
1,200	Wire, copper, soft	20	0.60	720.00
40	Wire, copper, soft	22	0.68	27.20
3,000 spools	Wire, brass, spring	16	0.72 ea.	2,160.00
4,000	Wire, brass, spring	18	0.80	3,200.00
6,000	Wire, brass, spring	22	1.00	6,000.00
2,000	Wire, brass, spring	24	1.04	2,080.00
1,200 #	Wire, nickel, silver	16	2.20 #	2,640.00
800	Wire, nickel, silver	18	2.24	1,792.00
600	Wire, nickel, silver	20	2.32	1,392.00
700	Wire, nickel, silver	22	2 40	1,680.00
400	Wire, nickel, silver	24	2.60	1,040.00
Page total				$23,755.20

8. Verify extensions, footings, and carry-overs. A certain amount of verification of extensions and footings is necessary in any inventory work. Ordinarily the items counted and traced into the inventory sheets will be those chosen for tests of extensions. Scattered other tests should also be made. The quantity, unit price, and amount columns should be scanned, and all items that show large amounts in any of these columns should be tested. In this way any underextensions will be brought to light. For example, in Exhibit 8-3, assume that the 18-gauge brass spring wire had been extended as $32 instead of $3,200. If only the large amounts in the value column are tested, this might escape notice. But if the three columns are scanned, the 4,000 quantity would be large enough to be tested and the double slide would be revealed. Enough

of the smaller items should be tested to satisfy the auditor as to the general accuracy of the extensions.

While proving the extensions, attention should be paid to the units of measurement. Often the application of common sense is sufficient to disclose errors of this type. It should be remembered that the people who make the extensions usually are clerks or independent comptometer operators, neither of whom would have much knowledge of or interest in the inventory. Hence their work is largely mechanical. The auditor, with his over-all knowledge of this business and other businesses, usually can spot any ludicrous errors just by scanning the sheets.

In most cases the proving of extensions is done mentally. At times the use of calculating machines may be necessary, but experience develops a facility in mental calculating that permits a rapid review of the reasonableness of the work. Calculations are not carried out exactly. Only material errors are important, unless there is a series of small errors that accumulates into a total which becomes material.

Again, in the footing of the inventory sheets, the experienced auditor can scan sheets with small amounts and satisfy himself quickly as to the reasonableness of the page totals. Usually inventory sheets are footed individually, with no carry-over. When the page total becomes more significant, greater care is taken and footing is done in more detail. If a discrepancy is noted in any case, the sheet should be totaled completely and the exact error noted in the working papers. A decision will be made later as to the action to be taken, after the work is completed. The number and seriousness of the errors will guide the auditor in deciding whether to ignore or adjust them.

After the extensions and footings have been tested, the carry-over of page totals into summary sheets should be traced in detail. The summary sheets should then be footed completely. Similarly, all subassemblies should be traced into the final assembly sheet completely. Here greater values are involved and the work merits more care.

9. Test unit prices. An important part of the inventory work lies in the testing of the prices used on the inventory sheets. Assuming the use of first-in, first-out, the auditor should select the items to be tested and then call for the most recent invoices or cost sheets to support the prices used. Once again, most of the items selected for price testing should be those which have been counted and tested for extension accuracy. If all the major items of the inventory now have been counted, priced, and had extensions proved, the auditor should be fairly certain at this point of the reasonableness of the final inventory amounts.

In examining invoices for prices, the auditor should note the quantity purchased. If it is less than the quantity shown on the inventory, the next most recent invoice must be examined to support the remaining cost. For example, there might be 1,000 units on hand. The most recent invoice shows a purchase of 500 at $10 per unit. The next most recent invoice shows 300 at $9.50 per unit, and the preceding invoice 500 units at $9.25. The cost of the inventory on hand then is $9,700, not $10,000. If prices are going down, the same procedure should be followed if the client values his inventory at cost. If, however, he uses the lower of cost or market, it is permissible to use the most recent invoice price to price all units, assuming this invoice to be fairly close to the balance sheet date. An exception might be made in cases where the drop is precipitous. Where large amounts are involved, the loss due to the market decline should be shown separately in the nonoperating section of the income statement. However, where the loss is relatively nominal, it may be permitted to flow through cost of goods sold. Exhibit 8-4 illustrates a working paper practicable for price tests.

If the last-in, first-out method of costing is used, the base prices for the inventory should appear in the auditor's permanent file. If this is a new client, reference must be had to the invoices used in originating the base prices for lifo. These prices and quantities should be compiled in a permanent file sheet for reference on future examinations. If the client is changing over to lifo this year, the auditor probably will be called on to prepare the papers necessary for the change. Again this information should be set up for the permanent file.

If the quantity of units has increased during the year, the increased units may be priced in any of three ways. The items may be priced in the order of acquisition; they may be carried at the average price paid for all purchases of the item made during the year; or they may be priced at the most recent prices. The first method is preferable since it keeps the inventory more closely on a lifo basis.

The use of the lifo method means that the inventory may not be valued at the lower of cost or market. Hence when the auditor is satisfied as to the costs and the consistency of the basis, he has completed the valuation problem also, except for obsolete or unsalable goods which should be written down to their net realizable value.

Where a client uses fifo and the lower of cost or market, the auditor must now review the inventory to determine whether any write downs

Exhibit 8-4

Interior Decorators, Inc.
Inventory Price Tests
December 31, 1961

Description	Quantity	Unit cost	Amount	Most recent invoice Date	Most recent invoice Voucher	Vendor	Invoice quantity	Unit cost	Amount	Write-down necessary
Duck cloth	187 yd	4.00	748.00	6/14/61	11-168	Allied Mills	250 yd	4.00	1000.00	
Damask	963 yd	2.80	2696.40	12/12/61	12-41	United Producers	600 yd	2.80	1680.00	
				8/16/61	8-110	United Producers	350 yd	2.50	875.00	[illegible]
Burlap	218 yd	4.20	915.60	10/1/61	10-3	Allied Mills	222 yd	2.40	532.80	382.80
Monks cloth	22 yd	2.61	57.42	7/21/61	7-50	United Producers	22 yd	2.61	57.42	
Duck-cloth drapes	10 pr	30.00	300.00	10/10/61	10-21	Allied Mills	10 pr	30.00	300.00	
Burlap drapes	12 pr	35.00	420.00	3/12/61	3-15	Allied Mills	12 pr	20.00*	240.00	180.00

* - Recent price list indicates price of $20 per pair

are necessary. Current market prices may be obtained by the examination of recent invoices, manufacturers' catalogues or price lists, and current quotations in trade and financial journals. As he is testing inventory prices, the auditor should mark those items not recently purchased so that he may investigate particularly the market price of these items.

As a final step in pricing tests, selling prices should be reviewed and compared with costs. Under no circumstances should unit prices in excess of current selling prices be permitted to remain as final inventory values.

If the engagement is a first one for the auditor, he must examine not only the closing but also the opening inventory. His examination is, of course, restricted to the paper and book work portions of the inventory. He must make the same tests for clerical accuracy, pricing, and valuation so that he is in a position to know whether or not the client has been consistent in his inventory practices. Although he is not able to take physical counts of the quantities, in many cases he is able to trace the inventory movements through the records and thus satisfy himself generally as to the existence of the inventory.

Oftentimes it is helpful to set up an inventory error sheet to accumulate and classify the errors found. The working paper shown as Exhibit 8-5 illustrates one form of error sheet. The errors are grouped by the major objectives and follow logically the work the auditor performs.

10. Compare with last year's inventory. The current year's inventory sheets should be compared in some detail with the preceding year's sheets. The purpose of this comparison is to reveal slow-moving, obsolete, damaged, depreciated, or deteriorated stock. Such a comparison also will often disclose major variations in costs.

If an apparently slow-moving item is discovered, further investigation should be made. The item may not sell, or a considerable amount of activity may have coincidentally resulted in approximately the same quantity on hand at the beginning and end of the year. It is good procedure to determine the facts before attempting to devalue the item. Any major price variance disclosed should be noted for further investigation. The change may be a valid one, but it may also be the result of having devalued an item last year. When prices were inserted on the current sheets, original costs instead of the devalued costs were used. All items written down last year should be traced out to determine their disposition. If they have once been written down, no increase in cost price should be allowed.

The inventory totals should also be compared with the preceding year's totals. Any large variance in totals should be investigated. One

Exhibit 8-5

DONALD AND TROUT

Inventory Error Sheet, Raw Materials

December 31, 1961

Description	*Per client*	*Should be*	*Inventory adjustment*	
			Debit	*Credit*
Quantities				
Part X-141	182	202	$ 40.00	
V-216	400	408	160.00	
Q-312	25	22		$ 30.00
Clerical accuracy				
Part R-12	$1,420.00	$1,320.00		100.00
T-15	165.00	1,650.00	1,485.00	
Pricing				
Part Q-41 25	70.00			
15		70.00		
10		65.00		50.00
Totals			$1,685.00	$180.00
			180.00	
Add to inventory, AJE 22			$1,505.00	

way of proving up inventory changes is by computing the ending inventory by the gross profits method. There are, however, so many variances that affect the gross profit that it is necessary to be certain of all the facts before placing much reliance on the results of this test. If there is only one product or if there is a standard rate of mark-on for all items, results will be more satisfactory. The following factors all affect the overall rate of gross margin and must be considered when applying this test:

Change of selling price without a change in cost

Change in cost without a change in selling price

Change in proportion to total sales of high- and low-margin items

Change in method of costing

Change in inventory valuation method

If it is certain that there has been no radical change in any of the above factors, the computation in Exhibit 8-6 may be set up as a final proof of inventory totals.

Exhibit 8-6

Inventory, January 1		$ 48,560
Purchases		198,250
Goods available for sale		$246,810
Sales	$296,500	
Gross margin (prior years' average 40 per cent)	118,600	
Estimated cost of goods sold		177,900
Estimated final inventory		$ 68,910

Even where there have been no changes in any of the factors listed above, this computation is expected to give only reasonably close results. Its major purpose is to point up any unreasonable variances. If, for example, the physical inventory for the computation shown came to $100,000, the auditor would be justified in extending his investigation. If, however, the physical inventory was $71,642, he would accept the computation as verifying in total the inventory changes.

11. Eliminate any inventory profits. In cases where goods are transferred between departments, divisions, plants, or companies at cost plus a profit, the amount of such profit remaining in inventories should be eliminated. These transactions should be eliminated in their entirety from sales and cost of goods sold. While there is no effect on gross profit, there is an overstatement of sales and cost of sales. It should be noted that this type of intercompany transaction is not confined to companies where consolidated statements are prepared. Whenever there is a transfer of goods between departments or plants, the auditor should satisfy himself that there is no profit factor in the transferred cost.

12. Examine purchase commitments. Purchase commitments should be examined for two reasons. If the commitments are reasonable for normal operations, nothing need be said. But if it appears that the company is committed beyond its normal capacity, this fact should appear as a footnote to the balance sheet.

Secondly, if the client uses the lower-of-cost-or-market method inventory valuation, the commitments should be examined to determine whether or not purchases must be made in excess of current market prices. The portion of the contract already purchased will have been reduced to market price already. The portion remaining to be purchased must now be considered. If a material amount is involved, a surplus reserve should be set up to reflect the probable future loss. If, however, there is a firm sales commitment covering the purchase contract, no reserve need be set up.

13. Prove cost of goods sold. A review should be made of the method by which the client calculates or accumulates cost of goods sold. For a wholesale or retail concern this means a review of purchases. It is presumed that the vouching of the voucher register was done in sufficient detail to support the entries in the purchases account. Or, the senior may feel that additional months' purchases should be examined to gain a well-rounded picture of this account. If a perpetual inventory plan is in use, a review should be made of the transfers of inventory to the cost of goods sold account. If the periodic plan is used, the auditor will compute cost of sales by the usual periodic method.

If the client is a manufacturing company using a perpetual inventory plan, a review should be made of the transfers of materials to cost, the accumulation of labor charges, and particularly the application of burden. The auditor should also review the basis by which the burden rate is determined and satisfy himself that it reflects reasonably the manufacturing expenses. Again it is presumed that the detailed work performed on the voucher register will be sufficient to prove the reasonableness of the debits to most of these accounts. Some of the manufacturing expense accounts will probably require a more detailed analysis because of the character or importance of the account. Depreciation is one of these, repairs and maintenance another. If the company uses the periodic plan, the auditor will want to accumulate from the various accounts the information necessary to build up the cost of goods sold section.

14. Obtain an inventory certificate. As a final step in the inventory work, the auditor should request from management a written representation concerning the inventory. This is requested primarily to impress on management the fact that it must take primary responsibility for inventories, just as it does for all other accounts. The auditor's task is to review what management has done.

The certificate also assists management in divulging particular points that the auditor needs to know about the inventory. Such things as obsolescence, hypothecation, liability recognition, and valuation are normally covered therein. While the certificate is an added assurance to the auditor that management has supplied him with all the information he needs, it does not relieve him of any of his inventory responsibilities. His work must all be done just as though he were not going to receive the written representation. A sample certificate is shown in Exhibit 8-7.

15. Review balance sheet presentation. Inventories should be shown in the balance sheet in sufficient detail to disclose their nature. The basis of valuation should be indicated. If declining market prices have caused

Exhibit 8-7

INVENTORY CERTIFICATE

Date_______________

Name of Auditor
Address

In connection with your review of the accounts of the_______________ Company as of _______________ 19___, we wish to make the following statements regarding the inventories which were taken under the personal supervision of _______________ (title) _______________

Classification	Amount
_______________	_______________
_______________	_______________
_______________	_______________
_______________	_______________
Total	$_______________

1. All inventory quantities were determined by actual count, weight, or measurements, with the following exceptions:_______________

____

2. The liabilities for all inventories have been recorded as of the closing date and do not include items billed by the company prior to the closing date, or inventories held on consignment.

3. The inventory is the unencumbered property of the company, was not held under trust agreement, pledged as collateral, or had any other liens applying thereon at the close of business as of _______________ 19___ except as noted below

____

4. The basis of pricing (cost, lower of cost or market) and method of computation of the inventories are consistent with the methods followed at the close of the preceding period. The cost was determined on the following basis_______________ _______________(fifo lifo average). Any changes in basis must be described._______________

5. No obsolete, inactive, imperfect, damaged, or unusable materials or merchandise are included in the inventory at prices in excess of net realizable values.

6. We feel that the value attached to the inventory stated as above is a fair and proper amount for inclusion in our balance sheet as of_______________19___.

Signed at_______________ Date _______
By_______________ Title _______

a devaluation of inventories, cost should be shown parenthetically. Where lifo is used, it is proper to indicate parenthetically the current market values of the inventory.

The devaluation of individual perpetual inventory records may be impracticable because of the large number of cards involved. Where such a situation exists, it is customary to use a valuation account to reflect the

drop in market value, rather than reduce the inventory control account. In line with current terminology trends, this account should not be called a reserve but rather should be given some such title as "reduction to decrease inventory to lower of cost or market." Normally this account is deducted from inventory on the face of the balance sheet.

A decrease in market prices continuing beyond the balance sheet date may require the use of a reserve in the equity section to indicate possible future inventory losses. As with all surplus reserves, any losses realized should flow through the operating accounts. The reserve should be returned intact to retained earnings when it is no longer needed. Some companies prefer to use a footnote rather than to set up a surplus reserve.

If inventories are used as security for loans, such fact should be indicated in the balance sheet, not only in the inventory section, but also in the contra account. The amount of the hypothecation should be indicated. Where a full description may be too long for insertion in the balance sheet proper, a footnote should be appended to the statement so that there may be full disclosure.

Summary

The examination of inventories is a many-sided task. The following steps indicate the major procedural aspects that should be followed.

1. Observe the inventory taking, making such tests of physical quantities as seem advisable.
2. Determine that all goods have been included that should have been.
3. Test the adequacy of the inventory record keeping.
4. Make tests of the clerical accuracy of the physical inventory sheets.
5. Review the valuation processes.
6. Review and test the cost of goods sold.
7. Obtain a representation from management concerning inventories.
8. Determine that the classification of inventories is proper for balance sheet purposes.

QUESTIONS AND PROBLEMS

1. What is the first step in inventory work? Why is it important?

2. What are some of the points that should be covered in the inventory instructions?

3. Your client closes his books on December 31. He wishes to take his annual inventory at October 31. Is this permissible, assuming that his per-

petual records are adequate? If so, what steps should the auditor follow after December 31?

4. Name three generally accepted methods of inventory costing. Which gives the most accurate results?

5. Name three generally accepted methods of inventory valuation. Which gives the most accurate results?

6. What are the accountant's responsibilities with respect to inventories? What are management's responsibilities?

7. What are the major objectives in auditing inventories?

8. What important internal control factors are related to inventories?

9. When do goods in transit become the property of the purchaser?

10. What responsibilities does a consignee have with respect to consigned inventories?

11. Your client is a book publisher. As part of his sales program he regularly ships books on consignment to some 200 outlets. The average balance reported unsold is about $40. As auditor, what procedure would you apply to these consigned inventories?

12. Why should the extensions of all large quantities on the inventory sheets be tested?

13. Your client uses the first-in, first-out method of inventory costing. Explain your procedure in testing inventory prices.

14. Why is a review of selling prices a necessary part of testing inventory prices?

15. Why should the details of this year's inventory be compared with last year's inventory?

16. You have performed all the normal inventory work and finally apply the gross profits test. The results of the test indicate that the physical inventory is understated by about 30 per cent. List the steps you will follow in investigating the discrepancy.

17. Your client is a department store using the retail inventory method of valuation. What is the inventory value of the department shown in Exhibit 8-8?

Exhibit 8-8

Beginning inventory, at cost	$12,595
Beginning inventory, at selling price	18,050
Markups	5,050
Markdown cancellations	850
Freight in	1,805
Sales	64,000
Purchases, at cost	40,000
Markup cancellations	2,100
Markdowns	3,450
Purchases, at selling price	60,600

Exhibit 8-9

Quantity	*Description*	*Unit price*	*Amount*
25	Men's hats	$ 2.86 ea	$ 71.50
108	Men's handkerchiefs	1.00 dz	108.00
75	Arrow shirts	2.80 ea	210.00
40	Manhattan shirts	2.75 ea	82.50
62	Arrow shorts	0.52 ea	32.24
78	Arrow undershirts	0.48 ea	37.44
32	Men's suits, $75	50.00 ea	160.00
38	Men's suits, $60	40.00 ea	1,520.00
64	Men's suits, $40	27.50 ea	1,760.00
20	Sport jackets, $40	28.00 ea	560.00
28	Sport jackets, $25	16.75 ea	469.00
40	Slacks, $20	12.00 ea	480.00
75	Slacks, $10	6.25 ea	468.75
22	Boys' suits, $30	21.00 ea	462.00
108	Boys' shirts	6.00 dz	54.00
50	Bermuda shorts	2.85 dz	142.50
6 dz	Neckties, $2	10.00 dz	60.00
4⅓ dz	Neckties, $3	15.00 dz	65.00
3 dz	Neckties, $5	22.50 dz	67 50
40	Belts	0.90 ea	36.00
120	Men's hosiery	9.00 dz	90.00
22	Cuff and tie clip sets	1.00 ea	22.00
27	Topcoats	20.00 ea	540.00
13	Wallets, $10	6.00 ea	78.00
20	Wallets, $15	8.50 ea	170 00
	Total		$6,746.43

18. You have completed your inventory work and have asked for signatures on the inventory certificate. The officers refuse to sign, saying, in effect, "We hired *you* to tell *us* whether the statements are correct." What would you do?

19. What is a "hollow square"? How would you find it used?

20. Your client is a gold mining company, with its office in New York and the mines in Alaska. All records are maintained in New York. It is impracticable and unreasonable for you to go to Alaska to count the inventory. What effect, if any, will this have on the opinion you render?

21. A retail store takes its inventory at selling price and reduces the final values to cost by deducting gross profit. The retail value of the inventory is about $60,000; the price of most items is from $1 to $2, although

there are a few that sell at $25 to $50 and a very few that sell at $300.

Set up a program listing the audit steps you would follow in verifying the inventory. Segregate your procedures as between verification of physical quantities and verification of clerical accuracy (including pricing).

22. In verifying inventories of your client, you find 102,000 pounds of copper ingots on consignment from one of the customers. Your client will process (roll) this metal and ship it back to the customer. What is your interest in this portion of the inventory? What audit procedures will you follow?

23. Your client is a publishing company. All printing is done by established printing companies located outside the client's city. Paper is purchased and sent directly to the printer selected to print the particular book. A perpetual record of paper is kept by your client, who receives reports from the printers as to paper used. The paper represents about 5 per cent of total current assets.

Prepare your program for the audit of the raw materials (paper) inventory.

24. You are to review the inventory sheet shown in Exhibit 8-9. The client has already recorded the inventory. He uses first-in, first-out. Your test counts of the inventory, which amounts the client has agreed are correct, are as follows:

Hats, 25; handkerchiefs, 110; shirts: Arrow, 75; Manhattan, 40; Arrow shorts, 60; undershirts, 68; men's suits, 32 @ $75, 38 @ $60, 74 @ $40; sport jackets, 20 @ $40, 28 @ $25; slacks, 40 @ $20, 75 @ $10; boys' suits, 22; boys' shirts, 120; Bermuda shorts, 50; neckties, 72 @ $2, 52 @ $3, 36 @ $5; belts, 40; hosiery, 120; cuff sets, 22; topcoats, 28; wallets, 13 @ $10, 20 @ $15.

Your pricing tests reveal that 24 of the $40 suits were bought for $27.50 each, and the other 40 for $25 each.

Prepare an error sheet, following the form suggested in Exhibit 8-5 (page 227). Prepare any adjusting entries you find necessary.

Chapter 9

PREPAID EXPENSES

Prepaid expenses generally are considered to include those prepayments of regularly recurring, normal operating costs that will be consumed within the next accounting period. There are exceptions to the time period, such as long-term insurance policies, but none as to the operational factor. Prepaid expenses include such costs as interest, insurance, rent, supplies for the offices and factory, and expense advances to salesmen.

Accounting Research Bulletin No. 43, prepared by the Accounting Research Committee of the American Institute of Certified Public Accountants, indicates that prepaid expenses are properly classified for balance sheet purposes as a current asset. While many printed balance sheets still place prepaid expenses in the deferred charge section there is a trend toward inclusion in the current asset section. It is probable that more and more companies will tend to follow the classification suggested by this bulletin.

INTERNAL CONTROL AND PREPAID EXPENSES

The question arises, since prepaid expenses usually are of relatively small value, whether it is worthwhile to pay any attention to control of these costs. In answer to this question it is noted that internal control deals not only with the safeguarding of assets but also with the processes that lead to an assurance of reasonably accurate financial statements. Control of these accounts is important for the second reason, if not the first.

The physical safeguarding of these assets is not so difficult as is the controlling of more liquid assets, and in most cases it is not nearly as important. However, inventoriable supplies, if usable for other than

business purposes, are likely to disappear unusually fast unless some safeguards are placed over them. The size of the business, the intrinsic value of the supplies, and their general utility will dictate the number and type of controls necessary. Particularly in smaller businesses, the auditor should note whether or not the client is safeguarded against this loss. The easiest method of control is to give one staff member complete responsibility over the supplies. If he has the responsibility, he should also have the authority for dispensing the supplies. He should have little difficulty in noting abnormal requests or excessive usage. While the current carrying value of these supplies may be small, rapid turnover will cause expense accounts to soar. Many businessmen tend to spend their time in controlling large costs, with little attention being given to the so-called minor expenses. Regardless of classification, all expenses result in decreasing net profit. Dollars saved are dollars of profit. Hence, control over inventoriable supplies may be of importance.

Naturally the cost of maintaining the control must be weighed against the possible loss. If the "minor" expenses are so small, relatively and actually, that no savings can be foreseen, it would be foolish to spend anything to control them. The placing of strict controls over these items may also result in making the employees disgruntled, not necessarily because they are interested in stealing supplies, but because of the necessity of requisitioning supplies when needed. It may thus be better business to take a calculated risk in this area and not attempt to control the supplies.

With other than inventoriable supplies, the primary control problem is one of determining that proper authority exists for the monthly or annual charge to expense. Many companies prepare a spread sheet when the expense is paid for, indicating the write-offs to be made. Many of these prepayments will be written off in the succeeding year. If the client does not prepare monthly statements, the matter is of no importance, except for the year-end split.

Insurance presents a different control problem. Here the client's system of scheduling the expiration dates of the policies should be reviewed to determine that he is protected against possible unintentional lapses of policies. Physical control and segregation of the insurance policies should be reviewed to see that the possible unauthorized use of insurance policies is kept to a minimum. If real estate is used as security for borrowed money, it is usually necessary to transfer the fire insurance policy. Strict control of the policies will help to prevent unauthorized borrowing of this type.

MAJOR OBJECTIVES IN AUDITING PREPAYMENTS

There are three major objectives in auditing prepaid expenses. These are (1) a determination as to whether the item is properly deferrable to future periods or should be currently expensed, (2) a determination of the amount properly deferrable, and (3) a satisfaction that the item is a prepayment and not a deferred charge. Deferred charges, in the accounting sense, are long-term, one-time, major expenditures that are to be written off over several succeeding periods.

There is usually no particular difficulty with respect to the first of these objectives. If a future period will be benefited by the prepayment, the appropriate portion should be deferred. One test is to inquire whether the item would be purchased again in the next period if none were carried over. If the answer is in the negative, there may be some question as to any benefit to be derived in the future period. But if the item would need to be repurchased or a similar substitute purchased, it is clear that the item will be of value to the company in the next period.

The fact that there is a supply of the item on hand does not necessarily mean that it has value. It may be that a supply of forms exists that have been made obsolete by a change in office equipment. Where such a situation is encountered the item should be expensed or at least written down to its scrap value.

Prepaid expenses usually are capable of measurement, either on a time basis or by inventorying. In some few cases it may be found that the prepayment is to be written off on an arbitrary basis. In any case, by one of these three measures, the amount to be deferred is rather easily determined. In some audits the calculation is made by the client and verified by the auditor but in many others the auditor makes the original calculation. Where this is done, the client should be requested to verify the calculation and to approve the expense distribution.

With many prepaid items, it is feasible to verify the expense account at the same time the balance sheet account is audited. This verification of expense helps to prove the remaining value in the asset account. It also helps to fulfill the auditor's responsibility to review the operating accounts, an integral part of most current examinations.

In many cases there will be only one entry in the expense account, the year-end adjustment. All transactions during the year will have been entered in the balance sheet account. Then the auditor's worksheet should show the distribution of the balance in the asset account, as between the amount to be expensed and the amount to be deferred.

Proof of the consumption is thus shown on the worksheet. This type of account is illustrated by the prepaid insurance account.

The supplies inventory account, on the other hand, may be dormant during the year, with all transactions being charged to the expense account. The consumption phase is much more difficult to prove here. Consumption is determined on an inventory basis, with both the asset and expense accounts being adjusted to conform to the physical inventory. This leaves a computed balance in the expense account but does not prove the propriety of that balance. About all that can be done here is to compare the expenses with the preceding year and with the budget, if there is one. This procedure will at least point up any substantial variation from normal. Such variations always call for further investigation as to causes and necessity.

Anything that the auditor can suggest through his review of the expense portion of these accounts to permit a better usage control by management is usually well received. Again, the added cost must be small enough relative to possible savings to merit the institution of the control. In many cases, the actual value of the audit is better shown through such suggested controls and savings than it is in the expression of an opinion on the statements. This is particularly true in the examination of a small business.

AUDIT PROCEDURES AND TECHNIQUES

It is convenient to discuss the auditing of prepaid expenses on an individual, rather than a group, basis. Although several of these items are similar and will be grouped in the discussion, others are dissimilar and are of sufficient importance to warrant separate treatment.

Unexpired Insurance

The commonality of insurance as a cost of doing business suggests that it is a proper account with which to begin the discussion.

1. Analyze the unexpired insurance account. Not much has been said in the preceding four chapters about account analyses. This device is a familiar tool of the auditor. It is used primarily for those accounts where entries tend to represent individual transactions, rather than masses of transactions. In some cases a complete analysis is impracticable, nor would it aid in the examination or in supporting the work done by the auditor. This holds true usually for such accounts as cash, accounts receivable, and accounts payable, where each monthly entry may represent a total of thousands of individual entries.

Exhibit 9-1

The Jones Company
Unexpired Insurance
December 31, 1961

				Dr.	Cr.
Balance, December 31, 1960				2,382.74 "	
1/31 United Casualty Co.	VR36	166.65 V			
National Industrial Ins. Co.	VR37	460.50 V		627.15	
4/30 National Mutual Ins. Co., Fire	VR42	822.00 V			
National Mutual Ins. Co., Sprinkler	VR42	300.00 V		1,122.00	
7/31 National Industrial Ins. Co.	VR47			420.20 V	
10/31 General Auto Ins. Co.	VR52			126.00 V	
Total per ledger				4,678.09	
AJE (13) To charge expense with portion consumed				2,602.74	
Balance per audit				2,075.35	

V = Vouched
" = Traced to 1960 W/P

[illegible]

It is the purpose of an account analysis to disclose the nature of the items that have been posted to the account, to prove the client's balance, and to show the adjustments to the account that have been made by the auditor, with the resulting balance of the account per the audit. The account analysis should show exactly what is in the ledger account, and the client's ending balance, before any adjusting entries

are added. Exhibit 9-1 illustrates this type of analysis sheet. Where a complete analysis is not made, it is customary to set up a worksheet showing the ending balance per books, and applying the audit adjustments thereto (see Exhibit 9-2). In many cases schedules will be prepared to support the analysis sheet. Exhibit 9-3 presents such a supporting schedule. It seems to the author that, since the examination is being made of the client's accounts, the audit working papers should support the examination by including a sheet for each account. This applies primarily to the balance sheet accounts.

When the analysis has been completed, the items appearing therein should be vouched. This is done to determine that the amounts are correct, that all items charged to the account belong in it, and that nothing has been omitted which should have been included.

Debit entries normally represent premiums paid. Where policies are purchased from mutual insurance companies, the amount charged to the account should be the total premium minus any dividend credit. Credits to the account arise from refunds for rate changes, cancellations of policies, and personnel changes under fidelity bonds.

2. Schedule insurance policies. After the account has been analyzed, the auditor should call for all insurance policies and schedule them. In many cases schedules of this type that carry over from one year to the next may be set up in the auditor's office during the slack season. Two general types of schedule are available. One is used particularly for balance sheet audits and includes only the policies in force at the year end. Since this examination is concerned only with balance sheet values, no attempt is made to prove the correctness of the expense account.

The second type of schedule, illustrated in Exhibit 9-3, is designed to prove three balances. The unexpired portions of the policies are copied from last year's papers. The total thus determined is proved to the client's beginning balance. The unexpired portion at the current year end is computed and proved to the ending balance of the unexpired insurance account. The expense portion of all policies in force during the year is computed and proved to the expense account balance. This sheet supports the analysis of the unexpired insurance account.

In scheduling the policies, all like risks should be grouped. This is done to enable the auditor to review the total coverage for each of the hazards insured against. When the schedule is being prepared and a policy is entered which expires during the year under review, the next line should be left blank so that the renewal policy may be inserted there.

Exhibit 9-2

The Jones Company
Unexpired Insurance
December 31, 1961

		①	②
1	Balance per ledger, December 31, 1961	4682.13	
2			
3	AJE (26) To charge insurance		
4	expense with portion of premiums		
5	consumed		1846.51
6			
7	AJE (27) To accrue liability on		
8	workmen's compensation insurance,		
9	cost included in above credit	172.80	
10			
11		4854.93	1846.51
12		1846.51	
13	Balance per audit	3008.42	

Some clients will provide the auditor with schedules of the insurance policies. The auditor should previously set up the form to be used, so that it serves the purposes for which he needs it. If the auditor can arrange to have the schedule prepared for him, it will represent a considerable savings in time.

3. Examine all policies. The auditor should call for all the policies on hand at the time of the examination. These should then be examined for the following points, and traced into the insurance schedule.

For all policies purchased during the year the premium, as shown on the policy, should be traced to the invoice and voucher. If the policies are issued by mutual insurance companies, it is possible that the premium shown on the policy will not agree with the amount on the invoice because dividends have been applied to reduce the premium. Sometimes a check is received for the dividend. Any check so received should be credited to unexpired insurance and applied against the premium paid for the renewal of the policy. The net premium should then be shown on the schedule as the cost of renewing the policy.

Some companies apply the anticipated dividend against the policy to which it pertains, thus netting the cost originally. While experience with the mutual companies may indicate the practicality of such an arrangement, it is hardly a conservative practice. These dividends, like all others, are subject to the discretion of the board of directors. The possibility of heavy losses during the year, with the consequent omission of the dividend, is an ever-present threat. Since these policies are held in mutual companies, the insured is a member of the company. This means that in case of a catastrophe the possibility exists that the member companies may be assessed additional amounts to cover the losses. In considering this subject, on the basis of a survey of actual assessments, the Committee on Auditing Procedure of the American Institute of Certified Public Accountants decided that the contingency was too remote to require recognition on the balance sheet.

The insurance policies should be examined for the name of the insurer, the policy number, the type and amount of coverage, and the dates of the policy. The percentage of co-insurance, if any, should be noted on the working papers. Co-insurance agreements provide that, unless the client keeps the amount of the insurance on an asset up to a stipulated percentage of the fair market value of the asset *at the time of the loss,* the client shares the loss with the insuring company. Consider the following situation:

Co-insurance clause, 90 per cent	
Fair market value at date of loss	$80,000
Insurance carried	64,000
Loss	45,000

Exhibit 9-3

The Jones Company
Unexpired Insurance
December 31, 1961

Insurer	Policy	Coverage	Co-ins.	Amount	Term From	Term To	Unexpired January 1, 1961	Premiums paid in 1961	Expense	Unexpired Dec. 31, 1961
National Mutual Ins. Co. "	Fo 13416	Fire and ext. coverage	80%	300000	4/1/58	4/1/61 "	68.50		68.50	—
National Mutual Ins. Co. "	Fo 14672 "	Fire and ext. coverage	80%	300000 "	4/1/59	4/1/62 "	342.50		274.00	68.50
National Mutual Ins. Co. "	Fo 16121 "	Fire and ext. coverage	80%	400000 "	4/1/60	4/1/63 "	822.00		365.33	456.67
National Mutual Ins. Co. "	Fo 17217 "	Fire and ext. coverage	80%	300000 "	4/1/61	4/1/64 "		822.00 V	205.50	616.50
State Mutual Ins. Co.	SL 8630	Sprinkler leakage	25%	75000	4/1/58	4/1/61	25.00		25.00	—
State Mutual Ins. Co. "	SL 9146 "	Sprinkler leakage	25%	75000 "	4/1/59	4/1/62 "	125.00		100.00	25.00
State Mutual Ins. Co. "	SL 9898 "	Sprinkler leakage	25%	75000 "	4/1/60	4/1/63 "	225.00		100.00	125.00
State Mutual Ins. Co. "	SL 10313 "	Sprinkler leakage	25%	75000 "	4/1/61	4/1/64 "		300.00 V	75.00	225.00
United Casualty Co. "	PC 1010 "	Plate glass		Replacement "	6/3/60	6/3/63 "	190.73		78.92	111.81
United Casualty Co.	PL 145111	Comp. pub. liability		25/50 #	1/20/60	1/20/61	9.26		9.26	—
United Casualty Co. "	PL 167730 "	Comp. pub. liability		25/50 # "	1/20/61	1/20/62 "		166.65 V	157.39	9.26
International Ins. Co. "	BD 261415 "	Burglary		10000 "	7/12/60	7/12/63 "	214.86		85.00	129.86
Hartford Ins. Co. "	112618 "	Boiler explosion		20000 "	1/1/60	1/1/65 "	240.00		60.00	180.00
General Auto Ins. Co. "	X 1141111 "	Fire, theft, P.D., P.L.		ACV 10,000-5/10 # "	10/15/60	10/15/61 "	97.09		97.09	
General Auto Ins. Co. "	X 1142781 "	Fire, theft, P.D., P.L.		ACV 10,000-5/10 "	10/15/61	10/15/62 "		126.00 V	26.25	99.75
National Industrial Ins. Co. "	410610 "	Workmen's Comp.			7/1/50	continuing "	22.80	460.50 V 420.20 V	875.50	28.00
							2382.74	2295.35	2602.74	2075.35

" = Examined policy
V = Vouched premium
# = Traced to last year's W/P
Compared coverage with appraisal values set by insurance broker. Adequate related to coinsurance clauses to use and occupancy coverage.
Confirmed all policies with issuing company.
Calculated allocation to expense.

W.B.J.

The co-insurance clause requires a coverage of $72,000 to gain 100 per cent insurance against loss. The coverage is only 8/9 of $72,000, so the client must stand 1/9 ($5,000) of the loss. Had the co-insurance clause been 80 per cent, the client would have been fully covered and would have received the entire $45,000. It is obvious then that the co-insurance clauses are important to the client and therefore to the auditor.

In examining the policies, it should be determined that there is a policy for each item listed on the schedule. Even where the client has prepared the schedule and there are so many policies that some of the work is done on a test basis, the auditor should examine each policy to be certain that there is one for each item listed. He should also note that what he examines is the actual policy, not a memorandum policy. Memo policies are given when the original policy has been assigned to a mortgagee. When memo policies are found, they should be cross-referenced to the liability working papers to be certain that the liability has been recognized.

If a policy is missing the auditor should use all his tact and ability to determine where it is. It may be that the company's insurance broker has the policy. If so, a confirmation of the details of the policy should be requested. However, it may also mean that the policy has been assigned to a mortgagee. Reference should be made to the liability section to make certain that the mortgage is recognized on the books.

Some auditors follow the practice of confirming all insurance coverages with the insurer rather than the broker. Cases have occurred where the broker issued a policy, retained the premium himself, and did not notify the insurer of the issuance. In case of a loss there is no coverage.

4. Make certain that all expired policies have been renewed. It is a rare situation nowadays where a risk once recognized is later deemed unimportant. In other words, every policy carried by the client should be renewed when it expires. When the auditor finds that a policy has not been renewed, he should search until he has received a satisfactory reason for the nonrenewal. There may be an adequate reason, but it may also be that some one has forgotten to renew the policy.

5. Calculate expense and unexpired portion of premium. In cases where the client has prepared the schedule, the auditor should verify the split of the premium between expense and asset. With an excessively large number of policies this work may be done on a test basis. All policies expensed on other than a straight time basis should be included

in the test, as should the large policies and all policies with unusual features. The schedule should then be footed and crossfooted.

Where the auditor prepares the schedule, he will make the original calculations himself. It is wise to inquire if the client has made the calculations so that there may be a comparison of the results. If the auditor can persuade the client to prepare the schedule for him, he saves considerable time.

Companies follow different policies in the calculation of insurance expense. Some will charge a full month's expense in the month in which the policy is purchased and none in the month in which it expires. Others will charge a half-month's expense at the beginning and end of the policy, regardless of the day of purchase. Still others are more exact and prorate the policy according to the date of purchase. It is unusual, however, to break the cost down into less than one-third of a month. The fractions normally used are ⅓, ½, and ⅔. It matters not what particular practice the client follows, as long as he is consistent. The auditor should determine what method is used and abide by it.

When the computations have been made and the schedule footed and crossfooted, any adjustment necessary should be set up on the auditor's list of adjusting journal entries. If a comparison with the client's computations shows only slight variations, it is permissible to accept an adjustment he has already made. If the account has not yet been adjusted, the auditor normally will use his own results. If the comparison discloses a large discrepancy and it is determined that the client has erred, any entry he has made must be corrected.

6. Analyze the insurance expense account. The sum of the expense column on the auditor's worksheet should be proved with the insurance expense account. In many cases no entry has been made to the insurance account for the year, in which case there is an automatic proof. In other cases monthly entries will have been made. If the client's calculations have been accurate, there should still be an automatic proof.

However, often there will appear numerous charges and credits in the insurance expense account that come directly from the voucher register or cash receipts book. These arise from changes in policies, charges for short-term policies, and refunds from cancellations. When the auditor finds this situation, he should analyze the account and vouch the charges and credits in it to be certain that they all pertain to the year under review. In some cases he may find that a portion of these items should be deferred to the following year. A reconciliation

should be made of the final balance per the expense account and the expense shown on the auditor's schedule of insurance.

Often the insurance expense will be spread among different departments or other units of the business. Somewhere in his working papers the auditor should tie together these charges and then prove the total against the insurance expense, per his schedule. One simple method of doing this is to make a distribution at the bottom of the expense column of the insurance schedule showing the accounts that have been charged. In other cases distributive columns may be included in the schedule for the various accounts.

7. Review the insurance coverage. Through his contacts with many businesses, the auditor becomes familiar with the risks commonly insured against by businessmen. His review of the client's coverage should serve to satisfy him that all the common risks are covered. If he finds what he considers to be uninsured risks, he should bring these to the client's attention.

The amount of coverage of various risks should also be reviewed to see if they are adequate. It should be noted, however, that one of the factors of adequate coverage is the fair market value of the assets. With respect to buildings and machinery, it is the author's opinion that the auditor is not qualified to determine these values. For this information he must depend on others. If a recent appraisal by an appraisal company has been made, this may be used as a basis for comparison with insured values. Otherwise, the company's insurance broker's appraisal may be adequate for such a comparison. Where no sort of appraisal figures are available, the auditor should apprise his client of the importance of the fair market value factor and indicate the wisdom of obtaining some sort of objective data. This is particularly important where co-insurance clauses exist.

Assuming that some sort of appraisal figures are available, the auditor should compare the stipulated percentage of the fair market values with the coverage to determine the adequacy. He should promptly inform the client of any deficiencies that he finds.

Prepaid Interest

Ordinarily interest is prepaid only on discounted notes payable. While the actual work of auditing prepaid interest is done at the time the liability is examined, the steps will be set down here.

1. Vouch the expenditure. When notes payable are discounted, the interest is deducted from the face of the loan. The proceeds represent

the loan less the interest. The terms and interest rate of the loan should be determined, and the interest should be calculated. Here is one area where a bank error could go undetected. In most cases there will be no invoice to support this expenditure for interest, but the minutes should disclose the authority for the loan.

2. Trace to the records. The proof of interest deducted is found in the cash receipts book where the proceeds of the loan are recorded. The charge to prepaid interest or interest expense should be recorded here. If the client uses a note register, the interest should be traced into that record also.

3. Adjust the records. Having determined that the interest charge is correct, the auditor should compute (or check, if already computed) the prepaid portion and adjust the prepaid interest account. In many cases the prepaid interest is shown adequately on the notes payable schedule and there is no necessity to set up a separate working paper for it. The final balance shown in the working trial balance will be referenced to the liability schedule. Interest expense should also be proved against this schedule.

Inventories of Supplies

Although the value of these inventories is usually relatively negligible, the procedures applied to other inventories should be used here. The supplies should be test-counted, with the auditor being alert for signs of obsolete supplies. The counts should be traced into the supplies inventory sheets and the sheets extended on a test basis. A comparison with last year's sheets is useful in disclosing unused supplies. Some of the larger items should be tested for unit prices. Then the sheets should be footed and the accounts adjusted.

The auditor will find in some cases that inventories of supplies are kept so low that they are expensed as purchased and no inventory is taken. In these situations an examination of some of the larger purchases with an estimate of the rate of consumption will indicate to him whether management has taken a tenable position in this regard.

Prepaid Rent

1. Examine the lease. The basic document for the examination of this account is the lease. Here the auditor should find the terms of the lease, the monthly or annual rental, and the dates when payments are due. He should record the basic terms in his working papers, being careful to note any escalator clauses. He should also note the duties of

the client as lessee. In some lease agreements, the lessor is responsible only for maintenance of walls and roof; the lessee maintains the rest of the structure, including insurance and real estate taxes. The auditor should determine that the client is fulfilling his responsibilities under the lease. If he is not, there is a contingent liability situation.

2. Vouch payments. Rent payments should be traced to the voucher register and the paid checks examined to see that they agree with the terms indicated in the lease. If there is no change in the lease during the year, the proof of expense is easy. The balance in rent expense, after adjustment, should equal the annual rent indicated in the lease or twelve times the monthly rent indicated.

Many leases now are written with a basic charge for rent plus a percentage of net sales. In this situation the auditor may have not only prepaid rent but also accrued rent. The proof of rent expense is only slightly more difficult here, since the additional cost should be the percentage of net sales for the year. Some contracts permit a base amount of net sales each month before the surcharge is applied.

3. Calculate the prepaid portion. Having read the lease, noted the terms, and vouched the payments, the auditor is in a position to determine the amount of rent prepaid at the year end. If the adjustment has not yet been put on the books, he should prepare the necessary adjusting journal entry.

Advances to Salesmen

Many companies make travel expense advances to their salesmen. Normally these funds are kept on an imprest basis, with the advance being reimbursed on the basis of a travel expense report.

1. Confirm year-end balance. The auditor should seek confirmation of the balances held by the salesmen at the year end. It will be necessary to send letters to some of them, but a chat with the sales manager will probably reveal that a number of the salesmen will be in the office sometime during the examination. These men can be asked to sign the confirmation request at that time.

2. Review expense reports and reimbursements. The expense reports should be reviewed to see that all for the last part of the year under review have been included. If all these reports have been recognized as payables at the year end, it is proper to carry the advances at the imprest amounts. If, however, the expenses were recorded and paid in the new year, it is necessary to recognize the accrued liability at the year end or to reduce the advance to the balance actually held at the year end, if the reduction is material. Recognition of the liability would

require a reversing entry at the beginning of the new year. The payment of the reimbursements should be traced to the cash payments book or to the actual checks.

In some cases advances are granted not only for travel expense but also for commissions to be earned. Here the auditor must determine the amount of the commission actually earned by the salesman and apply it against the advance payment.

It is not unusual to find that salesmen have left the company without earning out all the commission advanced. It will be necessary here to discuss the possibility of recovering the amount. Usually the possibility is remote. The amount should be removed from advances to salesmen and reclassified as a receivable or written off as a bad debt, as circumstances demand.

Other Prepaid Items

Various miscellaneous prepaid items such as prepaid advertising, prepaid royalties, and prepaid taxes exist on the books of many companies. The audit procedures are common to all of them. First, determine that the item is reasonably deferrable until the next operating period. Then vouch the charge to the prepaid account to determine its correctness and proper classification. Next, determine by one of the three methods the amount that should go forward to the next period. Finally, where it is possible to do so, determine the consumption and prove it to the expense account. Classification as a prepaid item or a deferred charge is usually easy to determine but it should not be overlooked.

Summary

The major verificational steps are much the same for all types of prepaid expenses.

1. Analyze the account.
2. Examine the underlying evidence supporting charges to the account.
3. Determine (or prove) the allocation to expense and the amount to be deferred.
4. Segregate prepaid items from deferred charges.

QUESTIONS AND PROBLEMS

1. Distinguish between a prepaid expense and a deferred charge.

2. What position has the Accounting Research Committee of the American Institute of Certified Public Accountants taken with respect to the

classification of prepaid expenses? What arguments are there in refutation of this position?

3. A controller of one of your clients stated, "At any balance sheet date our prepaid expenses are so small that we don't worry about controlling them." Discuss.

4. What are the major objectives in auditing prepaid expenses?

5. Your client had a fire which completely destroyed a building insured for $40,000. The insurance policy had an 80 per cent co-insurance clause. The fair market value of the building before it burned was $75,000. The net book value of the building was $30,000.

How much should your client recover from the insurance company?

6. Why does the auditor analyze accounts?

7. Why does the auditor schedule the insurance policies?

8. Why should similar risks be grouped on the insurance schedule?

9. In your examination of insurance policies, you note that a policy that had over two years of remaining life at the beginning of the fiscal year is missing from the policies handed you. Your records indicate this is a fire policy on buildings, for $100,000. Your question about the policy is answered with the statement that the company was overinsured and the policy has been canceled.

What procedure will you follow?

10. Under your direction the client's staff has prepared the schedule of insurance policies and has computed the expense and unexpired cost of each of the more than 500 policies. In this situation, what procedures would you follow in auditing unexpired insurance?

11. In auditing the cash account of the Baker Novelty Company, you request a confirmation of the bank balance from the Ohio Bank of Commerce. The confirmation indicates a direct liability to the bank on a 6 per cent note payable, as of December 31, 1961, of $5,900.12. Investigation reveals the following:

On September 1, 1961, your client purchased a three-year insurance policy costing $6,438.58, paying $200 cash when the policy was issued. This was charged to insurance expense. On October 1, 1961, the balance was paid with the proceeds of a note for $6,238.58 given the bank. The note calls for a $200 payment to the bank the first day of each month. Payments were made on November 1 and December 1, with insurance expense being charged. Neither the note nor the unexpired insurance has been recognized on the books.

Prepare the adjusting journal entries you would make. What audit procedures would you apply?

12. Your client has 200 salesmen who travel constantly. When a salesman is hired, he is given a travel advance of $250. Monthly expense reports are filed as a basis for reimbursement. In any one week twenty to thirty of

the salesmen may stop in at the home office. The others are located throughout the country.

List the steps you would follow in auditing prepaid travel expense, $50,000.

13. You are making a first audit of the Grandview Corp. for the year ended March 31, 1961. Your analysis of the prepaid expenses account reveals the items shown in Exhibit 9-4.

Exhibit 9-4

	Debit
Interest Interest on a $20,000 one-year note, at 4 per cent, paid in advance to the Ohio Bank of Commerce, dated January 2, 1961.	$ 800
Insurance (balance, April 1, 1960) Comprehensive fire, burglary, and liability policy, dated January 2, 1960, expiring January 2, 1962, premium $1,800.	1,575
Advertising Ads to appear in April, May, and June national magazines, $1,500. Cost of special advertising campaign, April and May of 1960, to introduce a new product, to be written off over three years, $30,000.	31,500
Supplies (balance, April 1, 1960) You find an inventory of supplies on hand at March 31, 1961, of $11,500, of which $4,350 represents supplies pertaining to an old office machine setup abandoned in 1959.	13,000
Advances to salesmen This represents advances of $500 each to eight traveling salesmen currently employed. The remainder is composed of the following balances owed when salesmen quit:	5,280

Name	*Date quit*	*Amount*
Henry Adams	8/17/60	$ 260
John Jones	4/16/58	245
William Smith	12/31/60	350
James Turner	9/17/59	425
		$1,280

Adams and Smith are currently paying their advances at the rate of $50 per month. Management agrees that there is little, if any, chance of collecting from Jones and Turner.

1. If you think adjustments are necessary, prepare the adjusting journal entries to correct each item.

2. State the audit procedures you would apply to each of these items.

14. Your client suffered a fire on August 17, 1961, which completely

destroyed his stock of merchandise and all the detailed inventory records. In prior years your client has maintained a fairly steady rate of gross profit of about 35 per cent. From the general records you find the following:

Date		*Amount*
12/31/60	Inventory	$ 52,000
1/1–8/16	Purchases	168,000
1/1–8/16	Sales	212,000
1/1–8/16	Freight in	8,400

Exhibit 9-5

Unexpired Insurance

1/ 1/61	Balance		3,660.37	
1/31	Workmen's comp.	VR	1,382.61	
2/29	Inventory	VR	80.52	
3/31	Bond	VR	168 00	
4/30	Auto	VR	311.20	
7/31	Fire & workmen's comp.	VR	1,548 61	
8/31	Inventory	VR	62 24	

Insurer	*Policy*	*Amount*	*Coverage*	*Term*	*Premiun*
Eastern Insurance Co.	P123456	250,000	Fire & E.C.	7/ 1/60–65	$ 817 00
Fire and Casualty Co.	L234567	250,000	Fire & E.C.	7/ 1/59–64	817 00
Universal Fire Insurance Co.	LQ47147	250,000	Fire & E.C.	7/ 1/58–63	817 00
Western Casualty Co.	P765432	150,000	Fire & E.C.	7/ 1/57–62	490 20
World Fire Insurance Co.	W404040	100,000	Fire & E.C.	7/ 1/56–61	326.80
Eastern Insurance Co.	C465732	500,000	Fire—contents	10/15/59–62	1,478 61
Hartford Insurance Co.	B873564	100,000	Boiler explosion	12/ 1/60–62	318 24
Celina Auto Ins. Co.	L479862	ACV	Fire & theft—fleet	4/ 3/60–61	286.52
Manufacturers Indemnity Co.	PR202711	100,000	Payroll robbery—outside	2/15/60–62	288.00
Manufacturers Indemnity Co.	B82164	100,000	Position bond	3/ 1/52	168.00
Southern Casualty Co.	IBU72181		Inventory loss	2/15/49	
Industrial Commission	41742		Workmen's compensation	4/12/38	

Exhibit 9-5 (Continued)

Date	*Invoice*	*Amount*
Jan.	Workmen's compensation, semiannual adjustment	$1,382.61
Feb.	Southern Casualty, inventory semiannual adjustment	80 52
March	Position bond continuance	168.00
April	Celina Insurance, replaces L479862 with L497121	311.20
July	World, W440404 replaces W404040, five years	382.50
	Industrial Commission, semiannual adjustment	1,166.11
Aug.	Southern Casualty, inventory semiannual adjustment	62.24

You are asked to calculate the inventory fire loss for presentation to the insurance company.

15. The insurance accounts and related data of the Emmons Brothers Company are given in Exhibit 9-5. The client furnishes you with a list of insurance policies in force January 1, 1961, and available invoices.

The inventory policy is adjusted semiannually, on the basis of the average monthly inventory carried the preceding six months. The cost is 35 cents per $1,000 of average inventory. The inventory for the year averaged $394,200.

Workmen's compensation classes, rates per $100 of payroll, and payrolls for the year were:

Factory	0.28	$942,750
Office	0.15	80,200
Sales	0.17	120,150

Prepaid portions of certain policies at 1/1/61 are shown below:

Inventory policy	$ 30.50
Workmen's compensation	186.72

Prepare the necessary working papers as of December 31, 1961.

Chapter 10

INVESTMENTS

TYPES OF INVESTMENTS

The activities of some businesses are such that at certain seasons of the year, or in certain years, cash becomes excessive for the operating needs. As a company finds itself with a large amount of cash in the bank, it may decide to put some of the funds to work. If the excess is a seasonal one and the cash will be needed soon, it will be invested in temporary investments. Safety of principal is a prime requirement. There must also be ready marketability, for when the funds are needed there must be no delay in obtaining them. In many cases securities may be purchased with a maturity date that coincides with the time when the money will probably be needed. With these two requirements fulfilled it is to be expected that the return on the funds will be low. However, the yield from safe marketable securities is usually more than that received from commercial banks.

United States treasury notes and bills meet the above requirements and are commonly used for this purpose. They may be purchased with a maturity date of from one month to a year and are convertible to cash before maturity on a few days' notice. At times longer term U.S. bonds are purchased as temporary investments. Although there may be some fluctuation of principal in these bonds, it usually is minor, and the interest rate is higher than that on the short-term paper. Most of these bonds are readily marketable, with varying maturity dates. The interest earnings on bonds of this type range from 2 to 4 per cent.

When a company decides that it has a permanent excess of cash it may act in several ways. One way is to pay out large dividends to stockholders. However, most companies are constantly seeking methods of increasing and diversifying their output and feel that any excess cash may best be used for this purpose. Thus the investment may be in adding

to the plant through a building program, or in purchasing existing plants or companies. Often a company may be purchased by a direct exchange of capital stock, with little additional cash needed. In other cases, the outstanding stock of the company may be purchased outright. Sometimes not all the stock is offered for sale and the company gains a controlling but not a 100 per cent interest.

Companies may not wish to gain control of other companies but may want to purchase some of their securities to effect a business affiliation. The company whose stock is purchased may be a source of supply, or it may be an outlet for the products of the buying company. In either event, there is a reason for having a closer relationship than would otherwise exist.

In rare cases securities are purchased merely because the rate of return is high. Normally a company can make a better return producing its own product, but if the market is saturated and the company does not wish to expand its line of products, it may invest for an attractive return.

More often securities are purchased to fulfill some future requirement, either contractual or managerial. Usually these securities are placed in a sinking fund which may be managed by a trustee or by the company itself. The purpose of the fund may be to redeem a bond issue, to retire preferred stock, or to provide cash for expansion at some future date.

Most of the investments for the above purposes are made in stocks and bonds of industrial companies. Long-term federal, state, or municipal bonds will suit the purposes of such an investment. Funds may also be invested in mortgage notes receivable, rental property, life insurance policies, or advances to other industrial concerns.

If the securities purchased are a temporary investment of excess cash, they are current assets, and should be listed immediately after cash. Generally these securities should be valued at the lower of cost or market. If market value is only slightly less than cost it is acceptable to retain the securities at cost, showing the market value as a parenthetical expression on the balance sheet. If the market value is above cost it may also be shown parenthetically. If they are to be held for a long period of time or for some restricted purpose, they should be classified as Investments (noncurrent) and should be valued at cost, plus or minus any adjustment of bond premiums or discount. As an exception to this rule, if the price of the security has fallen considerably and it appears that the decline is more permanent than temporary, the securities should be written down to reflect the loss.

Marketable securities, by definition, are those for which there is a ready market. These securities should be classified as current or non-current assets depending on the purpose for which they were purchased. It is not uncommon to find marketable securities listed as a current asset when, in fact, they do not fulfill the requirements of a current asset. It is quite generally accepted that current assets are those which will be converted into cash or used within the operating cycle or within a year, whichever is longer. They are not those assets which *can* be realized, but those which are reasonably *expected to be realized* within the operating cycle. Nonetheless, many companies include as current assets all securities not purchased for a specific restricted purpose, even though they appear on the balance sheet year after year. The auditing student should recognize the fact that this treatment is incorrect, even though it is a fairly common practice.

In making his examination the auditor should determine the purpose for which the investment was made. The purpose is usually ascertainable from the board minutes or from discussion with officers. Only then is he able to determine the classification of the investment and thus the principle of valuation to be used.

INTERNAL CONTROL AND INVESTMENTS

There should be a complete separation of the custody of the investments and of the bookkeeping for them. While it is common to find one official of the company charged with the responsibility for and physical control of securities, it provides better control to have two. The individual who does the record keeping should not be accountable to the officer in charge of the securities.

Most companies rent safety deposit boxes in bank vaults for the physical protection of securities owned. There should be a joint responsibility for the control of these investments; that is, it should be so arranged that two persons must be present to gain access to the deposit box. While this is an inconvenience, it is the best control over securities. Where securities are kept in the company's office, adequate physical protection should be afforded. Even here a double lock should be provided that will require the presence of two persons to obtain the securities.

All securities owned by the company should be registered in the company name. At times securities may be purchased through officers of the company in their names. This may be advantageous in purchasing, where it is desired not to disclose the actual purchaser, but the securities should be transferred to the company name as soon as is feasible.

There should be periodic inspections of the securities on a surprise basis. If an internal audit staff is in existence this inspection is a part of their audit routine. If there is no such staff, officers not responsible for the securities should take over this task. The surprise element is of importance and the time of the inspections should not be made known in advance.

Authorization for investing company funds and for the liquidation of investments should lie with the board of directors. In some cases, this authority may be delegated to a finance or executive committee. The control over the investments should be such that no transactions may occur without the express authorization of the proper group.

Finally, the internal controls should be so devised that the company is protected from loss of income from the investments. Routines should be so established that the income is anticipated. Failure to receive it should lead to instant investigation. In the course of his examination, the auditor satisfies himself as to the correctness of the income, but this may be too late to be effective. The internal controls should be so devised that any lapse in income is automatically and promptly revealed.

MAJOR OBJECTIVES IN AUDITING INVESTMENTS

Generally the major objectives in auditing investments fall into five categories. These will vary somewhat according to the type of investment, but as a group the audit procedures and techniques are designed to fulfill these major objectives. They are (1) the physical existence of the asset, (2) the client's ownership, (3) the valuation of the asset, (4) the balance sheet presentation, and (5) the verification of income.

AUDIT PROCEDURES AND TECHNIQUES

Since audit procedures are applicable to types rather than to investments as a group, the different types of investments will be considered separately. Because securities (stocks and bonds) are the investment most commonly encountered, their examination will be presented first.

Stocks and Bonds (Marketable Securities)

1. Analyze the account. The securities account(s) should be analyzed to determine what transactions have taken place during the year. The analysis of the account aids the auditor in the preparation of the securities schedule. He thus will be forewarned about the purchases and sales

that have been made during the year. This information should be obtained before the securities are examined. It may be noted here that many bookkeepers do not know how to account for securities. The auditor is apt to find as entries in the account the net cash paid or the net proceeds from the sale of the stocks or bonds. In analyzing the account he should copy these entries as they appear in the ledger, thus arriving at a balance per the ledger. Then the adjustments necessary to correct the accounts may be applied. The beginning balance should be traced to last year's working papers to determine that both the client and the auditor are starting at the same point.

2. Schedule the securities. The next step is to schedule the securities. Here is another working paper that may be started in the auditor's off season. Or one of the client's staff may be asked to prepare it if he has the necessary ability. The schedule should be set up to show the balance at the beginning of the year and the transactions for the year (see Exhibit 10-1). Columns should be provided for gains or losses on sales, for market values, and for dividends or interest received. Normally a separate schedule will be prepared for stocks and one for bonds. Exhibit 10-2 illustrates a combined schedule suitable when there are relatively few of each type of security.

All the transactions for the year should be recorded on the schedule prior to the examination of the securities, so that the actual counting of securities will not be delayed by the necessity of writing descriptions of items that were not included on the schedule. It should be remembered that the executive who observes the count is usually a busy man who does not like to be kept away from his work unnecessarily.

To this end some clients furnish the auditor with a list of the stocks and bonds that should be on hand. This enables the count to be made without reference to the schedule, which may then be prepared at the auditor's convenience. This is a commendable practice to be followed when the count must be made precisely at the year end and when there is a long list of securities with many changes from the preceding year end.

In preparing the bond descriptions, it is essential that extreme care be used. There are many issues of certain types of bonds, usually utilities, which vary only slightly in description. Unless care is taken in recording, an incorrect description may be set down. This is particularly important when it becomes necessary to obtain market values for the bonds. The

Exhibit 10-1

Yancey and Sons Co.
Stocks
December 31, 1961

Description	Class	Par value	No. of shares	Balance Dec 31, 1960	Purchases	Sales At cost	Sales Profit or (Loss)	Balance Dec 31, 1961	Market Quote	Market Amount	Dividends received	Remarks
Abitibi Airlines "	Com "	50.00 "	200 "	2,000.00				2,000.00	4	800.00	—	
Central Copper Co. "	Com "	n.p. "	100 "	1,865.00		1,865.00 VT	2,135.00				20.00	Sold April 15
Frontier Mines "	Com "	1.00 "	50 "	5,000.00				5,000.00	42½	2,125.00	50.00	
Iron Oil Co. (C)	Cap (C)	n.p. (C)	2,000 (C)	2,000.00				2,000.00	8¼	16,500.00	1,000.00	
Long Branch Distillers "	Com "	5.00 "	200 / 100 "	1,800.00				1,800.00	28	5,600.00	275.00	100% stock dividend
O'Malley Stores "	Com "	100.00 "	125 "	12,500.00		12,500.00 VT	1,500.00				125.00	Sold March 15
Reliable Steel Co. "	Cap "	5.00 "	100 "	4,200.00				4,200.00	64¼	6,425.00	300.00	
Unsteady Mfg. Co. "	Com "	n.p. "	50 "	1,200.00		1,200.00 VT	(300.00)				—	Sold December 21
Zoner Engineering Co. "	Com "	1.00 "	125 / 100 "	4,000.00				4,000.00	65½	6,550.00	200.00	25% stock dividend
				34,565.00 ✓								
Union Car Co. "	Com "	10.00 "	100 "		4,300.00 VT			4,300.00	50⅛	5,012.50	20.00	Bought February 1
Inter-City Paper Co. "	Com "	n.p. "	100 "		2,800.00 VT			2,800.00	42⅝	4,262.50	100.00	Bought March 12
Gardner Motors "	Cap "	2.50 / 5.00 "	200 / 100 "		4,000.00 VT			4,000.00	31⅜	6,275.00	50.00	Bought July 12 – 2 for 1 split
Sharp Oil Corp. "	Com "	n.p. "	100 "		2,350.00 VT			2,350.00	30¼	3,025.00	50.00	Bought September 15
Central R R Co. "	Com "	n.p. "	100 "		7,400.00 VT			7,400.00	42¼	4,225.00	—	Bought October 20
					20,850.00	15,565.00	3,335.00	39,850.00		60,800.00	2,370.00	
									W		S	

" - Examined certificates.
(C) - Held by Third State Bank as collateral. Details on bank confirmation.
V - Examined broker's invoice.
T - Traced to cash receipts or cleared check.
✓ - Traced to last year's working papers. Agrees with ledger account.
S - Taken from Standard & Poor's Dividend Record. Traced to ledger account.
W - Taken from January 4, 1962 issue of Wall Street Journal.
All transactions traceable to minutes for authorization.
Securities examined January 5, 1962 at safe-deposit vault of National Trust Co.
Last entry in vault box made December 23, 1961. Charles Yancey, Treasurer and
John Smith, Controller, have joint custody of securities.
Purchase prices fall within range of prices published for days of purchase or sale.

Securities examined in my presence and returned intact.
Chas. Yancey, Treas.

W.B.J.

different issues sometimes vary widely in market value. It is helpful to include in the description the interest payment dates. This permits the computation of the interest accrual without reference to other sources.

After the schedule has been set up, the beginning column should be traced to last year's working papers. If the schedule has been started from last year's schedule (as is normal), the balance should be traced to the ledger account or account analysis.

3. Examine the securities. Having prepared his schedule or having obtained a list from the client, the auditor should make the necessary arrangements for examining the securities. This is a task which demands extreme care. It should never be undertaken, even if it were possible, except in the presence of a qualified representative of the client. This observer should be the person who has physical custody of the securities. Except in certain cases (brokerage houses, for example) it is no longer considered necessary to have the count of securities on a surprise basis. If the auditor considers the internal control poor, he may want to make a surprise count or a second count at a later date. However, it is customary to make all counts of cash and negotiable securities at the same time, so that there may be no shifting of funds. Hence, if it is not convenient to count the securities along with the cash and the other negotiable instruments, they should at least be controlled. If the securities are kept in the client's office, a seal may be placed over the lock. If the securities are kept in the bank vault, a letter may be written by the client requesting the bank to deny access to the deposit box unless the auditor is present.

In the presence of the client's representative the auditor examines the securities. At this point he is particularly interested in the existence and the ownership of the securities. Existence is determined by examination of the securities present in the box. Ownership of stocks and registered bonds may be indicated by one of four methods. Normally the client's name will appear on the face of the stock certificate or registered bond. However, the security may have been endorsed over to the client on the back of the certificate, or the certificate may be endorsed in blank. Finally the client may hold a separate power of attorney enabling him to have the security transferred to his name at his convenience. Wherever the auditor finds securities not in the client's name, he should strongly recommend that they be transferred to the client. These evidences of ownership are indicative but are not complete. Other steps

Exhibit 10-2

Black and White, Inc.
Investments
December 31, 1961

Description	Class	Par value	Number of shares or face value	Balance Dec. 31, 1960	Purchases	Sales: Cost	Sales: Selling price	Balance Dec. 31, 1961	Market value	Interest accrued Dec. 31, 1960	Interest earned	Interest received	Dividends received	Interest accrued Dec. 31, 1961
Amalgamated General Co.	Com.	10	100	4825.00				4825.00	7162.50				300.00	
Consolidated Works Co.	6% Pfd.	100	100	8000.00				8000.00	9175.00				600.00	
International General Co.	Com.	50	200	10000.00				10000.00	8650.00				200.00	
ABC Corporation, 5% 1st mtge. A+O 1, 1970			10000	10000.00				10000.00	8825.00	125.00	500.00	500.00		125.00
Interspace Missile Co. 6% debs. of 2000 M + S 1	Purchased 3/1/61		5000		5000.00 VAT			5000.00	5050.00	—	275.00	(125.00) 300.00		100.00
				32825.00 (W)	5000.00			37825.00	38862.50 W	125.00	775.00	675.00	1000.00 S	225.00

V- Examined broker's invoice.
A- Traced to minutes for authority.
T- Examined check in payment of bonds.
W- Taken from January 2, 1962 Wall Street Journal.
S- Traced to Standard & Poor's "Dividends paid in 1961."
(W)- Traced to last year's working papers.
Securities held by Jones & Jones, brokers.
Confirmation of details of above list received from Jones & Jones.

WBJ

will be taken to complete the proof of ownership. These include examination of the invoice and paid check.

Coupon bonds usually are not registered. Possession is an indication of ownership, but here again the auditor will take additional steps to satisfy himself as to ownership.

In examining stock certificates the auditor should compare the details of the certificate with his list or schedule. The comparison should be of the name, the par value, the class of stock, and the number of shares. As he makes the comparison he should place tick marks against these items on his schedule to indicate that he has examined the certificate and that the details are in agreement with the client's records.

Where the auditor is tracing to his own schedule he may find that some securities do not tally with his worksheet. For example, on any noncash transaction affecting the stock, that is, stock splits, stock dividends, recapitalizations, it is quite possible that the client has not recognized the change in his records. In such cases the old number of shares, or old par value, should be crossed off on the schedule and the new inserted. Later, published records of capital changes may be examined to support the change. Correspondence in the client's office may also be examined if it has been retained.

Securities held by the client as collateral for loans should be excluded from the list of securities owned and should be noted separately on the working papers. The face value should be indicated, along with the market value of the security. Ordinarily, where collateral is demanded, the value of the note is no better than the value of the security.

The examination of bonds should include tracing the descriptive matter into the schedule. The interest coupons should be examined to determine two points: (1) that all the coupons have been clipped to the date of the examination, and (2) that all coupons not yet due are attached to the bond. Interest coupons are almost as good as cash. No particular identification is necessary for their collection. Hence, the auditor should see that the client is protected in this respect.

When all the securities have been examined and checked to the schedule the auditor should return them to the client's representative and request a receipt releasing him from responsibility for the securities. This receipt is usually given on the appropriate schedules and may read as follows: "Securities counted in my presence and returned intact."

Some auditors prefer to include in the schedule of securities owned only those owned at the audit date. This type of schedule would omit the first four money columns shown in Exhibit 10-1. Verification of pur-

chases and sales transactions and proof of dividend income is more difficult when this type of schedule is used, since the auditor must work completely within the client's records. For most companies security transactions are infrequent enough and important enough to warrant the small additional amount of time necessary for a complete scheduling of transactions.

4. Confirm securities not on hand. It is quite possible that not all the securities claimed by the client as being owned at the year end will be on hand at the time of the examination. Some may have been sold since that time. Others may be out as collateral for loans, either with banks or with vendors. Still others may have been purchased late in the year and may not have been received yet from the transfer agent. This last situation would hold true only if the count were made right at or very closely after the year end. These securities usually can be produced for the auditor's examination when they are received. Securities that have been sold since the year end should be traced into the cash book and other evidence examined in support of the transaction.

For other securities not available for examination the auditor should send requests to the holders seeking confirmation of the details of the securities and the fact that they belonged to the client. Ordinarily, banks will supply such details on the regular bank confirmation request.

In some cases the client will arrange with his brokerage office to hold all his securities in safekeeping. Here the auditor should request from the broker a list of securities so held, plus confirmation of any balance due to or from the client.

5. Vouch transactions. Where transactions in securities are numerous it may be satisfactory to test-vouch the transactions. In most audits security transactions are few enough and important enough that a complete examination of the transactions is desirable. The client's broker furnishes an invoice for each purchase or sale. These should be examined and traced to the disbursements or the proceeds.

In the case of stocks the net cash paid is the cost of the stock. The net proceeds are considered to be the selling price for determining gain or loss. When bonds are purchased, the interest purchased must be deducted from the amount paid to determine the cost. Similarly, when bonds are sold, interest sold must be deducted from the net proceeds to determine the effective selling price. Purchased interest is sometimes charged to the accrued interest account. Usually, however, it is immediately debited to interest income. The entry to the investment account must be examined to make certain that the amount was not added to the cost of the bonds.

If the client has received securities as a gift, they should be valued at the fair market value as of the day of receipt.

The authorization for the transaction should be ascertained. Ordinarily, this will be found in the minutes of the board of directors meetings, but in some cases it may be found in the minutes of an executive, finance, or investments committee. Wherever the authority lies, the auditor should prove the transactions to that authority.

Where transactions in securities constitute a major share of the client's business and thus are voluminous, an additional step should be taken in the vouching process. On a test basis the transaction prices should be traced from the broker's invoices to an acceptable financial journal to prove that the price used fell within the range for that day.

Using the broker's invoices as a basic evidence, the accounting for the transaction should be checked. For purchases, the cost price used in the ledger should be compared with the cost per the broker's slip. With sales, the gain or loss on the transactions should be independently determined by the auditor and should then be traced into the ledger. The client may have credited the net proceeds to the investment account. Should this be the case an adjusting journal entry should be set up to make the correction.

If numerous sales have occurred, a schedule should be set up for inclusion in the report showing the gain or loss on the transactions. The headings of the schedule might follow the pattern shown below:

Description	*Date purchased*	*Date sold*	*Net proceeds*	*Cost*	*Loss*	*Gain*

The auditor should indicate in his working papers whether the gain or loss is long- or short-term, for later use in the preparation of the income tax return.

6. Determine market values. The market values of the securities should be determined as of the last day of the fiscal year. These values are taken from a reputable financial journal, such as *The Wall Street Journal, The Commercial & Financial Chronicle, Barron's,* or similar publications. If there have been transactions in the security on that day, the closing price is used. If there have been no transactions but the security is listed in the bid and ask quotations, the bid price is used. It should be recognized that since there are many stock exchanges in this country a search through several tables may be necessary before the security is found. An alternative measure is to look up the security in any

standard financial statistical record. The exchange on which the stock is listed will be shown there.

If a stock is not listed on any of the exchanges or if there is no record of recent transactions, a brokerage company with which the auditor has contacts will attempt to determine bid and ask quotations for him. While bid prices are usually used, in some inactive stocks there is a wide spread between bid and ask prices. Here an average price may be more desirable.

The valuation of the securities may be on an individual basis or on the basis of the total value of the securities. The latter method, illustrated in Exhibit 10-3, is justified on the basis that the entire group of securities can be sold readily, and thus the loss can be held at the difference between the market gains and losses of the individual securities.

Exhibit 10-3

Security	*Cost*	*Market*	*Lower of cost or market*
A	$ 2,000	$ 2,100	$ 2,000
B	2,200	2,050	2,050
C	2,400	2,200	2,200
D	2,800	2,400	2,400
E	1,600	2,500	1,600
Total	$11,000	$11,250	$10,250

On an individual basis a loss of $750 would be recognized. On an over-all basis no loss would be recognized, since total market is greater than total cost.

Stocks of some companies do not have a readily ascertainable market price. Usually this will be true of the stock of closely held companies. Where brokers are not able to obtain a market price, other means must be used to determine the reasonableness of the valuation. The auditor may write to the issuing company asking for the price (and date) of the most recent transactions (buy or sell) the company itself has had. He may also request a copy of the most recent financial statement issued by the company and attempt to determine from it whether or not the stock is reasonably valued. He may also refer to any standard corporation statistical service to obtain additional data concerning the company. It should be noted that if there is no ready market for the securities they should not be classified as marketable securities; they would not be in-

cluded as current assets and the lower-of-cost-or-market principle would not apply. Marketable securities generally are found in both the current asset and investment sections but securities without a ready market should be classified only as noncurrent assets.

Stock prices are quoted in dollars and fractions of dollars. Bonds are usually quoted as a percentage of the face value of the bond. Thus a $1,000 bond, quoted at 101⅜, has a value of $1,013.75. United States bonds are quoted on the basis of 32nds. Thus a $1,000 bond listed at 100.24 would have a value of $1,007.50.

Having established the market values of the securities, the next step is to determine whether or not any devaluation is necessary. Marketable securities (current assets) should be valued at the lower of cost or market or at cost. This may be done on the basis of individual securities or on the basis of total values. Any reduction should be charged to "loss due to market decline of securities," while the credit may be made to the individual securities (investments) or to a "provision for market decline of securities." This account should be deducted from the investments account on the face of the balance sheet. The total market value of the securities should be indicated parenthetically in the balance sheet. Dealers in securities value their inventory of securities at market, recognizing a current gain or loss on the market fluctuations.

7. Verify income from securities. The auditor should make an independent proof of income from securities. Proof of bond interest is made by calculating the face of the bonds times the interest rate. The total of the interest earned column on the worksheet should then be reconciled with the balance of the interest received account (after adjustment). Interest should be accrued on bonds to the balance sheet date.

Dividends from stocks should be entered on the worksheet from subsidiary records or from the cash receipts book. The original data may be obtained from a published record, such as Standard and Poor's *Record of Dividends Paid.* After the original data have been entered on the sheet they should be cross-referenced as between recorded amounts and amounts indicated in the published record. After the column is totaled it should be proved to the dividends received account. Care must be taken with stocks not held the entire year. Dates of purchases and sales should be noted on the worksheet so that they may be checked against the date of record for dividend purposes. It is particularly important that dividends due after stock has been sold should be traced into the records to be sure that they have been received and recorded.

It is not customary for the usual industrial client to recognize divi-

dends as income until they are received. However, a financial institution or an investment trust, where stocks are a major portion of total assets, may well recognize dividends receivable as of the record date.

8. Check miscellaneous matters. Bonds on which interest payments have ceased are known as bonds in default. They are sold "flat"; that is, no interest is added to the quoted price. Where the auditor finds such bonds he should indicate in his working papers the date of the oldest coupon and the fact that all subsequent coupons are attached. This is usually written "6/1/50 and SCA." Ordinarily the client should not accrue interest on such bonds. If such bonds are purchased after the default occurs, the price paid includes an amount to cover all the old unpaid coupons. If these coupons are paid later, they should be treated as a recovery of cost up to the coupon which was due at the purchase date. Thereafter the interest collected represents income. If it becomes apparent that the company is going to pay the remaining coupons, it is proper to accrue the interest from that point forward.

Stock dividends issued by a company in the same class of stock as that held are not income to the stockholder. The unit value of shares should be recognized but there is no change in the balance of the ledger account. If, however, the stock issued is of a different class, then fair market value must be determined and income recognized. Similarly, if stock of a different company is issued as a dividend, the fair market value of the shares at the date of issue is recognized as income.

Occasionally stock rights are received by stockholders. The cost of the stock should be reduced by the allocated cost of the stock rights. If the rights are sold, a gain or loss should be recognized. If the rights are used, the unit value of stock should be recomputed.

A stock split is similar to a stock dividend in that it puts more shares into the hands of the shareholders with no cash being paid. There the similarity ends. A stock dividend results in a transfer of retained earnings to capital stock. A stock split results in a reduction in the par value of the shares, but there is no change in the total capital stock value. Ordinarily the old certificates must be turned in and new ones received, indicating the decreased par value.

Mortgage Notes Receivable

It is not usual to find the industrial or commercial client holding mortgage notes receivable. When this does occur, the mortgage is usually a so-called "straight" mortgage, due at some future period, with no provisions for partial payment. A financial institution or an investing organ-

ization may well have mortgage notes receivable as one of its major assets. There may be some straight mortgage loans here also, but the majority of the loans will be of the semiannual or monthly reduction type. The mortgagor pays a fixed monthly amount, often 1 per cent of the face of the loan. The payment is applied first to the interest for the month (or the six months). If any balance remains it is applied to reduce the principal of the loan. Thus there is a constantly reducing balance. With one exception (explained in step 7), the application of the audit procedures is the same for both straight and reducing types of loans.

1. Schedule the notes. A schedule of mortgage notes receivable should be prepared from the subsidiary ledger or from the account cards. As this is done the accounts should be scanned to determine whether or not the receipts have come in according to the terms of the loan. Again there is a choice of scheduling just the notes on hand at the year end, or of showing all the year's transactions. Exhibit 10-4 illustrates the latter type of schedule. The details of the notes should be listed so that the auditor has in his working papers the results of his examination. The totals of the beginning and ending balance columns should be proved to the ledger account.

2. Examine mortgage deed, note, insurance. These are the basic documents underlying the loan. The auditor should examine the mortgage deed and the mortgage note. Ordinarily the note is incorporated in the deed, but the formal note represents the actual liability. The mortgage deed is given as security for the note. The examination should include a comparison of dates, names, and amount, as shown by the document, with the client's records. As the examination is made, the notes should be ticked off on the schedule.

The mortgagor is usually required to have his insurance on the property assigned to the mortgagee. The auditor should examine the policies to determine that they have not expired, that the mortgagee is indicated as the first recipient of any amounts paid by the insuror to the extent of his equity, and that the coverage is adequate to protect the client's equity.

It is also customary to find some evidence of the mortgagor's ownership of the property. This may be in the form of an abstract of title. If such is the case, the auditor should examine the abstract to see that it has been brought up to date. The actual continuation of the abstract is a legal task. The auditor should not judge as to the correctness of the continuation but merely observe that it has been done. He may wish, in-

Exhibit 10-4

Central Savings & Loan Association
Mortgage Notes Receivable
December 31, 1961

Mortgagor		Interest rate	Original loan Date	Original loan Amount	Principal balance, Dec. 31, 1960	New or additional loans	Interest accrued, Dec. 31, 1961	Cash receipts Interest	Cash receipts Principal	Principal balance, Dec. 31, 1961	Unpaid interest	Fire insurance coverage
Alum Rock Realty Co. ✓		5½ ✓	10/14/60 ✓	4500 ✓	2675.33		266.52 x	266.52	—	2675.33		5500
Amey, Ralph L. ✓		5 ✓	12/27/55 ✓	14700 ✓	14700.00		735.00 x	735.00	14700.00	—		
Ballmer, Bernard F. ✓		5 ✓	12/6/49 ✓	5653.34 ✓	3716.48		180.64 x	180.64	419.36	3297.12		7000
Bartlett Company, The ✓		4½ ✓	11/7/45 ✓	50000 ✓	9655.00		873.62 x	258.75	4600.00	5055.00	614.87	20000
Cather, Paul ✓		5 ✓	12/3/49 ✓	5431.95 ✓	3268.06		213.18 x	125.00	—	3268.06	88.18	5500
Wardle, John T. ✓		6 ✓	12/3/47 ✓	2545.76 ✓	1479.03		85.57 x	85.57	184.43	1294.60		4000
Whick, Horace O. ✓	ᵡ	5 ✓	5/7/61 ✓	14900 ✓	—	14900.00	200.75 x	200.75	—	14900.00		15000
Woder, James R. ✓		4½ ✓	12/22/45 ✓	2000 ✓	962.18		41.76 x	41.76	138.24	823.94		3500
Young, Harry T. ✓		5 ✓	10/3/53 ✓	8000 ✓	7383.19		364.28 x	364.28	331.69	7051.50		10000
Totals					36463.00	29761.00	2117.36	1926.80	14444.73	43739.28	190.66	

✓ - Examined note, mortgage deed, and insurance policy.
ᵡ - Traced to county recorder's records.
x - Verified interest calculations.

stead, to obtain a letter from the client's attorney, certifying that the mortgagor had clear title to the property. In place of the abstract, there may be a title policy insuring the mortgagor's title to the property. The auditor should satisfy himself that the client has some evidence of the mortgagor's proprietary interest in the mortgaged property.

3. Trace to county records. On a first examination the auditor should make certain that all mortgage deeds are recorded in the county recorder's office. After the first examination this need be done only for new loans. The purpose of this examination is twofold. First, for the client's protection the loan needs to be listed in the official county records. Second, the auditor needs to satisfy himself that the details of the loan have been recorded correctly.

In counties where the documents are entered in the records as photostatic copies of the original, there is no longer the necessity of examining the details of the deed. Many auditors now accept the county recorder's stamp on the face of the document as being satisfactory evidence of the recording of the deed.

4. Obtain confirmation from mortgagors. Letters should be sent to mortgagors requesting confirmation of the loan balances. Where the client holds mortgage notes from business concerns it is probable that close to a 100 per cent return will be obtained. If the mortgagors are mostly homeowners the results of the circularization will be less successful. Many of these people have no concept of the reason for the confirmation request. They either ignore the request or sign it without knowing what they are signing. As with accounts receivable, the circularization may be made on a test basis. It is probable that the confirmation results will be better if the letter is written on the client's letterhead and signed by the client. Second requests should be sent after a specified time, so that the final result of the circularization will be a reasonable percentage of the total sent out.

5. Examine authority for new loans. Loans of this nature made by commercial companies should be authorized by the board of directors. Financial institutions will usually have a committee of officers to pass on mortgage loans. The auditor should examine the minutes of the properly constituted body for authorization for new loans. The loan should then be traced through the records. The check should be examined to determine that the amount paid is in agreement with the loan. When construction loans are granted it is customary to call for funds only as needed. The note indicates the total loan, but the cash records must be examined to determine the amounts actually paid out. It is customary to

charge interest on the total amount of the loan since that amount must be kept available for withdrawal by the mortgagor.

6. Trace receipts to cash records. Tests should be made of payments received from mortgagors. Straight mortgage notes should be examined to see that partial payments have been recorded on the back of the notes. On the reduction type notes a separate subsidiary account is set up for each note. The receipts from these mortgagors should be traced from the cash receipts book to the account to determine that the posting has been made to the proper account.

7. Verify interest received and accrued. Where monthly payments are made the auditor should test the calculation of the interest and determine that there has been a proper split between income and principal. The tests are made primarily to determine the accuracy with which the client's staff has done its work. In many cases preprinted tables are available showing the split between principal and interest for the life of the loan. If these are on hand, the checking becomes a routine task. If not, the auditor must make his own calculations. The total of the interest received column should be proved to the general ledger interest account. If the notes are not scheduled to include the year's transactions, proof of interest earned is difficult to obtain.

Interest should be accrued on loans to the balance sheet date. This will apply to all commercial clients and to some financial institutions. There are some institutions which, by state regulation, may include interest as income only when it has been received. Exhibit 10-4 illustrates this situation. Here there is no accrual if the payments are up to date, even though a portion of a month has been earned. If the mortgagor is behind in his payments, the interest may be shown in a memorandum column but it should not be entered on the books.

Real Estate Owned

Real estate owned is shown as an investment when it is purchased as rental property for income purposes or when it is purchased by an industrial client in anticipation of future expansion. As long as the property is not used in the operation of the business, it should be classified as an investment, whether it is income-producing or not. When the anticipated expansion is started the real estate should be reclassified as a fixed asset. The audit procedures for these two types of properties are the same except that there may be no income from the second type.

1. Examine the warranty deed. A warranty deed is given by the seller of real estate to the buyer. On a first audit the warranty deeds for

all parcels of property should be examined. In later examinations it is necessary to check this only for property purchased during the year. A new deed is prepared when the land is sold. The old deed often is retained, so the fact that a deed is on hand does not necessarily mean that the client now owns the property, but merely that he once did.

2. Examine results of legal title search. The auditor should find some evidence that the client's title to the property is clear. This evidence may be in the form of a continued abstract. This is a history of the ownership of the property going back to the original grant. Or, the client's title to the property may be insured by a title company. If the auditor has any questions in his mind about the title, he should write to the client's attorney for certification of the client's claim to the property. As far as the abstract is concerned, all that the auditor can do is to see that the client has it and that it has been continued to the date the client purchased the property.

3. Examine contract of sale. The next step is to examine the sales contract, sometimes called a settlement sheet. This shows the details of the purchase. Ordinarily, in addition to the contract price, there are several adjustments for such items as rents already collected, prepaid insurance, accrued real estate taxes, transfer tax stamps, and so on. These should be charged or credited to the accounts involved, so that the sales price appears as the cost of the property. The check in payment of the purchase should be examined to see that it is in agreement with the net amount shown on the sales contract. The entry setting up the purchase should then be examined to see that the accounting has been correctly done.

4. Trace to county records. All purchases of real estate should be traced to the county recorder's office to see that the warranty deed has been recorded. The volume, page number, and date of recording are noted on the face of the deed, so that there is no particular problem in finding the recording in the county offices.

5. Prove gain or loss on property sold. Where property has been sold, the same type of adjustments will be found in the sales contract. In addition the seller pays a commission on the sale. The auditor should see that the recording of the transaction classifies the adjustments properly. If the property sold is rental property, there is probably a related depreciation reserve. Depreciation should be charged for the year to the date of the sale, and the reserve should then be closed out. Only then may the gain or loss on the sale of the property be computed.

6. Examine authorization for transaction. The purchase or sale of real estate is usually considered as a major transaction. Authority therefore is generally found in the board minutes. The auditor should satisfy himself that proper authority has been granted for these transactions. If he is unable to find it, he should note that fact in his report.

7. Vouch income and expenses. Where the real estate is income-producing property the auditor should vouch, at least on a test basis, the income and expenses of the property. Leases should be examined so that the lessee's responsibilities may be determined. The pertinent points of the lease should be recorded in the permanent file.

Where the property is an office building or other multispaced property, a computation should be made of the maximum rent income. Actual income should then be tested against the maximum and any major variation investigated to determine the cause.

In some cases the management of the property is turned over to a property management company. All rents are collected by the company and all repairs, taxes, insurance, and maintenance costs are paid by the company. The net receipts are remitted to the owner monthly. In these cases the auditor must use extra care to see that the management company's work is accurate.

The monthly reports indicate the vacancies. These should be verified by a visit to the property. The report also contains invoices in support of the various disbursements made by the company. These should be examined to see that they are chargeable to the property and that they are proper expenses. The rental agent makes no attempt to classify expenditures, merely deducting what he has paid. The auditor must distinguish between the purchase of assets and the purchase of repairs and maintenance, and, in rare cases, items not chargeable to the client at all. The author recently found a situation where a rental agent had paid a water bill late, incurring a 10 per cent penalty. The entire amount paid was charged to the client. Needless to say, the client recovered the penalty.

Depreciation should be charged on the rental property. In some cases, nonprofit institutions use depreciation methods that result in a higher rate being charged than that normally used. Since there is no income tax problem for these organizations, the higher rate may be accepted. However, the auditor should watch to see that the depreciation charge is always at least equal to the normal straight-line rate. A commonly used method for this purpose is to determine the net income that is needed

to obtain a desired return on the amount invested in the property. All net income in excess of that amount is considered to be the depreciation to be charged. If the auditor states in his report the rate of return on the various parcels, he should use net income before depreciation, since the depreciation charge acts to bring all rates of return down to a common desired rate.

8. Review charges to real estate held for future use. When real estate is being held for future use and no income is derived from it, all expense incurred in holding the property may be capitalized in the asset account. Normally real estate taxes and assessments are the only costs so incurred. The auditor should review the charges to the account to determine that they are properly capitalizable. When the land is put to productive use, such charges should cease, the debits being made to the proper expense accounts.

Cash Value of Life Insurance Policies

Many companies insure the lives of their officers and key personnel for the benefit of the company. The premiums paid for these policies consist of two portions, investment and expense. During the first two or three years of the life of the policy there is no cash value recognized by the insurance company. This does not prevent the auditor from recognizing the cash value. If, for example, the policy has a $1,000 cash value at the end of the second year, there is no good reason for failing to recognize one-half of it at the end of the first year. Since most accounting is carried forward on a going-concern basis, there is no reason to assume that the policy will be canceled prior to the time the cash value attaches. The auditing techniques are indicated below.

1. Examine the policies. Life insurance policies should be examined along with the other insurance policies. The life policies may be filed apart from the other policies, sometimes being held in the bank vault. The policies should be reviewed to determine the insurer, the amount, the premium, and the policy year. The cash values for the various years are usually shown in the policy. The auditor may note the amount for checking against the value indicated by the insurance company.

2. Obtain confirmation from insurers. Letters should be written to the insurance companies requesting confirmation of the cash value of the various policies. Ordinarily this value will be indicated as of the end of the current premium year. To be technically correct, the increase in cash value should be discounted back to the balance sheet date, at the current interest rate charged by the insurance company. In most in-

stances the amount of discount relative to the cash value is insignificant and is ignored.

The letter to the insurance company should also request information as to whether or not there are any loans outstanding on the policy. If there are such loans outstanding, they should be shown as liabilities, unless it is planned to cash the policies in the near future, in which case the loans may be netted against the cash value. Some companies stamp the policies with a legend indicating that a loan has been obtained with the policy as security. However, this is not always done. The only reliable procedure is to ask the insurer to confirm that there are no loans outstanding on the policies.

The question should also be raised with the insurer as to the right of the insured to change the beneficiary. The client should be the irrevocable beneficiary. If the insured reserves the right to change the beneficiary, the client has no protection against a sudden switch in beneficiary. Where the insurance company indicates that the insured has reserved this right, the auditor should bring the matter to the attention of the client.

3. Adjust the cash value. The auditor should adjust the cash surrender value of the insurance policies if the client has not already done so. The unexpired portion of the net premium expense should also be adjusted. Computation of these adjustments is illustrated in Exhibit 10-5.

Exhibit 10-5

Confirmed CSV, December 31, 1961	$22,680
Confirmed CSV, January 1, 1961	20,420
Increase in CSV	$ 2,260
Premium paid	$ 3,400
Increase in CSV	2,260
Net expense	$ 1,140
Policy year ending March 1, 1962	
Unexpired portion	$ 190(1/6)

The cash surrender value of the policies is normally classified as a permanent investment. However, intent should govern. If it is the intent to cash the policies within the next year, the cash value may be shown in the current section if the proceeds are to become available for current operating purposes. If the insured has died and the face value of the policy has not been collected, it may be shown as a current asset. There is no justification, however, for including the cash surrender value as a current asset merely because it is available for cashing in if the company becomes pressed for funds.

Investments in Subsidiary Companies

Many companies own, partially or completely, the shares of other companies. In some cases the ownership includes many companies. A parent-subsidiary relationship evolves. In some instances the auditor will examine the statements of all the companies. In others, some of the subsidiary companies will be examined by other independent accountants. Where this is done the auditor for the subsidiary will supply the auditor for the parent company with certified statements of his examination. The major audit steps for this type of investment are as follows.

1. Examine the stock certificates. Normally, these certificates will be kept with the rest of the securities and will be examined along with the others. If new companies are purchased during the year, the auditor should seek the usual authorization and review the purchase agreement. He should also review the compensation method, whether it be by check or by an exchange of stocks, and satisfy himself that the transaction has been correctly taken up on the books.

2. Is subsidiary to be consolidated? It is necessary to determine which of the subsidiary companies are to be consolidated and which are to be shown as investments. The basis of inclusion or exclusion from the consolidation should be determined and noted in the permanent file. If the subsidiary is not consolidated, the auditor must determine the basis for its valuation in the balance sheet. This may be at cost, or by the so-called actual value method.

3. Review certified statements for consolidation. When subsidiary statements are certified by another independent accountant the question arises as to whether the auditor examining the parent company books wants to accept responsibility for the subsidiary statements. To help decide this the auditor will attempt to determine the other accountant's reputation. If the subsidiary auditor is well known in his community and has acquired a reputation for doing good work, it is probable that the parent company auditor will accept his work. In expressing his opinion on the consolidated statements, the auditor accepts the responsibility and liability for the fair presentation of all underlying statements unless he specifically states that he will accept such responsibility only for specific portions of the statements. This, of course, results in the qualification of his opinion of the statements as a whole.

The statements of all subsidiary companies should be reviewed to determine that there is reasonable consistency of practice, not only from

year to year but from company to company. If the companies are not consistent, the final statements represent something of a hodgepodge for which no clear-cut basis of valuation can be given.

In reviewing the consolidated statements prepared by the client the auditor will want to review the basis for consolidation and the determination of goodwill. For companies added during the year the original purchase should be reviewed. The cost basis for consolidation should be determined and the amount of positive or negative goodwill ascertained.

Advances to Subsidiary or Affiliated Companies

A type of investment often found when the parent-subsidiary relationship exists is that of advances to the subsidiary companies. This may be in the nature of a temporary loan or it may be a long-term advance.

1. Determine authorization for the loan. In the year the loan is made the minutes should be reviewed to find the authorization for the loan. The check by which the advance was made should be examined and the entry traced through the books to see that it was properly recorded. The terms of the advance should be examined to see whether or not interest is to be charged. This puts the auditor on notice as to another income item to watch for.

2. Obtain confirmation of loan. The advance should be confirmed like any other loan. However, if the auditor also examines the records of the subsidiary company, he may determine the existence of the loan by examination. A confirmation would not then be necessary.

3. Determine likelihood of repayment. Where the loan is of a temporary nature the auditor should follow through the books any repayments (partial or complete) made by the subsidiary company. If the loan is still outstanding at the balance sheet date, the auditor must attempt to determine the probability of current repayments. Classification as a current asset or as a permanent investment (for loans to nonconsolidated companies) will depend on the answer to this question. Usually the resolution authorizing the advance will be so worded that the company intent is clear. A review of later correspondence will indicate whether this intent has been changed. It might well be that a loan, originally intended as a current advance, has been converted into a long-term advance with little likelihood of repayment in the near future. Even though loans to consolidated subsidiaries will be eliminated in the consolidation, the auditor should attempt to have this question answered, and should incorporate the answer in his working papers.

Sinking Funds

Sinking funds are set up for any number of purposes. Some of the most common are bond redemption, preferred stock redemption, pension plans, and future plant expansion. The fund may be handled by a trustee or it may be managed by company officials. The fund may be set up on an actuarial basis, with interest added to the fund, or a check for the net income of the fund may be turned into the corporate treasury each year. The following procedures and techniques should be applied to sinking funds.

1. Determine the purpose of the fund. The minutes authorizing the establishment of the sinking fund will normally state the purpose for which the fund is being set up. These same minutes will also usually indicate whether the company or a trustee is to be in charge of the fund. This information should be set up in the permanent file. The number of years the fund is to exist should also be noted.

2. Read and abstract the conditions. If the sinking fund has been set up for the redemption of bonds, the bond indenture should indicate the conditions under which the fund is to be maintained. These conditions should also be incorporated in the permanent-file working papers. They will have to do ordinarily with the amount of the annual payment and the date it is to be paid. The treatment of income will also be covered.

3. Analyze the account. The sinking fund account should be analyzed. In many cases the only entry will be the annual payment to the trustee. The payment should be vouched and the check examined. Authorization of the annual payments will usually be found in the board minutes.

4. Obtain confirmation from trustee. Confirmation of the details of the fund should be requested from the trustee. The trustee's report will show the transactions for the year, the balance of the fund, and the net income earned by the fund. It will also show the composition of the fund, detailing the various securities, and the uninvested cash balance. Since this is a permanent investment there is no necessity of valuing the securities at the lower of cost or market. The trustee may have purchased some bonds at a discount or premium. The auditor must decide whether the variance from par is enough to warrant amortization of the amount. The trustee keeps his records strictly on a cash basis. If the auditor decides to amortize premium or discount, the sinking fund on the books will not agree with the trustee's records, and it will be necessary to

reconcile each period until the bonds are sold. Unless the premium or discount is material, the added accuracy hardly seems worth the additional effort.

If the client is managing the sinking fund, the auditor should examine these securities at the same time that he does all others. If income is to be added to the fund, the working papers for these securities should be so marked that, by inadvertence, the cash interest or dividends received cannot be included in general cash.

5. Adjust the fund for earnings. Many times the client's staff does not make the adjustment to add the income to the fund. After reviewing the trustee's report the auditor should adjust the fund for the net earnings. Normally no attempt is made to classify the trustee's income and expenses, the net income being credited to income from sinking fund. If the trustee's report indicates that he has turned over to the client a check for the net income, the transaction should be traced into the cash receipts book.

After the auditor has satisfied himself that the account is mechanically correct and that all adjustments have been made, he should review the fund as a whole. He should review the purpose of the fund to determine not only that the client is fulfilling his obligations, but also that the fund is increasing according to schedule. For example, interest rates change. A fund set up on an actuarial basis of 4 per cent may earn only 3 per cent because of a general drop in money rates. If this happens early in the life of the fund, the actuarial build-up originally envisioned will not take place. Further, if the trustee uses poor judgment the fund may suffer losses. The liability remains the client's even though a trustee is amassing funds to pay off the issue. If there is not enough to pay the bondholders, the client will have to make up the shortage. Hence, the auditor should determine whether the fund is progressing as it should. If it is not, he should notify the client so that steps to correct the condition may be taken at an early date.

Deposits

Deposits with utilities, airlines, the post office, and others are sometimes found on the books. Ordinarily these deposits are not prepayments of expenses but are deposits held to guarantee their payment. Hence, they properly belong in the investment section rather than in prepaid expenses.

In examining these accounts the auditor should determine the terms of the deposit. If made during the current year, he should vouch the transaction. Confirmation of the amounts should be sought from the

holders of the funds. The expense incurred should be reviewed to make certain that the liability for the year end has been recognized. These expenses should not be offset against the deposit but should be set up as a current payable.

Summary

The examination of investments should include the following major verificational techniques and procedures.

1. Verify the existence of the investments either by physical inspection or by confirmation.

2. Verify the ownership of the investments by examination of the proper documentary evidence.

3. Prove the authenticity and correctness of, and the authority for, the purchases and sales of investments.

4. Determine market values for marketable investments. Prove or adjust a valuation account where deemed desirable or necessary.

5. Ascertain that all income earned has been recognized and recorded.

6. Classify the investments for proper balance sheet presentation.

QUESTIONS AND PROBLEMS

1. Why should a company engaged in the manufacture and sale of a product invest funds in securities?

2. What are the requirements of temporary investments?

3. What is the best control over the physical custody of securities?

4. Where does the auditor look to determine the purpose of investments?

5. What rules of valuation apply to marketable securities? To permanent investments?

6. You are the internal auditor of XYZ Company. Your company owns a few stocks and bonds of other companies, which you decide to examine. List the audit steps that you would follow.

7. What are the major objectives in the audit of investments?

8. In examining the securities of a client you find that several of those on the list prepared by the chief accountant are not in the safety deposit box. Where might they be? How would you verify their existence at the balance sheet date?

9. What is the purpose of obtaining a release from the client after the securities have been counted?

10. In determining market values for securities for which there have been no transactions on the last day of the client's year, the bid price is used. Why is this used instead of the asking price?

11. What sources are available in your library for the determination of market prices?

12. What is the purpose of proving dividends received to a published source?

13. How do you ascertain that all bond interest due has been received?

14. A client owns fifty shares of General Electric stock. Dividends on this stock are declared in December and paid in January. The record date is in December. The client wants to set up the dividend declared as a receivable at December 31.

Is this permissible? As his auditor how would you suggest treating this?

15. On August 1, 1958, your client bought $10,000 of 4 per cent bonds of the Defunct Railroad at 68½, as a long-term investment. The next interest coupon to be paid is dated January 1, 1955. On January 2, 1961, the railroad paid the 1955 coupons, and on July 1 paid the 1956 coupons. You find in your examination for 1961 that these were credited to interest income.

Is this correct? If not, what adjustment would you make? If not, when would you advise the client to start accruing interest on these bonds?

16. What documentary evidences would you examine in auditing mortgage notes receivable?

17. You are the internal auditor of the Interstate University. Your school owns 250 separate real estate parcels, some office buildings, some apartments, and some single units. The real estate is all managed by Intercity Property Management, Inc. Each month your school receives statements of collections, disbursements (with invoices attached), and a check for the net.

In auditing the rental property owned account, what procedures would you follow?

18. Your client bought 90 per cent of the stock of the Ajax Corp. at the beginning of the year for $75,000. During the year Ajax earned $15,000. On December 15 of this year it declared a dividend of $5,000 payable on January 15. Your client wants to keep this investment on the actual value basis and to exclude it from the consolidation.

At what value would this investment appear on the December 31 balance sheet?

19. In examining the records of Consolidations, Inc., for the first time, you find that the company has made a number of advances to its subsidiary companies over the past several years. The advances to subsidiary account is classified as a current asset. What problem does this pose to you as the auditor in examining this account?

20. You are examining the records of the Juno Corporation for the first time. You find that eleven years ago a twenty-year, $100,000, 5 per cent bond issue was sold. The bond indenture calls for a $3,025 payment to a

sinking fund trustee each year. The trustee confirms the balance of $33,150. You have vouched the current payment and have adjusted the fund for net interest earned.

Should anything more be done in connection with this sinking fund?

21. Your client has 100 mortgage notes receivable totaling $178,000. These are the monthly payment, semiannual adjustment type. Set up a program for auditing these notes.

22. The investments and dividend accounts of the Jones Corporation are shown in Exhibit 10-6.

Exhibit 10-6

Investments

Date	*Description*	*Ref.*	*Debit*	*Credit*	*Balance*
6/18/59	500 shares common, par value, $50, Troy Co.	VR 18	19,500		19,500
6/30/61	250 shares Troy Co. received as a stock dividend				
11/20/61	Sold 250 shares @ 35	CR 21		8,750	10,750

Dividends Received

Date	*Description*	*Ref.*	*Debit*	*Credit*	*Balance*
11/30/61	Troy Co. common	CR 22		1,000	1,000

The following information was obtained during your examination:

1. The balance in the investments account at 12/31/60, per your last year's working papers, was $19,500.

2. From independent sources you determine the following dividend information:

Type of dividend	*Date of record*	*Date of payment*	*Rate*
Stock	5/15/61	6/28/61	50%
Cash	11/15/61	11/28/61	$2

3. Closing market quotations as at December 31, 1961:

	Bid	*Asked*
Troy Co. common	23¾	26½

Prepare working papers for your audit of short-term investments of the Jonas Corporation as of December 31, 1961. Assume that you have done all the work which you considered necessary. Draft any adjusting journal entries you consider necessary.

23. Your client loaned a contractor $100,000 for the construction of a building. The contractor organized 607, Inc., as the building company. When the building was completed, 607, Inc., placed a $75,000 mortgage on the building with an insurance company in New York. These funds, with other funds advanced by the contractor, were used to pay off the construction loan. The building was then leased by 607, Inc., to a national business machine company for twenty years. The lease was assigned to the insurance company as security for the mortgage. Your client now buys the stock of 607, Inc., for $50,000 and assumes the mortgage payable (which remains in the name of 607, Inc.). This corporation will be dissolved and title to the building will be in your client's name, but this has not yet been done.

How will these facts be reflected in the balance sheet of your client?

24. A company has insured the life of its president for its own benefit and is carrying the full amount of the premiums paid in its balance sheet as a current asset. What position would you as an auditor take in regard to these premiums? What audit procedures would you apply in verifying this account?

25. Your client owns $500,000 worth of U.S. government 2 per cent coupon bonds, all in $10,000 denominations. Present a complete audit program for these temporary investments.

26. Your client, an established orphanage, received by bequest the income from a million dollar trust. A local bank is the trustee. The income has been accumulating while the estate dragged through the courts. There is about $200,000 accumulated income, which, under the terms of the will, is to be used to build children's cottages. Your client proceeds with the erection of the cottages. All construction bills are paid by the bank, upon presentation to it of the contractors' invoices, with the architect's approval. There is about $30,000 income each year which is to be used for general purposes and which is paid to the orphanage by the bank in quarterly installments.

What new accounts would you advise your client to set up to handle the legacy? How would you audit them?

Chapter 11

TANGIBLE FIXED ASSETS AND DEPRECIATION

TANGIBLE FIXED ASSETS

In most manufacturing enterprises the tangible fixed assets represent a large investment and normally constitute the major portion of total assets. In the case of public utilities, the fixed assets represent a preponderant portion of the total assets. Even merchandising companies oftentimes own land and buildings that represent major investments. It is true that some large retailing companies have sold their real estate and then leased it back on a long-term basis, thus reducing materially their investments in fixed assets, but even these companies have substantial investments in fixtures and equipment of various kinds, including delivery equipment.

Tangible fixed assets may be defined as long-term assets purchased for use in the business. While these assets are subject to sale, the primary purpose of the acquisition is use, not resale. The life span of these assets is relatively long, certainly longer than one year. Such assets are also relatively costly. Both the useful life and the cost are considerations in determining whether or not the purchase should be capitalized or expensed. Tangible fixed assets include land, buildings, machinery, factory equipment, jigs, dies, trucks, automobiles, office furniture and fixtures, office equipment, and salesroom fixtures.

Long-lived assets may be classified as inventory or fixed assets, depending on the purpose of their acquisition. For example, an automobile dealer will list his stock as inventory, but the same item sold to a company for use by a salesman becomes a fixed asset. If the item is purchased or manufactured for sale to others, it is inventory. If purchased for use in the business, it is a fixed asset.

Tangible fixed assets may be divided into three categories, according to their consumption. Most fixed assets are depreciable and are to be

written off over their estimated useful economic life. Land, generally, does not depreciate. Its cost is not recovered until it is sold. Mining lands, however, and other wasting assets are subject to depletion. These lands produce other assets which are converted into inventories. As the inventories are removed the value of the land decreases pro rata.

The audit of most of these fixed assets is difficult, not because of the auditing techniques, which are relatively simple to apply, but because of the complexity of the cost and valuation problems. In some cases, the actual determination of the cost is difficult. In others the facts are easily determined but application of the rules is difficult. This situation is further complicated by the fact that authorities are not in complete agreement as to the rules for valuation.

BASIC COST PRINCIPLES

General Principles

The general basis for recording fixed assets is cost. This cost is then gradually written off over the useful economic life of the asset. With this general statement there is not much disagreement. Difficulties arise as we move from the general to the specific. Cost generally is taken to mean the net expenditure made in acquiring the asset to the point where it is ready to be put into productive use. Some situations will now be examined in detail to illustrate the different aspects of the cost problem.

As a starting point, the cost of a purchased asset should include the invoice price net of discounts offered (not necessarily taken), plus freight and handling costs to get the asset to its situs. If the asset must be installed and test runs made to prove its satisfactory operation, these would be added to the basic cost.

Financial costs are not a part of the cost of the asset. This extends to discounts not taken, which should be written off currently and the asset capitalized at the offered price. This theory is often disregarded in practice, the outlay made for the asset being the amount capitalized. Often the amount is too immaterial to argue about, but the theory is correct. Obviously, no interest cost (with the one exception discussed below) should be capitalized.

Land

The cost of land includes the purchase price plus any legal fees incurred in the acquisition. If buildings are on the land when it is pur-

chased and they are razed, the cost of razing, less any receipts therefrom, is added to the land cost. If the buildings are to be used, the total cost of the real estate must be allocated as between land and buildings. If at a later date it is decided to demolish the buildings and build a new structure, the undepreciated portion of the buildings is taken as a loss currently, rather than being added back to the land cost.

If the land must be drained or filled to be usable for the purpose purchased, such costs are added to the land costs. Special assessments for water lines or paving are part of the total cost of the land, even though they are assessed at a later date. Back taxes paid to obtain a clear title to the property are also capitalizable. Current taxes are an expense.

Buildings

The cost of purchased buildings includes the allocated portion of the price of the real estate plus any costs that are necessary to prepare the buildings for use. If improvements or additions to the buildings are made, they are added to the cost. It is normal to encounter adjustments to the purchase price for prepaid insurance and accrued utilities and taxes. These should be removed from the net outlay in capitalizing the building cost.

If a building is constructed by a contractor, the cost to be capitalized will be the contract price, plus any extras, plus the architect's fee. If the contract specifies cost plus a fixed fee or percentage, the cost to the client is composed of the amounts paid to the contractor, plus the architect's fee.

If the building is constructed by the client, many costs are includible. The major costs will be the material and labor. Theoretically, the material price should be the cost, net of discounts offered. The labor cost includes all labor working directly on the construction and may include some indirect labor. For example, if a vice-president spends one-third of his time in connection with the construction for a period of six months, one-third of his salary for that period may be charged as a part of the building cost.

Fees charged by engineers and architects for their services in connection with the building are a part of its cost. If any legal fees have been incurred in connection with the building (not land), they should become a part of the building cost. Historically, if a bond issue is floated to obtain funds for the construction of the building, the interest expense of the bond issue may be capitalized up to the time the building is ready for use. After the building is ready for use the interest should be expensed.

The support for this practice lies in the thought that since the building is not producing income, no part of its cost should be expensed. Note, however, that if the building is ready for use but for some reason stands idle, the interest should be expensed after the completion date.

Most of the items normally included in burden—insurance, depreciation of machines and tools used, electricity, payroll taxes, administrative salaries, and so on—may be calculated separately and charged directly to the building cost on a usage basis. There may be some instances in which it is more reasonable to charge a portion of the total burden to the building. The important point is to see that the current year's operations are not advantaged by charging to the asset account a larger share of the burden than it should bear. It is relatively difficult to determine a reasonable basis for such an allocation. On the other hand, it is relatively easy to make the direct charges indicated above.

Machinery, Equipment, and Similar Items

Assets of this type are usually purchased. Where they are constructed by the client the above principles apply. When purchased, expenditures for the net invoice price, freight, installation costs, and test runs represent the cost of the asset.

When exchanges of like assets (trade-ins) take place, the cost of the new asset should be capitalized at the invoice price, plus the additional costs. The old asset should be removed from the books and a gain or loss on the trade-in recognized. However, the Internal Revenue Service considers such an exchange a continuing transaction and refuses to recognize a gain or loss for tax purposes. Some companies, rather than keeping two sets of records, follow this practice in recording such exchanges.

Two methods are available to the accountant in recording the exchange. He may remove the accumulated depreciation, crediting the fixed asset in the same amount. This leaves in the fixed asset account the book value of the asset. To this value is added the net outlay to the vendor.

As an alternative the accountant may remove the fixed asset and related depreciation, debiting the asset account with the book value of the asset to balance the entry. The net outlay is then added to the asset account.

The net result of either method is to add to the invoice price of the net asset the loss suffered in the exchange. If a gain is made the invoice price is reduced. Thus the gain or loss is taken up over the life of the new asset through lesser or greater depreciation charges.

Where equipment is purchased under a rental plan with an option to

buy, the recording will depend on managerial decision. If it is decided immediately to purchase the asset, the invoiced cost and liability should be set up. If the decision to buy is made at a later date, the records must be adjusted to show the situation just as if the asset had been purchased originally. Assume the following:

Date of rental	July 1, 1960
Monthly rental	$1,000, applied to cost if asset is purchased
Cost if purchased	$35,000
Useful life	5 years
Decision to buy made	December 31, 1961

The following entries, as of December 31, 1961, will correct the records:

Asset	$35,000	
Contracts payable		$35,000
To record the cost of the asset		
Contracts payable	$18,000	
Machine rental		$12,000
Correction of prior year's profit		6,000
To cancel liability for rentals paid		
Correction of prior year's profit	$ 3,500	
Depreciation expense	7,000	
Accumulated depreciation		$10,500
To recognize cost of using machine		

The $17,000 remaining liability may be partly long term, depending on the contractual terms of payment. These entries may, of course, be compounded; they are given separately here to show clearly the various parts of the transaction that must be recognized.

Appraisals

Appraisals constitute an exception to the general principle of valuing fixed assets on a cost basis. An appraisal may be made without any intention of having the results recorded on the books of account. In other cases the results of the appraisal are recorded. Such appraisals are made legitimately for insurance purposes, in connection with a pending bond issue, or in connection with the proposed sale or merger of the business. Historically many appraisals have been made because inflationary or deflationary pressures increased the disparity between the cost of the fixed assets and their reproduction costs. Despite the fact that the recording of the results of the appraisal on the books is a questionable practice that

many accountants decry, they are sometimes recorded. In these cases the auditor can do little but accept them and work with them.

The appraisal report should be reviewed to determine the basis upon which the appraisal was made. To be valid the determination of values must be arrived at by some recognized appraisal method and must not be just an arbitrary estimate. The increase in owners' equity arising from an upward revaluation should be clearly labeled and set forth separately in the equity section of the balance sheet. It should never be mingled with retained earnings. Based on assumed amounts, the entry to record the appraisal of a building is

Building	$50,000	
Accumulated depreciation		$20,000
Equity arising from building valuation		30,000

In periods of decreasing economic activity and profit it is not unusual to find that assets have been devalued. In some cases these will be the same assets that were written up on the ascending side of the economic curve. There is no more reason for a writing down of the assets than there is for the upward appraisal. Nonetheless this occurs. Again, the auditor's task is to review the appraisal to determine its validity and then to see that it has been properly recorded. The purpose of such a write down is to reduce the annual charge to depreciation, thus relieving manufacturing operations of a sizable burden item. Factory managers may present rather cogent arguments in support of such a practice.

INTERNAL CONTROL AND FIXED ASSETS

It might appear at first glance that neither the auditor nor the client need be concerned about internal control and fixed assets. It is true that most fixed assets are of such a size and nature that little attention need be paid to the physical control over them, but the investment in these assets is so great that proper attention must be paid to the procedural aspects to prevent unnecessary loss. In this area, loss is incurred not by theft, although there may be some theft of small equipment and tools, but by misuse, disuse, inattention, uncontrolled purchasing policies, poor maintenance policies, incorrect reports, and similar procedural problems.

Importance of Fixed Procedures

Perhaps the most discouraging feature in attempting to control fixed assets lies in the attitude of most factory personnel concerning these assets.

In too many cases these persons are interested in production only and neither understand nor care about the importance and necessity of proper procedures and record keeping. The importance of fixed procedures lies in the necessity of controlling and accounting for the very large expenditures made for fixed assets. Furthermore, it is not customary to take a physical inventory of fixed equipment. Unless there is complete adherence to the procedures set forth in the accounting manual, there is no way for the auditor to assure himself that all the fixed assets indicated by the records actually are on hand. Thus the auditor's most important task in this area is to determine that the client has adequate procedures for the purchase and disposition of fixed assets and then to see that they have been followed.

Lines of Purchasing Authority

In a small company the president will probably originate or supervise the purchase of all fixed assets. As his company grows he may delegate to his superintendent the authority for purchasing any fixed asset costing less than, say, $1,000. This process of delegation continues with the growth of the company. In very large businesses several lines of demarcation may be drawn with respect to amounts that may be authorized at various levels of management. The boards of directors of most companies reserve the right to authorize *all* major transactions, including the purchase and disposition of fixed assets. The review of internal control should include tests to determine that there is proper authority for each purchase, as indicated by the size of the purchase.

Most companies budget for fixed asset expenditures. This control should be reviewed and compared with actual expenditures to ascertain any major variations. The review should also include tests to determine that the proper financial officer is promptly apprised of all large-scale commitments. The necessity of securing funds with which to pay for these commitments is obvious, as in many cases funds must be accumulated to meet the debt. Hence, it is imperative that the financial officer know well in advance of the due date what his commitments will be.

Dispositions of Fixed Assets

The auditor's review of the controls surrounding the disposition of fixed assets is equally important. Strict compliance with established procedures is necessary to prevent the disappearance of fixed assets from the plant, by whatever means, without the proper recording of the disposition on the books. In smaller companies the active manager

usually knows what has been retired even though the entries for the proper recording of such retirements have not been recorded. As the company grows, as distances between top management and operations become greater, the problem becomes more acute. The only satisfactory means of control is through effective compliance with procedural steps established through the accounting manual.

The plant ledger, if maintained, may be used as one of the controls over fixed assets. In many large companies the internal auditor regularly takes a physical inventory of fixed assets for comparison with the plant ledger. The independent auditor would probably find this to be a difficult task because of his unfamiliarity with the names and descriptions of much of the equipment. His particular interest is to determine whether the internal audit staff takes such an inventory and to review its findings.

The auditor's best assurance is that the internal controls that have been set up with respect to the disposition of fixed assets are properly working and that such controls safeguard the company with respect to the recording of dispositions. In other words, if well-planned procedures are working as they should be, there is adequate assurance that there has been a proper accounting for all major retired items.

Depreciation

Finally, the auditor is concerned with the controls established in regard to depreciation policies and procedures. While there need not be consistency of depreciation methods throughout the plant, there should be consistency as between years. His review should determine whether the controls are such as to assure this consistency. The controls should also be so devised that they prevent the inadvertent under- or overdepreciation of any fixed assets.

MAJOR OBJECTIVES IN AUDITING FIXED ASSETS

The auditor's major objectives in the examination of fixed assets have to do largely with policies and theory, although existence and ownership are also of importance. He is interested in the basis of recording the assets. He needs to know the company policy with respect to the distinction between capital and revenue expenditures. He expects to ascertain whether any expenses have been capitalized or any capital items expensed. He will investigate the acquisition of fixed assets to determine authorization and ownership. Sometimes he will attempt to make a

physical examination of the assets. In all cases he should ascertain that all dispositions have been recorded, and he may investigate the possibility that some of the assets now on the books should be removed because of obsolescence or nonuse.

AUDIT PROCEDURES AND TECHNIQUES

The basic auditing procedures and techniques applicable to fixed assets are relatively simple. Since certain peculiarities apply to some assets but not to others, the procedures will be discussed by type of asset to be audited.

Land

1. Analyze the account. The land account should be analyzed to determine what changes have taken place therein. In many audits there will be no change in this account. Where there is no change, the auditor may prefer to mark the land account in the working trial balance with NC rather than to prepare an analysis sheet for the account.

2. Vouch changes. Where changes have occurred, either purchases or sales, the auditor should obtain all the evidential material necessary to satisfy himself as to the actuality of the transaction and the propriety of the recording. The minutes should be examined to ascertain the authority for the transaction. In all but the very largest corporations the board of directors will authorize all land transactions. The invoice or purchase contract should be examined and traced to the voucher register. The check in payment of the property should also be examined to see that it is in agreement with the contract and recording.

Legal counsel for the client should be asked to furnish the auditor with a statement as to the client's clear title to the property or an indication of any liens that may exist against the property. The warranty deed provided by the seller should be examined and traced to the county records to see that the recording has been made. Real estate tax bills should be examined for evidence of assessments that should be capitalized instead of being expensed. These bills are also a further indication of ownership.

Sometimes a piece of land that is a portion of a larger unit of land will be sold. In such cases some reasonable method of cost allocation must be determined. This might be on the basis of front footage, area, or value as determined by an independent appraisal. The sales contract should be reviewed and, on the basis of the allocated cost, a gain or

loss determined. The proceeds should be traced into the cash receipts book and the bank statement. The land account should be reviewed to see that the proper amount of cost has been removed.

Buildings

Many companies have blueprints or plans mapping and identifying the buildings they own. Such identification sheets are helpful to the auditor in discussing the buildings and improvements with the clients. Also, with this sheet at hand, the buildings can be inspected and checked off against the sheet. Thus, in effect, they can be inventoried.

If this is the first time the auditing firm has examined the company, it will be necessary to review all fixed asset transactions for some years back. Theoretically the review should go back as far as is necessary to verify all fixed assets currently on the balance sheet. Practically, this sometimes is not feasible. If other reputable independent auditors have made audits in prior years, the current auditors may accept their work on the basis of the certified statements. A better plan, if it can be arranged, is to copy the previous auditor's permanent file on fixed assets, then test the work as much as is felt necessary and bring it up to date.

If this is the first time that the client has had an audit made, there is no substitute for a complete review of all fixed asset accounts. Ordinarily, on a first audit, the client will not have been in business so long as to make such a procedure impracticable. In one way or another, the auditor must satisfy himself as to the fairness of the amounts shown in the fixed asset and accumulated depreciation accounts to a degree that will enable him to express an opinion on them.

1. Review purchased buildings. The building account should be analyzed to determine the changes that have taken place. If the client has previously furnished the auditor with a building identification sheet, any new structure (or additions to old structures) should be drawn in on the sheet.

Additions to the account should be traced to the directors' minutes for authorization. The invoice, settlement sheet, or contract should be examined. To be certain that the payment is in agreement with the contract, the paid check should be examined as to amount and payee. The endorsement should also be examined. In most cases land and buildings are purchased for a lump sum. The purchaser must then allocate total cost between the two accounts. This allocation may be made on the basis of valuations assessed by the county tax board. It may also be made on the basis of an appraisal by competent real estate

appraisers. If the seller has had the accounts separated on his books, he may be willing to provide the purchaser with the percentage breakdown of his total cost.

The maintenance and repairs account should be reviewed to determine that no capital expenditures are included therein. It may be difficult to determine where a repair job on a building stops and a capital improvement starts. Through objective judgment and discussion with the client, a reasonable decision may usually be reached as to the classification of the expenditure.

2. Review constructed buildings. Where the building is constructed for or by the client, one of three different plans may have been used. The building may have been built by an outside contractor for a fixed price, or for his cost plus a percentage of cost to cover his overhead and profit. In some cases a flat fee may be substituted for the percentage. Or the client may do his own contracting, using some outside help and some of his own employees. Each of these situations will now be examined from the point of view of the auditor's application of procedures and techniques.

Fixed Price. Wherever the building is constructed by outsiders, there will be a written contract for the construction. The auditor should read and understand the contract. Terms of payment and other pertinent points should be included in his working papers. The minutes should be examined to find the authorization for the letting of the contract and the total or maximum price. The contract price should be compared with this price to see that the authorized price has not been exceeded.

In a fixed-price contract, payments are normally made as the contractor completes certain portions of the building. For example, payments may be due when the foundation is completed, when the walls are completed, when the building is under roof, and so on. In some cases the necessary completion is stated in terms of percentages. It is customary for the client to engage an architect to draw the plans and supervise the actual construction to see that it agrees with the specifications. The architect is an independent professional man whose responsibility is to protect the interests of his client. The architect will furnish the contractor with certificates as the stipulated portions of the work are completed. The contractor attaches the certificates to his invoices for partial payment. Usually the contract states that the client is to withhold 5 per cent of each payment until the building is completed, approved, and accepted.

In vouching payments to the contractor, the auditor should know the contractual terms. He should examine the contractor's invoices and should see that they are supported by the architect's certifications. He should then examine the paid check to see that the proper amount (after withholding) has been paid.

The architect's fee is usually computed as a stated percentage of the total cost of the building. The selection of the architect is also usually indicated in the minutes. The agreement with the architect will indicate the basis for determining his fee and the times at which it is to be paid. This agreement should be briefed for the working papers, the architect's invoices examined, and the paid checks examined. This fee, of course, should be charged to the cost of the building.

Cost Plus Fee. In cost-plus contracts, the contractor periodically submits invoices to the client for costs incurred. Attached to these invoices will be documentary evidence supporting the charges. Invoices for material, labor, and such overhead items as are chargeable to the job will be included. There should be some sort of documentary support for every charge made except the contractor's fee. The fee charged should be supported by a calculation shown on the contractor's invoice. These invoices should also be accompanied by the architect's certification as to completion of the work billed.

In reviewing these charges, the auditor should have well in mind the terms of the contract. The contract should identify specifically the types of overhead items that are chargeable to the job and those which the contractor is to assume. The audit of the contractor's invoices should include a review of the overhead to see that no unwarranted charges are included. The review should start with a detailed examination of the underlying documents. They should be checked for clerical accuracy and should then be traced into the main invoice, which should then be footed and the contractor's fee proved. Finally, the paid checks should be examined to see that the correct amount was paid to the proper persons.

Constructed by Client. Where the building is constructed by the client, with perhaps some subcontracting done, the examination should start in the minutes with a review of the authorization of the construction. It is probable that some kind of work order, or construction-in-process work number, was assigned to the project. It is also probable that a separate construction in process account will be used to accumulate the costs until the building is completed.

The examination of the debits to the construction in process account

should include a detailed review of invoices for material usage. While most of the material will be purchased directly for the job, some may be used from materials stocked in the warehouse. Requisitions for these materials should be reviewed and tested against perpetual inventory cards.

Payroll records should be reviewed to verify the labor charged against the job. No distinction need be made between direct and indirect labor. The normal tests applicable to payroll records should be applied to this labor.

Other items (normally burden) of cost charged to the building project should be reviewed for accuracy and propriety. If the client has used some means of allocating burden to the job, the auditor should review the basis of allocation. He should satisfy himself that the method used is a reasonable one and that it does not penalize the building and benefit current operations.

If some of the specialized work has been let out to subcontractors, it should be reviewed and examined as though it were a complete job. Contracts should be reviewed, and invoices and checks examined and traced into the records.

3. Review dispositions. It is unusual to find any credits to the building accounts. Manufacturing buildings are rarely sold unless the entire company is sold. Buildings *are* sometimes demolished. In any event the disposition of a building is a major transaction. Authority for disposition should be sought in the minutes. If there was a sale, either of the building as a whole or of parts of the demolished building, the auditor should read the sales agreement and trace the proceeds into the cash receipts book. He should make certain that the cost has been removed from the building account, the accumulated depreciation removed from its account, and the proper gain or loss recognized on the transaction.

Machinery, Equipment, and Similar Items

This group of accounts includes the balance of the tangible fixed asset accounts. While the characteristics of the items in some of the accounts may vary, the same techniques and procedures may be applied to all of them.

1. Analyze the accounts. All the fixed asset accounts should be analyzed to disclose the various additions and dispositions. These analyses may be prepared in different forms. The point of major importance is that they show in detail the various debits and credits included in the accounts. It is also important that the analyses arrive at the

client's balances before any adjusting journal entries are applied (see Exhibit 11-1).

Exhibit 11-1

CAPITOL CITY MOTORS, INC.

Machinery and Equipment

December 31, 1961

		Debit	*Credit*
1/ 1/61	Balance	$54,086.21 T	
3/28	Automatic hoist	8,428.00 VE	
	Freight on hoist	262.40 V	
	Installation costs	309.60 V	
6/20	Proceeds, sale of grease gun set		$20.00 C
10/15	Traveling hoist	1,163.80 VE	
	Installation costs	140.60 V	
		$64,390.61	$20.00
		20.00	
12/31/61	Balance per ledger	$64,370.61	
	AJE (14) To remove balance of cost of grease outfit sold	330.00	
	Balance per audit	$64,040.61	

T = Traced to last year's working papers
V = Vouched
C = Traced to cash receipts
E = Examined minutes for authorization
Examined maintenance and repairs account

Cost of grease outfit	$350.00
Less accumulated depreciation	245.00
Book value	$105.00
Proceeds	20.00
Loss on sale	$ 85.00

2. Vouch all additions and dispositions. While some items of machinery and equipment may be constructed by the client, most of them will be purchased. Invoices for these items should be vouched against entries in the account. The auditor here needs to know the levels of authority for the purchasing of the various assets. Otherwise his vouching of the purchases is incomplete. He also needs to know the company policy with respect to the demarcation line between capital assets and expense. This is discussed in step 3.

In cases where very large and numerous expenditures have been made for fixed assets, it may be reasonable to vouch the purchases on a test

basis. For example, the auditor may decide to vouch completely all items costing in excess of $10,000, and to vouch items costing less than that on a 10 per cent basis.

Dispositions should be traced back to the original entry. The cost of the item must be determined and the amount of depreciation accumulated, so that there is an assurance that these amounts have been properly removed from the records. Any proceeds should be traced to the cash book and the gain or loss determined. Where dispositions have been numerous, it is advisable to schedule them and to include the schedule in the audit report, as shown in Exhibit 11-2.

Exhibit 11-2

HARRIS MANUFACTURERS, INC.

Schedule of Disposition of Fixed Assets

December 31, 1961

Description	*Purchase date*	*Cost*	*Accumulated depreciation*	*Book value*	*Proceeds*	*Gain (loss)*
Calculator	1/23/55	$ 560	$ 420	$140	$100	$ (40)
Lathe	7/18/49	23,680	22,732	948	—	(948)
Chevrolet truck	4/14/57	3,852	3,852	—	250	250
Total		$28,092	$27,004	$1,088	$350	$(738)

3. Examine maintenance and repair accounts. The examination of the fixed asset account discloses any items that should have been expensed. The examination is not complete until the related expense accounts have been studied to determine whether any capital items have been expensed. Most companies will have a definite policy as to what should be capitalized and what should be expensed. This is often reflected in an arbitrary dollar amount set up as a line of demarcation. Expenditures below this amount will be expensed, regardless of the type of expenditure, on the premise that it is impracticable and unreasonable to attempt to keep detailed records of and to depreciate such minor items of cost. Expenditures of a capital nature, in excess of the arbitrary amount, will be charged to an asset account or to the accumulated depreciation account. The auditor should determine what the policy is, review its reasonableness, then see that it has been properly applied.

In examining the repairs and maintenance account, major attention will be given to those items in excess of the line of demarcation, with

limited tests being applied to expenditures of lesser amount. Even with this policy as a guide, it is often difficult to determine practically whether an expenditure has been properly expensed or whether it should have been capitalized. In many situations, practical expedients are followed that vary slightly from correct theory. The auditor must exercise judgment as to the final disposition of the item. Many times the client will object to the auditor's decision. Then there must be further conferences and a final judgment as to how to treat the item.

4. Check physical existence. If the client uses a plant ledger, the auditor may well consider spending some time on tracing items from the records into the plant. Where the equipment is tagged and numbered, the task is not too onerous. Where it is not so identified, the client may furnish an employee who is familiar with the equipment to accompany the auditor to locate and identify it for him. The purpose of this test is to make certain that all items recorded as being owned actually are on hand.

5. Tape the plant ledger. Where a plant ledger is maintained, a tape of the costs should be run to tie in to the asset control account. Similarly, the cumulative totals of the depreciation section of the cards should be footed to prove to the accumulated depreciation accounts. Any differences must be investigated and corrected to bring the plant ledger into agreement with the control accounts, or vice versa, as the case may be.

Many companies do not use a plant ledger. The auditor may find a schedule of fixed assets similar to that shown in Exhibit 11-3. This type of schedule at least permits the accumulation of additions and dispositions by years. The difficulty with such a schedule is that when many dispositions have been made the schedule becomes cluttered and hard to work with. The auditor oftentimes retains in his permanent file a schedule of this type so that he has some control over the amounts shown in the ledger.

DEPRECIATION AND ACCUMULATED DEPRECIATION

Depreciation is the allocated cost of use of fixed assets for a period of time. While there is a concurrent reduction in value of the asset, depreciation does not attempt to keep the book value in line with market value. Normally there is no interest in market values of fixed assets, since they are to be used, not sold.

Proceeds from the profitable sales of manufactured goods provide funds with which to pay operating costs, return profits to owners, and

General Manufacturing Company
Machinery and Allowance for Depreciation 10%

Permanent File

	Cost	Allowance for depreciation 1958	1959	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969
1958	1648200	164820	164820	164820	164820								
1959	(200000) 754050		(20000) 75405	(20000) 75405	55405								
1960	1342860			134286	134286								
1961	1855000 5400110				185500								
1962													
1963													
1964													
1965													
1966													
1967													
1968													
1969													
Totals		164820	(20000) 240225	(20000) 374511	540011								

increase working capital. The selling price of goods should be set at a level high enough to cover all costs, including depreciation, and to provide a profit. Depreciation charged to operations reduces net profit but does not reduce the funds received from sales. Thus there is less net profit from which to declare dividends but the funds provided by the depreciation charge remain. While the depreciation charge thus indirectly provides current assets, it does not assure that there will be enough cash available to replace the asset when it is worn out.

Depreciation Methods

The auditor should be familiar with the generally accepted methods of computing depreciation. While there are other acceptable methods, those shown below are the ones in most common use.

It should be noted that depreciation is closely related to the client's policy of maintenance and repairs. Under normal circumstances, a policy of heavy maintenance and repairs results in a longer useful life and thus a lower depreciation rate. Where necessary repairs are delayed and the machine is used to its limit, the depreciation rate should be higher.

To illustrate the various depreciation methods, the following data are assumed concerning a delivery truck.

Cost	$ 3,000
Estimated trade-in value	500
Estimated life	5 years
Estimated miles to be driven	150,000
Estimated working days	1,250

Straight-line method. In this method the net cost is divided by the estimated life of the machine to determine the annual depreciation.

$$\frac{\$3,000 - \$500}{5} = \$500$$

Each year would stand a charge of $500. This method is the one most commonly used because of its simplicity. It should be realized that both the salvage value and the estimated useful life are at best educated guesses. For this reason it is not anticipated that any great degree of accuracy may be obtained in determining depreciation charges.

Units of production method. Assuming one mile as the unit of pro-

Exhibit 11-3

duction for a delivery truck, and assuming 36,000 miles driven the first year, the computations of depreciation will be as follows:

$$\frac{\$3,000 - \$500}{150,000} \times 36,000 = \$600$$

The charge each year will be the result of the miles driven times 1⅔ cents per mile. This method is useful where units of output can be measured and particularly where the asset is not in constant use. It has the disadvantage of being more difficult to use, since records of output must be maintained.

Working hours method. In this method the total estimated working hours for the useful life of the asset is used as the denominator. Here again a record must be kept of the hours (or other unit) of use. In the illustration, assuming that the truck was used for 264 days, the computation would be

$$\frac{\$3,000 - \$500}{1,250} \times 264 = \$528$$

Again, in situations where the total number of working hours may be fairly estimated but the use of the machine is inconstant, this method may provide a more reasonable allocation of cost.

Reducing charge methods. Two reducing charge methods are generally accepted and in common use. One of them is called the *sum of the year's digits.* The number of years of useful service of the machine is estimated. The years are numbered from 1 through *X*, and these numbers are added to determine a denominator. Reversing the numbers and using each year number as a numerator, the fraction is then applied to the net cost. This is illustrated in the following table:

	Year	*Fractions to be used*
	1	5/15
	2	4/15
	3	3/15
	4	2/15
	5	1/15
Total	15	15/15

The first year's depreciation for the delivery truck is computed as follows:

$$\$2,500(\$3,000 - \$500) \times 5/15 = \$833$$

The second reducing charge method uses a constant rate but applies it to the book value rather than to cost. The straight-line rate is doubled to determine the constant rate. Using this method, the balance of the account will never be fully depreciated. The undepreciated balance at the end of the estimated useful life is assumed to be the salvage value. It should be noted that the constant rate is applied originally to the cost, not cost less salvage value, because a scrap value is automatically provided.

First year	$3,000 × 40% = $1,200
Second year	1,800 × 40% = 760

Under both of these reducing charge methods, the major portion of the cost of the asset is recovered in the early years of its use. For companies which use equipment having a heavy obsolescence factor there is much to be said for using such a method.

For study and comparison, the results of the methods explained above are shown in Exhibit 11-4. Assuming the additional data shown below, the computations for comparative depreciation are as follows:

Exhibit 11-4

Year	*Miles driven*	*Days used*
1	36,000	264
2	30,000	252
3	26,000	239
4	27,500	242
5	30,500	253
Total	150,000	1,250

Year	*Straight line*	*Units of production*	*Working hours*	*Sum of the years' digits*	*Reducing balance*
1	$ 500	$ 600	$ 528	$ 833	$1 200
2	500	500	504	667	760
3	500	433	478	500	416
4	500	458	484	333	259
5	500	509	506	167	146
Total depreciation	$2,500	$2,500	$2,500	$2,500	$2,781
Remaining book value	$ 500	$ 500	$ 500	$ 500	$ 219

Obviously no set of depreciation figures will work out with the exactitude shown above, but the amounts are realistic enough to form a basis for comparison between the different methods.

AUDIT PROCEDURES AND TECHNIQUES

1. Analyze reserve accounts. The first step in examining the accumulated depreciation (or reserve for depreciation) accounts is to prepare analyses of them. It is true that many clients do not record depreciation, leaving that for the auditor's adjusting entries. However, many others do make entries in the reserve accounts. The auditor must know what these entries represent. The best way to find out is to record them in the working papers, then trace them back to the original entries and explain in the working papers what they do represent.

The auditor should be just as concerned with the balances in the various reserves for depreciation as he is with the rates currently being used. The balances should represent a reasonable estimate of the economic usefulness of the asset which has been consumed. It is just as poor accounting to overdepreciate as it is to underdepreciate.

2. Verify annual credits. When the depreciation has already been recorded, the auditor should review the method used and check the computation. The review should include a comparison with the prior year to assure consistency of treatment. Where the entries have not been made the auditor will compute them and include them in his adjusting journal entries.

Several generally acceptable policies are followed in charging depreciation on additions and dispositions. Under one method a full year's depreciation is charged in the year of purchase, with none being taken in the year of disposition. Or this might be reversed, taking no depreciation in the year of acquisition. Other companies charge one-half year's depreciation for each of the years. Still another method breaks down the depreciation charge to a monthly basis and charges for the months of use in each year. The method used is not of as much importance as is the consistency of its application.

3. Vouch all charges. Debits to these accounts are of two types. One is for the removal of accumulated depreciation for assets that have been sold, abandoned, retired, or otherwise disposed of. Presumably these transactions were proved in connection with the credits to the asset accounts. Care should be taken to see that all are accounted for.

The other class of debits to the accumulated depreciation accounts

arises from extraordinary repairs and replacements. The primary evidence for these transactions should be examined to determine that the transaction actually does reflect an extension of the life of the asset. The usual authorization should be sought for all major debits to these accounts.

4. Search for additional retirements. One of the most difficult problems facing the auditor in his examination of fixed assets is his search to make certain that all retirements have been recorded. The determination that the recorded retirements have been accounted for properly is only part of the task. Because the control over fixed assets is often loose, the auditor must apply all the techniques at his command to make certain that the disposition of fixed assets has not gone unrecorded.

Each purchase of a fixed asset should be questioned to determine whether it is additional equipment or a replacement of existing assets. If a trade-in was indicated on the invoice, the disposition of an asset is evident. Where no trade is indicated, questioning should ensue to determine whether or not there was an asset disposition.

A general questioning of employees at the time the auditor tours the plant may also lead to the disclosure of fixed asset dispositions. On this same tour, he should be curious about any place in the plant that obviously once held fixed assets.

If the company takes a physical inventory of fixed assets each year, comparison of the current inventory with the prior year's listing may disclose an unexplained omission of a piece of equipment, which should call for a complete investigation.

A scrutiny of sales invoices may sometimes disclose the sale of a fixed asset erroneously included in the sales account. All credits to miscellaneous income should be investigated to determine whether they may represent the proceeds from the sale of fixed assets.

As indicated earlier, the auditor's best assurance lies in a knowledge that proper procedural controls have been set up over the disposition of fixed assets and that they are being effectively applied. Where such knowledge is lacking, the above alternative procedures should be carried out.

5. Consider depletion. Depletion for income tax purposes is computed on arbitrary percentages permitted by the internal revenue code. For book purposes, such rates are of no significance. Depletion should be computed on the basis of total estimated units underground or growing. For example, if a logging company purchases the rights to log a tract containing 500 million board feet of lumber, the cost of the rights di-

vided by 500,000 gives a unit depletion cost per 1,000 board feet logged. The auditor must rely on other independent specialists for the determination of the original estimate of units available. With this estimate, he may then determine what the depletion charge for the year should be, on the basis of units produced.

When the company does not plan to continue operations after the tract has been logged, it may pay liquidating dividends. These dividends represent the return of the investment in the timber or mineral rights. The liquidating dividends should be set forth specifically in notices to stockholders. The amounts paid should be accumulated and shown on the balance sheet as a return of the stockholders' capital.

Summary

The major procedures to be followed in the examination of fixed assets may be set forth as follows:

1. Analyze the account.
2. Vouch the changes in the account.
3. Prove the plant ledger to the control account.
4. If there is no plant ledger, determine the feasibility of taking a physical inventory of equipment.
5. Review the repairs and maintenance accounts.
6. Analyze the allowance for depreciation account.
7. Prove all entries to the accounts.
8. Inquire into the possible disposition of fixed assets if no record has been made.

MISCELLANEOUS CONSIDERATIONS

In connection with his examination of the plant and equipment, the auditor should review the insurance coverage as it applies to these assets. Insurance appraisal figures should be surveyed to determine the adequacy of the coverage. Co-insurance clauses should be reviewed to see that the client is carrying sufficient insurance to protect him completely. If not, the possibility of loss should be pointed out in discussions with the client and perhaps in the audit report.

In presenting fixed assets on the balance sheet, the basis of recording should be indicated. If appraised amounts are used, original cost figures should be indicated parenthetically in the balance sheet. Many auditors show a net figure for fixed assets on the balance sheet. This amount is then supported by a schedule showing the changes in the plant and equip-

Exhibit 11-5

CENTRAL CITY MANUFACTURING CO.

Summary of Fixed Assets

December 31, 1961

	Assets				*Reserves for depreciation*				*Net book value*	
Description	*12/31/60*	*Additions*	*Disposi-tions*	*12/31/61*	*12/31/60*	*Provision*	*Disposi-tions*	*12/31/61*	*12/31/60*	*12/31/61*
Land	$ 25,100	—	—	$ 25,100					$ 25,100	$ 25,100
Buildings	97,600	$ 9,200	—	106,800	$17,008	$ 1,884	—	$ 18,892	80,592	87,908
Machinery and equipment	120,840	12,733	$3,590	129,983	27,771	6,088	$ 718	33,141	93,069	96,842
Furniture and fixtures	20,495	335	115	20,715	13,174	1,060	46	14,188	7,321	6,527
Leasehold improvement	38,979	1,440	—	40,419	11,465	1,354	—	12,819	27,514	27,600
Autos and trucks	34,624	4,980	4,250	35,354	24,984	4,713	4,250	25,447	9,640	9,907
Total	$337,638	$28,688	$7,955	$358,371	$94,402	$15,099	$5,014	$104,487	$243,236	$253,884

ment accounts for the year, similar to Exhibit 11-5. Where such a schedule is not used, the fixed asset section in the balance sheet should be shown in enough detail to comply with the spirit of full disclosure.

Liens which have been placed on real estate should be disclosed in the balance sheet. A notation should be made against the proper fixed asset account and also against the liability account. Alternatively, the information may appear as a footnote to the balance sheet.

QUESTIONS AND PROBLEMS

1. A client of yours is disturbed because he needs to replace a costly machine and does not have cash available for the purchase. He writes you a letter asking why he has been depreciating fixed assets all these years if it is not to provide ready cash for replacements.

Draft a letter explaining why depreciation does not guarantee having cash available.

2. State the basic general rule as to what is to be included in the cost of a fixed asset.

3. The James Company constructed a building for its sales and administrative offices. On July 1, 1959, a $200,000, 4 per cent bond issue was floated to pay for the new building. The building was started in July, 1959, and was ready for occupancy on July 1, 1960. Because of the press of business, the move to the new offices was not made until January 1, 1961. Your examination of the office building account disclosed charges to the account as shown in Exhibit 11-6.

Exhibit 11-6

Materials (amount paid, $98,000; discounts, $2,000)	$100,000
Labor	55,000
One-quarter salary of vice-president who spent about one-fourth of his time in planning and supervising construction (salary 7/1/59–12/31/60, $30,000)	7,500
Filling and grading of land	2,000
Indirect costs directly allocable to construction	28,560
Interest on bonds	12,000
Paving assessments	500
Excess of price quoted by contractor for the building (credited to profit and loss)	19,440
Balance per ledger	$225,000

Indicate the audit program you would follow in auditing these charges. Prepare such adjusting journal entries as you feel are necessary.

4. The Hampton Corporation anticipates buying a machine within the

next month. The officers and accountants of the company have been discussing the purchase and have taken several positions as to the cost of the asset to be recorded under varying circumstances. You are asked to settle the matter. The invoice price of the machine is $200,000. Freight and installation costs will be $14,000. A 3 per cent discount is offered for payment within ten days. The various plans (and cost indicated by their proponents) are as follows:

1. Purchase the machine and pay for it within ten days, $208,000.

2. Purchase the machine and pay for it at the end of the normal thirty-day credit period, $214,000.

3. Borrow $200,000 at 4 per cent for twenty days and take the discount, $208,888.

4. Borrow $200,000 at 3 per cent for six months and take the discount, $211,000.

5. Float a bond issue at 5 per cent for five years and take the discount, $258,000.

Each of the participants favors one of the above plans, and each one has a different cost that he would charge to the machine. In your opinion, what is the proper cost under each of the plans?

5. On April 1, 1960, the Mammoth Company rented some office equipment at a monthly rental of $800. The company has a two-year option to buy the equipment for $25,000. All rentals are to be applied against the purchase price if the option is exercised. As of December 31, 1961, the company decides to purchase the equipment, which has an estimated remaining life of thirty-nine months. The chief accountant asks your advice as to the necessary corrections.

Set up a single journal entry that will adjust the accounts.

6. Indicate the major internal controls relating to fixed assets in which the auditor is interested.

7. Design a working paper satisfactory for the analysis of machinery manufactured by a company for its own use.

8. You are called in to make an examination of the Harmony Mfg. Corp., as of December 31, 1961. The company has been in existence for four years and has not been audited before. The books have not been closed. There is only one machinery account, shown in Exhibit 11-7. The bookkeeper tells you that he has been using a straight-line depreciation rate of 10 per cent per year, which was suggested by the manufacturers of the machines.

Set up a columnar working paper that will permit the proper accumulation of depreciation. Depreciate a full year in the year of acquisition, nothing in the year of disposition. Prepare any adjusting journal entry necessary to correct the account.

9. Your client purchased a plot of land with a building thereon. He razed

Exhibit 11-7

Machinery

Date	Description	Ref.	Debit	Credit	Balance
1/ 4/58	Machine #1	VR 1	2,000		2,000
1/ 6/58	Machine #2	VR 2	2,000		4,000
7/ 2/58	Machine #3	VR 21	2,400		6,400
12/31/58	Depreciation	GJ		640	5,760
4/ 1/59	Machine #4	VR 29	3,000		8,760
12/31/59	Depreciation	GJ		876	7,884
7/ 1/60	Machine #5 (#1 traded in, allowance $1,100) net	VR 38	2,200		10,084
12/ 1/60	Repairs to machine #4	VR 42	16		10,100
12/31/60	Depreciation	GJ		1,010	9,090
6/12/61	Major overhaul of machine #2	VR 48	560		9,650
7/ 1/61	Automatic controls put on #5	VR 51	540		10,190
12/31/61	Depreciation	GJ		1,019	9,171

the building and had a new building constructed. The building was designed by an outside architect and constructed by an independent contractor, at cost plus 10 per cent. Payments for the building were made on receipt of the contractor's statements, supported by materials invoices, payroll sheets, etc., with a certification by the architect of percentage of completion.

Prepare an audit program for the examination of the land and building account.

10. What evidence would you want to examine in support of debits to the accumulated depreciation account?

11. You are examining the books of Harper and Lyle for the first time. Your review of the internal control relating to fixed assets indicates a looseness in controls. List and give briefly the purpose of all audit procedures which might reasonably be taken by an auditor to determine that all fixed asset retirements have been recorded on the books.

12. You are examining a company that has been in existence ten years. This is the first time that it has been audited. Looking at the machinery account you surmise that some machines have lasted the ten years while others have been replaced. Set up a program for the examination of the machinery and related reserve for depreciation.

13. Your client normally spends $500,000 to $750,000 annually for capital additions and about $200,000 for repairs and maintenance. The normal policy is to expense all items under $5,000. What program would you follow in auditing fixed assets? Repairs?

14. You are examining the accounts of Harrop, Inc. You find in the miscellaneous income account a credit of $4,862. Investigation indicates that this represents the proceeds from the sale of a piece of equipment. Give in detail the procedure you would follow in the verification of this item.

15. Your client is having a building constructed by an outside contractor. The contract price is $200,000. As of December 31, 1961, you find that $118,750 ($125,000 — 5 per cent withholding of $6,250) has been paid on presentation of invoices and architect's certificates. The certificates indicate a 75 per cent stage of completion. The bookkeeper opened a buildings account when the contract was let and charged it with the contract price of $200,000, offsetting this with a contracts payable account of $200,000, the balance of which he shows as a current liability.

Will you accept the bookkeeper's presentation? If not, how would you show the building value and any liability to the contractor?

16. You are engaged in making your second annual examination of Jones, Inc. The equipment accounts are shown in Exhibit 11-8.

Exhibit 11-8

Equipment

1/ 1/61	Balance	22,300	9/ 1/61	Machine no. 8 sold	450
6/ 1/61	Machine no. 14	1,800	12/31/61	Balance	23,700
9/ 1/61	Dismantling of machine no. 8	50			
		24,150			24,150
1/ 1/62	Balance	23,700			

Allowance for Depreciation, Equipment

12/31/61	Balance	13,570	1/ 1/61	Balance	11,200
			12/31/61	1961 depreciation	2,370
		13,570			13,570
			1/ 1/62	Balance	13,570

Your examination disclosed the following information:

1. The firm has depreciated all items of equipment at 10 per cent per annum. The oldest item owned is seven years old as of 12/31/61.

2. The following adjusted balances appeared on the 12/31/60 working papers:

Equipment	$22,300
Allowance for depreciation	11,200

3. Machine no. 8, which was purchased March 1, 1954, at a cost of $1,500, was sold September 1, 1961, for $450 cash.

4. Included in charges to the repairs to equipment account was an invoice covering installation of machine no. 14, in the amount of $125.

5. It is the company's practice to take a full year's depreciation in the year of acquisition and none in the year of disposition.

On the basis of this information, prepare the working papers for your audit of equipment as of December 31, 1961. (Assume that you have done all the work which you considered necessary.)

17. During the year under review (1961) you find your client, the Waxman Corp., has sold three pieces of equipment. Item A, purchased in 1956 for $5,000, was sold for $2,500; item B, purchased in 1954 for $12,000, was sold for $1,800; item C, purchased in 1955 for $7,260, was sold for $4,500. The client uses a 10 per cent depreciation rate and follows the practice of taking no depreciation in the year of purchase and a full year in the year of disposition.

Prepare a working paper schedule that will show all the necessary details, including the gain or loss for each transaction, and the total.

18. In examining the plant records of the Jardin Company you find the following situation in the machinery and equipment account:

Total cost	$1,416,214
Accumulated depreciation	1,308,150
Book value	$ 108,064

Investigation reveals that $1,100,000 worth of assets are fully depreciated, although they are still being used.

Should this situation concern you? If so, how? What comments would you make in your audit report?

19. Your client has just purchased a piece of equipment costing $220,-000. The estimated useful life is eight years, with an estimated salvage value of $40,000. Prepare a depreciation schedule for his bookkeeper to use during the life of the machine, using the sum of the years' digits method of depreciation.

20. The Transom Company was organized as of January 1, 1957. You have performed the annual examination for the company each year. The company purchased land and building when it was organized and leased an adjoining building on a twenty-five-year leasehold. The building accounts are shown in Exhibit 11-9. The building and leasehold improvements are depreciated on a monthly basis (straight line) with depreciation starting in the month following the month of acquisition. The rate of depreciation used in prior years for the building and building improvements account is two per cent. The balance in building and building improvements as of January 1, 1961, is the original cost of the purchased building.

Exhibit 11-9

Building and Building Improvements

Date	Description	Ref.	Debit	Date	Description	Ref.	Credit
1/1/61	Balance		87,600.00				
April		VR	8,450.00				
May		VR	1,440.50				
June		VR	1,500.00				

Allowance for Depreciation—Building and Building Improvements

Date	Description	Debit	Date	Description	Credit
			1/ 1/61	Balance	7,008.00
			1-10	JE	146.00
			2-10		146.00
			3-10		146.00
			4-10		160.10
			5-10		162.50
			6-10		192.50
			7-10		192.50
			8-10		192.50
			9-10		192.50
			10-10		192.50
			11-10		192.50
			12-10		192.50

Leasehold Improvements

Date	Description	Debit	Date	Description	Credit
1/1/61	Balance	28,979.25			

Allowance for Amortization—Leasehold Improvements

Date	Description	Debit	Date	Description	Credit
			1/ 1/61	Balance	1,465.05
			1-10	JE	109.20
			2-10		109.20
			3-10		109.20
			4-10		109.20
			5-10		109.20
			6-10		109.20
			7-10		109.20
			8-10		109.20
			9-10		109.20
			10-10		109.20
			11-10		109.20
			12-10		109.20

The leasehold improvements account contains the following improvements to the leased building.

6/28/59	$20,475.00
9/15/60	8,504.25
	$28,979.25

The following transactions took place in 1961:

1. An addition to the purchased building for stock storage space was completed in April, 1961, at a total cost of $8,450.
2. Floor tile was installed in the offices in May, 1961. The cost of $750 was charged to furniture and fixtures.
3. Also in May fluorescent light fixtures were installed in the leased building at a cost of $1,440.50. This was charged to building improvements.
4. In June the interior of the purchased building was painted by an outside contractor. The cost ($1,500) was charged to the building account.

Prepare the necessary working papers for the audit of these fixed assets for the year ended December 31, 1961.

21. Shown below in Exhibit 11-10 are the machinery and automotive accounts of the Transom Company (see problem 20). One-half year's depreciation is charged in the year of acquisition and/or disposition for these assets. The client has in prior years used the straight-line method of depreciation. The autos and trucks account contains 8/31/57 purchases of $21,500 and a 9/15/59 purchase of $3,124. There is a notation in your last year's working papers that starting in 1961 the client is to use the declining balance method for new purchases in these two accounts. The declining balance rates are to be twice the straight-line rates of 5 and 25 per cent, respectively.

The 1961 transactions affecting these accounts were:

1. A 1961 Ford model K-12 truck was purchased for $4,980 in June. In the same month a 1957 Ford model K-10 truck was sold for $300 to the Acme Excavating Company. The truck had been purchased in April, 1957, at a cost of $4,250.
2. In June a Warner-Swasey drill press was purchased for $4,852.50.

Exhibit 11-10

Machinery and Equipment

1/1/61	Balance		110,840.50	June	CR	3,250.00
June		VR	5,038.00			
July		VR	7,455.00			

Exhibit 11-10 (Continued)

Allowance for Depreciation—Machinery and Equipment

June	CR	660.00	1/ 1/61	Balance	17,771.00
			1-10	JE	461.80
			2-10		461.80
			3-10		461.80
			4-10		461.80
			5-10		461.80
			6-10		461.80
			7-10		482.80
			8-10		520.00
			9-10		520.00
			10-10		520.00
			11-10		520.00
			12-10		520.00

Autos and Trucks

1/1/61	Balance		24,624.00	June	CR	4,250.00
June		VR	4,980.00			

Allowance for Depreciation—Autos and Trucks

June	CR	4,250.00	1/ 1/61	Balance	18,269.00
			1-10	JE	289.04
			2-10		289.04
			3-10		289.04
			4-10		289.04
			5-10		289.04
			6-10		377.97
			7-10		377.97
			8-10		377.97
			9-10		377.97
			10-10		377.97
			11-10		377.97
			12-10		377.97

Freight in cost $185.50. A South Bend drill press which had been purchased by the client in March, 1957, for $3,250 was sold to Ace Machine Tool Co. in June for $2,400.

3. One Bliss 240 milling machine was purchased in July at a cost of $7,455. Freight in, which was paid by the client and charged to freight expense, amounted to $240.

While analyzing the miscellaneous income account, your assistant found that the proceeds of $200 from the sale of an electric welding machine had been credited to this account. The machine, acquired in March, 1957, had cost $340. The machine was sold in September, 1961, to Dan's Body Shop.

Prepare the necessary working papers for the audit of these accounts for the year ended December 31, 1961.

Chapter 12

INTANGIBLE FIXED ASSETS AND DEFERRED CHARGES

MAJOR CLASSES OF INTANGIBLES

Intangible fixed assets may be separated into two groups according to their life. Some of these assets have a life limited either by law, by economic conditions, or by contract. Others have no limitations and may last as long as the company uses them. In some cases the economic value of an intangible fixed asset may be lost very quickly. This may be due to an act of management, such as some ill-advised action which alienates customers and destroys goodwill, or it may be due to some action over which management has no control, such as a new invention which destroys the usefulness of company-owned patents.

Intangibles which are capable of monetary measurement should be recorded at cost. These assets have value only if they will contribute to the income of future periods. Cost may be easily determined if the asset is purchased but it may be very difficult to determine if the asset is developed by the company. Even where adequate cost records are maintained a patent may be obtained on an idea that came into being as a result of work on other projects.

Subsequent valuation of intangible fixed assets is difficult because there are few objective measurements which may be applied to them. The value of many of these assets diminishes constantly, which must be recognized through periodic amortization. In many cases the legal life of the asset exceeds the economic useful life. For amortization purposes the legal life should be replaced by the estimated number of years in which the asset will make a contribution to income and the asset should be written off over these productive years. Since this estimate is often extremely

difficult to determine, many businessmen attempt to write off all intangible fixed assets as rapidly as possible.

In a recent survey of 100 companies which reported intangibles, 68 included intangibles at nominal amounts while 32 reported at cost or amortized cost. Other companies did not include intangibles on the balance sheet at all. The absence of these assets on the balance sheet does not necessarily indicate that the company does not own any. Occasionally these intangible assets may be the most valuable assets the company owns, but they are not listed because of the difficulties involved in costing and valuing them. Although the majority of the large companies in this country use a nominal value for intangibles, there are many businesses that use cost or amortized cost. For example, Coca-Cola Company in a recent annual balance sheet reported its intangibles (formulas, trademarks, and goodwill) at an amount in excess of forty million dollars.

Patents

A patent is a right granted to an inventor by the government, giving him a monopoly on the use of the idea patented. This right is granted for a seventeen-year period. Theoretically, patents should be capitalized at their cost to the company. If a patent is purchased from an inventor, the cost is represented by the amount paid plus any legal costs involved. The patent should then be written off over its remaining useful life. This is not necessarily its remaining *legal* life.

If the company develops the patent itself, a much more difficult costing task is involved. Oftentimes the research workers do keep cost records from which a cost may be developed. Unfortunately in many cases patentable ideas arise as an outcome of work done on other projects and costs are not easily ascertainable. Further, at any year end it is almost impossible to determine which projects currently in process will result in patents. Hence it is difficult to determine how much of the current year's research and development costs should be carried forward and how much should be written off to expense. As a result many companies which carry on constant research make no attempt to distinguish between these costs and write them all off currently. This, of course, results in a balance sheet that includes no patent costs except for a nominal value.

If a patent is valuable a successful infringement suit increases its value. Thus, the costs of the legal action should be added to the patent cost. If the suit is lost the legal fee as well as the patent costs should be written off to patent expense.

The auditor should discuss with the client (either the engineer or production manager) the usefulness and anticipated life of all patents. New ideas developed and patented, whether by the client or by others, may make existing patents worthless. As with any asset, full loss of value requires the elimination of the asset from the accounts. Patents recognized as completely worthless should be removed immediately.

Sometimes a client will start amortizing patent costs when the application for the patent is filed, even though it may take two to three years from the date of filing to the granting of the patent. During this time additional costs, mostly legal, are being added to the patent value. It would appear, then, that when the letters patent are received the annual amortization should be redetermined, by dividing the unamortized cost at that time by the legal or anticipated useful life. The discussion with the client would also disclose any patents which now appear to have less than the legal life remaining. Where the useful life has been shortened for one reason or another, the write-off should be increased to reflect this fact.

Copyrights

An author may write a book by arrangement with a publisher. The publisher then normally obtains a copyright and pays the author a royalty based on the sales of the book. In this case the actual cost of the copyright is a nominal amount and is currently expensed. However, in some cases, the author copyrights the book himself and then sells the copyright to a publishing company. The sales price is in lieu of royalties. In this instance the copyright is often capitalized. This cost is usually written off over the first printing of the book.

Leaseholds and Leasehold Improvements

Some leases stipulate that a fixed sum, or bonus, be paid when the lease is signed. This is in addition to the annual rental, and is usually called a leasehold. It should be amortized over the life of the original lease even though the lessee has an option to renew the lease.

In many cases the leased property is not suitable for the lessee's needs. The lessee makes improvements to the property. The improvements will vary from the setting up of partitions to the complete construction of a new building. Technically the improvement is the property of the lessee only during the life of the lease. Any improvement remaining at the termination of the lease normally reverts to the lessor. Hence the lessee should write off the cost of the improvement over the life of the lease.

The Drayer Corp.
Leasehold Improvements
December 31, 1961

Permanent File

Year	Description	Cost	Years for Amortization	1955	1956	1957	1958	1959	1960	1961
1955	Rearranging office space	12500.00	25	500.00	500.00	500.00	500.00	500.00	500.00	500.00
1956	Remodeling	3600.00	24		150.00	150.00	150.00	150.00	150.00	150.00
1959	Storage shed built	8460.00	21					403.00	403.00	403.00
1960	Added wing to building	72455.00	19							3813.00
	Annual amortization			500.00	650.00	650.00	650.00	1053.00	1053.00	4866.00

Lease dated as of January 1, 1955
Lease expires December 31, 1979

WBJ

Again, options to renew are ignored, the cost being written off over the life of the original lease.

A small problem arises in the amortization of leasehold improvements where there are continuing improvements. The life of the lease is constantly diminishing, providing each year a smaller number of units over which additional improvement costs may be spread. The auditor must make certain that each year's additions are written off over no more than the remaining years. This problem is illustrated in Exhibit 12-1. Obviously, if the life of the improvement is less than the life of the lease, the cost should be written off over the shorter period.

Secret Processes, Trademarks, Perpetual Franchises

This group of intangibles normally is not limited as to legal life. Although trademarks are registered for a period of twenty years, the registration may be renewed indefinitely. However, the registration will become ineffective if the trademark is abandoned.

The cost of a trademark consists of expenditures for drawings, developmental costs, and legal fees. In many cases this cost is nominal and is expensed immediately. The trademark may be purchased from a preceding owner in which case the invoice price and allied costs represent the cost of the asset.

Secret processes and formulas often are intangibles of great value. They should be valued at the sum of the experimental and developmental costs incurred in their development. Under normal circumstances there is no amortization of these costs until it is evident that the assets no longer produce income for the company. When this is determined to be the situation the costs should be written off.

Goodwill

Goodwill is ordinarily considered to be the earning power of an organization in excess of the average earning power for that particular industry. If an organization shows a sustained record of earnings less than average, presumably it has no goodwill. Goodwill may be built because of a better than usual product, a better than usual service, an advantageous location, or through managerial methods that entice customers to return to make additional or continuing purchases. Thus, actual goodwill is an asset valuable primarily because of current conditions. These conditions may change, or be changed, almost overnight. There is some

Exhibit 12-1

question, therefore, as to how much this asset may be projected into the future. If the goodwill has been built through personal services and personalities provided by management, it may well disappear with the sale of the business. Conversely, if the goodwill is a direct result of a better product, presumably the sale of the business should not affect it, providing that managerial policies and production techniques maintain the quality of the product.

In any event, when the sale of a business is contemplated it is customary to calculate goodwill with past profits as a base. This base should include profits for at least five years so that the trend, as well as average profits, may be determined. The calculation may then be made as the purchase of a certain number of years' profits, or the excess earnings over the average for the industry may be calculated and capitalized. It should be remembered, of course, that the past profits are the only factual item in the determination and that the selection of the other factors in the calculation are all subject to higgling between buyer and seller. Even when a tentative goodwill has been determined the amount is still subject to negotiation.

From the point of view of the purchaser, goodwill arises when he pays more for the net assets of a business than the appraised book value thereof. It is assumed that an appraisal has been made and the fair market values of the assets determined. Hence it is not possible to allocate the excess payment to the assets and it must be charged to a goodwill account. The debit to goodwill should contain nothing other than this excess payment.

At times erroneous charges have been made to a goodwill account. Losses from operations of the early years of the company, developmental costs, and organizational costs have all been found in goodwill accounts. In rare cases management has written goodwill onto the books as a result of a determination of the company's excess earning power. All such charges are incorrect and have no theoretical justification. Goodwill should be recorded only when it has been purchased.

Goodwill also arises when the capital stock, instead of the assets, of a company is purchased. This goodwill is developed in the consolidation process and appears only on the consolidated balance sheet, not on the company's books.

INTERNAL CONTROL AND INTANGIBLES

It might appear to the reader that there would be no particular problem of internal control in so far as the intangible fixed assets are con-

cerned. However, since internal control is concerned with the accuracy of the accounting statements as well as with fraud, there are some problems to be recognized.

Company procedures should be so designed that there will be proper authorization for all amounts charged to these accounts. The auditor should review the company's internal control manual to see that such

Exhibit 12-2

Harris Manufacturers, Inc. — Permanent File
Discount on Serial Bonds
December 31, 1961

	Dr.
Balance, July 1, 1961	14000.00
AJE (32) To write off current discount	2000.00
Balance, December 31, 1961	12000.00

5% serial bonds issued July 1, 1961. Total issued, $200,000. First installment of $50,000 payable July 1, 1963, with $50,000 due each July 1 thereafter.

Amortization schedule

Bond year ended	Bonds in use	Amortization Fraction	Amortization Amount	Calendar year	Calendar year amortization
6/30/62	$200,000	20/70	$4000	12/31/61	$2000
6/30/63	200,000	20/70	4000	12/31/62	4000
6/30/64	150,000	15/70	3000	12/31/63	3500
6/30/65	100,000	10/70	2000	12/31/64	2500
6/30/66	50,000	5/70	1000	12/31/65	1500
	$700,000	70/70	$14000	12/31/66	500
					$14000

WBJ

authorization is provided. Then he should note whether or not the normal processes are such that the controls set forth actually do control. In most instances transactions resulting in charges to intangible fixed asset accounts are of sufficient importance that authorization is reserved to the board of directors and will be noted in the minutes of the board meetings.

The other problem relates to the disposition of the assets. Those intangibles having a limited life will be written off over this life or over a shorter period where the economic life is less. Intangibles with a perpetual or unlimited life may be maintained in the accounts at cost or they may be written down to a nominal value. Thus it appears that, with respect to the amortization of these assets, the client may follow almost any treatment he chooses, as long as he follows a consistent policy and as long as it is reasonable.

The auditor's problem, then, is to determine that the company's internal control is such that there is proper authorization for the amortization method chosen. A method having once been chosen, it is important to see that proper control exists over the consistency of the application of the method. Control may be exerted by having all general journal entries approved by the chief accountant, who presumably is aware of the company policy. Another method of control exists by prescheduling the amortization at the time the asset is acquired (see Exhibit 12-2).

MAJOR OBJECTIVES IN AUDITING INTANGIBLES

The examination of intangibles is made with three major objectives in mind. These include (1) the verification of year-end balances, (2) the propriety of charges to the accounts, and (3) the method and consistency of the write-off. Rather obviously, if objectives 2 and 3 are fulfilled, objective 1 is automatic, except in cases where events have occurred that require a re-evaluation of the method used or of the remaining value of the intangible asset.

AUDIT PROCEDURES AND TECHNIQUES

1. Discuss intangibles with management. As backdrop for this examination of the intangibles the auditor should discuss with management the various concepts of valuing the particular intangibles carried by the client. From this discussion he learns the general policy followed by management and is able to point out any errors or fallacies created or extended by such policy. This discussion should center around the in-

tangibles with an unlimited life. As indicated earlier, there is a growing tendency on the part of companies to write down intangible assets, particularly the unlimited-life items.

In the discussion the auditor should question the value to future periods of all intangibles. As with any asset, the only justification for including these assets in the balance sheet is that they will contribute to the profits of the company in future periods, either directly as the result of a sale of the asset or through operations. Management is apt to accept without question the continuing value of these assets. In some cases the discussion will indicate the desirability of a rapid devaluation of the asset. This applies not only to unlimited- but to limited-life assets as well. The discussion will at least cause management to think objectively about the intangibles.

2. Analyze the accounts. After gaining the necessary background, the next step the auditor should take is to analyze the various intangible asset accounts. If this is a first audit, it is necessary to trace the origin of the accounts to determine their composition. In cases of limited-life intangibles, the auditor need go back only far enough to include all charges which have not yet been completely amortized. In recurring audits it is presumed that running analyses or carry-forward schedules of the intangibles will be included in the permanent file. It is then necessary only to analyze the current year's transactions. Where there are no changes in the current year many auditors merely mark the account on the working trial balance "No change—see permanent file." Where additions have been made during the year the analysis should disclose enough details to permit ease in vouching.

3. Vouch all additions to the accounts. For first audits it will be necessary to vouch all the charges and credits included in the analyses mentioned above. Many of the charges probably will not be supported by invoices. For example, a patent may have been developed by the company's research and development department. The support for the debit to the patents account will be found in time sheets, materials requisitions, and overhead charges. Since the client's accounting department had to develop the charge, there should be a schedule indicating the component parts of the total, which may serve as a starting point for the auditor's examination. He is interested in seeing that the charges made are reasonable, particularly with respect to the amount of overhead included.

As a further step in his audit, the auditor should examine the letters patent, making certain that they are all still within the legal life. He

should discuss the patents with the company engineers to determine that they are still being used. If any have lost their productive usefulness they should be written off immediately.

Purchased patents or other intangibles should be supported by invoices, contracts, or correspondence. The examination should include a review of the minutes for authorization, a search for the checks used in payment of the purchases, and an examination of the underlying agreements.

For example, if the client has purchased the net assets of another company the auditor should review the contract of sale, the audit and appraisal reports, and the terms of payment. He should satisfy himself that the underlying values assigned to the assets are reasonable and properly supported and should compute for himself the goodwill as suggested by these values. If payment for the assets was made in capital stock he should determine that the value assigned to the assets was reasonable. Although the board of directors has the right to place a value on intangibles, the auditor has the right to question this valuation where it appears to be out of line with reality. Failure on the part of the board of directors to correct gross overvaluations should result in a qualified opinion. The auditor must tread carefully, for the valuation of these intangibles is almost completely a matter of opinion. Nonetheless, where there is no satisfactory support for what appears to be a gross over- or undervaluation, he has the responsibility to disclose the facts and his own opinion in the audit report.

4. Determine the basis for amortization. As indicated earlier, the bases for amortization of intangibles are varied. Obviously, with limited-life assets, the legal life is the maximum period over which the amortization should take place. But the minimum time must be determined on the basis of the economic usefulness of the asset. An estimate must be made of the asset's anticipated useful life and of just how long it will be income-producing, and the amortization set up on that basis.

The plan to be followed in amortizing intangible assets not limited as to life must be determined by the client's chief accountant and/or board of directors. As indicated earlier, there are no widely accepted principles to be followed except the general rule that the value of any asset is a reflection of its future earning power and the policy of management. For example, if it is obvious that the value of purchased goodwill is limited to the next four or five years, it should be written off over that period of time. Conversely, if it is intended to so manage a business that goodwill remains intact or is increased, it is proper to retain the

goodwill at its original purchase price. Increasingly businessmen are striving to write down intangibles to a nominal value over as short a period of time as is consistent with good business management.

The auditor should have learned from his discussion with management the plans used for the amortization of the intangibles. His interest in each plan is twofold. First, the plan should be a reasonable one, based on the estimated useful life of the asset. Second, the client must be consistent in his application of the plan. If the plan is reasonable, the consistent application is of more importance than the plan itself.

Occasionally an intangible asset is sold. Credits arising from the sale should be completely vouched. The sales agreement should be reviewed and the accounting traced through the records to determine that the unamortized cost has been removed from the account. The cash received should be traced into the bank statement.

DEFERRED CHARGES

Deferred charges to expense are composed of expense items which appear on the balance sheet because the incurrence of the items will benefit future periods. They are distinguished from prepaid expenses by (1) their large amount, (2) their extended write-off period, and (3) the nature of the charge.

One of the characteristics of a deferred charge is that normally it is incurred only once. Organization expense arises only on organization of the business. Bond discount occurs only on the flotation of a bond issue. An advertising campaign to introduce a new product takes place only once, and so on.

Presumably if the amount involved were small there would be no problem; the expense would be charged off currently even though some benefit would accrue to future periods. This is justified on the basis of immateriality. It is only when the amount becomes material that the problem of deferral becomes important.

INTERNAL CONTROL AND DEFERRED CHARGES

The controlling of deferred charges to expense is of importance to the client in two areas. While there is no problem here of loss of assets through fraudulent transactions, there is a problem of correct statement preparation. Controls in force should prevent unauthorized charges

to these accounts and should provide for the proper write-off of the accounts to future periods.

Many companies prepare a schedule of write-offs, on a monthly or an annual basis, at the time the charge is incurred. There is little danger then that the write-off will be ignored or incorrectly calculated. The auditor should have in his permanent file the basis for the write-off and the annual charge to expense. A glance at the permanent file each year will indicate whether or not the company is consistent in its write-offs.

The auditor should also review the procedure in force for controlling the charges to these accounts. In most cases authority for determination as to whether the item should be expensed or deferred will be vested in the controller or chief accountant. In reviewing these debits the auditor should make certain that the entries were properly approved by the person to whom this responsibility has been delegated and that the entries are proper.

MAJOR OBJECTIVES IN AUDITING DEFERRED CHARGES

The major objectives in auditing deferred charges are threefold. Of most importance is the determination as to whether, under any circumstances, the item is properly deferrable. If a future period will receive benefit from the outlay, the proper portion of the deferred charge should appear on the balance sheet. Conversely, if no discernible benefit will accrue to future periods the item should be written off. The fact that a large amount has been expended should not affect the decision. Unless some value can be determined as flowing into the future, there is no justification for capitalizing the item.

Secondly, the auditor is concerned with seeing that the proper authorization exists for the outlay and for the capitalization. As indicated above, this will be determined through the vouching process and by reference to the accounting manual, which should indicate where the authority for capitalization lies.

The final objective is the determination of the reasonableness of the period of amortization. In some cases the time involved will be related directly to some other account, as in the case of bond discount and expense. In others it may be affected by taxing regulations, as in the case of organization expense, which by the 1954 Internal Revenue Code may be written off over a sixty-month period. In many instances such as deferred advertising, plant rearrangement, etc., the number of years

to be benefited (thus setting the write-off period) is arbitrarily determined either by the board of directors or by the chief accountant. The auditor should satisfy himself in each case that the time element is proper and reasonable.

AUDIT PROCEDURES AND TECHNIQUES

The audit procedures applicable here are common to all types of deferred charges. Their purposes are to fulfill the objectives stated above and to assure the auditor that the balance derived is a proper item and amount to be carried forward.

1. Analyze the account. As with any analysis, the purpose here is to determine the composition of the account balance and to set forth the individual items for ease in vouching and verification. In most cases the original analysis of the account may be included as a permanent file sheet. As long as there are no additions to the account, and this would be unusual except where the action or transaction took place over a year end, this sheet may then be used in succeeding years to indicate the write-off of the expense. This type of working paper is illustrated in Exhibit 12-3.

2. Vouch the expenditures. In the year in which the deferred charge originates the auditor should vouch the items making up the balance in the account. He should satisfy himself that the items are valid charges to this account and that they represent actual expenditures. For example, in vouching organization expense he should make certain that no items such as operating losses or discount on stock are included in the account. There should be charged to this account only the costs involved in getting the business under way. Legal fees incurred in incorporating, costs of printing stock certificates, commissions and fees paid to promoters, and accounting fees incurred in the initial devising of the system of accounts for the new company represent the type of expense that should be charged to organization expense. These costs are all necessary to get the corporation under way. Once having started in business, the company should make no more charges to this account.

Invoices, contracts, and checks should all be examined to determine the propriety of the expenditures charged to the deferred charge accounts. While the authority for determining the account classification for some of these items may rest with the chief accountant, the authority for the transaction itself will many times be found in the minutes of the board of directors.

Exhibit 12-3

Harris and Hennessey, Inc.
Plant Rearrangement
December 31, 1961

Permanent File

Line	Description	Amount
1	3/31/60 Labor costs	47268 15 V
2	Material costs	2420 12 V
3		
4	Balance per ledger, December 31, 1960	49688 27
5	Amortization, 1960	16562 75
6	Balance per audit, December 31, 1960	33125 52
7	Amortization, 1961	16562 75
8	Balance per audit, December 31, 1961	16562 77

V – Examined payroll records.
Reviewed material requisitions.
Rearrangement authorized by board of directors at January, 1960, meeting. To be written off in three years.

W.B.J.

3. Verify the amount and consistency of the amortization. The auditor should review the plan for the disposition of the deferred charges. He should note in his permanent file the terms of and the authority for the write-off. In many instances the board of directors will determine an arbitrary number of years over which the item is to be expensed. This

will be true particularly in those cases where there is no applicable time basis for making an allocation. As long as the plan is a reasonable one and is followed consistently there should be no objection to it.

For bond discount and expense, the auditor should make his own calculation of the annual amortization. While the straight-line method of amortization is most commonly used, there is no reason why the client should not employ the effective-rate method if he so chooses. The greater the discount (or premium), the greater the justification for using the effective-rate method.

Prior to the enactment of the 1954 code, the Internal Revenue Service considered organization expense as an asset of permanent value and did not permit its deduction as an expense until the company ceased business. Most accountants disagreed with this philosophy, considering organization expense as a deferred charge to be amortized as rapidly as possible. The 1954 code permits the amortization of organization costs over a five-year period. This is one of several areas in which the 1954 code narrowed the areas of difference between tax regulations and generally accepted principles of accounting. It may well be that many boards of directors will want to amortize the costs of organization over a shorter period of time, to which the auditor should not object. In fact, if the first year of operations is profitable, there is no reason why the organization costs should not be expensed immediately.

In all cases the auditor should satisfy himself as to the reasonableness of the plan and the amount of amortization of deferred charges and should determine the consistency of application of methods used.

Summary

In summary, the procedures to be used in auditing intangible fixed assets and deferred charges are as follows:

1. Analyze the account.
2. Vouch all debits to the account, inquiring into the propriety of the charges.
3. Determine the amortization policy and review the reasonableness thereof.
4. See that the policy has been followed consistently.

QUESTIONS AND PROBLEMS

1. Distinguish between prepaid expense and deferred charges.

2. A client's ledger includes an account for goodwill, $44,500. On investi-

gation you find that the client has determined the goodwill as follows: Its average excess net profits over the industry average for the past five years was $4,450. This amount was capitalized at a 10 per cent rate. A credit was made to revaluation surplus offsetting the debit to goodwill.

Would you accept this evaluation and action? If management refuses to accept any suggestions you make, what will you do?

3. Under what conditions would you advise a client in the publishing business to capitalize the cost of a copyright?

4. Define *leasehold, copyright, franchise.*

5. Your examination discloses a lawsuit pending against your client on a patent owned by him, which the client's attorney is hopeful of winning. The patent has been amortized 50 per cent and the unamortized portion of the patent is listed in the accounts at $1,000. Total tangible net assets are $500,000. However, this patent is the major income-producing asset of the company.

Would you disclose this contingency in the financial statement and/or your audit report? If so, how?

6. Why are intangible assets so often valued at $1?

7. What is the legal life of a patent? A trademark? Should they be amortized over their legal lives?

8. What is goodwill? How is its value calculated?

9. What is the auditor's interest in the internal control of intangibles?

10. What are the major objectives in the audit of intangibles?

11. The cost of a copyright should be amortized over the period for which it is granted (twenty-eight years). Comment.

12. Your client owns approximately thirty-five patents, five of which were granted this year. List the audit steps you would follow in examining the patents account.

13. What are the major objectives in auditing deferred charges?

14. Your client has floated an issue of serial bonds on which there is a sizable premium. Explain to him the most equitable plan for amortizing the premium.

15. Your client has leased some property under a twenty-year lease. The lease indicates an annual rental of $1,200 per year for the first five years, $1,500 per year for the next five years, and $1,800 per year thereafter. The lease is renewable for an additional twenty years at the option of the lessee. In addition to the annual rentals, the lessee paid the lessor $10,000 outright. The client has written the $10,000 off to rent expense. When you object to this treatment he proposes that the $10,000 be written off over forty years since it is intended that the lease be renewed.

Is this satisfactory? Support your answer.

16. You are auditing the Harley Corporation for the year ended De-

cember 31, 1961. This is the first time the company has been audited. In your examination of the intangible asset account you are furnished with the following information:

Patents

Patent A (1961)	12,000	
B (1958)	5,000	
C (1960)	19,000	

Concerning patent A, the company paid $12,000 for the right to produce 1,200 units of a product for which the Maxson Company owns the patent; 20 per cent of the items have been manufactured, all this year.

Patent B was obtained from the Kelly Brothers four years ago, in exchange for a building that the Harley Corporation owned. At the time of the exchange the book value of the building was $1,000 but the fair market value was $5,000. At the time the patent was obtained it was management's best judgment that its economic useful life was for five years. The sales for the current year are down 20 per cent from the preceding year. Management has decided to discontinue the item as of the end of next year.

The client has in its files a letter dated in June, 1960, from a patent attorney which states that after a thorough investigation he believes patent C is the only patent containing this new technique and that the letter granting the patent should arrive from the U.S. Patent Office very soon. Your letter to the attorney requesting information as to the present status of the patent application is not answered. You call the attorney on the telephone. He is very vague but admits the possibility that the patent may not be granted. The details of Patent C costs are as follows:

Research expense	$18,000
Insurance	400
Tubes and other material	600
Total	$19,000

What adjustments, if any, would you make to this account?

17. The ABC Company entered into a twenty-year leasehold agreement on December 1, 1959, for the use of forty acres of land, with an option to renew for another twenty years. On December 31, 1961, an office building was completed on the land. The building has an estimated life of twenty-five years.

Over what period should the office building be depreciated? Support your answer.

18. The Horwig Company has a leasehold running from July 1, 1956, to July 1, 1981. The property occupied is land and a building on which certain improvements have been made. The balance in the leasehold improvements account is composed of:

January, 1959	Improvements	$20,475.00
April, 1960	Improvements	8,504.25
Total		$28,979.25

The company ordinarily starts amortization in the month following acquisition. The ledger accounts are shown in Exhibit 12-4.

Exhibit 12-4

Leasehold Improvements

1/1/61	Balance	28,979.25			

Reserve for Amortization—Leasehold Improvements

			1/ 1/61	Balance	2,015.48
			1-10	JE	109.20
			2-10		109.20
			3-10		109.20
			4-10		109.20
			5-10		109.20
			6-10		109.20
			7-10		109.20
			8-10		109.20
			9-10		109.20
			10-10		109.20
			11-10		109.20
			12-10		109.20

The transactions affecting fixed assets during 1961 include the following: In May, additional fluorescent light fixtures were installed at a cost of $1,440.50. This was charged to buildings. The company owns a building in addition to the leased property.

Prepare the necessary working papers for the audit of these accounts for the year ended December 31, 1961. Include any necessary journal entries.

19. Your client, a closely held corporation, owns approximately fifty patents. There is no patents account, all costs having been charged to research and development. During the year under review your client won $250,000 damages in a patent infringement case. Continuing royalty income from businesses licensed to use the patents will amount to several times the net operating income. For tax purposes the Internal Revenue Service has now insisted that the cost of the patents be set up and amortized. Although no dollar value is shown for patents in the balance sheet, the audit report for each year contains a schedule listing each of the patents owned.

Do you feel that this is satisfactory treatment and disclosure for this apparently valuable asset? If not, what suggestions would you make to your client? What arguments would you advance in support of the suggestions?

20. The general ledger of the Halifax Company contains the prepaid advertising account shown in Exhibit 12-5.

Exhibit 12-5

Prepaid Advertising

1/ 1/61	Balance	4,671.20	1/1/61	To reverse	4,671.20
3/ 6	2d quarter ads in magazines	5,540.00			
6/ 7	3d quarter ads	4,841.50			
7/ 8	Campaign to introduce item X	86,750.40			
9/10	4th quarter ads	6,260.00			
11/15	Direct-mail ads for item X	13,249.60			
12/ 9	1st quarter ads 1960	4,751.50			

The campaign to introduce product X has been estimated to be of benefit for the next three years and should be written off in four equal amounts over this and the succeeding three years.

Prepare the working papers, including adjusting journal entries and audit steps, for this account.

21. The patents accounts shown in Exhibit 12-6 are found in the accounts of The Jumbo Corporation, whose books you are auditing as of December 31, 1961.

Your permanent file shows the composition of the beginning balance of the patents account. It is the company's policy to charge a full year's amortization in the year of acquisition.

Exhibit 12-6

Patents

Date	*Description*	*Debit*	*Credit*	*Balance*
1/ 1/61	Balance			108,375
6/18	Patent L purchased (10 years remaining life)	5,000		113,375
8/ 4	Legal fees—successful defense of Patent F	8,450		121,825
10/12	Damages awarded to X Company—Suit defending Patent H lost	25,000		146,825
11/30	Legal fees for above suit	3,655		150,480

Reserve for Amortization of Patents

Date		*Debit*	*Credit*	*Balance*
1/ 1/61	Balance			64,975
12/31	Annual amortization ($\frac{1}{17}$ of balance in Patents account)		8,852	73,827

Patent	*Date granted*	*Cost*
D	3/ 1/44	$32,300
E	9/12/50	21,420
F	2/15/52	18,700
G	1/ 5/54	13,600
H	4/19/57	9,350
J	7/25/59	5,950
K	2/20/60	7,055

Prepare working papers, including adjusting journal entries, for the patents and related accounts.

Chapter 13

NOTES PAYABLE

There are some changes in the auditor's approach in the audit of liabilities although many of the basic auditing objectives remain unchanged. During the asset examination, the problems of valuation, collectibility, obsolescence, salability, and reasonable allowances for depreciation were constantly in the auditor's thinking. These are now replaced with a different set of problems relating to the equity side of the balance sheet. There is no particular valuation problem with respect to most liabilities. Assuming that the claim against the company is valid, the amount billed by the vendor is the amount to be recorded and paid. Some debts must be estimated at the balance sheet date, but such estimates can usually be made with reasonable accuracy.

The major problem involved in the examination of payables is the determination that all liabilities that should be recognized are recognized. This problem may be subdivided into two types. First there is the recognition of liabilities which the client may have failed to recognize, either deliberately or unintentionally, relative to purchases of goods or services. Secondly, there is a class of liabilities, actual or potential, about which the client may be in complete ignorance at the balance sheet date.

In the few cases where the client is willfully attempting to understate his liabilities, the auditor must use all his acumen and skill to reach a point where he feels that he has discovered all the major payables. In situations where apparent, or not so apparent, attempts have been made to overstate *assets,* the auditor must approach the examination of payables very carefully. The understatement of liabilities is a natural continuation of the overstatement of assets. Both are designed to present a more favorable financial position than actually exists. Hence, where

either of these misuses of accounting data is discovered, extreme care must be exercised in examining all the accounts.

The liabilities the client may not know of are much more difficult to deal with since there may be a complete lack of information available. These liabilities generally are created through means other than the usual purchasing procedure. A company may have a very satisfactory system in effect for the purchasing of goods and services and thus the assuming of liabilities. Even though this is true, the company may become committed for a debt, either unknowingly or unintentionally, outside of the purchasing department. As an example, a company truck driver may have a serious collision with a bus full of school children. The ensuing damages awarded may be greatly in excess of the public liability insurance the company carries.

INTERNAL CONTROL AND NOTES PAYABLE

The reader may have assumed that, now that the assets have been examined, there is no further interest in internal control. This is not the case, for two reasons. The first is that the incurring of a liability will cause a decrease in assets at some future date. The second reason is that the protection of company assets is only one objective of the internal control system. Another important internal control objective is the protection against errors in the financial statements. This purpose permeates the entire chart of accounts and all policies and procedures affecting accounts. The auditor must pay careful attention, then, to internal control throughout all phases of the examination.

Control of power to authorize notes. The internal control system should be so devised that the power to authorize notes payable is definitely placed. In many companies, the power to authorize notes payable to banks is retained by the board of directors. Authority for note issuances then will be found in the minutes of the board meetings. In large companies, the authority is sometimes delegated to an officer of the company. In these cases the procedures should be so devised that the notes cannot be issued without this authority.

Normally the control over the issuance of trade notes payable is vested at a slightly lower level than it is for bank loans. Bank loans result in a cash increase, whereas trade notes merely effect a transfer from accounts payable to notes payable or occur as a result of purchases of goods. It is felt that the control need not be quite so strict for trade notes payable.

Separation of functions. The recording function should be separated from the physical control of the notes. The control in this case will be over unissued note forms and over paid notes. Many companies use a preprinted notebook, similar to a checkbook in that the notes are stubbed, printed, and prenumbered. The notebook should be controlled by the individual empowered to sign the notes. If the company uses note forms provided by the lending agencies, the control problem over unused forms does not exist. Whichever form is used, the control over paid notes is important and should not be in the hands of the person who performs the recording function.

Which banks may be used as lenders? This control is exerted by the board of directors. Most banks demand a certified copy of the board resolution authorizing the officers to sign notes, which usually indicates the banks from which funds may be borrowed. In addition, the name of the lending bank will frequently be indicated in the resolution authorizing the loan transaction. Where the authority to borrow has been delegated by the board of directors to a committee or an officer, the board minutes should clearly indicate the agencies from which funds may be obtained.

MAJOR OBJECTIVES IN AUDITING NOTES PAYABLE

The major objectives in auditing notes payable may be summed up in these questions. Have all notes been recognized and properly stated? Is the auditor certain that the notes indicated are valid debts? Has there been a proper classification between bank loans and trade notes? Are the notes properly classified as current or long-term? While the objective for the audit of any account is the proper statement of the account, answers to the above questions help the auditor to arrive at this result. The questions may normally be answered by use of the following audit steps applicable to notes payable.

AUDIT PROCEDURES AND TECHNIQUES

1. Analyze the account. As explained in an earlier chapter, the auditor analyzes those accounts in which individual transactions, rather than columnar totals, are entered. This is usually the situation with respect to notes payable. The analysis of the account discloses the amounts that have been borrowed and those that have been repaid. The beginning balance of the account should be traced to last year's working papers.

If the engagement is for a new client, the beginning balance should be broken down so that the individual notes are disclosed and so that they may be traced to payments of the notes.

2. Schedule the notes. The notes payable at the year end should be scheduled for audit purposes. In some cases this schedule may include only the notes outstanding at the balance sheet date. This might be the situation where so many individual notes payable have been issued and paid during the year that the auditor decides the volume is so great that a complete scheduling of notes is not worth the cost involved. This type of schedule is illustrated in Exhibit 13-1. The total outstanding should then be proved to the control account. The information necessary for this schedule may be obtained from various sources, determined by the records kept by the client. The most satisfactory record is a note payable register in which all pertinent details of the notes are recorded. If such a record is not available, the stubs of the notebook should provide the necessary details of the notes outstanding. The client may, instead of using a notebook, use bank forms, keeping a duplicate note for each note used. Or, no record at all may be maintained. The entry in the ledger and the entry in the cash receipts book must then be used as basic data, supplemented by information received from the officer in charge of notes. This information, whatever its source, will be verified later.

Where note borrowing is not too voluminous, it is helpful in auditing notes payable to prepare a schedule containing all these transactions for the year. This type of working paper is illustrated in Exhibit 13-2. The use of this schedule enables the auditor to review the year's transactions easily and to prove the interest expense for the year.

The preparation of this schedule usually is started by copying from last year's working papers the notes outstanding and the prepaid interest at the end of last year. The total of these columns should then be traced to the ledger account balances to determine that the auditor and the client agree on the starting point for this year's examination.

3. Examine authorization for notes issued. There should be proper authority for each note issued. This authority may be examined in the minutes of the board of directors' meetings or of finance or executive committee meetings if the authority has been delegated. If the authority rests in an officer, the auditor should make certain that the officer has authorized the note by written memoranda.

Exhibit 13-1

Feth Iron Works
Notes Payable, Trade
December 31, 1961

Payee	Traced to accounts payable	Interest rate	Dates Made	Dates Due	Notes payable	Interest expense	Prepaid interest, Dec. 31, 1961	Accrued interest, Dec 31, 1961	Remarks
Vaughn Sand Co.	✓	6%	9/15/61	3/15/62	5000.00 C	87.50		87.50	
Fleigh and James	✓	5%	10/1/61	2/1/62	7860.00 C	98.25		98.25	
Livi, Christensen & Co.	✓	6%	11/1/61	3/1/62	4285.00 C	42.85		42.85	
Center Coal Corp.	✓	6%	11/15/61	1/15/62	8766.80 C	65.10	21.70		Interest included in face of note
Alger Bros. Inc.	✓	7%	12/1/61	6/1/62	14700.00 C	63.00		85.75	
Totals					40611.80	379.45	21.70	314.35	
					¥		¥	¥	

C - Confirmed
¥ - Agrees with control account

James Feth, treasurer, has authority to issue trade notes as needed. He writes a memo to the bookkeeper authorizing transfer from accounts payable to notes payable. Examined these memos.

WRB

4. Trace proceeds to cash receipts. The proceeds from bank loans should be traced to the cash receipts record and to the bank statement. Since companies customarily borrow from banks in which they maintain checking accounts, it is usual to find that the bank has credited their account rather than having issued a check. Consequently, there should be a bank credit memo available for the auditor's review. This memo is the basis for the entry in the cash receipts book.

Trade notes issued should be traced back through the accounts payable account to the original transaction. This is done not only to determine that there was a proper transfer from the accounts payable account to the notes payable account, but also to determine that the original credit to accounts payable was the result of a valid transaction.

5. Examine paid notes. Notes that have been paid during the year should be examined. They should have been stamped or perforated PAID and should have been so mutilated that it would be impossible to borrow money on them again. As he examines the notes, the auditor should tick the amount on the schedule. In this way he satisfies himself that he has seen all of them. Disbursements in payment of the notes should be examined. These may be in the form of company checks supported by vouchers or in the form of bank debit memoranda. Payments of trade notes normally include the interest cost. Here again the interest calculations should be verified, since there is no automatic proof of the correctness of the amount.

6. Confirm notes outstanding. As a verification step, confirmation of outstanding bank loans payable should be obtained. If the auditor uses the standard bank confirmation request (see Exhibit 5-3, page 126), he should have already received this information. If he does not use this form, he should write to the banks with whom the company maintains checking accounts. The letter should request confirmation of the details of the notes and details of any collateral securing the note.

Confirmation requests should also be sent to holders of trade notes payable, asking for details of the notes and whether or not the holder also holds any collateral. Normally the percentage return of confirmations of payables is appreciably higher than it is for receivables. Second requests should be sent if replies are not received within a reasonable time.

7. Account for unused notes. If a prenumbered notebook is used, all note numbers should be accounted for. In setting up the schedule of

Exhibit 13-2

Kelcher Equipment Company
Bank Loans
December 31, 1961

Payee	Note ①	Term From ②	Term To ③	Balance, January 1, 1961 ④	New notes ⑤	Notes paid ⑥	Balance, Dec 31, 1961 ⑦	Interest rate ⑧	Prepaid interest, January 1, 1961 ⑨	Interest paid ⑩	Interest expense ⑪	Prepaid interest, Dec. 31, 1961 ⑫
World State Bank	247	11/1/60	2/1/61	20000.00		20000.00 EV		4	66.67		66.67	
County National Bank	248	11/15/60	1/15/61	30000.00		30000.00 EV		4½	56.25		56.25	
World State Bank	249	12/1/60	3/1/61	25000.00		25000.00 EV		4	166.67		166.67	
State National Bank	250	1/15/61	4/15/61		40000.00 AT	40000.00 EV		4		400.00 T	400.00	
World State Bank	251	3/1/61	6/15/61		20000.00 AT	20000.00 EV		4		233.33 T	233.33	
First National Bank	252	5/1/61	7/1/61		25000.00 AT	25000.00 EV		3¾		156.25 T	156.25	
Second National Bank	253	8/1/61	12/1/61		10000.00 AT	10000.00 EV		4¼		141.67 T	141.67	
County National Bank	254	9/1/61	1/1/62		50000.00 AT		50000.00 C	4½		750.00 T	750.00	
World State Bank	255	10/1/61	12/1/61		40000.00 AT	40000.00 EV		4		266.67 T	266.67	
State National Bank	256	11/15/61	1/15/62		30000.00 AT		30000.00 C	4		200.00 T	150.00	50.00
First National Bank	257	12/1/61	3/1/62		20000.00 AT		20000.00 C	3¾		187.50 T	62.50	125.00
Second National Bank	258	12/15/61	3/15/62		10000.00 AT		10000.00 C	4		100.00 T	16.67	83.33
				75000.00 Ⓣ	245000.00	210000.00	110000.00 ℓ		289.59 Ⓣ	2635.42 ⓧ	2466.68 ⓧ	258.33 ⓧ ℓ

E - Examined paid note.
V - Examined check or debit memo.
Ⓣ = Traced to last year's working papers.
A - Examined authorization in minutes.
T - Traced proceeds to cash receipts book.
C - Confirmed by bank.
ⓧ = Calculated interest.
ℓ - Compared with ledger account balance.
Notes numbered 259-500 in note book.

WBJ

notes, the auditor should scan the numbers to make certain that none is missing. He should also examine the notebook to see that no notes in the back of the book have been removed and to see that all that have been removed appear on the schedule.

8. Verify interest computations. The tracing of the proceeds of bank loans into the cash receipts book should include a verification that the correct amount of interest was deducted from the face of the note. As a continuation of this step the interest expense should be calculated for each note. Crossfooting this portion of the schedule will result in an amount of prepaid interest. This amount should then be proved by independent calculation.

Similarly, interest expense should be calculated for trade notes. Normally this type of note calls for payment of interest at maturity rather than at the date of the loan. The accrued interest at the balance sheet date for all notes outstanding will normally be the same as the interest expense. In rare cases, interim interest payments may be made. This will result in the accrual being less than the expense by the amount of the payment. All payments of interest indicated by the schedule should be traced to the cash disbursements record. This step is usually done when tracing the payment of the note itself. In case of interim interest payments, a separate tracing is necessary.

If the client has already made adjustments for prepaid and accrued interest, the columnar totals determined by the auditor should be compared with the balances of these accounts. If the adjustments have not been made, the auditor should prepare the necessary entries and record them in his papers. This is necessary for the next step.

9. Compare computed interest with interest expense account balance. The interest expense computed by the auditor should be compared with the adjusted balance in the ledger account. Interest expense may arise from short-term bank and trade notes payable, from long-term debt, from income tax deficiency assessments, and in rare cases, from overdue accounts payable. Obviously, all sources must be explored and interest expense determined before the comparison is made.

If the total thus determined is less than the adjusted ledger balance, the discrepancy should be investigated. An independent search should be instituted to determine if the auditor can discover the item and the reason for it before he seeks help from the client. The extra interest may represent interest cost on an unrecorded item. Discrepancies may exist because of posting errors. Probably the easiest way to make the search is to go through the cash disbursements (or voucher) record tracing payments actually made to amounts shown in the interest paid column of

the various liability schedules. The extra charge will show as an item for which there is no comparable amount on the auditor's schedules. Having determined the facts concerning the interest payment, the auditor should then ask the client for a full explanation of the transaction.

10. Review post–balance sheet transactions. The cash and voucher records of the new year should be examined to determine whether or not any notes have been paid. If substantial amounts have been paid by the completion of the examination, the auditor might want to mention the fact in the long-form report. Conversely, if substantial amounts have been borrowed after the close of the year, the auditor has the responsibility of deciding whether or not this is such a material factor that it should be disclosed in the report.

11. Classify for balance sheet presentation. In reporting notes payable on the balance sheet, the proper distinction should be made between bank and trade notes. Notes given in payment of purchases of fixed assets should be set forth separately, as should those given to officers, stockholders, and affiliated companies. Notes with maturities beyond the next operating cycle should be classified as long-term.

Adequate disclosure is necessary where assets have been pledged as collateral for notes. This is usually accomplished by parenthetical expression attached to both the asset and the note. Any restrictions attaching to notes payable should be disclosed by a footnote to the balance sheet. Such restrictions might have to do with dividend payments, maintenance of a certain current ratio, or the use to which the borrowed money could be put.

Summary

The major techniques and procedures to be applied to notes payable are summarized below:

1. Analyze the account.
2. Schedule the notes payable.
3. Review the authorization for borrowing.
4. Review the entries for borrowing and repayment.
5. Confirm the notes outstanding at the year end.
6. Prove calculated interest expense against the ledger account.

QUESTIONS AND PROBLEMS

1. Contrast the problems arising in the auditing of liabilities with those arising in the auditing of assets.

2. Under what circumstances would you show notes receivable discounted as a current liability?

3. You have recently been engaged by a fairly new company to make an examination. The company has expanded rapidly and has had to borrow frequently on short-term notes from banks. Additionally it has given notes to vendors in payment of overdue accounts payable.

Prepare an audit program for notes payable for this company.

4. What interest does the auditor have in his client's system of internal control as it affects notes payable?

5. What are the major objectives in the audit of notes payable?*

6. Contrast two methods of scheduling notes payable. Which do you prefer?

7. Why is it important to compare computed interest with the balance of the interest expense account?

8. List all the types of notes payable that you can think of that would require separate balance sheet classification.

9. X Manufacturing Co. borrows from its bank regularly and frequently. In connection with the loan agreements, the bank requires the company to maintain a $10,000 bank balance. Does this require the auditor to reclassify the $10,000 as a noncurrent asset? Is this restriction of enough importance to require disclosure in the financial statements?

10. During your examination of Herald Machine Co. you find an account

Exhibit 13-3

Date made	*Date due*	*Note number*	*Payee*	*Interest rate*	*Amount*	*Remarks*
11/ 1/60	2/ 1/61	819	North Mfg. Co.	4%	$10,000	
11/15/60	1/15/61	820	State Banking Co.	4½	30,000	
12/ 1/60	2/ 1/61	821	Black Supply Co.	5	15,000	
12/15/60	2/15/61	822	State Banking Co.	4½	25,000	
3/ 1/61	9/ 1/61	823	National Banking Co.	4	50,000	Renewed for six months
5/12/61	8/12/61	824	Morgan Equipment Co.	6	8,120	Interest included in face of note
8/15/61	11/15/61	825	State Banking Co.	4½	30,000	
9/15/61	9/15/63	826	Harry Harmony	3	50,000	President of company
11/ 1/61	1/ 1/62	827	Green Mfg. Co.	5	12,000	
12/ 1/61	3/ 1/62	828	County Bank	4½	25,000	
12/15/61	2/15/62	829	Baldwin Corp.	5	18,000	
12/20/61	3/20/62	830	State Banking Co.	4½	30,000	

called scrip dividends payable. What does this represent? How would you audit it?

11. You are examining the notes payable records of The White Corporation as of December 31, 1961. As part of your normal routine you inquire about new loans made and old loans paid in 1962. Mr. White, the president, becomes rather disturbed and indicates that you have been engaged to report on the December 31, 1961, balance sheet and that he is not interested in having you start the 1962 audit at this point. He indicates that if you persist there probably will be no 1962 audit for you.

How would you answer him? In view of his excited feelings would you increase the procedures applicable to 1962? How?

12. The record of notes payable shown in Exhibit 13-3 includes all note transactions for Harmony, Inc., for the year 1961. All bank loans are discounted. All others have interest payable at maturity, except as indicated. All notes are paid when due, except as indicated.

From this information prepare the necessary schedules for notes payable. Include therein any adjusting journal entries you deem proper, and programs of audit steps followed.

Exhibit 13-4

Date	*Due*	*Maker*	*Rate*	*Balance end*	*Interest accrued*	*Expense*	*Prepaid*
6/15/61	6/15/62	Adams Company	6	5,000.00	137.50	162.50	
9/ 1/61	3/ 1/62	Burns Company	5	3,000.00		62.50	12.50
12/15/61	2/15/62	Coe Company	6	2,500 00	6.25	6 25	
10/20/61	1/20/62	Dea Company	4	4,000.00	13.33	46.67	
12/ 1/61	5/ 1/62	Ohio Bank	4	49,166.67			833.33
10/ 1/61	12/ 1/61	Earl Company	6	2,000 00			
				$65,666 67	$157.08	$277.92	$845.83

13. The Smith Manufacturing Company buys all its raw material from the Jones Company and pays upon receipt of the goods. Normal purchases amount to $50,000 annually. In December, 1961, the Jones Company required extra cash to take advantage of favorable market conditions and borrowed $20,000 from the Smith Company on its (Jones) negotiable promissory note maturing June 1, 1962. By agreement apart from the note, payments were to be made on the principal of the note by application of billings for raw material successively supplied to the Smith Company. The Smith Company discounted the note at the bank and turned over the cash proceeds to the Jones Co. No entries recording the transactions were made

on the books of the Smith Co. In December, 1961, Smith bought $2,000 of material from Jones and applied the invoice to the note as per agreement. On preparing financial statements of the Smith Co. as of December 31, 1961, how should the facts relating to the note be shown on the company's balance sheet? State your reasons.

14. You are reviewing the working paper shown in Exhibit 13-4 covering notes payable, as of 12/31/61. You have called in the junior who prepared the schedule, who gives you the following information. The note given to the Ohio Bank was discounted and the note to Earl Company had not been paid because the merchandise received was unsatisfactory. Criticize the working paper presented by the junior.

Chapter 14

ACCOUNTS PAYABLE AND OTHER CURRENT LIABILITIES

ACCOUNTS PAYABLE

Variations in Accounting for Purchases

The recording of purchases of goods and services and the collateral recognition of liability is subject to more variation in the mechanics of recording than is true in accounting for assets. The application of auditing procedures varies according to the system used by the client in accounting for purchases. The most commonly used methods are here indicated.

The voucher system. Under this system, liability is normally recognized when a voucher is prepared and entered in the voucher register. Some companies voucher individual invoices after receipt, inspection, and approval of the merchandise. Other companies hold invoices for each vendor in a voucher jacket until the end of the month. Then a voucher is prepared for each vendor for the purchases of that month. In still other companies invoices are saved until time for payment, at which time they are vouchered. It is apparent then that even within one system, there are variations possible in the mechanics of processing invoices.

Basically, the liability for unpaid purchases of goods and services may be determined by listing the open items in the voucher register. In some of the situations described above, this listing must be increased by adding to the total of the listing the accumulated invoices that have not yet been vouchered.

The purchase journal system. This system envisages the use of a purchase journal for recording the purchase of materials. The purchase of services is ordinarily recorded in the cash disbursements journal. However, use of the purchase journal will vary from situations in which only merchandise purchases are recorded to those in which all purchases on

account are recorded therein. In this latter case cash purchases are recorded in the disbursements journal. It is customary to find an accounts payable subsidiary ledger in use in conjunction with the purchase journal.

In these cases the liability for unpaid goods and services is determined by taking off a list of the balances shown in the accounts payable subsidiary ledger. Here again it is possible that not all invoices will have been processed and that unrecorded invoices must be added to the list of account balances.

The cash basis. Generally, the cash basis is used by nonprofit organizations of various kinds and by some very small businesses. Companies which follow this method recognize the existence of a liability for goods and services only at the time that the liability is wiped out by payment. In most such cases, there is no accounts payable account in the ledger.

Since there is no recognition of the liability until the payment of the invoice, there is no record of payables to which the auditor can turn. His approach must be one of inquiry, examination of all unpaid invoices on hand, and review of items paid in the new year. It may well be that the liability for unpaid items is so small that it will be ignored. If the examination is, in essence, an examination of a cash receipts and disbursements statement, it may also be that no balance sheet is required by the terms of the engagement. This is often true in the review of records of small nonprofit organizations. Here, as in other examinations, the auditor has a responsibility for determining, as best he can, whether or not there is any material liability which should be disclosed even though he is not preparing a balance sheet.

Necessity for Varying Procedures

The auditing procedures to be applied must be chosen to fit the system the client uses in recognizing liabilities. Some procedures will be used in all systems, but others apply only in certain situations. The senior auditor, in preparing the audit program, must know what system the client uses before he can choose the procedures that should be applied. While this is true to some degree in all areas of the engagement it is of greater significance in the accounts payable area than elsewhere.

INTERNAL CONTROL AND ACCOUNTS PAYABLE

Purchasing procedures. Internal control as it applies to current liabilities is primarily concerned with the purchasing procedures. The first step in the study is to review the acquisitions section of the internal control

manual. An understanding of the controls that have been established is essential to the proper auditing of purchases. This study should disclose the limits to which men at the various organizational levels may commit the company.

In making his study of the area, the auditor should start with the requisitioning process. To make an intelligent review of requisitions, he must know who is authorized to sign requisitions. The names of the requisitioners must be supplemented by samples of their signatures or initials. In many cases, there is no reasonable similarity between a name and a signature.

After reviewing the requisitioning process, the auditor should move to the purchasing department. Here he must familiarize himself with company policy with respect to requesting bids for expensive purchases. He should observe the process used in determining how orders are placed where bids are not required. As part of the review, the auditor may make tests of the actual purchasing procedure, following the same steps used in the department. He may thus satisfy himself that the members of the department are following the departmental policies established for the determination of vendors.

As with all phases of the system, the purchasing procedures should be so devised that there is a proper separation of functions. The system should provide controls that tend to prevent collusion between requisitioners and the purchasing department and between the purchasing department and vendors. It is difficult to determine whether or not vendor favoritism exists, but the auditor should keep alert for any signs that would indicate the existence of such a condition. He then should question the purchasing agent and have him justify the apparent favoritism.

On a first review of the purchasing department, the auditor might well obtain a blank set of purchase orders for the permanent file. The write-up of the purchasing procedure then may be illustrated with purchase orders. The distribution of the copies should be shown, with an indication of the checks and balances developed by the various departments to which they are sent. On recurring engagements, the permanent file should be reviewed to determine whether or not there have been any changes in the procedure.

The receiving department should be visited next to determine what independent controls exist over the receipt of materials. Some companies use blind purchase orders as one means of obtaining independent counts of receipts. Methods of counting, examining, and testing for specification requirements should be reviewed.

Then the point at which all the underlying documentary evidence is

compared with the invoice should be reviewed. Many companies have this function performed in the purchasing department. A better practice, which is currently gaining in popularity, is to have the check point set up as an independent unit midway between the purchasing department and the vouchering department. The purpose here is to separate from the purchasing department some of its authority and to extend the principle of introducing into the internal control system independent units wherever practicable.

Separation of functions. Throughout the review of the purchasing process, the auditor should watch to see that there is a proper separation of functions in the system. Where weaknesses are noted because one individual has too much control, recommendations should be made to correct the situation by inserting an additional person in the process. Most of the deficiencies noted in systems of internal control (often too late) are caused by the vesting of too much authority and control in one person.

Availability of data concerning liabilities. An important facet of every business is the accumulation of data concerning debts coming due so that the treasurer may plan to have the necessary amount of cash available as needed to pay the debts. The auditor should review the system to determine that this information is made available. The data should include information concerning commitments made as well as debts currently in existence.

Efficiency of processing invoices. The review of this area should include tests of the vouchering and payment processes. The important points to be noted are the checks and balances used to control the correctness of the original distribution of charges, the accuracy of the recording of the invoices in the distribution journal, the assurance that all invoices are recorded, and the filing of the unpaid invoices.

An important point to note is the method used to ensure the presentation of invoices in time to take all available discounts. The use of a discounts lost account provides an automatic signal when a discount has been missed, but this is too late to take preventive action. The auditor's interest at this point is in seeing that the system provides the necessary controls to prevent the inadvertent loss of discounts.

No vouchers should be presented for payment without a final review to determine their authenticity, propriety, and readiness for payment. This inspection should be made by someone in a fairly responsible position. As a part of his examination of the system of internal control the auditor should determine whether or not this process is being followed.

Periodic proof of unpaid invoices. Finally, the auditor should determine whether or not there is a periodic proving of unpaid invoices against the control account. This proof should be made at least monthly. Where the system and volume permit it a daily proof may be run. This proof is an important step in any system of control since it discloses errors. Strong representations should be made if this step is not being followed. It is much easier to find errors and discrepancies currently than it is after several months have passed and many differences may have accumulated.

MAJOR OBJECTIVES IN THE AUDIT OF PAYABLES

One important task of the auditor in reviewing the current payables is the determination that all payables of material amount have been recognized on the client's records. This includes liability not only for purchases of materials and supplies but also for accrued liabilities which may not yet have been billed. It is much more probable that such unrecorded items will be encountered in the liability section than in the assets. Techniques used to disclose these accruals are indicated below.

Another important objective is the determination of the clerical accuracy of the work done on the payables records. Satisfaction as to this accuracy may be obtained only by making certain detailed tests of the transactions. These tests will be explained in the procedures and techniques below.

Finally, the auditor is interested in determining that the payables are properly classified for balance sheet presentation. Several classifications are available, both from point of view of the relationship of the creditor to the client and of the due date of the obligation.

AUDIT PROCEDURES AND TECHNIQUES

1. Examine control account for unusual entries. It is not a customary procedure to analyze the accounts payable control account since each of the usual entries represents a great number of transactions and so is of no help as far as determining the component parts of the account is concerned. Instead of analyzing the auditor satisfies himself by scrutinizing the control account for unusual entries. Entries normally are posted to accounts payable from the voucher register or purchase journal and from the cash disbursements book. If a notes payable register is used as a book of original entry, there will be debits to the accounts payable

control from it. All other entries to the control account should be reviewed to determine their source. They should be traced back to the book of original entry and the documentary evidence supporting the entry should be reviewed to determine the reason, necessity, and authority for the entry.

2. Prepare list of open payables. The auditor should prepare a list of open accounts payable. If a voucher register is in use, he should list the open vouchers. If this list is prepared at some time after the audit date, it should be remembered that some of the vouchers may have been paid. It is necessary then to review carefully the date paid column of the voucher register to pick up vouchers recorded in the year under review but paid in the new year. Before starting the list, the client's list of open vouchers should be scanned to determine the oldest unpaid voucher. The register should be scanned for a month or two prior to this date to determine that this is, in fact, the oldest open item (see Exhibit 14-1).

If the client uses a purchase journal–accounts payable ledger system, a list of account balances should be taken from the subsidiary ledger. In some cases, it may be advisable to prepare an aging schedule of these account balances. Debit balances should be set forth separately on the schedule and not netted in the total. Exhibit 14-2 illustrates an aging schedule.

If the client is on a cash basis, there is no record of payables. The auditor will use some of the steps described later to determine the year-end liability in this situation.

It is proper for the list of open payables to be prepared for the auditor by the client's staff. If this is done, the auditor must trace the items back to the voucher register or subsidiary ledger to make certain that all items have been correctly included in the list. After this has been done, he must then readd the list to determine that the total is correct. An adding machine tape may easily be prepared which appears correct and untampered with, but which shows an incorrect total. No schedules, lists, reconciliations, tapes, or any other material should be accepted from the client without proving the mechanical accuracy of the amounts shown.

After the list of open payables has been prepared and added, the total should be compared with the balance in the payable control account. The auditor should make an independent proof of the footings and balance in the control account before accepting it for comparison with the total of the list. It would be a simple matter to insert an incorrect

balance in the control account and to offset it by a compensating error in the balance of some operating account. All accounts not analyzed should be footed and balanced at some time during the audit. This is one of them.

Next the auditor should call for creditors' invoices in support of the

Exhibit 14-1

Gotham, Inc.
Vouchers Payable
December 31, 1961

		Date	Voucher	Amount	
Factor and Factor		10/16/61	10-31	862.50	C
Harold Jones		11/20/61	11-24	1281.40	C
Holly Bros		11/25/61	11-33	48.60	C
Harris Supply Corp.		12/2/61	12-8	4762.50	C
Malvern Repair Shop		12/4/61	12-12	162.41	C
Corelde Engine Co.		12/6/61	12-18	840.50	
Brueckner's Office Supply		12/16/61	12-26	54.20	C
Sam's Electric Service		12/18/61	12-29	27.25	C
Cole Corp.		12/21/61	12-33	2621.20	C
Paul Levene and Co.		12/21/61	12-35	2250.00	C
Citywide Ins. Co.		12/22/61	12-39	166.65	C
Manufacturers Corp.		12/23/61	12-43	3221.52	C
Northern Cotton Mills Co.		12/24/61	12-46	987.65	C
Harris Supply Corp.	(1)	12/28/61	(12-8)	(500.00)	C
Reliable Sales Co.		12/30/61	12-48	486.30	
Havens General Corp.		12/30/61	12-50	1246.53	C
James Mercantile Co.	(2)	12/31/61	(12-51)	(486.70)	
Merrill Distributors		12/31/61	12-52	1652.20	C
Total per control				19484.71	
AJE (D) To reclassify Vo. 12-51 as receivable				486.70	
AJE (32) Unrecorded invoice, Jones Coal Co. 12/31/61				376.80	C
Total per audit				20348.21	

(1) - Allowance for defective goods. Offset against Vo. 12-8
(2) - Goods returned. Had been paid. Set up as receivable - AJE (D)

C - Confirmed
Compared all open invoices with voucher register.
Footed and posted voucher register for test months.
All October and November vouchers paid by January 15, 1962
Examined receiving records December 20, 1961 - January 10, 1962
Examined voucher register entries and invoices for first ten days in new year.

[illegible]

Hamilton Electronics Co.
Accounts Payable Aging Schedule
December 31, 1961

	Balance Dec 31, 1961	Not due	Past due 1-30 days	Past due 31-60 days	Past due 31-90 days	Past due over 3 months	Due to officers	Notes payable	
Abel Electric Supply	2462.12	2462.12							
Bloom Radio Distributors	9400.00		9400.00						
Collins Company	481.20	481.20							
Durand & Sons	10000.00							10000.00	
Francis Corp.	168.26			168.26					Note given but not recorded
General Supply	1141.20		1141.20						
George Hamilton	15000.00						15000.00		
William Hamilton	10000.00						10000.00		
Kleining Bros.	286.10					286.10			In dispute
Mahoning Valley Electric Co.	42.18	42.18							
Orton & Reiber	7462.21		7462.21						
Thaler Corp.	1234.56	1234.56							
Harold Williams	10000.00						10000.00		
Yalem & Harvel	4141.41	4141.41							
Zinger & Co.	4231.65	4231.65							
Zuratey Corp.	2162.20	2162.20							
Total per control	78213.09	14755.32	18003.41	168.26		286.10	35000.00	10000.00	
AJE (27) To recognize note	168.26			168.26					
Total per audit	78044.83	14755.32	18003.41	-0-	-0-	286.10	35000.00	10000.00	

Traced all balances to invoices.
Searched for unrecorded invoices.
Compared balances with creditors' statements.
Compared invoices with purchase journal for January, May, and December.
Footed and posted purchase journal for test months.

[illegible]

amounts shown on the list of open payables. These invoices should be reviewed for the clients' name, data, extensions, and footings. The purpose here is to make certain that the client really owes the amount stated on the list.

3. Make a test of transactions. If it has not yet been done, the auditor should now make a detailed test of the purchase-payables-disbursements transactions for the test periods. Although he may have followed through certain isolated transactions from requisition to payment in his review of the internal control, the current review should be an intensive examination of the details of a number of transactions. This may be done using a random sampling basis, a block sample test, or a statistical sample, if conditions for statistical selection are auspicious (see Chapter 4).

Assuming the use of block samples, the auditor should ask for all the vouchers for the year. In large companies, this would be too many to have at one time and he merely asks to be shown and to be given access to the filing cabinets containing the paid vouchers. The point to observe here is that the client need not know on what basis, nor for what periods, the auditor intends to make his tests.

Having obtained the vouchers, the auditor should start his examination for the test periods. Once again, it might be well to mention that the word "test" refers to the number of vouchers examined, not to the details of the examination. The review should be complete and thorough for the selected vouchers.

Each invoice should be examined to see that it is addressed to the client. Extensions and footings should be verified. The underlying documentary evidences attached to the voucher should be reviewed to see that all are present and that they have been properly prepared and initialed for authorization. A comparison should be made of the quantities and items to see that what was requisitioned was ordered, received, and billed.

The distribution of charges should be reviewed. Although the auditor may not be able to distinguish minor variances in classification, he should be able to perceive major classification errors. At the same time he should review the items for the general propriety of the purchase. For example, it should pique the auditor's curiosity if in the review of the purchases of an airline company he finds an invoice for some mining machinery. Unusual purchases should be listed for later follow-up.

Exhibit 14-2

The vouchers should then be compared with the entries in the voucher register. Voucher number, date, vendor, date paid, check number, and amounts should all be compared. The auditor should be careful to determine that the accounts are charged into the voucher register in accordance with the distribution on the voucher. After the voucher comparison has been made, the voucher register should be footed and posted for the test months.

Another test that may well be made is a test by vendors. The purpose of this test is to determine the reasonableness of the amount of purchases from any single vendor, or more properly the amount of certain types of material. If an accounts payable system is used, the amounts are easy to determine, but in a voucher system there normally is no segregation by vendor. If the review of the test months raises any question in the auditor's mind about the purchase of certain materials or expense items, he might well make a listing of purchases from the vendor involved. If copies of vouchers are filed alphabetically by vendor this search is simplified. Analysis of the expense accounts might not disclose the overpurchase because of distribution to various departments.

As a final step, paid checks should be compared with the voucher register entries to ascertain that the checks were made out in the proper amount to the proper payees. This may be done at the time the checks are examined or at this point, but the procedure should not be overlooked.

4. Search for unrecorded invoices. In the normal flurry that surrounds the closing of the records for a year, it is not unusual for some invoices to go unrecorded. In small companies they may be ignored or forgotten in the hurry to close the books. In large companies the vouchering process is sometimes so slow that these invoices may not be included. Invoices may be received prior to acceptance of the material, or the classification of the purchase may be in doubt. In the latter case, it is not unusual to find a debit suspense account to which these items may be charged until their final disposition is determined. It is also common to find an account unvouchered payables to which these unrecorded invoices are credited until such time as they may be vouchered.

Whatever the cause and whatever the situation, the auditor's interest is in seeing that the proper liability is expressed for all unrecorded items. He should call for all unrecorded invoices on hand, even though it is stated that they pertain to the new year. These invoices should be examined to determine whether they do belong in the new year or should be recognized as liabilities for the year under review. Where material

liabilities are discovered, an adjustment should be made to record the items.

In most cases, the omission of such items either is unintentional or is the result of a misunderstanding as to what should be included. On rare occasions a situation will be encountered where management intentionally attempts to conceal liabilities in order to present a better financial position than actually exists. Then the auditor must use all the skill and techniques at his command to satisfy himself that he has uncovered all the major liabilities. Some of the steps to be used are discussed in the following sections.

5. Examine creditors' statements. The practice of sending monthly statements to customers has declined somewhat with the increasing use of the voucher system; customers are expected to pay individual invoices rather than monthly statements. However, there are still enough vendors who send statements to make this step worthwhile. The auditor should arrange with his client to retain for him all creditors' statements received as of the year end. These statements should then be compared with the liabilities expressed on the list of open payables. Any discrepancies must be satisfactorily resolved.

6. Confirm accounts payable. For many years after the circularization of accounts receivable became standard practice, the matter of requesting confirmation of accounts payable balances was subject to discussion by the client and the auditor. The growth of this practice has been steady and increasing until now it may be regarded as generally accepted. Failure to request confirmation of accounts payable does not yet require disclosure in the short-form report. However, where a long-form report is written and there was no confirmation, it is customary to make a statement to the effect that "Although we did not request confirmation of balances from the usual suppliers, we have satisfied ourselves by other means that all material payables have been recognized." This statement by implication indicates that circularization is a procedure that might well have been used.

The primary purpose of the confirmation of payables is the same as that of confirming receivables, that is, to obtain satisfaction as to the correctness of the client's record keeping. Secondarily, it is quite different. The confirmation of receivables satisfies the auditor as to the validity of the debt and proves that there is not an overstatement of assets. The confirmation of the large accounts receivable is thus of primary significance. Confirmation of payables is designed to throw light on any understatement of liabilities. The process of account selection then must

be varied. If a complete circularization is desired, requests should be sent to all suppliers with whom the client has done business during the year, regardless of the balance or lack of balance in the account at the year end. If the process is to be on a test basis, names should be selected from creditors whose accounts show large balances, those whose accounts show small balances, and some who show no balance. In this way understatement of balances or failure to record will be disclosed. If the client has failed to keep the creditors' statements for the auditor, independent confirmation of creditors' balances assumes added significance.

7. Examine receiving records. In connection with his examination of inventories the auditor may have reviewed the receiving records sufficiently to give him the information he needs at this point. In that review, he was interested in determining the cutoff and in making certain that all goods in transit were recognized. Now he wants to ascertain that the liability for all goods received up to the cutoff has been recognized. This includes, of course, materials in transit that belong to the client. It is good practice to take off a list of all goods received during the last few days of the year and the first few days of the new year. These should then be traced into the liability records to make certain that all the material received has been booked in the correct period.

8. Examine purchase commitments. The auditor should review the purchase and sale commitments made by his client. There are two points in which he is interested. The first is that a review of purchase commitments may disclose additional actual liabilities that may not have been discovered elsewhere. If the commitments record discloses that shipments of certain material should have been received prior to the balance sheet date, the auditor should trace these out to determine that they have been properly recognized.

The second phase of the review has to do with the problem of possible future losses. In many instances, where supplies are plentiful, a manufacturer will not make a purchase commitment unless he has a covering sales commitment. In such cases, the probability of loss is decreased although not entirely eliminated, for the retailer may break his contract and be in such a poor financial position that no damages are recoverable. Under normal conditions, then, no disclosure need be made when matching commitments are encountered.

In periods when demand is high and supply is limited, it is not unusual to find purchase commitments with no matching sales commitments, or with purchase commitments greatly in excess of sales commitments. It is in these situations that market conditions must be care-

fully appraised. If the current market is less than the contract price or if it appears probable that it will drop to less than the contract price, consideration must be given to the matter of disclosure. This may be accomplished by an appropriation of surplus or by a balance sheet footnote. In either event, the matter should be fully discussed in the text of the report.

9. Examine transactions in the new year. The purchase records for the first week or two of the new fiscal period should be reviewed to determine whether or not any of the items included therein properly belong in the year under review. The record to be examined will depend on the purchase system in use. If a voucher system, the voucher register and supporting documents should be reviewed. Shipping terms must be considered in determining in which year the transaction belongs.

If a purchase journal is used, both this book and the cash disbursements record should be reviewed, for not all liabilities are expressed in the purchase journal. In many cases, it is restricted to the purchase of materials or merchandise on account. Again, the evidence supporting the entries should be reviewed.

Where a cash basis is in use the search will be concentrated in the cash book and in a review of all new-year invoices available. It is primarily from this search that the auditor will determine the year-end liability. Since no payables are recorded until paid, the review of the disbursements in the new year assumes paramount importance. If the audit is made early in the year, additional importance attaches to the review of the receiving records, if any. Materials received during December should all be traced to the disbursement record. Those not found must be assumed to be unpaid. From the review of invoices, statements, receiving records, and new-year disbursements, a list of open accounts is prepared. By adjusting journal entry, these liabilities are recognized. Presumably, the client will make a reversing entry as of the first of the year canceling the liability and crediting the asset and expense accounts involved. His normal payment routine will then cancel these credits.

10. Confirm open balances with related companies. Positive-type confirmation requests should be sent to all companies having a parent or subsidiary relationship to the client. In addition, if the client has open balances with companies affiliated by stock ownership but not controlled, confirmation of the balances should be sought. The fact that some or all of these balances may disappear in the consolidation process does not remove the necessity of obtaining their confirmation. For those remaining unconsolidated, the question of whether these amounts should be

set forth separately on the balance sheet is posed. If the amounts are material, separate classification is desirable.

11. Investigate old unpaid bills. Unpaid items that are long past due should be carefully investigated. If a voucher system is in use, these items will be disclosed automatically in the preparation of the list of open payables. If an accounts payable subsidiary ledger is in use, disclosure will be accomplished only by aging the accounts.

Failure to pay invoices when due may be caused by any of a number of reasons. One may be that the internal control system is not operating efficiently and the item has just been missed through carelessness. This raises the question of how much has been lost by failure to take discounts available. Management should be apprised of such a situation.

A second common cause of failure to pay invoices when due is a weak financial position. Here the auditor should compute the discounts lost to determine whether it would be advisable for the client to borrow to take advantage of allowable discounts.

It may also be that the client has given a note in payment of the invoice and has failed to make the necessary transfer from accounts payable to notes payable. This is of concern to the auditor not only from the viewpoint of the proper classification of liabilities, but of more importance, because it points up a breakdown in the system of checks and balances.

Finally, failure to pay may be the result of a disagreement between buyer and seller on any of a number of points—specifications, failure to make timely deliveries or to deliver at all, improper materials received, unsatisfactory materials, and so on. The auditor must review the situation to determine as best he can the responsibility and liability of the client to the vendor.

12. Investigate the taking of discounts. Although many companies no longer allow discounts, the practice is still prevalent enough to merit consideration by the client of the use of a purchase discounts lost account. Where this account is used, all purchases are recorded net of discount. If the discount is not taken because of late payment, the allowable discount is then charged to purchase discounts lost. This account normally should have no balance. Any entry to the account is a signal to management that something is wrong, that a control somewhere in the system has broken down. If the company is so weak that it regularly does not take its discounts, the balance in the account indicates the loss to the company and is easily comparable to the interest cost that would have

been incurred had money been borrowed to take advantage of all discounts. This account provides an effective control that is not available when purchases are recorded gross and the discounts taken account is used.

In the latter situation, the auditor's best technique is to compare the ratio of discounts to purchases over the years. The ratio will be affected by the changes from a discount to a no-discount basis by vendors. Any radical change in the ratio should be thoroughly investigated.

The detailed examination of invoices by the auditor should include the determination of whether all allowable discounts were taken. Since this review is only for test periods, the results of the discount practice can be only for those periods, but it may be indicative of the general practice.

13. Review the balance sheet classification. The accounts payable caption should include only trade payables to outside vendors. Amounts payable to officers and employees, related or affiliated companies, and to other vendors for the purchase of nontrade items should be classified separately according to the relationship. Debit balances, if material, should be shown as an asset in the receivables section. Advances on purchase contracts should be shown in the inventory section.

Summary

A summary of the major procedures applicable to accounts payable is presented below.

1. Prepare list of open payables.
2. Prove to control.
3. Compare invoices with list.
4. Search for unrecorded invoices.
5. Confirm accounts payable.
6. Examine January records for transactions applicable to year under review.
7. Segregate payables for proper balance sheet presentation.
8. Examine purchase transactions for test periods.

OTHER CURRENT LIABILITIES

There is a variety of relatively minor liabilities remaining to be examined after the audit of notes and accounts payable has been com-

pleted. Some of these are common to most companies, others are peculiar to particular industries. Since the audit procedures are similar for many of these accounts, the following discussion will be limited to a few of those most frequently encountered.

Accrued Wages and Salaries

In most instances the liability account should be used as a springboard to a study of the related operating account. The intensity of the review should be dependent on the materiality of the operating account.

1. Survey the payroll function. The payroll area historically has been used to a considerable degree for the perpetration of fraud. While the reporting requirements of the various tax and social security laws and regulations have made more difficult the practices of payroll padding and related payroll fraud, they have not eliminated them. The auditor must be particularly alert in reviewing the entire payroll function.

The system of internal control is of paramount importance as it affects and controls payroll practices and procedures. The auditor's review of the system should indicate to him whether or not the functions are separated at enough points to ensure the minimization of opportunities for fraud. Opportunities for collusion must not be overlooked.

The review should be started in the personnel department where authorization to hire and separate and authorization to increase or decrease wage rates should be found. The procedural aspects of these steps should be studied to determine that proper checks and balances are in effect to prevent unauthorized transactions. A common fraudulent practice is the retaining of an employee's name on the payroll after his employment has been terminated. The auditor's review should reveal specifically how such a practice is controlled.

Next the method of accounting for employees' time should be considered. If time clocks are used, note should be made of the control in effect that prevents one person from punching in for another. One control used is to make periodic "floor checks." That is, a clerk from the payroll department will walk through the plant and list the employees who are (or are not) present. The list is then compared with the clock cards. In another method, a payroll department employee observes the men punching in and out, presumably preventing one man from punching more than one card.

The auditor should then move to the payroll department where information on the clock cards is entered on the payroll register. He should observe the procedure for determining hourly rates, the means of deter-

mining amounts to be withheld, and the authority for the withholding. The next step is to review the process for paying the employees. If payment is made in cash, the process should be observed to see that once again there is a proper separation of function and proper control over the cashing of the payroll check and the preparation of the pay envelopes. If payment is made by check, the process should be reviewed to determine that here also controls are used in the proper places.

As a final step in the survey of the payroll function, the auditor should either observe the payment of the employees or make the pay off himself. The purpose of this step is to determine the observance of means of employee identification and to observe the procedures applied to unclaimed wages.

2. Prepare payroll summary. Payroll costs are used as a measure of the cost of several other expenses. The best way to have available the necessary information for the verification of these costs is to have a summary of the total labor costs, broken down by the various classifications necessary. This may be prepared by the auditor or he may ask the client to prepare it for him. A typical classified summary is shown in Exhibit 14-3. This information is used in verification of the various payroll tax expense accounts and in computing workmen's compensation costs.

3. Make tests of payroll work. As a means of satisfying himself as to the accuracy and care with which the payroll work is done, the auditor should make tests of the various phases of this task. In a small company, the review may be made of the entire payroll for the test periods. In large companies, the tests will be made on a departmental basis for the test periods. If the auditor has selected three months as his test periods, one pay period in each month would be selected for testing. If random testing is being used, any pay periods may be selected.

To start this test, the personnel department should be requested to provide a list of employees on the payroll for the test periods, along with the authorized hourly wage (or other pay rate) for each. With this information available, the auditor should then acquire the clock cards for the selected pay periods. These cards should be examined in all respects—name, social security number, daily clock times, total time worked, and pay rate (if shown). Company policy must be ascertained as to late arrivals and early departures. Overtime policy and procedures must also be determined.

The cards should then be compared with the payroll register. The accuracy of the transfer of hours worked and pay rates from the card

Hanf Manufacturing Co.
Payroll Summary
December 31, 1961

	Total	Direct labor	Indirect labor	Maintenance crew	Warehouse	Office salaries	Sales salaries	Officers' salaries
January	12000.00	4002.40	1145.00	844.50	648.20	1150.00	1212.90	3000.00
February	11236.20	3821.20	928.20	612.20	610.10	1040.00	1224.50	3000.00
March	11731.80	4152.10	1015.40	549.60	650.30	1128.00	1236.40	3000.00
April	11931.00	4344.50	941.70	715.40	640.70	1040.00	1248.70	3000.00
May	12250.20	4677.20	1101.80	460.00	661.20	1130.00	1220.00	3000.00
June	12061.70	4508.40	1210.90	382.10	610.50	1075.00	1274.80	3000.00
July	12228.30	4750.00	1004.60	408.00	663.20	1120.00	1282.50	3000.00
August	12004.20	4341.40	982.10	721.90	640.30	1114.00	1204.50	3000.00
September	11900.60	4152.10	947.30	914.50	620.80	1040.00	1225.90	3000.00
October	11910.90	3941.50	1120.50	870.40	615.40	1150.00	1213.10	3000.00
November	11542.30	3726.80	1040.00	830.20	584.90	1180.00	1180.40	3000.00
December	16348.20	3985.10	990.50	790.10	602.00	1260.00	1220.50	7500.00
Totals	147145.40	50402.70	12428.00	8095.90	7547.60	13427.00	14744.20	40500.00 (4)
Less: Amounts in excess of $4,800	24762.80	3462.80	—	—	—	—	—	21300.00
Taxable for FICA	122382.60	46939.90	12428.00	8095.90	7547.60	13427.00	14744.20	19200.00
Less: $3,000 to $4,800	15813.20	7113.20	—	—	—	900.00	600.00	7200.00
Taxable for unemployment	106569.40	39826.70	12428.00	8095.90	7547.60	12527.00	14144.20	12000.00

4 = Proved one pay against underlying evidence. Clock cards to payroll register to checks

(4) = Proved total to amount authorized in minutes

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to the register should be verified. Extensions of hours times rate should be calculated and compared with the gross earnings amount shown in the register. Amounts withheld should be deducted and the net pay proved. Tests should be made of the authority for the various deductions. The payroll register should then be footed and crossfooted and the totals traced to a payroll voucher or to the general ledger.

If payment is made in cash, the receipts signed by the employees should be compared with the net pay shown in the register. If checks are used, the individual checks should be compared as to name and amount with the register entry. The checks should be examined carefully for proper endorsements.

If labor records are available, the total time charged to the various departments or jobs for the test period should be compared with the total per the payroll register. This proof sometimes will expose payroll padding.

4. Verify year-end accrual. If the client has made the adjustment for the year-end accrual of wages and salaries, the auditor should examine the process used and verify the results. In some cases the auditor will be expected to make this adjustment. The payroll records may be set up in such a way that an exact computation of the accrual may be made. If wages are computed primarily on an hourly rate basis and no accrual has been made by the client, the auditor may feel that an estimate of the accrued wages rather than an exact computation will be satisfactory. Assuming no unusual factors, the number of days in the accrual period divided by the number of days in the work week times the total wages paid on the first payday in the new year will produce a reasonable accrual. If all wages are on a weekly basis, it is satisfactory to accrue on the basis of a daily average.

The first pay in the new period should be reviewed to determine the reasonableness of the accrual and to see that the liability recognized at the year end was actually paid off.

5. Examine disposition of unclaimed wages. The liability for unclaimed wages should be reviewed and the entire process of handling this liability examined to ascertain the controls in effect. If wages are paid by check, unclaimed checks should be written back to cash periodically to relieve the person reconciling the payroll bank account of the necessity of carrying the checks on his reconciliation. Although the checks technically are not outstanding since they are still in the possession

Exhibit 14-3

of the company, as a practical expediency they will probably be carried as outstanding checks on the reconciliation. The credit for the write back should be to unclaimed wages. If the payroll is paid in cash, a similar entry should be made periodically.

The auditor should then determine how the unclaimed wages are controlled and what evidence is demanded before any wages are released. The unclaimed wages account should be analyzed and all debits should be subjected to a searching scrutiny. Authorization for all dispositions should be demanded. Controls should be tight as this is a fruitful area for fraud, particularly if wages are paid in cash.

Accrued Payroll Taxes

The payroll summary (Exhibit 14-3) is helpful in the examination of payroll taxes and tax liability. There is not much to be gained by analyzing the accrued payroll tax accounts. A better approach is to work from the payroll summary, making independent calculations of both tax expense and tax liabilities and then comparing these amounts with the client's balances.

Exhibit 14-4, based on the payroll shown in Exhibit 14-3, shows one approach to the audit of the payroll tax expense and liability. The beginning balances should be traced to last year's working papers. Normally all amounts accrued as of December 31 are paid in January. The client's copies of the returns and the checks used to pay the amounts due should be examined and compared with the ledger balances. Then the expense for the current year should be computed. Different amounts of payroll must be used for the different taxes because of statutory exclusions. Most states have some type of merit rating plan which means not only that the rate will differ between companies but also that it will change for any one company depending on its labor turnover experience. For states not having a merit rating plan the rate is 2.7 per cent for unemployment insurance.

Payments of the tax should be vouched. The copies of the returns should be reviewed and the checks should be examined to determine that the amounts and payees are correct. In all but the smallest of companies payments of federal insurance contributions (both employees' and employers' portions) and income tax withheld must be paid monthly by the fifteenth of the following month to an authorized depository. Quarterly returns are required to be filed. The payment for the third month of the quarter may accompany the return if it is filed on or before

the last day of the month following the calendar quarter. If payment is made to a depository, the due date for filing the return is extended ten days. Depository receipts must accompany all returns.

State unemployment tax returns must be filed quarterly on or before the last day of the month following the end of the quarter. The quarterly tax must accompany the return. The federal portion of the unemployment insurance tax is filed on or before January 31 of each year for the preceding year. The total tax must accompany the return.

Deducting the total amount paid for the year to date from the total computed tax expense should result in the amount to be accrued at the year end. This should be the tax on the December payroll for FICA, the tax for the fourth quarter for state unemployment, and the tax for the year for federal unemployment. These amounts should be compared with the ledger balances. It is to be expected that minor discrepancies will be present because of the amount of detailed computations, half-cent breakage, employee turnover, and corrections of errors. If the discrepancies are relatively minor, they are ignored. If they are material, the auditor should review the client's work in detail to ascertain the cause of the variance. If the accruals prove out, the total payroll tax expense should be in close agreement with the expense per the books.

State and Local Taxes Accrued

State and local taxes abound in such a variety of forms that it is difficult to describe programs for specific taxes. Basically these taxes may be divided into two categories according to method of billing. In some cases the tax is self-determined, a tax return being completed and filed. In others the taxing authority computes the tax and bills the taxpayer.

The examination of accrued tax liabilities and the related expense accounts should start with analyses of the liability accounts. These analyses should disclose the amount of the liability and the amounts paid thereon. There should be no other entries in the accounts. The beginning balance in the accounts should be traced to last year's working papers. In some cases this balance will represent the total expense for the year, none of which has been paid. In other cases it will represent only an unpaid portion of the total liability.

The tax returns should be reviewed. If the returns were prepared by the client, the auditor should examine them carefully to determine that the liability is reasonable and that there is no probable additional

Exhibit 14-4

Hanf Manufacturing Co.
Payroll Tax Accounts
December 31, 1961

	Federal insurance contributions	Unemployment insurance — State	Unemployment insurance — Federal
Accrued, January 1, 1961	271 60	677 70	310 35
Payments, January, 1961	271 60	677 70	310 35
Taxable payroll per payroll summary	122382 60	106569 40	106569 40
Tax rates	.025	.027	.003
Tax expense	3059 57	2877 37	319 71
Payments made	2795 84	2167 89	—
Balance unpaid	263 73	709 48	319 71
Add: Employees' portion of FICA	263 79		
Liability, December 31, 1961	527 52	709 48	319 71
Clients' balances:			
Liability	527 55	709 67	319 74
Tax expense	3059 60	2877 56	319 74

No adjustment necessary

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tax that might be assessed when the return is audited by the taxing authorities. If the tax has been billed, the tax invoices should be examined. The total tax liability either from the return or from the invoices should be traced to the accrual account to determine the correctness of the total credit.

The debits should be traced to paid checks. The checks should be examined not only for amounts but also to see that they were made payable to and endorsed by the proper taxing authorities.

Once the credits and debits have been proved, the balance in the account should represent the year-end accrual. The auditor should review the account and the tax laws to ascertain that the liability is properly expressed and particularly that the expense has been charged to the correct period. As indicated earlier, in some cases an entire year's tax expense must be accrued at the year end. Particularly for real estate taxes, the tax may have to be estimated since the bills may not be issued until some months after the year end. A review of the preceding year's assessed valuations plus any information that may have been published relative to proposed changes in valuation or in tax rates should permit the computation of a reasonable estimate of expense for the year under review.

The correspondence files for the various taxing bodies should be reviewed to ascertain whether or not any additional taxes have been proposed or are currently being litigated. Discussions should also be had with the chief financial officer for the same purpose.

As a part of the verification of the accrued tax liabilities the related expense accounts should be reviewed. The reasons for this are to determine that the credits to the liability accounts have been properly classified in the expense accounts and that the correct periodicity has been observed. Furthermore, there may be some minor tax charges that have been put directly in the expense accounts without being reflected in the liability accounts. The auditor should be cognizant of these charges even if they are properly handled.

Other Accrued Liabilities

There are various other accrued liabilities which may appear on the client's books. The basic procedures to be applied are as follows:

1. Determine the reason for the account.
2. Prove the beginning balance to the preceding year's working papers.
3. Review the client's method of computing expense and accruing the liability.
4. Make tests of the payment of the liability.
5. Review the method of determining the year-end accrual.
6. Review last year's balance sheet for clues as to additional accruals that should be recognized.

7. Review the expense accounts for possible additional accruals that should be recognized.

Dividends Payable

Reference to the minutes of the board of directors' meetings should disclose any dividend declarations that have been made. Any dividend declared but not paid should be proved to the liability account. The number of shares outstanding may be obtained from the corporate records or from the transfer agent. The total shares outstanding times the rate per share authorized in the minutes should provide verification of the unpaid balance. A more detailed discussion of dividends paid will be provided in the section on retained income.

In large companies unclaimed dividends often pose a problem. Stockholders move and fail to notify the company of their new address. Some may die and their stock is temporarily or permanently lost. Others may, for various reasons, disappear. This creates difficulty for the company. Many thousands of dollars are spent trying to locate missing owners. The auditor's interest in unclaimed dividends lies in the protection afforded the company against the diversion of these unclaimed dividends to improper persons. The controls placed about this liability should be similar to those used for unclaimed wages. The liability for unclaimed dividend checks should not be written off to income unless and until there is positive proof that there is no person entitled to receive the dividend. As owners of the business the stockholders have a permanent claim against the company for dividends declared. However, some state laws provide that unclaimed wages, dividends, etc., must be turned over to the state treasury after a stipulated period. The auditor should be aware of such provisions.

Current Maturities of Long-term Debt

The examination of this liability will be made when the long-term debt is examined. The rules for the showing of current maturities as a current liability should be recalled. If the bond issue or a portion of it matures within the year and is to be paid from current assets, the maturing amount should be shown in the current section. If there is a sinking fund from which the maturing portion is to be paid, only maturing amounts in excess of the sinking fund should be shown as a current liability. The maturing amount should be indicated in the long-term debt presentation by showing the amount outstanding and a deduction for the current maturity. If the entire issue is maturing within

the year but is to be refinanced, the issue should remain in the long-term debt section, with full disclosure appended.

Obligations to Deliver Goods or Render Services

Customarily a company delivers merchandise or performs a service before being paid, but on occasion it receives cash in advance of performance of the contracted obligations. There are two basic situations involved. In one the use of current assets is required to complete the contract. Thus, an advance payment by a customer on an order for merchandise requires the use of current assets for the filling of the order. Theoretically, since current assets are used in liquidation of the debt, the advance should be classed as a current liability.

The other situation involves transactions in which income is received in advance of being earned but in which the passage of time alone converts the liability into income. Examples of this type are interest received in advance and rent received in advance. Here all that is necessary for the completion of the transaction is the passage of time. No current assets will be used to extinguish the liability. Any current assets involved in the transaction have already been used. From the point of view of good accounting theory such balances either should be included in a separate section between liabilities and net worth or set forth separately in the retained income section. Profit on installment sales deferred to future periods is also properly classified as deferred income. The liability aspect of these balances is negligible. However, there has been a trend over the past decade to include such items in the current liability section, on the basis of immateriality and balance sheet simplification, and because if the service is not performed a refund of current assets (cash) will have to be made.

The verification of the interest and rent received in advance is relatively simple. Interest should be related to the notes receivable and interest income. In fact, the verification of interest received in advance is normally accomplished during the examination of the notes receivable account. The lease or rent contract should be examined to determine the terms of payment. Payments should be traced to the cash receipts book and the computation then made of the amount to be included in income and the amount to be deferred.

Federal Income Tax Payable

The computation or estimate of federal income tax is left by many clients for the auditor to determine. Since it is dependent on net income

Harsco Steel Distributors, Inc.
Income Tax Worksheet
December 31, 1961

	Line	(1) Audited	(2) Statement	(3) Statement per return	(4) Cost of goods sold	(5) Dividends	(6) Compensation of officers	(7) Salaries and wages	(8) Taxes and donations	(9) Depreciation	(10) Schedule M	
1	Sales		1362800.00	(1362800.00)								
2	Inventory, January 1	172415.00			172415.00							
3	Purchases	821615.00			821615.00							
4		994030.00										
5	Inventory, December 31	186725.00			(186725.00)							
6	Cost of goods sold		807305.00									
7	Gross margin		555495.00									
8	Sales salaries	125853.00					25000.00	100853.00				
9	Advertising	24000.00		24000.00								
10	Delivery expense	72150.00		72150.00								
11	Miscellaneous selling exp.	26810.00		26810.00								
12	Warehouse expense:											
13	Labor	40615.00						40615.00				
14	Taxes	5680.00							T 5680.00			
15	Insurance	8450.00		8450.00								
16	Depreciation	13605.00								13605.00		
17	Office salaries	82580.00					50000.00	32580.00				
18	Supplies	5287.00		5287.00								
19	Telephone	3860.00		3860.00								
20	Property taxes	4415.00							T 4415.00			
21	Insurance	4250.00		2750.00							1500.00	Life insurance
22	Depreciation	7280.00								7280.00		
23	Donations	10000.00							D 8389.00		1611.00	Excessive donation
24	Total expenses		434835.00									
25	Net operating profit		120660.00									
26	Dividends received		20620.00			(20620.00)						
27			141280.00									
28	Loss on trade-in of											
29	delivery equipment		1280.00								1280.00	Loss capitalized
30	Net income and totals		140000.00	1219483.00	807305.00	(20620.00)	75000.00	174048.00	T 10095.00 D 8389.00	20885.00	4391.00	

it is usually the last account balance determined or verified. The determination of the *actual* tax liability is often deferred until a later date, the auditor or the client merely making a reasonably close estimate for purposes of the financial statements. The auditor should prepare a rough estimate of the tax liability and adjust the account to a rounded amount reasonably close to his calculation. If the client has already made the computation and recorded the liability, the auditor should make an independent proof of the reasonableness of the liability so recognized.

If the client prepares and files his own tax return, the auditor should review the return for the previous year to satisfy himself that there are no major errors of arithmetic, classification, or principle. He should analyze the liability account and make certain that the liability shown on the return is reflected in the account. He should then vouch the payments that have been made, making sure that the checks have been made payable to and were endorsed by the correct payee.

The correspondence file for the local District Director's office should be reviewed to determine through what years the returns have been audited and whether or not any additional assessments are proposed or are in process of being determined. This information should be noted in the permanent file.

If the auditor prepares the tax return, it is common practice to prepare a working paper which will segregate information required on the return. Such a worksheet is shown in Exhibit 14-5. The auditor's working papers should contain all the points pertinent to the preparation of returns. As the size of the company increases and its tax problems become more numerous and complex, it is customary to prepare a separate set of working papers for the return. This does not excuse the auditor from making in the audit working papers the notes necessary for the proper preparation of the return.

Summary

Miscellaneous liabilities include accounts to which particular procedures might apply. General procedures applicable to all (or most) of these accounts follow.

1. Analyze the account (if reasonable).
2. Review documentary (or other) evidence for credits to the account.
3. Examine checks in payment of these liabilities.
4. Prove the year-end balance of the account.

Exhibit 14-5

QUESTIONS AND PROBLEMS

1. Describe the three accounting systems commonly used to recognize and record liabilities. What variations in the application of auditing procedures are necessary because of the different systems?

2. In what particular points of internal control affecting accounts payable is the auditor interested?

3. What are the major objectives in the audit of payables?

4. Why should the auditor review the accounts payable control account for unusual entries?

5. What advantages are gained by preparing an aging schedule of accounts payable?

6. What purposes are served by making a test of purchase transactions?

7. Is the auditor qualified to determine the propriety of the classification of charges in the voucher register?

8. What difference is there in the confirmation of accounts payable as compared with accounts receivable?

9. What purpose is served by the examination of the receiving records for the last of the old and the first of the new year? Why generally should records of the new year be examined?

10. What interest has the auditor in old unpaid bills?

11. What advantages are there in using a discounts lost account?

12. Prepare an audit program for the examination of the payroll records for a company employing 100 men.

13. Why do unclaimed wages interest the auditor?

14. It is not uncommon to find debit balances in accounts payable. Give three possible causes of such balances. How would you classify these balances on the balance sheet?

15. In the tentative income statement for the year 1961, furnished you when you begin the examination of the Garner Company, you find taxes listed at $5,250. Your analysis of the ledger account, taxes, provides the following information:

Mar. 1	First half 1960–1961 real estate tax	$1,500
June 1	Second half 1960–1961 real estate tax	1,500
Dec. 1	First half 1961–1962 real estate tax	2,250
Total		$5,250

The tax year runs from July 1 to June 30. Tax bills are due at varying dates, usually late in the year and in the spring. Sometimes the first half bills are not issued until early in the new calendar year, although the liability attaches on July 1. You also discover a bill for the state franchise tax due November 1, 1961. This covers the year ending October 31, 1962. This bill is for $4,500, the same amount as was paid last year.

Prepare the working papers and adjustments for the tax accounts, as of December 31, 1961.

16. You have been retained by a bank to examine the books of Jones Bros., Inc. The brothers Jones are very uncooperative and refuse to give you any assistance. As your work progresses, you become suspicious of unrecorded liabilities, but the management refuses to allow you to circularize the creditors.

Indicate in some detail the steps you would follow to make reasonably certain that all major payables have been recognized.

17. Where you find no voucher register or purchase journal in which materials and expenses may be recorded as incurred, what precautions would you take to make certain that all liabilities have been recognized for balance sheet purposes?

18. A company is using the voucher system, modified as follows: Vouchers are prepared only when invoices are ready to be paid. The voucher is a duplicate of the top portion of the voucher check. The vouchers are attached to the proper invoices and filed alphabetically. The third copy of the voucher check is filed numerically. No voucher register is kept. At the end of each month, the third copies of the voucher checks are analyzed and classified and an entry is made debiting the proper accounts and crediting vouchers payable. Then a further entry is made debiting vouchers payable and crediting cash. A third entry records any unvouchered payables. The company buys from approximately 500 vendors.

Outline your audit program for the verification of accounts payable.

Exhibit 14-6

Date	*Voucher no.*	*Creditor*	*Amount*
Aug. 28	486	J. R. Smith	$ 686
Sept. 3	519	Reliable Vendors	392
7	528	Buckeye Sales, Inc.	98
8	530	Major Suppliers	343
10	536	Harris Future Co.	882
13	541	James Mercantile Co.	784
19	553	Hall Distributors	441
22	559	Andrews Supply Co.	686
26	567	Havens General Corp.	735
27	571	F. G. Hiley and Sons	196
30	584	Hall Distributors	588
30	585	Zehnker Art Supply	980
Total			$6,811

Exhibit 14-6 (Continued)

Voucher Payable Control Account

Cash disbursements	26,190	Voucher register	32,900
Purchase returns journal*	735		

* Vouchers 519 and 530 canceled as goods were returned in September.

19. What procedures would you follow in the examination of the account "income taxes withheld"?

20. The Haraband Company uses a voucher system. All invoices subject to terms of 2/10, n/30 are entered net with the discount entered in the purchase discount column of the voucher register. The regular bookkeeper has become ill and a new inexperienced person has been keeping the records. At the month end he finds that his unpaid vouchers do not prove against the vouchers payable control. You are called in to adjust matters.

A schedule of unpaid vouchers as of September 30, all of which are net of discount, is shown in Exhibit 14-6.

Prepare a corrected schedule of unpaid vouchers. Assuming the most probable cause, prepare the journal entry or entries necessary to correct the accounts.

21. In each of the following situations, indicate how much of the debt should be shown as a current liability.

	(1)	*(2)*	*(3)*	*(4)*	*(5)*
Total long-term debt	$2,000,000	$50,000	$100,000	$500,000	$200,000
Amount coming due within next year	2,000,000	5,000	20,000	500,000	25,000
Sinking fund available	—	—	25,000	465,000	22,000

22. In the course of your initial examination of the accounts of the Model Stores Company, you ascertain that a large portion of accounts payable outstanding at the close of the period is owing to six creditors. The manager of the company is hesitant to approve your request for confirmation, as some of the items are overdue and he is afraid that correspondence may give rise to demand for immediate payment.

What procedures will you now follow to prove that the amounts are correct and are payable to legitimate creditors?

23. You have agreed open vouchers with the control, have examined the supporting invoices, and have generally satisfied yourself that the *recorded*

accounts payable of your client are properly stated. List the steps you would take in searching for additional actual liabilities.

24. In examining invoices, you discover several invoices for large amounts missing. List the steps you would follow in satisfying yourself as to these items, assuming that ultimately you do not find them.

25. From the list of suggested procedures at the right, select those that you would use to verify accounts payable in each of the following situations.

1. Your client is a large manufacturer using a complete voucher system, with a tight system of internal control.
2. Your client is a medium-sized retail store, using a purchase journal and accounts payable system.
3. Your client is a small manufacturer. He records purchases through the cash disbursements book at the time he pays for them. The internal control is poor.

a. Take off list of unpaid vouchers from the voucher register. Prove against unpaid voucher file.

b. Take off schedule of account balances from subsidiary ledger.

c. Prove to control.

d. Examine statements of creditors.

e. Confirm accounts payable.

f. Test invoices with receiving stores' records.

g. Vouch entries in voucher register for test periods.

h. Vouch entries in purchase journal for test periods.

i. Vouch entries and distribution in cash disbursements journal for test periods.

j. Examine current unpaid invoice file.

k. Examine entries in voucher register for new year.

l. Examine new-year entries in purchase journal.

m. Examine new-year entries in cash disbursements book.

n. Set up unrecorded invoices.

Chapter 15

LONG-TERM DEBT AND CONTINGENT LIABILITIES

LONG-TERM DEBT

The one feature common to all types of long-term indebtedness is that they all become due more than one year from the date of the balance sheet. Long-term debt may be represented by bonds payable secured by a pledge of tangible assets of the issuing company, by bonds (debentures) secured only by the general credit of the company, by a mortgage payable secured by real estate, or by a long-term promissory note secured only by the general credit of the company.

The most common type of long-term debt is bonds payable. However, in recent years many companies have been able to borrow very large amounts of money from one institution, giving a promissory note (or notes) secured by a mortgage on real estate. The major distinction between such a mortgage payable and a bond issue secured by real estate is that the corporation issuing a mortgage note will sell it to only one person or institution, the mortgagee, while the company floating a bond issue must dispose of the total issue in small units to many people.

INTERNAL CONTROL AND LONG-TERM DEBT

Control exercised over original issue. The system of internal control should be such that there is no opportunity, without collusion, for the unauthorized issuance of long-term debt. It makes little difference whether the debt be a mortgage payable, part or all of a bond issue, or some long-term notes. The point at issue is that the authorization of all long-term debt should be a matter of such formality that lenders will refuse to loan unless they have received copies of the formal authorization of the borrowing.

Control exercised by independent parties. The bond indenture for most bond issues provides for employing a trustee for the bondholders. While his primary responsibility is to act as liaison between the bondholders and the corporation, he acts also as an independent outside agent whose presence tends to prevent fraudulent bond transactions by company employees.

In some cases a registrar and a transfer agent are also employed. The company is protected even more when this is done since all the bond transactions, after the original issue, now take place outside of the corporate organization.

Control over unissued bonds. Many times a company will authorize a bond issue which is larger than the amount of cash currently needed. Only part of the bonds authorized will be sold; unissued bonds will remain with the company. Proper controls must be placed over these bonds both as to their recording and their physical custody. In most cases the treasurer is the proper person to act as custodian of the bonds. Proper protection should be provided for the safekeeping of the bonds.

If the company is handling the detailed issuing and record keeping of the bonds, the auditor should satisfy himself that adequate safeguards prevail not only for the physical safekeeping but also for the record keeping. He should examine the subsidiary records to determine that they have been properly set up and that the recording has been done correctly. He should also see that provision has been made for taking periodic lists of the subsidiary records for proof against control accounts. This is of particular importance where the client has unissued bonds on hand. If an internal audit staff is available, their program should be examined to determine whether or not surprise examinations are made of the unissued bonds and of the detailed bond records.

Control over interest expense. The primary purposes of controlling interest expense are to be certain that the payments are made when due and that no more is paid than should be paid. Most trusteed issues provide that the company shall pay the interest to the trustee, who then shall distribute it to the bondholders. However, some companies pay the interest to the bondholders where bonds registered as to principal and interest have been sold. Interest on coupon bonds is normally paid by depositing the total interest in a bank designated as a paying agent. The bondholders clip the coupons and deposit them in their own banks. The coupons then flow through the regular banking channels until they reach the paying bank, where they are charged against the deposit of the

company. The auditor should satisfy himself that proper disposition of the paid interest coupons has been made. This is usually accomplished by cremation, in which case there should be a certificate attesting to the destruction of the coupons.

The auditor should review the procedure for handling unclaimed interest. Any unclaimed interest held by a paying agent should be brought back on the books and set up as a liability.

MAJOR OBJECTIVES IN AUDITING LONG-TERM DEBT

Primary among the objectives in auditing long-term debt is the verification of the balance outstanding at the year end. This verification is usually obtained by analysis of the records and by confirmation from outside parties.

Another important goal is the verification of the proceeds from the issuance of the bond, mortgage, or note. In connection therewith the auditor should satisfy himself that the accounting for the proceeds, including any premium or discount on the offering, was done properly.

As a third major objective the auditor should satisfy himself that the client has complied with the accounting requirements of the bond indenture or promissory note. He should confine his study to the accounting requirements, being careful to avoid commenting on any legal requirements.

Finally the auditor is interested in determining that the presentation of the long-term debt is satisfactory. The debt should be described on the balance sheet adequately enough that the reader of the statements is informed of all salient features of the issue. Full disclosure of all important data is required by generally accepted auditing standards.

AUDIT PROCEDURES AND TECHNIQUES

The major objectives discussed above are satisfied through the use of some or all of the procedures and techniques shown below. Not all of these apply to each type of long-term debt. The auditor selects those which apply to the specific situation and uses them.

1. Review authority for the issue. Authority for issuing the notes or bonds should be traced to the minutes of the stockholders' meeting and directors' meetings. In almost all cases the floating of long-term debt is of sufficient importance that the owners and/or directors will want to maintain control over its authorization. The details as disclosed by the

minutes should be compared with the terms of the actual issue to determine that the directions were followed.

2. Abstract (or review) provisions of the agreement. In the year of issue the auditor should abstract the major provisions of the loan agreement for inclusion in the permanent file. It may be that he can obtain an extra copy of the agreement or indenture from the client to keep in the permanent file. In succeeding years he should review the major provisions of the agreement before starting the audit of the long-term debt. This permits an intelligent review of the accounts.

From the agreement, or bond indenture, he obtains the name of the trustee, the total amount of debt authorized, the date of the debt and its maturity date, provisions for calling part or all of the issue prior to maturity, any premium attached to early calls, the interest rate, the interest dates, any provision for converting bonds to stock, and data concerning a sinking fund. Information with respect to any restrictions should also be included. Such items as the necessity of maintaining a specified current ratio, restrictions on the use of the proceeds of the issue, or restrictions as to the declaration and payment of dividends should become a part of the auditor's abstracts of the indenture for the permanent file.

3. Analyze the accounts. The activity in the long-term debt accounts is usually very limited or nonexistent. Nonetheless the auditor should start his examination by preparing an analysis of the account or by indicating on the working trial balance that no change has taken place. Where there have been entries in the account the analysis places before him the details of the activity and enables him to complete more easily the verification of the changes.

4. Vouch proceeds in year of issue. A bond issue may have been sold to an underwriting syndicate. The underwriting agreement between the corporation and the syndicate should be reviewed to determine the amount the client should have received. This amount should then be traced to the cash receipts records. Any difference between the amount received and the face of the bonds should be set up as premium or discount on bonds.

If the client company has handled the marketing of the bonds through its own promoters or salesmen, the auditor should read the agreement with the salesmen and review the sales record or other record that exists between the seller and buyer. Test tracings should then be made to the cash receipts record.

Where the debt consists of long-term notes placed with banks, the

details of the debt should be ascertained from the client's records. Again the proceeds should be traced to the receipts record. On long-term loans of this type interest is usually paid on an annual basis but not in advance, as is true when short-term notes are discounted. The entry in the receipts record should agree with the face of the loan.

5. In succeeding years vouch any changes in the account. All entries in the accounts should be vouched. If there are additional credits, the processes indicated in the preceding step should be followed. Debits to the accounts indicate payments of the debt, for which authorization should be sought in the minutes. The check in payment of the debt should be examined to determine whether or not the entire amount was paid. If the debt payment was made at a discount or premium, the accounting should be verified to make certain that the correct amount was charged to the long-term liability account. There should be available some evidence of the payment in the form of a bond or note. These should be examined to determine that they have been mutilated and cannot be reissued.

If a maturity of a serial bond issue has been paid, the auditor should take off a list of the numbers of the bonds redeemed so that he may ultimately account for all bond numbers. In some cases the bonds will have been destroyed. There should then be a certificate from the destroying company indicating the numbers of the bonds destroyed.

All charges to the liability account should be supported by three pieces of documentary evidence. These are the minutes authorizing the payment, the check used in payment, and the canceled note or bond or crematory certificate.

6. Obtain confirmation of the debt. Confirmation of the indebtedness should normally be requested. If the debt is represented by a trusteed bond issue, a letter should be sent to the trustee requesting confirmation of such items as the total authorized issue, the balance outstanding, the amount of interest unpaid by the company, and any unclaimed interest held by the trustee. If the trustee also manages a sinking fund in connection with the issue, he should be requested to confirm the composition of the fund and its balance at the balance sheet date.

If the entire debt is held by an individual, a bank or other institution, a confirmation request should be directed to the holder. This request should call for confirmation of the date (original and maturity) of the loan, the original amount of the loan, the balance outstanding at the balance sheet date, a description of any security for the loan, and the date through which interest has been paid.

It is not customary to request confirmation from individual bondholders even in the rare cases where there is no trustee for the issue and thus no place where the auditor may obtain confirmation of the total bonds outstanding. However, it may become necessary to request such confirmation where the client's records are in very poor shape or where the facts are in dispute. Often in cases where the client's records are not adequate or are poorly kept the auditor will maintain a record of ownership as part of his permanent file (see Exhibit 15-1). Moreover, in many of these small issues the bonds are registered both as to principal and interest, and endorsement of the interest checks gives an implied confirmation of bond ownership. It may be assumed that if there has been a transfer of the bond the new owner will protest vigorously if he does not receive his interest check when it is due.

7. Verify recording of the mortgage. In the year of issue the county records should be examined to determine that the mortgage deed has been correctly recorded. This examination need not be repeated after the first year until the debt is paid and the mortgage is canceled. The auditor should then ascertain that the cancellation has been recorded.

8. Determine whether client is complying with accounting provisions of indenture. The auditor has a responsibility to management and to the bondholders to determine whether or not the accounting requirements and restrictions set forth in the agreement are being observed. As a matter of full disclosure the auditor should indicate in his long-form report whether or not the requirements are being fulfilled. It material requirements have not been met, the deficiencies should be reported.

The auditor should be very careful to restrict his comments as to compliance to those phases of the agreement which clearly are matters in the accounting area. If he feels that the client is also failing to live up to some of the legal requirements of the document, he should suggest that the client confer with the company counsel. The auditor should be extremely careful to refrain from making any comments or interpretations which might imply that he is making legal decisions.

9. Vouch interest transactions. Interest payments on long-term debt should be proved to the related liability working paper. The examination should be made to prove that: (1) all interest payments due on the debt have been paid on time and (2) all interest payments made are directly related to liabilities recognized on the books. In other words, the auditor should prove that all interest payments recorded in the interest expense account are the result of debts shown on the records. Some debts may have been paid during the year, but they should appear on the various

Permanent File

Jenkins Corp.
5% Bonds Payable (Serial)
December 31, ~~1958~~ ~~1959~~ ~~1960~~, 1961

Bondholder	Bond	January 2, 1958	December 31, ~~1958~~ 1959	Transfers	December 31, 1960	Transfers and redemptions	December 31, 1961
R. B. Burkhart	X 2	2000.00	2000.00		2000.00	(2000.00) V	–
W. D. Dooley	3	1000.00	1000.00		1000.00		1000.00
H. D. Allen	X	1000.00	1000.00		1000.00	(1000.00) V	–
C. B. Boder	5	1000.00	1000.00		1000.00		1000.00
W. K. Cookston	X X 8	3000.00	3000.00		3000.00	(2000.00) V	1000.00
Harry Dailey	9, 10, 11	3000.00	3000.00		3000.00		3000.00
S. J. Ellis	12, 13, 14	3000.00	3000.00		3000.00		3000.00
William Hunter	X	1000.00	1000.00	(1000.00)	–		–
E. B. Kray	X X	2000.00	2000.00		2000.00	(2000.00) V	–
J. W. McCann	18, 19	2000.00	2000.00		2000.00		2000.00
B. C. Quintance	X, X, 22	3000.00	3000.00	(2000.00)	1000.00		1000.00
John Schmidt	23, 24, 25, 26	4000.00	4000.00		4000.00		4000.00
James Sipe	X	1000.00	1000.00		1000.00	(1000.00) V	–
Peter Smelty	X, X, X, X	4000.00	4000.00		4000.00	(4000.00)	–
Luke Stemler	32, 33, 34	3000.00	3000.00		3000.00		3000.00
R. D. Watrous	35	1000.00	1000.00		1000.00		1000.00
Total issue		35000.00 X	35000.00				
Paul De Lowe	15			1000.00	1000.00		1000.00
J. O. Quintance	X, X			2000.00	2000.00	(2000.00) V	–
				-0-	35000.00		
Horace Seward	28, 29, 30, 31					4000.00	4000.00
						10000.00	25000.00

Balance sheet presentation

	1960	1961
Current	$ 10000.00	$ 5000.00
Long term	25000.00	20000.00
	$ 35000.00	$ 25000.00

X = Examined cash receipts book. Examined minutes for authority to issue.
V = Examined checks in payment of redeemed bonds.
Examined redeemed bonds. Properly mutilated.
Contract calls for redemption of $10,000 on 1/1/61 and $5,000 each January 2 thereafter.
Bonds redeemed January 1, 1961 – #1, 2, 4, 6, 7, 16, 17, 27, 21, 22.

analyses. The point to be made is that the interest expense shown on the various liability schedules when totaled should agree with the adjusted balance in the interest expense account. If this total is less than the account balance, it means either that interest has been paid on some unrecorded liability or that the auditor does not have a record of all liabilities and related interest.

The vouching of interest transactions includes an independent computation of the interest charge and an examination of the checks used to pay the interest. The name, amount, and endorsement should be carefully examined to see that the proper person received the proper amount of interest.

The amount of interest accrued at the year end should be developed in connection with the liability schedule. If the amount has already been booked, the auditor's computation should be compared with the account balance. Otherwise the auditor should set up the adjustment necessary to bring the account into agreement with the facts.

10. Verify discount or premium adjustments. If the issue was originally floated at a premium or a discount, the auditor should see that the correct adjustment of the account has been made. The basis for the annual adjustment should be included in the permanent file.

If any part of the bond issue is retired, the proper proportion of the premium or discount should also be retired. Ordinarily this does not present any complexity unless the bonds are part of a serial issue. Here the customary practice is to use the bonds outstanding method. As long as the retirements are made according to the original plan there is no adjustment to the premium or discount account for the retirement, since each retirement was anticipated in the original scheduling of the bonds outstanding.

11. Examine treasury bonds, if any. If the client has purchased some of its own bonds either on the open market or directly from bondholders, it may do one of two things with them. It may hold the bonds as treasury bonds or it may retire them. If the bonds are held in the treasury, no interest should be paid on them. They should be presented on the balance sheet as a reduction of the outstanding bonds. If, however, the bonds are held by the sinking fund trustee and the fund is being accumulated on an actuarial basis, interest will be paid to the trustee so that the fund may increase as intended. The bonds may be shown as part of the sinking fund assets or as a reduction of outstanding bonds.

Exhibit 15-1

If the bonds have been retired, the bonds payable rather than a treasury bonds account should be debited. The auditor should examine the canceled bonds or a statement certifying to their destruction. Regardless of whether the purchased bonds are held or retired, the auditor should apply the same audit procedures as he applies to bonds and stocks held as investments.

Summary

The major audit procedures used in auditing long-term debt are listed below.

1. Review the authority for issue and payments.
2. Review abstract of indenture. Determine that client is complying with accounting provisions.
3. Analyze the account.
4. Vouch all changes.
5. Obtain confirmation from lender (or trustee).
6. Prove interest payments and expense.

CONTINGENT LIABILITIES

A distinction must be drawn between estimated liabilities and contingent liabilities. There is no question concerning the factual nature of an estimated liability; doubt exists only as to the amount. This is illustrated by the estimated federal income tax payable. It is probable that the tax return will not have been completed by the time the examination is finished. Hence an estimate will be made of the amount payable, which will be included as a current liability. The debt is owed and must be paid but, at the moment, the exact amount is not known.

Contingent liabilities, on the other hand, are those in which there may never be an actual liability. Whether or not liability finally attaches is dependent upon the occurrence of some future event. One event has already occurred but another must also take place. In opposition to the existing liability of current federal income taxes payable is the contingent nature of a proposed deficiency assessment. Discussion between representatives of the client and the Internal Revenue Service and/or the courts will determine whether or not the contingent liability becomes an actuality. Similarly, whether or not the contingency indicated by a pending lawsuit becomes actual will be determined by a judge and/or jury. Until this future event has taken place there is no actual liability.

Contingent liabilities may be disclosed by a footnote to the balance

sheet, by an appropriation of retained income, or by being shown short in a contingent liability section on the balance sheet. Since the statements are the representations of management, it is customary to follow the client's wishes in reporting the items.

The auditing of contingent liabilities is a task that exercises all the ingenuity the auditor can muster. The major difficulty is that many of these contingencies may not be recognized as such. The auditor must use such procedures and techniques as he is able to search out and disclose the contingencies. Generally he will do this by direct questioning and by examining documents in related areas.

AUDIT PROCEDURES AND TECHNIQUES

1. Examine purchase and sales commitments. The purchasing records should be examined from two viewpoints to determine whether there are any commitments that might result in possible losses. First they should be compared with current market prices to see whether any future loss is probable because of current depressed market prices and fixed contract prices. It should be recalled that if there is a firm sales contract covering the purchase contract, no consideration need be given the current market price. Secondly, the commitments should be reviewed to determine whether or not they are greatly in excess of the company's needs or capacities. Direct questioning of the purchasing agent and perhaps of the heads of the planning and production departments should satisfy the auditor as to possible future losses.

It is just as possible to take losses on sales commitments as it is on purchase commitments. The sales contracts should be reviewed to determine that costs are still in line with sales prices. Again, if sales contracts are covered by purchase contracts, there may be no cause for alarm. However, while material costs may be contracted, it may well be that labor and overhead costs could not be so covered and have risen far beyond the costs originally computed when the order was taken.

Such possible future losses come under the heading of contingent liabilities. Where material, the possible loss should be disclosed. The loss may be estimated and set up as an appropriation of surplus, or it may be shown in a footnote to the financial statements.

2. Review pending lawsuits. Discussions with the officers of the company should disclose whether or not any lawsuits are pending or have been settled unfavorably to the company in a lower court. The auditor should write to the company counsel inquiring as to any pending lawsuits

and asking also whether the attorneys have billed the client for services rendered up to the year end.

Such a suit might arise as a result of an accident in which someone outside of the company has been injured or killed. It might be initiated by a competitor as a claim for damages for patent infringements. Suit might also be brought by a consumer of the company's product on the basis of injury due to the use of the product. The causes are many. The auditor's interest is to see that proper disclosure is made.

This contingency may also be handled either as a reservation of surplus or as a footnote. It is practical to assume that most clients will prefer to show this as a footnote, since recognition in the accounts may to their minds indicate to the opposition an acceptance of guilt. The company may already have prepared the financial statements properly footnoted. It would then be most unusual for the auditor to insist that a change be made from a footnote to a surplus appropriation.

3. Check other contingencies. The correspondence file with the Internal Revenue Service should be scanned to determine whether or not any deficiency assessments have been proposed. This review should also indicate through what year the tax returns have been audited and closed.

The bank confirmations should include the details of any notes receivable that have been discounted. Although a more complete disclosure is obtained by showing these discounted notes on the face of the balance sheet as a deduction from notes receivable, the method most commonly used is to set them forth in a footnote. Accommodation endorsements occasion a contingent liability somewhat similar to that of notes receivable discounted.

Obviously, materiality is a very important factor in the decision as to disclosure or nondisclosure of contingent liabilities. The client normally will be somewhat loath to disclose the items. After considering all the factors involved, including the materiality of the item, the auditor must decide whether he will insist on disclosure. This disclosure may come in the financial statements if the client agrees or may be shown as an exception in the auditor's short-form report.

4. Obtain a liability certificate. As a final step in the examination of all liabilities the auditor should request a statement from the client setting forth factual data and the client's opinion as to the recognition of all liabilities. Such a representation is shown in Exhibit 15-2. This statement does not relieve the auditor of any of his responsibilities in his examination. It does not give a statement behind which he can hide deficiencies in his review, but it does impress on the client the fact that all the fi-

nancial statements are managerial representations and represent a primary responsibility of management. Part of management's responsibility is to provide the auditor with all the information he needs to permit him to form an opinion as to the fairness of the statements. The liability certificate provides the auditor with certain information needed in the formation of this opinion. Furthermore, it indicates to the client that there are certain areas where it is difficult, if not impossible, for the auditor to obtain basic information by himself.

Exhibit 15-2

GENERAL MANUFACTURING COMPANY

11116 West High Street

Columbus 51, Ohio

March 12, 1962

Abner & Jones
Certified Public Accountants
Columbus, Ohio

1. As of December 31, 1961, all liabilities for materials and supplies, on hand or in transit, to which we had title, had been recorded on our records, except as follows:

2. All wages, salaries, and expenses had been recognized as of that date, except as follows:

3. Neither at that date nor now were any inventories, real estate, or other assets hypothecated or assigned as security for any loan, except as follows:

4. There are now and were at that date no proposed additional assessments of federal income taxes, except as follows:

5. No contingent liabilities existed as of December 31, 1961, nor do any now exist, on account of pending lawsuits, accommodation endorsements, guarantees, notes receivable discounted, or for any other reason, except as noted below:

6. The company is the record owner of all real estate recorded on the books, none of which is mortgaged, except as follows:

GENERAL MANUFACTURING COMPANY

By ______________________________
President

QUESTIONS AND PROBLEMS

1. Define *long-term debt.*

2. List as many classes of bonds as you can with respect to the security behind the bonds.

3. What major points of internal control affect bonds payable?

4. List eight items of interest concerning a bond issue which you should obtain from a trust indenture and/or the trustee's confirmation.

5. What evidence would you seek in verification of debits to the bonds payable account?

6. Give three examples of contingent liabilities. What audit techniques would you use to discover each?

7. In his 1960 examination of The Products Company the auditor verified the existence of a mortgage payable of $100,000 by obtaining confirmation from the mortgagee, by examining the mortgage book in the county recorder's office, and by tracing into the cash receipts book the proceeds from the mortgage. As of December 31, 1961, he found a receipt for payment of $20,000 on the debt. Without taking any other steps he reported the balance in the balance sheet at $80,000.

Should additional steps have been taken to verify the balance of the mortgage? If so, state what should have been done.

8. State two primary reasons why the auditor should abstract the trust indenture.

9. Your client has a 5 per cent $500,000 first mortgage bond issue outstanding. The client also manages a sinking fund for the retirement of the bonds. During the year he purchased on the open market $100,000 worth of his own bonds payable at par. These he put in the sinking fund, which now amounts to $126,452.

How should these treasury bonds be shown in the year-end financial statement?

Exhibit 15-3

Total amount	$250,000
Date of issue	October 1, 1959
Proceeds from issue	$245,000
Interest rate	5 per cent
Interest payment date	October 1
Maturity date	$50,000 annually, starting October 1, 1961

5% Serial Bonds Payable

10/1/61	VR	50,000	10/1/59	CR	245,000

Accrued Interest Payable

		1/1/61	3,125

10. You are examining the records of the Bonner Corporation for the year ended December 31, 1961. This is the first time the company has been audited. The company floated a serial bond issue in 1959. The details of the issue and the accounts, as of December 31, 1961, are shown in Exhibit 15-3.

You are to prepare working papers for the affected accounts. Include a list of journal entries and programs of work done.

Chapter 16

PROPRIETORSHIP ACCOUNTS

SINGLE PROPRIETORSHIPS

The assumption is sometimes made that if the accounting equation holds true, if assets minus liabilities equals proprietorship, then, having satisfied himself as to the reasonableness of the asset and liability accounts, the auditor has little or no concern with the residual account in a single proprietorship. This is not true for several reasons. Since much of the audit has been made on the basis of tests, it is necessary to examine the proprietorship account in even greater detail than has been true of the asset and liability accounts because all operating transactions come to rest finally in the equity account. The following procedures will help the auditor form an opinion as to the reasonableness of this final balance sheet account.

AUDIT PROCEDURES AND TECHNIQUES

1. Analyze the accounts. The equity accounts usually found are the proprietorship account and a temporary withdrawals account. Several alternative names may be applied to each of these accounts, but regardless of the names used the auditor should analyze each of them. Exhibit 16-1 illustrates such an analysis. The proprietorship account often contains only the beginning of the year balance. On occasion an additional investment will be made, which may be found in either the proprietorship account or in the withdrawals account. All additions to the owner's equity should be vouched regardless of which account is credited. Frequently the offsetting debit is to cash, but it may be to other asset accounts. In rare cases debits may be found in liability accounts. Usually this merely means that a short cut has been taken and that a cash in-

Exhibit 16-1

Harold's General Store
Proprietorship Account
December 31, 1961

Line	Description	Amount	Mark
1	Balance, December 31, 1960	32461 80	✓
3	5/17 Investment	1500 00	T
5	8/28 Contributed personal adding machine to business	75 00	X
7	Balance per ledger, December 31, 1961	34036 80	
9	Net income ($9,362.51) less withdrawals ($6,000)	3362 31	
11	Balance per audit	37399 11	

✓ = Traced to last year's working papers.
T = Traced to cash receipts record.
X = Examined adding machine. Valuation is reasonable.

[illegible]

vestment in the form of a payment to creditors from the owner's personal funds did not go through the cash account. Nonetheless it should be recognized for what it is, a cash receipt and a cash disbursement.

Debits made to other assets result from contributions of assets other than cash from the personal assets of the owner. There may be some

doubt in the auditor's mind (and even in the proprietor's mind) as to the accuracy of the valuation of such assets. A good example of such a situation is found in the contribution of a used fixed asset which the owner had previously used for personal affairs and for which no records had been kept. Here the auditor and the owner must agree to the reasonableness of the valuation of the item.

2. Obtain approval of withdrawals. Exhibit 16-2 illustrates the analysis of a withdrawals account. This analysis has several purposes. First it serves to inform the auditor as to the type and size of drawings the proprietor makes. This is important from another point of view, to be discussed in the next section.

The analysis of the withdrawals account normally should show each drawing separately. The drawings may be shown in only one amount if they are constant, for example, twelve at $400 each. The analysis sheet then serves as a listing of drawings which the owner should be requested to examine and to sign if it is correct. In other words, the auditor asks the owner to confirm the drawings as shown on the books. In a very small enterprise where the owner is the manager and operator this request loses some of its significance. As the business unit grows and the owner has less personal contact with operations and accordingly loses some of the personal control he formerly exercised, the request becomes important, for it forces the owner to scan this account carefully. Presumably if there are unauthorized charges to the account, he should be able to recognize them and to point them out. Through this process the owner regains a little of the control he has lost.

The auditor should vouch most of the debits and all of the credits found in the withdrawals account. He should make certain that there are no credits to the account for interest on investment or for a salary for the owner. Debits resulting from withdrawals of merchandise may be difficult to vouch but the attempt should be made.

Some owners consistently pay personal bills from business funds. In fact, some owners have only one checking account and run all their personal checks through the business account. This makes the task of analyzing the withdrawals account difficult. It also means that the cash examination must be almost a complete examination to make certain that all personal checks have been charged to the withdrawals account. Invoices must be matched with checks to be absolutely sure of the propriety of the charge. The auditor should recommend to these clients that they establish separate bank accounts for their personal transactions. Even when this is done, force of habit and convenience may cause certain

Exhibit 16-2

I. R. Persons
Withdrawals
December 31, 1961

Line	Date	Description	Dr.	Cr.
1	1/31/61	Cash	500 00	
2				
3	2/23	Check to Harris Furniture Co.		
4		Furniture for home	1143 80	
5				
6	2/28	Cash	200 00	
7				
8	3/30	Cash	250 00	
9				
10	4/30	Cash	300 00	
11				
12	5/31	Cash	350 00	
13				
14	6/30	Cash	1000 00	
15				
16	7/18	Cash	500 00	
17				
18	8/31	Cash	400 00	
19				
20	9/30	Cash	300 00	
21				
22	10/31	Cash	200 00	
23				
24	11/30	Cash	300 00	
25				
26	12/20	Cash	500 00	
27				
28	12/31	Cash	56 20	
29				
30		Balance per ledger, December 31, 1961	6000 00	
31				
32		Net income for year	14862 15	
33				
34		Transfer to capital account	8862 15	
35				
36				
37		Examined all checks. Mr. Persons reviewed this sheet		
38		and approved it verbally. He signs all checks.		
39				
40			[illegible]	

personal transactions to continue to be run through the business account.

3. See that no withdrawals are expensed. Each reader of this text can probably call to mind some situation in which he knew that an owner of a business had withdrawn either cash or merchandise without recording it. This practice is reprehensible for it represents a dishonest

practice. Each auditor should take such steps as he can to assure himself that his client does not engage in this practice. Failure to record withdrawals results in an incorrect net income, which results in a misstated federal income tax liability. Federal income taxes—both the expense and the liability—are usually omitted from the business statements of a sole proprietor because he usually has other items of income and deductions includible in the tax return and thus this would show only a portion of his tax expense and liability. Nonetheless if the withdrawals are not shown in the business records, it is doubtful that they would be picked up for tax return purposes.

The auditor certainly is not a representative of the tax collector. He has no duty to report what he senses, or knows, are violations. Yet as a citizen he should have an interest in seeing that each other citizen pays all the taxes that he owes. Moreover, as a highly ethical professional man he should be distressed at any signs of unethical practice on the part of his clients.

Obviously, the auditor is no more interested in insignificant amounts in this area than he is in any other. A review of the analysis of the withdrawals account should provide him with a basis for forming a tentative opinion as to the reasonableness of the owner's cash drawings. The owner may well support a case of no drawing by indicating that he has other sources of income which he uses for living purposes. If the auditor prepares the client's tax return, he will be aware of these sources and of the reasonableness of such a statement.

The auditor should also discuss with his client the undesirability of making merchandise withdrawals without charging them to the withdrawals account. If no record is made, the cost of goods sold is overstated and gross and net incomes are understated. It might be well to point out to the client that the Internal Revenue Service has access to statistical data which pretty well indicate how much this particular business should have sold and how much gross income it should have made, when compared with businesses of similar size in comparable locations. Granted that the auditor can use little except moral suasion and psychological arguments, the author believes he should use these to such degree as the circumstances indicate.

4. Prepare statement of changes in capital. When he has satisfied himself as to the correctness of the entries in the proprietorship accounts, the auditor should prepare a statement of changes in capital. This is a simple statement indicating the sources of the changes. An example is shown in Exhibit 16-3.

Exhibit 16-3

JONES DRUG COMPANY (NOT INC.)

Statement of Changes in Owner's Equity

For the year ended December 31, 1961

Balance, January 1, 1961		$32,461.20
Add: Additional investment		5,000.00
		$37,461.20
Net income for year	$15,450.62	
Less: Withdrawals	9,911.82	
Retained in business		5,538.80
Balance, December 31, 1961		$43,000.00

PARTNERSHIPS

The examination of the equity accounts of a partnership will follow along the same lines as those of a single proprietorship. Additional problems are presented because of the fact that more than one person is involved and because some actions by individual partners affect the equities of the remaining partners.

AUDIT PROCEDURES AND TECHNIQUES

1. Read and abstract the partnership agreement. In a first audit the examiner should read and abstract the partnership agreement for inclusion in the permanent file. Although every partnership should have a written agreement, not all firms do. Where one is not in existence, the auditor should attempt to convince the client of the wisdom of having one prepared by the client's attorney. Under no circumstances should the auditor attempt to write up such an agreement. After one has been prepared, he may wish to point out deficiencies in the agreement and suggest that it be returned for redrafting.

It may be that the partners refuse to have a written agreement prepared. The auditor then is forced to set up for his personal use the terms of the division of profits as agreed to by the partners. This should be written in ink and should be signed by all partners so that the division of profits drafted by the auditor is supported by some documentary evidence. The partners may of course decide at any time to change the method of sharing profits. As long as there is agreement among the partners, the auditor will abide by their wishes. If there is disagreement, the

auditor has evidence that at one point they did agree as to the division. In addition to the method of dividing profits and losses, the auditor is interested in the amount of original investment, the maximum withdrawals that each partner may make, and the methods of making up deficiencies.

In succeeding audits the partnership agreement should be reviewed to determine whether or not any changes have been made. All changes affecting accounting matters should be changed in the abstract of the agreement. The auditor's work in connection with the partnership agreement should be done in such a way that he handles only accounting matters and leaves the legal aspects to the client's attorneys.

2. Analyze capital and personal accounts. In addition to analyzing the equity accounts and to seeing that they are in line with the terms of the written agreement, the auditor should determine whether or not there are any additional amounts due from or to the individual partners. For internal accounting purposes these may be set up as accounts receivable or payable. If the firm encounters financial difficulties, these accounts will be merged with the equity accounts. The analyses of these receivable and payable accounts should indicate the cause for the establishment of the account and the indicated terms and method of payment.

3. Obtain approvals for withdrawals. The mere fact that a business is conducted under a partnership form of organization rather than as a sole proprietorship does not necessarily indicate that it is larger than a proprietorship. However, the partnership form is often an outgrowth of a single proprietorship brought about by the growth of the business and the necessity of obtaining additional capital. This additional capital then tends to cause such additional growth in the size of the business that it is not at all unusual for a firm to expand to the point where the partners are all in administrative positions and have little contact with actual operations. It is in this situation that it becomes relatively important for the auditor to list the withdrawals of each partner and to have the partner initial or sign approval of his own withdrawals. This serves to focus the attention of the partner on the activity in his account for the year and also serves as some protection for the auditor.

4. See that no withdrawals are included in expense. Since some partnership agreements include interest on capital and salary credits as provisions of profit distribution, it is not unusual to find these items charged to interest and salary expense accounts. The charges should, of course, be made to the profit and loss summary account if they appear at all as individual items. The auditor should review the interest and

salary expense accounts to make certain that such erroneous charges are not included therein.

The withdrawal of merchandise by partners with failure to record the withdrawal is even more serious in a partnership than in a sole proprietorship, for here the partners' equities are affected. Only when the withdrawals are in precisely the same proportions as are the distributive shares of profit will there be no inequity between partners.

By discussions with the partners and by reviewing the records, the auditor comes to a decision concerning the presence or absence of unrecorded merchandise withdrawals. Usually he should point out to the partners not only that such transactions are inequitable but that they represent a bad business practice, which sooner or later may boomerang to their discomfort.

5. Verify the division of profit. The auditor should verify the division of profit along the terms indicated in the partnership agreement. He should have no interest in the equity or apparent inequity of distributive ratios. The partners presumably knew what they wanted when they agreed to the arrangement, and it is not the auditor's task to attempt to rearrange the method of distribution. Particularly he should not seek out one partner and indicate that that partner is at a disadvantage. If there is anything at all concerning the agreement which the auditor feels must be discussed, it should be done only in a meeting of all the partners Otherwise the auditor, who has been engaged by the firm, is discriminating in favor of one member of the firm.

Net income may be divided by a firm in so many ways that no attempt will be made here to describe the various methods. It is assumed that the student has learned the basic methods of division. Beyond this point special conditions require special methods. The method should be clearly described in the written agreement. If there is no written agreement, the partners will need to indicate to the auditor the terms of the oral agreement. In those rare cases where there has not even been an oral agreement, the income or loss must be divided equally among the partners. Regardless of the complexities involved, the auditor need only apply the terms of the agreement to the net income or loss and make a final distribution according to those terms.

6. Prepare a statement of changes in capital. After the division of net income has been determined, the auditor should prepare a statement of changes in partners' capital. There are several forms in use for this purpose, one of which is shown as Exhibit 16-4. All factors entering into the division of profit may be clearly set forth in this statement; or only

the net distributive shares may be included here with the factors being shown in the income statement as a subschedule (after net income has been determined) showing the disposition of net income.

Exhibit 16-4

HARRIS, ICEL, AND JONES

Changes in Capital

Year Ended December 31, 1961

	Total	*Harris*	*Icel*	*Jones*
Balances, January 1, 1961	$52,625.00	$18,412 25	$24,562.15	$ 9,650.60
Additional investments	15,000.00	3,000.00	—	12,000.00
Total	$67,625.00	$21,412.25	$24,562.15	$21,650.60
Net income				
Interest (beginning capital)	$ 3,157.50	$ 1,104.73	$ 1,473.73	$ 579.04
Salary	3,600.00	1,200.00	1,200.00	1,200.00
Balance	13,242.50	3,972.75	3,972.75	5,297.00
Net income	$20,000.00	$ 6,277.48	$ 6,646.48	$ 7,076.04
Less: Withdrawals	18,000.00	7,000.00	6,000.00	5,000.00
Net increase in capital	$ 2,000.00	$ (722.52)	$ 646.48	$ 2,076.04
Balances, December 31, 1961	$69,625.00	$20,689.73	$25,208.63	$23,726.64

CORPORATE EQUITY ACCOUNTS

Terminology used in printed reports, especially as it affects corporate equity accounts, has undergone drastic changes in the past two decades. It is quite possible that the pendulum has swung as far as it will go and is now in a reversing process. Certain it is that in recent years there has tended to be a settling of the wild gyrations represented by the new and unusual titles for these accounts and a concentration around some that will probably become generally accepted. The reader should also recognize that the "old-fashioned" account titles may still be used in the books of account of many of the companies who use the new titles in their published reports.

Two of the changes which have been most universally accepted are discussed below. The use of the word "reserve" as an account title has been restricted to surplus reserves. Valuation reserves and liability reserves have been replaced by such words as "estimated," "provision,"

and "allowance." This change is commendable since it removes ambiguity and makes for a more understandable statement for those readers not trained in accounting. In this text an attempt has been made to conform to this change.

The second most commonly accepted change substitutes for "earned surplus" some title such as "retained income." Since to many readers "surplus" connotes "extra or not needed cash," the change was welcome. However, the author believes that this change has been restricted to statements. The title "surplus" is still used freely whenever accountants gather together and talk. Hence, the terms "earned surplus" and "retained income" have been used interchangeably throughout the text.

INTERNAL CONTROL AND EQUITY ACCOUNTS

The important points concerning internal control and the equity accounts of single proprietorships and partnerships were discussed in the sections dealing with those forms of organization. Consideration is now given to the corporate accounts and the phases of internal control affecting them.

Authorization for entries. The system of checks and balances should be so devised that a responsible official is required to approve all entries to the equity accounts. In a large company this official may be the controller; in a small company it may be the treasurer or the president. The auditor should observe that such approval is built into the system and then should determine whether or not the control is actually used.

Control exercised by independent agents. The use of a registrar and a transfer agent by a corporation injects a measure of control into the record keeping. These independent agents perform details of the record keeping of capital stock, relieving the corporation of this work. The two parties are usually banks or trust companies. One company may not perform both functions.

The major duty of the registrar is to determine that the company does not issue shares of capital stock in excess of the amount authorized by the corporate charter. He must examine (and sign) all stock certificates prepared by the transfer agent. When transfers of stock are made, both old and new certificates are sent by the transfer agent to the registrar, who thus determines that no new (additional) shares are being issued.

It is the task of the transfer agent to maintain a record of the name and address of the stockholders of the company and the number of shares owned. When a stock certificate is transferred from one individual

to another, the transferor's certificate is sent to the transfer agent. He cancels the old certificate, prepares a new one in the name of the transferee, and corrects his record of stockholders. These certificates are both sent to the registrar, who signs the new certificate and returns them to the transfer agent. The agent files the canceled certificate and sends the new certificate to the transferee. In this way the transfer agent has a current list of stockholders at all times. He will, on request, supply the company with the current list of owners to whom dividends should be paid.

With the registrar keeping a current list of the total number of shares outstanding, an independent proof of the company's records of capital stock is maintained. It is to be understood of course that where these records are maintained independently the corporate records will be confined to the general ledger accounts for capital stock.

Control over unissued certificates. If the corporation keeps its own capital stock records, there will be a stock certificate book with blank certificates in it. The auditor should see that proper control is provided against the possible unauthorized issue of these certificates. As with bank checks, the certificates should not be signed by the proper officials prior to their issuance. There should also be proper physical protection provided for storing the blank certificates.

Most preprinted stock certificate blanks are prenumbered, which provides another control feature. The officer charged with the responsibility of issuing the stock certificates should keep a list of certificate numbers used and should occasionally determine that all blanks are present that are supposed to be unused.

Separation of recording and issuing functions. As with most situations the best control is attained by the separation or division of function. The officer who has custody of the blank certificates should not keep the record of the capital stock transactions. If any clerical help is available, the person doing the recording should not be under his supervision. For example, if the certificates are kept in the treasurer's department, the recording should be done by someone in the accounting department.

Periodic proof of detailed records against control. The frequency with which such a proof is to be made will depend on the number of stock certificates issued and/or transferred. Most small companies find that the issuance of stock certificates occurs so infrequently that a proof of the stockholder's ledger (or other detailed record) against the capital stock account is necessary only once or twice a year. If issues are numerous, it may be advisable to make the proof more often than this. The

auditor should review the situation, determine how often this proof would be desirable, and then find out whether or not it is done. It may well be, in very small companies, that the auditor is the only person who makes the proof. This is satisfactory where there are only isolated transactions or even no transactions during the year. The auditor should, however, apprise the client of the need for this check in the system of internal control.

MAJOR OBJECTIVES IN AUDITING CORPORATE EQUITY ACCOUNTS

The major objectives in auditing corporate equity accounts are included in the following statements:

1. All stock issues are in accord with charter provisions. The auditor should ascertain that the stock is authorized and that there has been no overissue.
2. The balances in the accounts are correctly stated. The procedures to be followed in proving these balances will vary according to the size and structure of the organization.
3. There is proper authority for each entry in all equity accounts.
4. The various accounts are clearly described and adequately presented on the balance sheet.

AUDIT PROCEDURES AND TECHNIQUES

Many of the following procedures and techniques are overlapping to a degree. They have, however, been divided into those applicable to capital stock accounts and those applicable to surplus accounts, as it is proposed to treat these two major sections of the equity section separately.

Capital Stock

The techniques to be applied in the examination of the capital stock account(s) depend basically on the types of stockholder records maintained and on whether or not the company or outsiders keep the records. This in turn depends on the size of the corporation and primarily on the number of shareholding owners of the company. The methods to be used will be discussed in terms of the size of the company, starting with the small company that keeps its own records and moving to the large company that does not.

Many corporations are formed with the minimum number of stock-

holders required by the state corporate code. This number in many states is three, but often two of the three individuals will own only one share each. It is probable that the only stockholder record maintained by such a company will be the stock certificate stub book, or there may not even be a stock certificate book. Individual stubbed stock certificates may be purchased at office supply stores, so perhaps all the company will have will be three certificate stubs properly filled in.

When a corporation grows to such a size (in number of certificates issued) that it is inconvenient for the corporate secretary to maintain a list of owners directly from the certificate book stubs, it is probable that a stockholder's ledger will be devised and maintained. This permits the secretary to arrange an alphabetical listing of owners and the number of shares each owns with a minimum amount of difficulty.

A still-expanding ownership will probably mean that a book of original entry—a stock transfer journal—will next be introduced. This journal has the advantage of including the complete journal entry in one place. The entries are then posted to the stockholder's ledger. The entries in both of these stockholder records are made in terms of shares rather than in dollars. The next step in the expansion will be to engage the services of a registrar and a transfer agent, thus relieving the corporate secretary of all detailed record keeping of ownership.

1. Read charter for authorization of stock issue. In a first audit the charter should be read and abstracted for the permanent file. The rights, preferences, and amounts of each class of stock should be included in this abstract. This need be done for the first audit only.

2. Read minutes of stockholders' meetings for amendments. In a first examination it is necessary to go back to the inception of the corporation and to read the stockholders' minutes from that time to the current date to determine what changes in the capital structure have been authorized by the owners. Whether or not these changes were also authorized by the proper state officials and were put into effect will be determined by examination of amendments to the charter. After the first examination it is necessary to read only the current year's minutes of the meeting of stockholders to determine whether or not any change has been authorized.

3. Analyze the capital stock accounts. In a first examination the auditor should start with the inception of the corporation and prepare a running analysis of all capital stock transactions to the date of the beginning of the current year. All changes in capitalization should be validated against the amendments found in the preceding step. If there

is more than one capital stock account, each one should be so analyzed. This information should be placed in the permanent file.

Analyses for the year under review should be prepared for the current year's working papers. In most examinations there will be no change in the capital stock account. Whether or not the auditor desires a sheet in the current file indicating this fact is a matter of personal or firm preference. Some auditors prefer having a sheet in the current working papers for each major account examined. Others simply mark the account on the working trial balance with NC, indicating no change. Still others transfer the carry-forward analyses from the permanent file to the current file until the examination is completed, then return them to the permanent file.

4. Verify the amount of stock outstanding. The steps to be followed here are dependent on the size of the ownership group and the records kept. The simplest situation is one in which the only record is the stock certificate book (or loose stubs). The certificate book is a preprinted, stubbed book similar in some respects to a checkbook. The stub contains the certificate number, the date of the transaction, the name of the stockholder, and the number of shares for which the certificate was issued. It is common practice to pin, staple, or tape to the corresponding stubs the certificates that have been turned in for transfer.

The auditor should prepare a list of the open certificate stubs with the certificate number, the name, and the number of shares. The total of this list, when multiplied by the par value of the stock, should agree with the balance in the capital stock ledger account. If the stock has no par value, the original transactions must be reviewed to determine the composition of the balance in the capital stock account. Exhibit 16-5 illustrates a stockholders' listing.

If the client keeps a stockholder's ledger, a list of owners may be prepared from this record. Here all shares owned by each stockholder are accumulated, no matter how many certificates he holds. The total of this list should be compared with the total developed from the stock certificate book.

As the number of stockholders increases, many companies find that the detailed record keeping in connection with stockholders' records takes too much of the corporate secretary's time. To alleviate this situation the company may engage independent parties to act as registrar and transfer agent. This action injects an internal control into the record keeping which enables the auditor to reduce his work with the stock records.

Since the corporation now has no stock records except the general

Exhibit 16-5

Harris Metal Co.
List of Stock Certificate Stubs
December 31, 1961

	Name	Certificate	Number of shares	
1	R. E. Harris	1	500	″ ″
2	F. E. Cox	2	100	″ ″
3	J. D. Schoonover	3	100	″ ″
4	Darwin Stooper	4	200	″ ″
5	Walter Milward	6	50	″ ″
6	Robert Erickson	7	20	″ ″
7	James A. Johnson	9	30	″ ″
8	R. E. Harris	11	50	″ ″
9	Samuel R. Dayton	12	23	″ ″
10	James R. Carley	16	100	″ ″
11	Albert Walsh	17	32	″ ″
12	Mrs. Anna Nichols	18	20	″ ″
13	Jane Austen	20	70	″ ″
14	R. E. Harris	21	100	″ ″
15	George R. Hall	22	100	″ ″
16	George O. Wessel	23	75	″ ″
17	R. E. Harris	24	350	″ ″
18	Harry O. Mohr	25	80	″ ″
19			2000	

″ - Proved dividend checks against number of shares and name.
Certificates 5, 8, 10, 13, 14, 15, and 19 attached to stubs and mutilated.
Transfer tax stamps attached.

WBJ

ledger capital stock accounts, the auditor will accept confirmation from these agents. Exhibit 16-6 illustrates a confirmation from a registrar. This agent confirms the total number of shares authorized and the total number issued. A similar letter from the transfer agent will confirm the number of shares outstanding. From these letters and from his review of

Exhibit 16-6

INTERNATIONAL TRUST CO.

690 Wall Street

New York, New York

January 15, 1962

Charles, Porter and Adams
Certified Public Accountants
700 Wall Street
New York, New York

Gentlemen:

The Andrews Company has asked us to inform you with respect to certain matters concerning their capital stock, of which we are the registrar.

As of December 31, 1961, the following shares were authorized to be issued, and were issued:

6 per cent nonparticipating, noncumulative preferred stock, par value $100 per share	10,000 shares
Common stock, no par value	100,000 shares

Very truly yours,
INTERNATIONAL TRUST CO.

By ______________
Secretary

the corporate charter if and as amended, the auditor is able to satisfy himself that the capital stock records and accounts are in order. The confirmation of shares issued should be compared with the capital stock account. If the confirmation of shares outstanding indicates a smaller number of shares than those issued, the auditor should expect to find treasury shares.

5. Test-vouch stock transfers. Where the client is keeping its own stock records, tests should be made of the stock transfers made during the year. As indicated earlier, the canceled certificate is usually affixed to the stub. The auditor should determine that the certificate has been so mutilated that it cannot successfully be issued again. He should trace the transaction from the transfer journal (if any) to the stockholders' ledger accounts to the stock certificate book. In his review of these transactions he should make certain that the shares issued were no more than the shares received.

The seller of shares is required to pay a federal tax on the transfer of the shares. Some few states also assess a tax on such transfers. Where

sales are made through a broker, the broker charges the tax to the seller and remits it to the proper governmental body. Where the company is small and all transactions are handled directly by it, the tax is often absorbed by the company as a convenience to its owners. The tax is paid by purchasing transfer tax stamps. These stamps should be affixed to the stub of the certificate transferred as valid proof that the tax was paid. As one of his audit steps the auditor should note that the proper amount of stamps is affixed to each canceled certificate stub.

6. Vouch any changes in capital stock accounts. In a first examination the auditor must go back to the very beginning of the corporation to determine that the opening entry was correct and that the entries to the capital stock account were properly made. In essence this means tracing to the cash account, or any other asset involved, the debits offset by credits to the capital stock account. This need be done only in the first audit but it should not be omitted in that examination. All credits to the capital stock account should be thus verified.

If any changes have taken place during the year under review, they should be fully vouched and described in the working papers. If a major change, such as the sale of a new stock issue, has occurred, the auditor should make certain that the accounting has been properly handled and that any assets received other than cash have been reasonably valued. He should also see that proper authority for the change was present. The working papers should also contain a rather complete narrative of the transaction.

7. Verify any treasury stock transactions. The audit program for treasury stock is comparable to that for investments. The auditor should examine the stock certificates and should list them by certificate number. He should compare the certificate numbers on last year's list with those on the current list. This either assures him that there has been no movement of the certificates or indicates very specifically which certificates have been used and replaced. Additional purchases of stock are easily added to the list. Since there should be relatively little movement in the treasury stock account, it might be practical to prepare a permanent file worksheet similar to the one shown in Exhibit 16-7. This may be used as a check list each year to save the time spent in writing the certificate numbers each examination.

All transactions in treasury stock should be authorized by the board of directors. The auditor's notes of the important items taken from the minutes should be referred to in search of such authorizations. Additionally the auditor should trace to cash receipts or cash disbursements

Exhibit 16-7

Delta Diamond Distributors, Inc.
Treasury Stock Certificates
December 31, 1961

Line		Certificate		Number of shares	
1		32	✓	54	(✓)
2		141	✓	116	(✓)
3		218	✓	122	(✓)
4		451	✓	100	(✓)
5		716	✓	500	(✓)
6		881	✓	240	(✓)
7		887	✓	100	(✓)
8		916	✓	50	(✓)
9		989	✓	100	(✓)
10	Last certificate dated	1114	✓	80	(✓)
11	April 14, 1960.			1462	

✓ = Compared certificate number with last year's record
(✓) = Examined certificates February 6, 1962. All are in client's name.

any proceeds for stock sold or payments for stock purchased. Often the stock will be purchased directly from stockholders, in which case the correspondence file will be a substitute for the broker's invoice. If sales are made directly to employees, contracts of sale should be available for the auditor's review.

Some states have laws prohibiting or restricting the purchase of its own shares by a company. The auditor should become familiar with the corporate code of the state in which his client is incorporated so that he may be aware of such restrictions. If he feels that the client is acting in a manner inconsistent with the law, he should suggest that the client consult his attorney to obtain an opinion on the matter. Under no circumstances should the auditor express an opinion on the legality or illegality of the transaction.

8. Review the balance sheet presentation. The auditor should make certain that all classes of capital stock are clearly described and presented on the balance sheet. He should observe that the total number of shares authorized and issued are indicated and that all restrictions on the stock are set forth parenthetically or in footnotes. In his examination of the capital stock accounts the auditor should satisfy himself that the rights and privileges of all preference stock have been observed.

Surplus

One of the areas in which there is a difference of opinion as to correct accounting treatment has to do with the earned surplus, or retained income, account. The conflict arises as to whether or not direct charges and credits should be made to this account.

Some accountants feel that it is misleading to include in the operating statement items of material amount which they feel are extraneous, nonrecurring, or unusual. The theory advanced is that readers of the financial statements will consider these items, if they notice them at all, as being normal operating items. The proponents of this philosophy feel that most readers of the operating statement look at the final profit figure and assume, without carefully examining the statement, that this profit represents a normal profit. This group of accountants feels that it is proper, in fact advisable, to remove these material nonrecurring items from the operating statement and place them directly in the retained income account. They feel that the concept of "current operating profit" is of such great importance in the analysis and understanding of financial statements that nothing should be included in the operating statement that will tend to confuse or mislead the reader or to upset the normal profit factors.

The opponents of this philosophy represent the so-called "clean surplus theory" or the "all-inclusive income statement" advocates. This group contends that the only items that should be placed directly in the earned surplus account are the following: net income or loss, dividend charges, appropriations of earned surplus, and returns of these appropriations.

They also propose that the operations of any business cannot reasonably be divided into the arbitrary time segments we call years; that any business is a continuing affair and that any attempt to include all factors pertaining to one year in that year is doomed to failure; that every charge or credit to operations should properly be shown in the operating statement; and that current operations may be adequately indicated by a proper presentation. Under this philosophy all these doubtful items would be presented *after* the current operating profit had been determined. Those items representing material amounts applicable to the current year which might mislead the reader if included as normal operating amounts may be included in an "extraordinary items" section. If the items clearly apply to former operating periods they should be shown as "corrections of prior year's income" and should be deducted or added after the final "net income for the year" has been determined. Obviously these sections must be clearly identified if the reader is to obtain the correct information from them and not be misled.

A compromise between these two schools of thought is proposed by a third group, which feels that a fair solution to the problem may be had by combining the income and surplus statements. One of the objections to direct charges to surplus is that the reader may not read the surplus statement and thus may not be apprised of the extraordinary charges and credits. If the two statements are combined, this could hardly take place.

The author feels that the all-inclusive income statement most clearly presents the results of operations for the year under review. The student, after studying all arguments and after gaining considerable practical experience, will have to make his own decision as to which philosophy is most acceptable to him.

1. Vouch all entries. The examination of the surplus account is usually made in detail. The first step is to analyze the account, as shown in Exhibit 16-8. All entries should be vouched. If the client follows the clean surplus theory, authorization should be found in the abstract of minutes for each entry in the accounts except for closing net income or loss. If direct charges and credits have been made to surplus, it is doubtful that they would have been brought to the attention of the board of directors. Authorization must then be sought from other sources, primarily the officers and/or controller. Each of these entries should be traced back to the underlying documentary evidence.

The permanent file should contain a continuing analysis of the surplus account. All major entries to the account should be displayed in such a way that the record is easy to read, shows the basic actions taken, and

Exhibit 16-8

Roberts Dry Goods, Inc.
Retained Income
December 31, 1961

		Dr.	Cr.
Balance, December 31, 1960			48,016.79
3/1/61	Transfer to reserve for Sinking Fund	5,000.00 T	
3/15	Dividends	2,500.00 T	
6/15	Dividend	2,500.00 T	
9/15	Dividend	2,500.00 T	
12/15	Dividend – regular	2,500.00 T	
	– extra	5,000.00 T	
		20,000.00	48,016.79
			20,000.00
Balance per ledger, December 31, 1961			28,016.79
Net income			27,420.50
Balance per audit			55,437.29

T = Traced to authorization in minutes.

portrays a history of the company's earnings record for a series of years. There are many forms this analysis may take; a commonly used one is shown in Exhibit 16-9.

2. Vouch dividends paid. Authorization for the declaration of dividends should be traced to the abstract of minutes. When the dividend

rate has been determined, it should be multiplied by the total number of shares outstanding at each date of record to prove the total dividend declaration. The auditor should make certain that all dividends declared by the directors have been recorded even though the payment date falls in the next accounting period. The charge may be made directly to the surplus account or it may be placed in a temporary dividends account. In the latter case the account is closed directly to surplus at the year end.

After the total liability for dividends has been determined, tests should be made of the individual liabilities and payments thereof. If the client has few stockholders, Exhibit 16-5 may be used in proving dividend payments. Checks to stockholders should be proved against the names on this list. The number of shares owned multiplied by the rate should agree with the amount of the check. In small corporations a complete proof of all dividend checks is usually made.

If the corporation employes a transfer agent, the auditor should call for the lists of stockholders supplied by the transfer agent. These lists indicate the name and address of each stockholder and the number of shares he owned at the record date. Dividend checks may then be tested or proved completely against these lists.

3. Verify all surplus reserves. The auditor should be familiar with the surplus reserves set up by the client. These reserves should be created to provide for specific contingencies or future transactions for which a segregation of earnings is deemed advisable. When the contingency has taken place or the transaction has occurred, the reserve should be returned intact to retained earnings. No charges should be made against the reserves. Once they have served the purpose for which they were created, there is no advantage in keeping the accounts in existence.

The auditor should be familiar enough with the purposes that he can ascertain whether or not the reserves have outlived their usefulness. Where this is so, he should suggest closing the reserve to retained income. If the client refuses to follow the suggestion, the auditor is faced with the problem of determining whether or not the statements fairly present the financial position of the company.

The use of a general contingency reserve, for which no specific contingency exists, is to be deplored. The purpose of such a reserve is to make provision for unknown contingencies. At one time this type of reserve was generally accepted, but it was so abused by groundless credits made only to diminish dividend declarations that it soon fell into disrepute. Currently it is not often used.

Haring Steel Corp.
Earned Surplus
1955—

Permanent File

	Balance January 1	Net income	Cr. Return of reserve	Gain on sale of machinery	Dividends	Res. for future inv. loss	Dr. Net loss	Tornado loss	Balance December 31
1955	203854	816475			400000				620329
1956	620329	1765142			400000	750000			1233471
1957	1233471	2410713	750000		400000				3996184
1958	3996184				400000		746134		2850050
1959	2850050	3812560		1341525	5000000* 400000				2604135
1960	2604135	2647250			1000000				4251385
1961	4251385	3512345			1500000			1246180	5017550

* - 25 per cent stock dividend

In his examination of surplus reserves the auditor should make certain that all entries to the accounts have been properly authorized. Normally he should have found this authorization in his review of the minutes of the board of directors' meetings. The creation of the reserve may be called for by some contract, or it may be set up at the discretion of the directors. The disposition of the reserve will always be at the direction of the board.

Even though it is incorrect, debits are sometimes made to surplus reserves. These usually represent the cost of some transaction or contingency which has now taken place. Such entries should be vouched in the usual manner, with the examination of underlying documentary evidence being a most important step. The auditor should point out to the client the error in accounting treatment and suggest a charge to some other account. If the client insists on leaving the item as a charge to the reserve account, the auditor must again consider whether or not the statements fairly present the operating results of the company and at the same time afford the full disclosure demanded in current financial statements.

4. Examine for secret reserves. A secret reserve is an understatement of net worth. It is created by any action which results ultimately in such an understatement. The understatement of asset values, either by undervaluing the assets (inventories) or by excessive credits to valuation accounts (accounts receivable or plant), creates secret reserves. The omission of assets by charging capital assets to expense accounts, the excessive write down of intangibles, the overstatement of actual liabilities, or the creation of mythical liabilities all serve to understate the proprietary interest of the company.

Many years ago it was considered generally acceptable and good conservative practice to have secret reserves. Currently this is not true. As has been pointed out in several chapters in this text, the auditor is just as concerned with understatement of net assets as he is with overstatement. In his review of the accounts he must look for and take cognizance of the existence of such reserves. If secret reserves exist, it is obvious that there is not full disclosure in the financial statements.

It must be admitted, however, that in the case of intangible fixed assets there is generally an understatement of asset values, because of the almost impossible task of valuing these intangibles. Companies which are successful rather obviously have goodwill even though they may

Exhibit 16-9

never have purchased any. Our accounting tradition holds that no goodwill may be acknowledged in the financial statements unless it has been purchased. Hence, even the philosophy of accounting tends to result in a secret reserve in the case of a successful company.

5. Determine that surplus is adequately presented. The classification and description of the accounts in the surplus section should be sufficiently adequate that the rights of all creditors and owners may be determined. Where necessary for full disclosure, sufficient explanatory notations should be made either in the balance sheet itself or by means of footnotes. Restrictions on the availability of free surplus for dividend declarations should be clearly set forth. If there are accumulated undeclared dividends on cumulative preferred stock, the amount per share and the total should be disclosed. The details of all stock options outstanding should also be shown in a footnote so that all readers may be informed.

QUESTIONS AND PROBLEMS

1. If $A - L = P$, why should the auditor pay any attention to the proprietorship accounts of a sole proprietor?
2. Why is it wise to obtain approval of withdrawals made by the owner?
3. What particular points would you look for in examining the capital accounts of a sole proprietor?
4. You have been engaged to examine the records of the Hartt and Rogers partnership. The firm has been in existence for three years. This is the first examination. You decide that as the first step you will read the partnership agreement. For what points should you look?
5. You are making an examination of a partnership. What steps will you follow in auditing the net worth section?
6. For your own state determine the number of incorporators and the minimum amount of capital necessary to form a corporation.
7. What are the important points of internal control affecting the corporate equity accounts?
8. What are the major objectives in auditing corporate equity accounts?
9. Describe briefly the duties of the registrar and of the transfer agent.
10. Distinguish between the three classes of reserves. Why is it the best practice to confine the use of this term to the surplus section?
11. Explain what is meant by an "all-inclusive" income statement. How is it related to the "clean surplus" theory?
12. Prepare an audit program for the capital stock account of a small, closely held company. This is the first time the company has been audited.
13. Your client, whose accounts you audited last year, has an issue of

100,000 no par common shares, traded on the American Stock Exchange. He also has an issue of 6 per cent preferred, par value $100, 1,000 shares authorized, issued, and outstanding. This stock is not registered on an exchange. The client's secretary keeps the preferred capital stock records There have been no changes in the capital stock accounts during the year.

List the steps you would follow in auditing each of these accounts.

14. The company keeps its own stock records. Prepare an audit program for dividends paid.

15. In your examination of the business of Harry Smith you encounter the accounts shown in Exhibit 16-10.

Exhibit 16-10

Harry Smith, Capital

			1/1/61	Balance	33,486.42

Harry Smith, Personal

1/ 7		800.00			
4/12		800.00			
6/ 6		800.00			
7/ 7		800.00			
9/12		800.00			
11/15		800.00			
12/20		1,200.00			

Profit and Loss

12/31/61	Costs (except the accounts shown below)	213,515.80	12/31/61	Sales	268,452.81

Salaries and Wages

12/31/61	Harry Smith, salary	3,000.00			
	All others	40,416.50			

Exhibit 16-10 (Continued

Interest Expense

12/31/61	Interest on capital	1,674.32	
	All other	2,461.70	

Prepare (1) working papers for the capital and personal accounts and (2) a list of any necessary adjusting and closing journal entries.

16. From the data shown in Exhibit 16-11 relative to the ABCD partnership contract, it is obvious to you that A is being disadvantaged to the benefit of the other partners. You propose to your supervisor that you are going to have a chat with A and tell him so. Your supervisor forbids you to say anything to A. Why?

Exhibit 16-11

Partner	*Capital contributed*	*Time spent in firm work*	*Share of profits*
A	$40,000	100%	15%
B	30,000	80%	20%
C	20,000	50%	25%
D	10,000	10%	40%

17. In examining the capital stock records of the Hamilton Corp. you find the following facts. The company was formed in January, 1961. Your audit is for its first year of operations. The capital stock has a par value of $100 per share, with 25,000 shares authorized. The listing of open certificate stubs indicates that 22,000 shares have been issued and are outstanding. The capital stock accounts in the general ledger are shown in Exhibit 16-12.

Exhibit 16-12

Unissued Capital Stock

1/4/61	Authorized stock, 25,000 shares	2,500,000	1/ 6	Issued for cash, 6,000 shares	600,000
			1/ 9	Issued for cash, 7,000 shares	700,000
			1/12	Issued for cash, 7,000 shares	700,000

Exhibit 16-12 (Continued)

Authorized Capital Stock

	1/ 4/61	25,000 shares	2,500,000

What possible explanations can you advance for the discrepancy? What steps would you take to determine the cause?

18. The firm of Haddad and Evans distributes profit and loss according to the method shown in Exhibit 16-13.

Exhibit 16-13

	Haddad	*Evans*	*Silver*
Contributed capital, January 1, 1961	$50,000	$30,000	$20,000
Salary credit	9,000	7,500	6,000
Interest rate on capital	6%	6%	6%
Balance	40%	30%	30%
Withdrawals for the year	$ 6,000	$ 7,500	$ 8,000

Assuming a net profit of $25,000, prepare a statement of changes in partners' capital for the year ended December 31, 1961.

19. The firm of Williams and Roberts is being liquidated. The liquidation has been going on since January 1 and one of the partners wants to withdraw some of his capital. The partners call you in to determine how much cash may be withdrawn as of March 1, 1961; June 1, 1961; and November 1, 1961. On the basis of the estimates given they also ask you to determine the estimated final settlement as of December 31, 1961. The following information is available:

Capital balances as of January 1, 1961, were: Williams, $82,650; Roberts, $47,450; Jones, $28,260. Profits and losses are shared 30 per cent to Williams, 30 per cent to Roberts, and 40 per cent to Jones. In addition the firm owes Jones $10,000 on a note payable, while Roberts is indebted to the firm on a note for $5,000. Liabilities to outside creditors amount to $36,640. Cash is available for distribution as follows:

March 1—Assets valued at $70,000 were sold for $72,000.

June 1—Assets valued at $30,000 were sold for $25,000.

November 1—Assets valued at $45,000 were sold for $40,400.

December 31—It is estimated that the remaining assets, valued at $54,600, will yield cash of $30,000.

Prepare (1) worksheets showing cash distribution at dates indicated and (2) an analysis of partners' accounts showing payments and final loss.

20. You are employed to make an audit by a stockholder who believes the management of the corporation is piling up large secret reserves with the view of buying up the stock of the minority holders. You are given free access to the books.

Indicate the general nature of the investigation you would make to determine the truth or falseness of this belief.

21. The Jurben Company was organized January 1, 1958. You are examining the records as of December 31, 1961. The company has never been audited.

Your investigation of the charter indicates that 1,000 shares of $100 par value stock are authorized. Your review of the minutes discloses the following dividend actions:

June 15, 1959—$2 per share, cash
December 15, 1959—$2.50 per share, cash
December 15, 1960—25% stock dividend
June 15, 1961—$5 per share, cash
December 31, 1961—$5 per share, cash, payable January 15, 1962

The capital stock and retained income accounts as of December 31, 1961, the data from the stock certificate book, and the stockholders ledger are shown in Exhibit 16-14. The net profit for 1961 is $15,450.

Prepare the following:
Permanent file analysis of capital stock
Permanent file columnar analysis of retained income
Current working papers for these accounts

Include your program of work done and a list of adjusting journal entries (if any).

Exhibit 16-14

Capital Stock—Par Value $100

				1/ 2/58		CR	50,000
				7/ 1/59		CR	30,000
				12/31/60		GJ	20,000

Retained Income

12/31/58	Net loss	GJ	5,680	12/31/59		GJ	18,675
6/15/59		GJ	1,000	12/31/60		GJ	21,570
12/15/59		GJ	2,000				
12/15/60		GJ	20,000				
6/15/61		GJ	5,000				

Exhibit 16-14 (Continued)

Stock Certificate Book

Date	*Name*	*Certificate No.*	*No. of shares*	*Remarks*
1/ 1/58	R. E. Cain	1	200	Certificate attached to stub
1/ 1/58	J. H. Deal	2	40	
1/ 1/58	W. J. Radock	3	10	Certificate attached to stub
1/ 1/58	T. Kramer	4	100	
1/ 1/58	B. L. Cohen	5	60	
1/ 1/58	R. T. Fury	6	40	
1/ 1/58	J. B. Ridler	7	50	
1/ 6/59	W. B. Cain	8	60	
1/ 6/59	Harry Cain	9	60	
1/ 6/59	R. E. Cain	10	80	
4/12/59	J. B. Ridler	11	10	
7/ 1/59	R. E. Cain	12	200	
7/ 1/59	T. Kramer	13	40	
7/ 1/59	James Brollock	14	60	
12/31/60	James Brollock	15	15	
12/31/60	Harry Cain	16	15	
12/31/60	R. E. Cain	17	70	
12/31/60	W. B. Cain	18	15	
12/31/60	B. L. Cohen	19	15	
12/31/60	J. H. Deal	20	10	
12/31/60	R. T. Fury	21	10	
12/31/60	T. Kramer	22	35	
12/31/60	J. B. Ridler	23	15	

James Brollock

	7/ 1/59	Original issue #14	60
	12/31/60	Original issue #15	15

Harry Cain

	1/ 6/59	From R. E. Cain #9	60
	12/31/60	Original issue #16	15

Exhibit 16-14 (Continued)

R. E. Cain

1/ 6/59	To Harry Cain #1	60	1/ 1/58	Original issue #1	200
	W. B. Cain	60	1/ 6/59	From R. E. Cain #10	80
	R. E. Cain	80	7/ 1/59	Original issue #12	200
			12/31/60	Original issue #17	70

W. B. Cain

			1/ 6/59	From R. E. Cain #8	60
			12/31/60	Original issue #18	15

B. L. Cohen

			1/ 1/58	Original issue #5	60
			12/31/60	Original issue #19	15

J. H. Deal

			1/ 1/58	Original issue #2	40
			12/31/60	Original issue #20	10

R. T. Fury

			1/ 1/58	Original issue #6	40
			12/31/60	Original issue #21	10

T. Kramer

			1/ 1/58	Original issue #4	100
			7/ 1/59	Original issue #13	40
			12/31/60	Original issue #22	35

Exhibit 16-14 (Continued)

W. J. Radock

4/12/59	To J. B. Ridler #3	10	1/ 1/58	Original issue #3	10

J. B. Ridler

			1/ 1/58	Original issue #7	50
			4/12/59	From W. J. Radock #11	10
			12/31/60	Original issue #23	15

Chapter 17

REVENUE AND EXPENSE

The examination of the operating accounts has become of as great importance as has the examination of the balance sheet accounts. The auditor expresses his opinion on the fairness of the results of operations as well as of the financial position. He must make a sufficiently comprehensive review of the revenue and expense accounts to enable him to form a professional opinion as to the reasonableness of the operating statement.

By the time the examination of the balance sheet accounts is completed, many of the operating accounts should also have been examined. This is particularly true of expense and revenue accounts directly related to balance sheet accounts. For example, bad debt expense should be examined when the allowance for doubtful accounts is being reviewed, cost of goods sold should be tested when the inventories are being verified, and so on. Some accounts will not have such a direct relationship and their examination will be conducted at this time. Some auditors prefer to defer the examination of the related accounts until they have completed the balance sheet examination. This is a matter of choice for the auditor.

INTERNAL CONTROL AND THE OPERATING ACCOUNTS

One group of the checks and balances in any system of internal control deals normally with the balance sheet accounts, particularly as it affects the protection of company assets. Another important phase of the system relates to the production of error-free statements. The controls over the balance sheet accounts generally will also affect the related income and expense accounts. The phase of the system relating to the detection and exposure of errors is devised to control specifically the operating accounts as well as the balance sheet accounts.

The proper classification of revenue and expense items is important for most companies, as incorrect initial classification of an item results in incorrect statements. Hence one important part of the control system is in making certain that operating transactions have been classified correctly.

The checks and balances relating to operating accounts are so numerous that it seems impractical to repeat them at this point. Instead the reader is referred to the internal control questionnaire in Chapter 2. Many of the questions in sections B, C, and D relate primarily to the operating accounts.

In reviewing the operating accounts the auditor should make certain that the controls are operating effectively. It might be well to point out once more that the answers given to the questionnaire are indicative only of the client's intent. The auditor must determine by personal observation that actual practice conforms to the printed program.

MAJOR OBJECTIVES IN AUDITING THE OPERATING ACCOUNTS

As the auditor approaches the operational review, he has several objectives in mind. First, he is concerned with the accuracy of the analysis and recording of the transactions. To satisfy himself on this point he has made many tests of the details of transactions. The books of original entry have been reviewed for the test periods and the documentary evidence underlying the transactions has been examined. The entries in the test periods have been traced to the general and/or subsidiary ledger accounts. Presumably entries to all revenue and expense accounts will have been included in the transactions reviewed. From this review the auditor should have a clear picture of the care and accuracy with which the clerical work has been done.

In addition to this spot test of all the accounts, many of the operating accounts have been examined in detail in connection with related balance sheet accounts. This gives the auditor an additional basis for judging the reasonableness of the operating statements.

From this detailed look at the operating records the auditor next turns to a broad, high-level review. The operating statement should be prepared in dollars and percentages, on a comparative basis. The budget for the year under review should also be at hand. A comparison may then be made between the three sets of figures. All major deviations from last year or from the budget should be subjected to a detailed scrutiny. If there is no sizable variance, in either dollars or percentages, it may

be assumed on the basis of this and the tests previously mentioned that the accounts are reasonable, from the over-all point of view.

It is assumed that the operating statement contains only the major totals usually found in such a statement. The next step is to make similar comparisons of the individual expense accounts. Many auditors feel that a comparison of the year-end balances is not adequate and prefer instead to make comparison of monthly totals. Major variations within the year which might be hidden in yearly totals are thus brought to light. These also are deserving of investigation to disclose the causes of the variances. Explanations should be sought from the chief accounting officer. Here again materiality comes into play. The auditor must use good judgment in determining what differences to follow out and in knowing how far to press his requests for explanations.

A second objective relates to the omission of income and expense items. While the examination of balance sheet accounts may reveal the omission, this is not necessarily true. The omission of an item from the operating account often means that it was also omitted from the balance sheet account. This will be true for all transactions except the transfer of operating items from the balance sheet accounts to profit and loss. If the transaction was omitted intentionally and was well hidden, it may never be found. Hence the examination of the operating accounts should be made with a view toward finding all such transactions possible.

Another specific objective lies in the examination of the maintenance and repairs account. In the review of the fixed assets the auditor looked specifically to see that expense items were not capitalized. Now he examines the expense accounts to make certain that no capital items were expensed. The client's maintenance policy, the depreciation rates, and the policy concerning the lower limit set for allowable capitalizable items must all be taken into consideration in the review of the maintenance and repair accounts.

Still another objective lies in the application of the matching theory. Current accounting theory and practice call for matching costs and expenses with the revenues obtained from the application of the costs and expenses. Certain assets and liabilities must be accrued or deferred to obtain the periodicity necessary. Many of these accrued and deferred items are determined through the balance sheet review but the auditor can be certain that all have been taken up only after he has examined the related income and expense accounts.

Finally, the auditor is keenly interested in reviewing the consistency of the accounting treatment accorded the transactions. In his short-form

report the auditor indicates that the accounting statements have been prepared on a basis consistent with the preceding year. This statement applies to the operating statements as well as to the statement of financial position. To satisfy himself that there is substantial consistency in the treatment of operating items, the auditor must make a reasonably comprehensive review of the operating statements.

With these objectives in mind the auditor approaches the review of the operating accounts in three ways. He makes a detailed inspection of certain segments of the original records embracing all operating accounts. Next he takes a broad approach comparing the statements with the preceding year's and with the budget, attempting to satisfy himself that the various relationships within the statements are reasonable. Through this type of broad review it is often possible to discover discrepancies and variations from normal that are not apparent when the review is confined to detailed tests of the accounts. The third approach is to make an intensive examination of some of the accounts. The procedures and techniques to be applied to the specific accounts will be described in the following paragraphs. Although it is probable that some of these steps have already been applied by the auditor in connection with the related balance sheet account, they will all be considered here as steps applying specifically to the operating accounts.

AUDIT PROCEDURES AND TECHNIQUES

Sales

1. Test sales records. The auditor wants to know that the balance in the sales account correctly reflects the sales made for the year. To satisfy himself of this fact, he applies various steps and techniques to the sales records. Perhaps the first procedure is to verify the sales totals for the test periods. If the client uses a sales register in which he records sales individually, the register should be footed for the test periods. The totals should then be traced to the ledger account. If an analysis of the sales account is not prepared, the sales account should be footed. If an analysis *is* prepared, footing the account is not necessary since the footing will be done on the analysis sheet.

If the company summarizes each day's sales in a sales register, the receipts for several days in each test period should be proved against the corresponding amount in the register. The register should then be footed and posted.

Some companies use the sales invoices as a book of original entry. The individual invoices are posted to customers' accounts and at the end of a month the invoices are classified and totaled. The general journal entry is then recorded on the last invoice, in a general journal, or in a book of standard journal entries. In such a situation the invoices for each test month must be footed and traced to the journal entry. Then the entry should be traced to the ledger accounts involved.

Tests should also be made of the individual invoices. The number to be examined will depend on the dollar value of each invoice. Where the individual sales are small relative to total sales a proportionately small number will be examined. Conversely, if each invoice represents a relatively large percentage of total sales, a proportionately larger number should be examined.

Each invoice should be reviewed to determine that it has been recorded correctly in the sales register (if one is used). All extensions and footing should be proved. At times it may be wise to obtain the company's price list or catalogue and compare prices shown therein with amounts charged on the invoices.

Tests should also be made of the postings to the customers' accounts. The number of tests to be made will depend on the size of the invoices. It is not worthwhile to make myriad tests of very small items. A calculated risk is taken here because of the immateriality involved.

Finally, if the client classifies or departmentalizes sales, the proof of total tests made by the auditor must conform to the classification used. This implies that he must be familiar with the various classes of sales so that he may select the proper invoices for totaling or, if they have been segregated, so that he may discern any incorrect classifications. Exhibit 17-1 illustrates a sales worksheet.

2. Review sales cutoff. As one phase of fulfilling the periodicity objective, a review should be made of the sales cutoff. Under normal conditions sales title passes with delivery of the merchandise to the customer. The precise point at which delivery is made depends on the terms of the sale. Merchandise sold f.o.b. shipping point becomes the property of the buyer when the goods are delivered to the common carrier which transports them to the buyer. Merchandise sold f.o.b. destination remains the property of the vendor until the purchaser receives it from the common carrier. The carrier acts as agent for the buyer if terms are f.o.b. shipping point and for the seller if the goods are sold f.o.b. destination.

This is of interest to the auditor because of his desire to see that

Exhibit 17-1

Hines Manufacturing Co.
Sales
December 31, 1961

	① Total	② Product A	③ Product B	④ Product C
January	29,153.00	11,678.00	14,847.00	2,628.00
February	37,101.00	12,687.00	16,900.00	7,514.00
March	45,359.00 V	13,625.00 V	19,484.00 V	12,250.00 V
April	54,187.00	14,562.00	22,625.00	17,000.00
May	63,913.00	16,758.00	26,715.00	20,440.00
June	73,622.00	20,415.00	30,201.00	23,006.00
July	84,161.00	22,840.00	35,660.00	25,661.00
August	97,523.00	28,652.00	40,414.00	28,457.00
September	114,792.00 V	36,815.00 V	47,515.00 V	30,462.00 V
October	86,853.00	25,412.00	36,221.00	25,220.00
November	58,105.00	18,106.00	24,584.00	15,415.00
December	33,285.00 V	9,715.00 V	13,216.00 V	10,354.00 V
Total per ledger, Dec 31, 1961	778,054.00	231,265.00	328,382.00	218,407.00
AJE (37) To remove 1962 sales	7,462.00	2,115.00	5,347.00	
Total per audit	770,592.00	229,150.00	323,035.00	218,407.00

V = Footed duplicate invoices. Tested distribution. Tested postings to customers' accounts. Traced standard journal entries to ledger accounts.

[illegible]

the sales are recorded in the correct period. Where goods are sold f.o.b. destination, there is a transportation period which must be taken into consideration. Thus if a sale were made and shipped on the last day of the fiscal year but two days were required for delivery, the transaction was not a completed sale until sometime in the next year.

The sales invoices for the last week in the year and the first week of the new year should be traced to shipping records. There are several points of interest to the auditor in this review. First he wants to make certain that all sales recorded in December were actually shipped in December. This means tracing the date of sale into the shipments record. If January shipping dates are found, those sales should be reversed and carried forward to the next period and the merchandise added to the year-end inventory.

Secondly, the auditor is also interested in determining that goods shipped during the last week of the year f.o.b. destination had ample time to arrive at their destination by the year end. Here, too, if it is obvious that delivery was not possible, the sale should be reversed and the goods added back to the inventory.

Next the January invoices should be reviewed to determine whether or not any of the goods billed in January were shipped in December. These sales should be pulled back into the year under review. If the company uses a perpetual inventory plan, it will be necessary to reverse the January entry transferring inventory to cost of goods sold. If the client uses the periodic inventory plan and the inventory was actually taken on or about December 31, no inventory adjustment is necessary, since the goods had been shipped and either were not counted or were adjusted out of the final inventory. In all cases where sales are changed one way or another, the auditor must be extremely careful to ascertain just what the inventory situation was and then take what action is necessary.

When he is tracing shipping dates, the auditor should also see that the purchaser is the one who is to receive the goods. It is not at all uncommon for the purchaser to request that delivery be made to some company or person other than himself; when this occurs, the original order should be examined. A rather common method of inflating sales is to ship unordered goods to a nonexistent receiver, then have them returned in the next period. Charging the sale to a bona fide customer lends some credence to the operation.

Some unusual transactions arise which affect sales in that they are not what they seem to be. What is commonly known as a "set aside" is one of these. The customer may enter into a complete purchase transaction and accept title to the goods but request the vendor to hold the material for shipment at a later date. This is a bona fide sale and should be recorded as such. The merchandise should be clearly marked as being

the property of the purchaser and should be set aside from the other merchandise. Obviously it should be excluded from the ending inventory.

The converse also occurs. The customer agrees to buy and accepts the merchandise and the vendor agrees to bill him at a later date. This type of transaction is called a "deferred or delayed billing." In this situation, as of the year end there is no sale. The merchandise is the property of the vendor and should be included in inventory. A sales invoice is usually issued, stamped with the deferred billing date. This transaction should be reversed and recorded in the next period.

3. Block proofs. It is possible in some situations to make an over-all proof of sales that adds to the credibility of total sales. This is a reasonable test where only a limited number of products is manufactured and where production records are kept. Using the production figures and adjusting for finished goods inventories, the net sales can be computed in units. Converting these units to sales dollars should produce a total sales dollar value approximating the ledger balances. If it does not, the variance should be investigated. Where the client departmentalizes sales or classifies sales by product, the same approach may be used on a departmental or product basis. An example of this type of block proof is shown in Exhibit 17-2.

Exhibit 17-2

	Product X	*Product Y*	*Product Z*
Inventory, finished units, January 1	226	132	318
Production per factory records	8,468	3,580	7,540
Total available for sale	8,694	3,712	7,858
Inventory, December 31	418	209	188
Net sales	8,276	3,503	7,670
Selling price	$ 15.	$ 20.	$ 25.
Sales values	$124,140	$70,060	$191,750
Sales per ledger accounts	124,100	70,075	188,460
Variances	$ 40	$ (15)	$ 3,290

The variances for products *X* and *Y* may be ignored but that for *Z* should be investigated. There are many possible causes of such a variance. The cause should be determined and an adjustment made to the proof of sales so that it agrees more closely with the ledger balance, or the sales account should be adjusted, whichever is necessary.

The auditor may not want to accept the production of finished units record without proof of its accuracy. At times he may be able rather easily to determine the materials used in producing the product. Making the same type of calculation shown above, he may satisfy himself that the records of production have been kept carefully and that the quantity of units produced is reasonable.

A variation of the gross profits test may also be used where there is a standard rate of mark-on. Adjustment must be made for markups and markdowns. The value of this test, as with the gross profits test, is that it will disclose major discrepancies. One cannot hope to make an exact proof because of the many factors present that may cause minor differences. Here again the test must be applied to products or departments; it cannot be used very effectively for a complete operation unless there is a standard rate of gross profit throughout. An illustration of this computation for proof of sales is shown in Exhibit 17-3.

Exhibit 17-3

	Department A	*Department B*
Inventory, January 1	$ 4,618	$ 3,525
Purchases (net)	104,012	253,810
Goods available	$108,630	$257,335
Inventory, December 31	4,630	7,335
Cost of goods sold	$104,000	$250,000
Rate of mark-on (per cent of cost)	25%	30%
Add: Mark-on	26,000	75,000
Total estimated selling price	$130,000	$325,000
Sales per ledger	130,115	307,542
Discrepancies	$ 115	$ 17,458

The variance for department *A* is small enough to ignore while that for department *B* should be investigated. There are many possible causes for the discrepancy. There may have been markdowns which were not recorded. The possibility of theft is always present. All that the test proves is that there is something wrong which merits further investigation.

Block proofs of this type are valuable adjuncts to the auditor's other techniques. They may disclose discrepancies which might not be brought to light by other means.

4. Test sales returns. Tests of the sales returns records should be made for the test periods. Particular attention should be given to the procedure for authorizing the return. Some of the returns invoices should be traced to the individual accounts. In addition the auditor should trace some of the invoices to the inventory department to determine that the goods were received and entered the inventory records. The sales returns journal should be footed and posted for the test periods.

The auditor should also investigate returns and allowances for the first week or two in the new year. A comparison may be made with the same period of the year under review to see whether there is any marked variance. All unusually large returns in the new year should be carefully investigated since they may represent fictitious sales. Reference should be had to the original customer's order, the invoice, the shipping records, and the customer's request to return the goods as means of substantiating the return.

Cost of Goods Sold

1. Test purchase records. Here, as with sales, the examination of the voucher register and the underlying documentary evidence may already have been accomplished for the test periods. In addition to these tests the auditor should have a clear understanding of, and should include in the working papers, the composition of cost of goods sold. For a merchandising concern this will be composed only of the net merchandise purchased plus transportation in, modified by the inventory adjustment. Any merchandise used for personal use or for use in the business should be removed from the purchases account and charged elsewhere. Any unusual features of cost of goods sold should be clearly explained in the working papers.

For a manufacturing company cost of goods sold must be built from the various component parts. If the company uses a periodic inventory plan, the cost of goods sold worksheet is basically an assembly of verified information from other working papers. Net purchases of raw materials plus direct labor plus the manufacturing expenses will be used for this assembly.

The auditor may want to satisfy himself as to raw materials usage by one of the block proofs explained previously. If the client presumably has no cost system tied in to the general ledger, there is no easy way of knowing whether or not all the materials purchased are reflected in finished units. Theft may occur either before or after the product is completed, depending on the type of material used and the type of

Exhibit 17-4

General Pump Co.
Cost of Goods Sold
December 31, 1961

Line	Description	①	②
1	Net purchases of material (W/P Q4)		147685.32
2	Freight in		13414.68
3	Total		161100.00
4	Less: Materials used, repairs (W/P Q8)		846.72
5	Net available for manufacturing		160253.28
6	Inventory of material, January 1		3462.72
7	Total goods available		163716.00
8	Less: Inventory, December 31 (W/P I3)		14629.51
9	Materials used in production		149086.49
10			
11	Direct labor (W/P S2)		246728.15
12			
13	Manufacturing expenses (W/P Q6)		87770.20
14			
15	Total manufacturing costs		483584.84
16			
17	Work in process, December 31 (W/P I5)	8462.80	
18	Work in process, January 1	4300.15	
19	Less: Increase in work in process		4162.65
20	Cost of goods manufactured		479422.19
21			
22	Finished goods, January 1	28722.40	
23	Finished goods, December 31 (W/P I2)	28144.59	
24	Add: Decrease in finished goods		577.81
25	Cost of goods sold		480000.00
29			[illegible]

product manufactured. Even though the material or finished units are not consumable immediately, there may be ready markets for them. Frequently, although many precautions are taken for safeguarding cash and securities, other convertible assets are largely ignored. A typical worksheet for the assembly of cost of goods sold is illustrated in Exhibit 17-4.

If cost records are maintained, the cost of goods sold is already determined. Here, as in all other accounts, the auditor should review the account. Since each monthly entry to the account is composed of a sum of completed jobs, the proper place to start the review is with the cost sheets. Departmental cost records should be reviewed if a process cost system is in use. Tests should be made of the orders transferring material into process. A comparison should be made of the total items transferred with the bill of materials covering the order. Individual stores cards should be examined to see that the materials are charged into the cost sheet at correct amounts and that excess material returned has been credited to the cost sheet. This test affords the auditor an opportunity to determine that the costing of materials to jobs is being applied consistently with the preceding year.

Direct-labor charges should also be tested. Random tests should be made of hours times rates on the time or job tickets for several jobs. Amounts on the job tickets should then be totaled and compared with the charge on the cost sheet. Where it is feasible to do so, total job tickets for one pay period should be footed to see that the total agrees with the charge to direct labor for that period.

In auditing overhead the first step is to ascertain and understand the client's method in setting predetermined burden rates. The method must be one that is generally accepted if an unqualified certificate is to be issued. Any standard text on cost accounting will indicate the generally acceptable methods.

Presumably all, or almost all, of the individual accounts included in burden will have been examined in connection with the related balance sheet accounts. There may be one or two miscellaneous expense accounts that do not first appear as balance sheet accounts. These should be reviewed and if material, should be analyzed.

Next the applied burden accounts should be reviewed. If a minor variance exists, it is normally closed to cost of goods sold. If the variance is material, it should be prorated between the finished goods inventory and cost of goods sold. It is not generally acceptable for over- or underapplied burden to appear on the balance sheet as a deferred charge or deferred credit. Exhibit 17-5 illustrates a cost of goods sold sheet for a manufacturing company using a perpetual inventory plan.

Some accounts in the overhead section deserve more attention than may be accorded them through the normal detail testing program. Insurance, taxes, payroll taxes, and depreciation will probably have been completely or substantially verified along with the related balance sheet

Exhibit 17-5

Supreme Manufacturers
Cost of Goods Sold
December 31, 1961

	(1)	(2)	(3)	(4)
Total per ledger			1784559.81	
Less: Overapplied burden (see below)			47005.67	
Total as adjusted			1737554.14	
Burden variance				52680.40
Applied as follows:		Amount	Per cent	Variance
Inventory of finished goods		215442.00	10.772	5674.73
Cost of goods sold		1784560.00	89.228	47005.67
Total		2000002.00	100.000	52680.40

WBJ

accounts. Repairs and maintenance should be analyzed and examined rather carefully to determine that no capital assets have been expensed. If a company has a policy of expensing all capital assets costing less than $500, the audit of material and labor items of less than that amount should be rather skimpy. For all items above that amount the auditor

would make a relatively exhaustive examination to satisfy himself that these are properly charged to repairs and maintenance.

Miscellaneous expense accounts of all kinds should be rather carefully reviewed if they are at all significant. Some companies maintain a strict policy with respect to the items that may be charged to miscellaneous expense. Others either have no policy or are lax in their enforcement of the stated policy. The result is that the account becomes a hodgepodge of unclassified expenses. There may be sufficient repetitious charges to the account to warrant opening a separate account for them. Or there may be isolated items of enough magnitude that they should be set forth separately. The miscellaneous account should be reserved for small or nonrecurring items that do not merit an expense account individually.

Selling and Administrative Expenses

Several of the accounts in this classification merit more intensive examination than is given others. These will be discussed below.

1. Review salesmen's commissions. Where compensation is paid on a basis other than a stipulated salary, tests should be made of the reasonableness of the amounts paid. Commissions paid are usually based on a percentage of net sales. Since the client must maintain records of sales and returns by salesmen, it is reasonably easy to make such tests as are desired of the correctness of payments. If the commission is at the same rate for all salesmen, an over-all proof should be made. Very little variance should arise if all salesmen receive the same percentage on sales. Even where varying rates are paid, it is easy enough to obtain annual sales by rate paid and thus prove total commission expense. Where different rates are paid for different products, the problem becomes more difficult, but again the client should have the basic information available, since the computation had to be made for the original payment.

2. Review travel and entertainment expense. Travel and entertainment expenses arise as a result of the sales effort. Much of the cost is incurred by the salesmen but often a sizable share is incurred by company officials as a further part of the total sales effort. In recent years the Internal Revenue Service has indicated a general displeasure with the manner of recording and reporting such costs. The auditor is in a good position to advise the client as to what is acceptable practice in this area.

The audit of travel expense is a difficult one. The question usually arises as to the reasonableness of the expense. Presumably the sales manager has approved the expense voucher but this procedure may

become more or less automatic. While the auditor generally is concerned with the correctness of the financial statements, he also has a responsibility to see that the stockholders' money is not wasted. If the auditor feels that the travel cost or entertainment of customers on an expense voucher is out of line, he should bring the matter to the attention of the sales manager.

Despite the difficulty of the task, tests should be made of the accuracy of the expense vouchers. Arithmetic errors often occur in these documents that are not always discovered in the routine office check of the vouchers.

3. Prove rent expense. Rent expense is usually a fixed amount and is supported by a lease. The auditor should examine the lease and abstract its provisions for the permanent file. A working paper should be prepared for the rent account but it is not necessary to list each month in analysis form when the monthly payment is fixed. Only where the balance in the account does not agree with the annual rental indicated in the lease is it necessary to make a monthly analysis. Rent expense for the test periods should be vouched and the checks in payment of the rent examined.

The examination of the lease is important because it fixes the responsibilities of the client as well as of the landlord. It is part of the auditor's task to see that the client is living up to the terms of the lease, for if he is not, a contingent liability exists. Some leases are so worded that the lessor is responsible only for the maintenance of the outside walls and roof of the building. The lessee pays all real estate taxes, insurance, and maintenance costs.

Many rental contracts have a fixed monthly rental plus an amount usually based on a percentage of sales, or a percentage of sales over a minimum amount. Here the auditor should make his own computation of rent expense to be certain that the amount is correct.

The client may sublease some of his space to others. The subleases should be examined just as carefully as the leases to make certain that the lessees are living up to the terms of their contract and that the client is receiving the full amount of rent due him.

4. Test advertising expense. Advertising budgets and costs are being increased each year as competition increases. The increased cost indicates that the auditor should increase his examination of the account. If the client keeps a record of the various advertising media used and the amount allotted to each, the review should include a comparison of actual expense with budgeted amounts by media. If the client does

Exhibit 17-6

Hogan, Hogan + Hogan
Advertising
December 31, 1961

	Total	Newspaper	Direct mail	Radio
January	284.61	284.61		
February	330.00	330.00		
March	386.50	286.50 √		100.00 √
April	472.00	372.00		100.00
May	620.00	420.00		200.00
June	2240.14	540.30	1339.14	360.70
July	2804.17	621.24	1642.43	540.50
August	3640.50	452.80 √	2450.50 √	737.20 √
September	1806.23	380.41	1014.22	411.60
October	1348.41	332.20	816.21	200.00
November	384.16	284.16		100.00
December	421.28	421.28 √		
Totals	14738.00	4725.50	7262.50	2750.00
Budget	15000.00	5000.00	7250.00	2750.00

√ - Vouched

not keep such a record, it might be worthwhile for the auditor to analyze the account to the degree necessary to determine such a classification. Exhibit 17-6 illustrates a working paper that might be used for such information not otherwise available which might be helpful in future planning. Tests should be made of the documentary evidence

and of the actual advertising where possible. As an example, if the client advertises in national magazines, the auditor might inspect the magazines for two or three months to see that the ad was included and that the space provided was the space paid for. Similarly newspapers should be examined to determine that the proper number of columns of advertising was received for the fee paid.

5. Review officers' salaries. Since officers' salaries are fixed by the board of directors, it is not usually necessary to analyze the salaries account. The type of proof shown in Exhibit 17-7 generally is all that is necessary.

Exhibit 17-7

Officer	*Salary voted*
President	$ 50,000
Vice-president	35,000
Treasurer	25,000
Secretary	20,000
Total	$130,000
Balance per ledger	$130,000

Salary checks should be examined for the test period. The individual earnings records of the officers should also be examined to see that they are in agreement with the amounts voted by the board. In the examination of cash disbursements the auditor should question any large payments to officers that are not charged to the salaries account.

Many companies have a bonus agreement with officers and other key personnel. The auditor should make a very careful examination of the computation of the bonus to see that it has been set up in conformity with the contract or bonus agreement. If the agreement indicates that the bonus is to be based on net sales or net profit, the auditor must look particularly at those segments of the accounts which might be misstated in order to increase the bonus base. It is only fair to those involved to be able to report that the bonus base had been correctly computed and that no inflation of the accounts existed.

It is still rather common to find bonus arrangements that require the use of a simultaneous equation for easy solution. It is possible to solve this type of problem on a trial and error basis but less time is consumed if the auditor is able to apply a little elementary mathematics. Both methods are shown below.

Problem. The President of Ajax Corp. signed an agreement with the

directors of the company whereby, in addition to his salary, he is to receive a bonus of 10 per cent of the net income after taxes. The bonus of course is to be deducted in determining net taxable income.

Determine the bonus and the tax, assuming taxable net income of $200,000 before bonus and a tax rate of 50 per cent.

Solution by Equation. Let bonus equal B. Let tax equal T.

Then $B = 0.1(200{,}000 - B - T)$

$$T = 0.5(200{,}000 - B)$$
$$B = 0.1[200{,}000 - B - 0.5(200{,}000 - B)]$$
$$B = 0.1(200{,}000 - B\ 100{,}000 + 0.5B)$$
$$B = 20{,}000 - 0.1B - 10{,}000 + 0.05B$$
$$1.05\,B = 10{,}000$$
$$B = 9{,}524$$
$$T = 0.5(200{,}000 - 9{,}524)$$
$$T = 95{,}238$$

In this particular situation the trial and error method is relatively simple because of the round numbers and percentages used. In actual cases it is more difficult and more time-consuming.

Solution by Trial and Error

Step 1

Net taxable income	$200,000
Bonus (10% of $200,000)	20,000
	$180,000
Tax	90,000
Net income	$ 90,000

Obviously the bonus is too much.

Step 2

Net taxable income	$200,000
Bonus (10% of $90,000)	9,000
	$191,000
Tax	95,500
Net income	$ 95,500

The bonus is closer but now is too low.

Step 3

Net taxable income	$200,000
Bonus (10% of $95,500)	9,550
	$190,450
Tax	95,225
Net income	$ 95,225

The correct bonus is being approached.

Step 4

Net taxable income	$200,000
Bonus (10% of $95,225)	9,522
	$190,478
Tax	95,239
Net income	$ 95,239

And finally,

Step 5

Net taxable income	$200,000
Bonus (10% of $95,239)	9,524
	$190,476
Tax	95,238
Net income	$ 95,238

The initial bonus used might have been set at $10,000 instead of $20,000, on the theory that the net income after tax would approach $100,000. This would have eliminated one set of computations.

6. Review repairs and maintenance. The repairs and maintenance accounts for the sales offices and the general offices must be reviewed in the same way as described for the factory repairs account. While the total amounts will not be as large as in the factory account, nonetheless the principle of capitalizing proper items must be applied. It is just as incorrect (although not as material) to expense a new calculating machine as it is to expense a new drill press. The same arbitrary amount as that set for factory purchases may or may not be reasonable, depending on the relative amounts involved.

In examining vouchers the auditor should note a possible violation of the capitalization policy made possible by the issuance of more than one voucher for one purchase, thus bringing the amount on each voucher below the stipulated amount for capitalization. The same trick is sometimes used to avoid seeking higher authorization for a purchase. Thus, if a foreman is authorized to approve purchases for items up to $500 and he wants to buy a tool that costs $700, he may issue two vouchers, each for $350, to avoid having the requisition approved by his superior.

7. Review legal and accounting expense. It is customary to analyze this account completely. The auditor is interested in reviewing the account for several reasons. A look at the legal invoices enables him to review the litigation the client has encountered during the year. He can

then write a better letter to the client's counsel inquiring about pending litigation. He can also determine from this review the last billing date. It is usual to ask the client's attorneys whether or not bills have been presented for services performed up to the year end. This question should certainly be posed if the most recent invoice was dated several months prior to the year end.

The auditor is interested in his own firm's invoice primarily to see how much the client was charged and to determine by reference to the check that the bill was paid. The amount charged for the engagement gives the auditor a fair idea of the amount of time allowed for the audit. While the prime requisite of all engagements is to make a satisfactory audit, the next consideration is completing the task in few enough hours that the firm makes a profit. After an audit has been performed a few times the fee tends to become fixed. There is generally some resistance on the client's part to raising the fee, even when it can be shown that additional work is required. Hence, as the auditor's salary is raised from year to year, he attempts to do a better, faster job so that the total charges do not exceed the fixed fee.

8. Analyze contributions. Contributions should also be analyzed completely. The auditor should be interested in the donees, since some of them may not be acceptable as deductions for federal income tax purposes. Furthermore, it is possible that some of the items charged to contributions might just as logically be charged to some other expense account. This may become important if total contributions exceed the maximum permitted by tax laws. The working papers should indicate clearly whether any items may be transferred to other accounts and whether or not the account is apt to exceed the limitation imposed by tax laws. Even if the client prepares his own tax return, the auditor should provide this information as a service to his client.

The authorization of contributions is also important, as the company is giving away money that belongs to its owners. Hence, there should be some statement of policy set forth by the board of directors indicating the maximum contributions that the president is authorized to make. Any contributions in excess of that amount should be authorized individually by board action. The auditor must be aware of these limitations if he is to make a satisfactory examination. All major contributions should be completely vouched and proper authorization observed. If any are found not to have proper authorization, they should be turned over to management with the request that retroactive authorization be obtained.

General Supply and Maintenance Co.
Miscellaneous Administrative Expense
December 31, 1961

	Total	Dues and subscriptions	Directors' fees and expenses	Employees' welfare	Dinners for staff at period end	Laundry and cleaning	Bank charges	Miscellaneous
January	338.16	250.00 °		33.25	24.00	32.90	8.51	
February	88.14			18.18	20.00	27.60	10.16	12.20
March	244.74		150.60 √	20.20 √	24.00 √	40.40 √	9.54 √	
April	357.31	250.00 °		23.15	28.00	35.20	7.16	13.80
May	89.32			30.50	24.00	26.50	5.12	3.20
June	208.43		137.85 √	16.28	24.00	30.30		
July	656.18	250.00 °		(1) 360.50 √	20.00	20.28		5.40
August	374.72	320.00 *		12.20	12.00	30.52		
September	227.36 √		171.20 √	18.40 √	16.00 √	20.50 √		1.26 √
October	334.36	250.00 °		30.45	28.00	25.25		.66
November	80.00			18.30	28.00	30.50	3.20	
December	786.77		160.40 √	(2) 541.10 √	28.00 √	31.60 √	11.15 √	14.52 √
Totals	3,582.49	1,320.00	620.05	1,006.17	276.00	351.65	54.84	56.98

W.B.J.

(1) - Office picnic
(2) - Office Christmas party
√ - Vouched
° - Dues - Trade Assn.
* - Dues for staff - Professional organization

9. Review miscellaneous expenses. As indicated in the factory expense section, there should be some review of all miscellaneous expense accounts. This holds as true for selling and administrative expenses as it does for factory expenses. The auditor should vouch all major items of expense, scanning for propriety of classification and proper authorization. It may well be that some of these items should be reported separately. If so, it is wise to make a subschedule on the analysis sheet showing the disposition of the items. Exhibit 17-8 illustrates an analysis of miscellaneous administrative expense.

Other Income and Expense

It is customary to analyze all accounts in this category. Interest income, dividend income, and interest expense will no doubt have been proved by this time to the related balance sheet accounts. If not, this should be done now. This is particularly important for interest expense. No audit is complete until interest expense has been tied in to the related liability accounts. The analysis need not be detailed if the proof can be made in total; otherwise the account must be analyzed and each entry traced back to the book of original entry. Exhibit 17-9 shows one method of accomplishing this in a simple manner.

Nonrecurring gains such as gains on sale of fixed assets, gain over cash surrender value on the death of an insured, and damages received should all be analyzed and a full story written in the working papers. These nonrecurring items are almost always of an unusual nature. All the facts surrounding the transaction should be determined and included in the write-up of the account. Not only will the details of the transaction probably be mentioned in the report, but also it is very possible that in future years there may be occasion to refer back to the particular transaction. If the information needed is lacking, the working papers have not served their purpose. It is always better to have too much information than not enough.

Nonrecurring losses may be caused by the sale of a fixed asset, by strikes, fires, floods, or unused plant. The determination as to the treatment of the loss as operating or nonoperating is sometimes easy, sometimes difficult. Management usually makes the decision but the auditor must satisfy himself that the treatment is or is not in accordance with generally accepted accounting principles.

It is not unusual to find charges of this nature carried directly to re-

Exhibit 17-8

Exhibit 17-9

The Ohio General Company
Interest Expense
December 31, 1961

	Dr.	W/P
Balance per ledger	3261 48	
Details from worksheets:		
Notes payable, bank	300 00	M1
Notes payable, trade	641 20	M2
Bonds payable	2000 00	O1
Interest on tax deficiency assessment	320 28	N12
Total per ledger	3261 48	

tained earnings on the theory that they would distort the income statement if shown there. The arguments for and against such a showing were presented in the preceding chapter.

With losses as with gains, the auditor should be certain that he has an analysis of each of these nonrecurring loss accounts and that the com-

plete story of each occurrence is included on the related working paper. A paucity of information in the working papers makes it difficult in later years to understand what happened and how it was treated.

The working papers for the federal income tax account were explained and illustrated in the section of accrued liabilities. If the client prepares the tax return, the auditor should have a sheet of notes for tax return on which he has recorded the items of interest that he will give to the client and also any unusual features or reconciling factors in the return. The auditor should review the return to be satisfied that it is a fair presentation of the expense and liability.

QUESTIONS AND PROBLEMS

1. Thirty years ago practically all audits were examinations only of the balance sheet. Today it is a rare occasion to have a balance sheet audit. To what do you attribute this change?

2. In what aspects of internal control relating to the operating accounts is the auditor interested?

3. What are the major objectives in auditing the operating accounts?

4. What are the basic approaches used by the auditor in examining the operating accounts?

5. If the assets and liabilities have been examined and the auditor is satisfied that the items included therein are correct, why should he concern himself with operating account errors?

6. Your client, a department store, writes 550 to 600 sales invoices each business day. These are summarized daily and recorded as one entry in a sales register. The statistical department gets a copy of each invoice. At the end of the month the sales register is footed and a standard journal entry is prepared and posted to the general ledger.

Assuming a reasonably good system of control, lay out a program for auditing sales.

7. Your client is a manufacturing company. In examining sales returns for the new year you note a return on January 2 amounting to 8 per cent of the December sales. You suspect that the sale was fictitious. Set down in order the steps you would follow to satisfy yourself on this point.

8. Your client has sales of $5,000,000 a year. There are only 20 to 25 sales a month, which are entered individually in a sales journal. Set up a program for auditing sales.

9. What is meant by a "set aside"? How does it concern the auditor?

10. What is meant by "auditing by comparison"?

11. Set up a program for the audit of tuition income of your college or university.

12. A stockholder who owns 28 per cent of the stock of his company asks you to make an audit of the company. He suspects management of overstating profits since they receive a bonus based on net income, in addition to their salaries. For the past five years the following bonuses were paid:

1957	$50,000
1958	—
1959	40,000
1960	—
1961	50,000

1. List some steps management might take to overstate net income.
2. Indicate the approach you would take to reveal these steps.

13. Your client maintains a cost accounting system tied in to the general ledger. You are assigned to audit the cost of goods sold account. List the steps you would follow in examining this account.

14. You discover that the applied burden account of a client has a debit balance of $103,462.18. Cost of goods sold amount to $778,986.80 and finished goods inventory to $121,025.61. Work in process inventory is negligible. Because of a serious recession late in the year the finished inventory has been reduced to $98,861.20, reflecting the lower of cost or market. All items in the inventory were reduced.

Prepare a schedule showing the disposition of the burden variance and prepare the adjusting journal entry to record it.

15. The officers of The Steel Company are entitled to a bonus of 10 per cent of net income in excess of $100,000 after taxes. The net income for 1961 before bonus and taxes is $268,540. Using a tax rate of 52 per cent, compute the bonus, the tax, and the net income.

16. The Sanford Rolling Mills spent $1,000,000 for a new rolling mill. Rolls are changed rather frequently because they become chipped and unusable. New rolls cost $30,000 each. When you examine the repairs account you find that the new rolls are charged to this account. You finally conclude that this treatment is permissible.

Justify each of the three treatments possible for such a disbursement.

17. You find the following accounts in the ledger of a new client:

Discounts lost (debit)	$ 103.62
Discounts not taken (credit)	4,816.52

What does each account represent? What disposition will you make of the accounts in the financial statements?

18. Your client sells farm machinery on the installment basis. For the year ended December 31, 1961, you find the accounts as listed in Exhibit 17-10 on the books.

Exhibit 17-10

Deferred Gross Profit—1959—40%

	1/1/61	Balance	2,460

Deferred Gross Profit—1960—40%

	1/16/1	Balance	22,910

Sales—1961

	240,000

Cost of Goods Sold—1961

146,400	

1959 Accounts receivable on hand as of 12/31/61	—
1960 Accounts receivable on hand as of 12/31/61	$ 5,500
1961 Accounts receivable on hand as of 12/31/61	80,000

To what would you pay particular attention in auditing these accounts? What was the total realized gross income for 1961?

19. The Shavely Mower Company makes power mowers. The mowers are driven by Clinton engines, which are purchased direct from the manufacturer. Your study of the production and sales records for 1961 reveals the data shown in Exhibit 17-11.

Exhibit 17-11

	1/1/61		*12/31/61*
Inventories			
Finished goods	480		360
Work in process	20		20
Clinton engines	225		186
Sales ($50 each)		$250,700	
Purchases of engines ($10 each)		54,000	

What conclusions may be drawn from the above facts? What steps will you take?

Chapter 18

COMPLETING THE AUDIT; THE FINANCIAL STATEMENTS

COMPLETING THE AUDIT

In every engagement the time comes when the auditor has analyzed the last account, prepared the last reconciliation, and read the last bit of documentary evidence necessary to give him a basis for forming an opinion. He has completed the portion of the audit having to do with the review of the accounts and thus has finished a major portion of the total task. After he has reached this point, there still remains a considerable amount of work to be done before the report is delivered to the client. The working papers must be completed, the financial statements prepared, and the audit report written. In this chapter the completion of the working papers and the preparation of the financial statements will be discussed. The audit report will be presented in the following two chapters.

COMPLETING THE WORKING PAPERS

The following steps are necessary to make certain that all is ready for the final review. While a certain chronology is apparent, it does not much matter in what order the steps are performed. It *is* important that each auditor work out for himself a standard procedure to follow so that this phase of the work becomes almost automatic as far as the order of steps is concerned.

There are two basic objectives in performing this final phase of the work. The first is to make certain that nothing has been overlooked, that all work deemed necessary has been done. The second is to see that the papers are complete and ready for final review and filing. Again at this point the auditor should remind himself that it is always possible his

working papers may be called as evidence in some litigation. This is his last opportunity to see that they are complete and in such order as he might want them to be at some unknown future date. The following steps, if carefully performed, should assure him of the readiness of the papers for final review and disposition.

1. Review the agenda sheet. During the course of the examination the auditor has made notes and raised questions on an agenda sheet about items that at the moment were unanswerable. He should now review this sheet to see that all questions have been satisfactorily answered.

Many reviewers turn first to the agenda sheet to learn what difficulties were encountered in the engagement and what problems had to be turned over to the supervisor or partner for decision. The auditor should recognize that his answers to these questions or problems must be such that they are understandable by others than himself. Since the review of the papers may not take place until he is enmeshed in another engagement, it will be much more difficult to explain the situation then than it is now. Hence his answers to the questions and problems listed should be clear and concise but complete.

2. Review the audit program. The audit program is a preplanned list of operational steps. Being preplanned, it is subject to modification as the audit progresses. Some steps will be dropped from the program, others may be added. New situations or operations may cause drastic revisions of the program. While it is perfectly in order for the auditor to make such changes, he should note on the program the reasons for making the revisions.

The other use of the audit program at this point is as a check list. Taking into consideration the revisions made, the auditor has laid out for himself (or has had laid out for him) a series of procedures and techniques he was to have followed in making the examination. He should now review the program to see that he accomplished all the steps he set out to perform. He should ascertain, through the review of the program, that he has done all that he wants to do. In many types of audit program this means seeing that all steps on the program have been initialed by the person doing the work. It is a simple matter to forget to initial the program. It is just as simple to make certain at this point that all steps that should be initialed have been. If some steps are not signed for, it is easy at this point to determine who was assigned the job and whether or not he did it. Later on it will not be so easy.

3. Review adjusting journal entries. During the course of the audit the auditor may have made many adjusting and reclassifying journal

entries, or he may have found it unnecessary to make any corrections. Some clients take great pride in having their books in such good shape and so up to date that no adjustments are necessary. In fact some clients, particularly if they have already prepared the financial statements, will object strenuously to any auditor's adjustments. Whatever the situation the auditor should now review the adjustments that have been made.

When completely posted these entries should appear in three places. The complete chronological listing of journal entries (both adjusting and reclassifying) should appear as a separate section of the papers. Many auditors wait until this point in the examination to post the journal entries but they should appear on this list, if nowhere else. The second place that the entries should appear is on the working trial balance or working balance sheet. While it is preferable to post the entries to the trial balance as the audit progresses, this often is not done. In any event the auditor should now post the entries (or trace this posting) to the working trial balance. Unless there are only a few adjustments it is wise to make a check mark against the entry as it is transferred to the trial balance. This serves in the same way as a folio reference in the books of account and indicates to the auditor that the posting has been done. The third place in which the entries will be found is on the individual analysis sheets to which they refer. It may not be possible to post all these entries to analysis sheets, for some may refer to accounts for which no sheets have been prepared. Unless they are posted to the available sheets, the individual worksheet balances will not agree with the amounts shown on the financial statements.

As the auditor reviews the entries he should raise several questions about them. First, is the entry necessary? This may seem superfluous but it sometimes happens that an entry deemed necessary at the time it is prepared may, because of information subsequently received, now be considered not necessary. What may appear material at the beginning of an audit may seem insignificant at the close of the engagement. So, although a deletion does not often occur, the auditor should question the necessity of each entry.

The entries should also be reviewed to see that they are mathematically correct and that the client's account titles are used. It is expected that there will be no arithmetical errors in the journal entries, but it is better to be certain at this point than to find out later when the worksheet will not balance. Explanations for the entries should be sufficiently clear that the client's bookkeeper will have no difficulty in understanding them. The entries should have been reviewed with the client as they were

made. The auditor does not have the authority to make changes on the client's statements without the client's consent. This authority may be a blanket authority granted at the outset of the engagement or it may be necessary to gain consent for each entry as it is made. The more capable the client's accounting staff, the more difficult it is to persuade them to make adjustments, since this implies that their work was incorrect originally.

Some auditors insist that the client book all adjusting entries as the auditor makes them. Others make a carbon copy of all entries and go over them with the client at the end of the engagement, leaving the duplicate copy for the client's use in recording the entries. Still other auditors have their office type a copy of the entries and mail it to the client for recording. One way or another the entries must be given to the client so that they may be recorded. Some auditors feel that they cannot release the audit report until they have satisfied themselves that the entries have been recorded, while others are content to trust the client to record them. On new engagements or in situations where the auditor is not certain that the client will comply, it is better actually to prove the final balances per the working trial balance with the adjusted book balance.

The auditor should also provide the client with the reclassification entries that he has made. Most companies do not record these entries but have them available for reconciling the audited statements with their own statements. Some few concerns insist that their statements be precisely the same as those included in the audit report. This makes it necessary that they record the reclassification entries. These entries are then reversed as of the first day of the new fiscal year. Regardless of which plan the client follows, he should be given a copy of the reclassification entries separate from the adjusting entries.

4. Complete the individual worksheets. It would be ideal if the auditor could work his way through the accounts in order from cash to other expense knowing that as he completed each account he would not need to refer to it again. Unfortunately this is not usually the case. In most audits it is not practicable to follow this plan of approach. Furthermore, the examination of an account may reveal a necessary correction of another account that has already been supposedly completed. Because of this many auditors follow the practice of not closing off the worksheets and analyses until they are certain that there will be no more corrections, that is, until they have reached this point in the audit. It is now advisable to review and complete the individual worksheets. As he reviews each

sheet, the auditor should attempt to place himself in the position of a reviewer and should pose these questions:

1. Does the sheet include all the data necessary?
2. Are there any ambiguities?
3. Is the sheet neat and legible?
4. Is there a clear, logical development of the material?
5. Do the headings, dates, initials conform to firm policy?
6. Are all audit tick marks explained?
7. Are all explanations, decisions, etc., complete?

If these questions can all be answered satisfactorily, the paper is complete for the time being.

5. Complete the working trial balances. The working trial balances should now contain the beginning trial balance, the ending trial balance, and all adjustments. The next step is to complete these sheets. Before attempting to extend amounts to distributive columns the adjusting journal entry columns should be footed. If the trial balance has not been broken into two groups (balance sheet accounts and operating accounts) the columns should balance. If separate sections have been used for the separate sections of the accounts, the journal entries for each section will not balance. A forcing figure—the difference between total debits and total credits—should be inserted opposite the net profit figure in each section. This represents the net of all the adjustments to net income and should permit both sections to balance. This is illustrated in Exhibits 3-7 and 3-8 (pages 76 and 77). Much time is wasted by failing to foot the adjusting entry columns and later finding that the final columns are out of balance.

The next step is to extend the ending trial balance, plus or minus adjustments, to the proper columns. If the complete trial balance is on a single sheet an error in extension will not cause much trouble. If fifteen or twenty sheets are involved one error will cause a considerable waste of time. Particularly on this task, it is better to do the job right the first time. When the trial balance amounts have been extended the distributive columns should be totaled and the sheets closed off.

6. Index the working papers. The technique of indexing the working papers was discussed in Chapter 3. The auditor may have partially indexed the papers as he completed them or he may have deferred this task until the present moment. In either case he should now complete the indexing of the papers. Before he starts this task the papers should be arranged or rearranged in the exact order in which he wants to file them. The indexing task is a simple one after the papers are put in order.

7. Reference and cross-reference the working papers. Each balance sheet account should be supported by some sort of work paper. This may be a leading schedule or an individual analysis sheet. The task now is to tie the two together and make certain that they are in agreement. The way in which this is most commonly done is to place on the working trial balance opposite the final balance of the account the index number of the page on which the account is supported. "T/B" placed under the amount on the individual sheet indicates that it has been proved to the working trial balance. Indexing and referencing are usually done in colored pencil so that the index number or reference stands out clearly from the rest of the material.

Many analysis sheets are supported by subsidiary schedules and analyses while others have reference to other accounts, sometimes far removed in the working papers. It is desirable to cross-reference all supporting and related working papers. This helps the reviewer in his examination of the audit and also is helpful on the engagement the succeeding year. The importance of this step cannot be overstressed since it is a phase of auditing in which most beginning auditors are woefully weak. Referencing and cross referencing are illustrated in Exhibit 3-10 (page 85).

8. Return client's papers. The client may prepare many schedules for the auditor's use, some to be retained by the auditor and some to be returned to the client. In addition the auditor borrows many items and examines many documents that belong to the client. It is embarrassing for the auditor to clean out a brief case in his office and to find some papers and material belonging to the client. As a last step in clearing up odds and ends the auditor should examine very carefully his working papers and his brief case to make certain that everything belonging to the client has been returned to him.

9. Review the working papers. Depending on the size of the auditing firm and of the particular engagement, the review of the audit work at this point may be done by a partner, manager, or supervisor. The field review of the audit should be made before the statements are prepared and the audit report written so that backtracking may be kept to a minimum.

The reviewer is interested in several points. First he is interested in seeing whether or not the story told in the working papers is supportive of the opinion the firm will express. He also wants to know if the audit has been made in accordance with generally accepted auditing standards and in accordance with policies established by the firm. The internal

control questionnaire should be examined to see that it has been brought up to date and that any changes in audit procedures necessitated by changed situations have been duly indicated and followed. The working papers should be reviewed to see that the audit procedures were applied in the light of the auditor's evaluation of the control system.

The reviewer is interested in the agenda sheet for he wants to know that all questions or doubtful points have been cleared. He also wants to satisfy himself that the decisions made on questionable items are reasonable in view of the surrounding circumstances.

The reviewer is also interested in seeing that the adjusting journal entries are reasonable and material. Here again unusual situations with which the reviewer ought to be familiar are brought to light.

The reviewer is keenly concerned with the working papers. He looks for completeness, neatness, legibility, and conformity with firm policy. The review of the working papers is a continuing affair. It starts with the lowest ranking man who is responsible for the work of another and proceeds through all the ranks to the partner who signs the report. As an auditor gains experience and indicates his capability and responsibility, more of the review work is thrust upon him and the review of his papers by others is less complete and intensive. Nonetheless there must always be some review of the work performed. This should be made by a person of greater experience and wider background than the auditor so that these factors will benefit the review. When the field review has been completed and the reviewer is satisfied with the working papers, the auditor may proceed to the preparation of the financial statements.

THE FINANCIAL STATEMENTS

Some companies will have their financial statements ready to hand to the auditor when he commences the examination. Others rely on the auditor to prepare them. Regardless of the pattern followed the statements as they appear in the auditor's report should include the characteristics indicated in the following paragraphs.

All-purpose versus Single-purpose

The auditor should be very cautious about issuing a so-called single-purpose balance sheet where undue emphasis is placed on one portion of the statement. These are prepared, if at all, for a person or group of persons having a great interest in only one section of the balance sheet. For example, short-term creditors are particularly interested in the current asset and current liability groups. Bondholders have a major interest

in that section of the balance sheet containing the security for the bonded debt, and so on.

Since a single-purpose report stresses one section of assets only, the other sections of the balance sheet may be so condensed as to render them meaningless. If the statement is circulated to persons other than those for whom it was prepared, it may be misleading. The auditor's safest course is to prepare an all-purpose balance sheet. If this is not permitted, he should mark the balance sheet very clearly as being a special-purpose statement prepared for the particular group requesting it. Then all who see it will recognize that it is not the normal balance sheet.

General Principles

The statements should be presented in comparative form, with the current year being shown first. More years may be presented if there is space. Practice in published reports to stockholders varies, with some companies presenting financial data for the past ten or fifteen years. Usually the formal audit report need have no more than two years' data unless a special situation demands special treatment.

The basis of valuation should be disclosed for all types of assets. Generally this basis is cost minus any valuation or other adjustments. Other types of valuations may be given parenthetically or by footnotes. For example, current values of fixed assets may be considered of enough importance to merit recognition in footnotes.

There is a considerable accounting literature concerning the effect of the changing price level on the business economy in general and on the individual company in particular. To date there has not been widespread acceptance of the principle of applying an index to financial statements, although the effects of inflation are well recognized. It is still recommended that cost should be the basis of recording and presenting accounting data. If statements *are* prepared on the basis of some price index, they should be considered as being supplementary to the formal statements prepared on a cost basis. It is not inconceivable that at some future date there may be sufficient general acceptance of a specific index number to cause the adoption of statements prepared on that basis. This day has not yet arrived. Most accountants agree that until there is such general agreement cost is the best basis that we have.

Full Disclosure

If one general principle of statement preparation can be singled out as being the most important, it is probably that of full disclosure. Under rule 5 of the *Rules of Professional Conduct* of the American Institute of

Certified Public Accountants, the auditor is held to be guilty of an act discreditable to the profession if he fails to make full disclosure of all material facts. These may have to do with the accounts, amounts, application of generally accepted accounting principles, or lack of consistency.

If the data shown on the balance sheet are incorrect or misleading, the auditor must disclose the fact. If additional data are necessary to prevent the statement from being misleading, he is required to include this information. Thus the auditor has the task of judging whether or not the statements as prepared present all the necessary facts correctly and com-

Exhibit 18-1

Exhibit A

THE GENERAL CORPORATION

Comparative Statement of Financial Position

December 31, 1961 and 1960

	1961	*1960*
Current assets		
Cash	$ 449,334	$ 435,110
Accounts receivable, less allowance for doubtful accounts: 1961, $78,080; 1960, $89,230	1,753,435	1,828,484
Inventories: Finished goods, work in process, and raw materials and supplies, at the lower of cost or market, on a first-in, first-out basis	2,694,863	2,626,786
Prepaid expenses	66,288	63,859
Total current assets	$4,963,920	$4,954,239
Current liabilities		
Accounts payable and accrued items	$ 879,624	$ 983,764
Income taxes payable, estimated	257,200	426,650
Notes payable to banks	624,632	1,114,892
Current maturities of long-term debt	21,325	25,011
Total current liabilities	$1,782,781	$2,550,317
Net working capital	$3,181,139	$2,403,922
Investments and deposits, at cost	258,318	243,180
Plant and equipment, at cost	3,474,382	2,987,190
Less: Accumulated depreciation	(1,321,980)	(1,144,760)
Deferred charges	56,890	45,514
Total assets less current liabilities	$5,648,749	$4,535,046
Long-term debt		
5½% sinking fund debentures, due 1970	$1,829,000	$ 758,000
3½% promissory notes	350,000	350,000
Mortgages and other long-term debt	57,288	58,561
Total long-term debt	$2,236,288	$1,166,561
Owners' equity, Schedule A1	$3,412,461	$3,368,485

pletely. This is quite a responsibility, but it is one which the independent public accountant must assume if he is to fulfill his obligations.

Disclosures may be made in several ways. They may consist of parenthetical expressions on the face of the statement; they may be made by footnotes which are attached to and become an integral part of the accounting statements; or, if the auditor feels that this disclosure is not sufficient, he must report the deficiency in the short-form audit report.

The balance sheet. The balance sheet may be presented in the conventional account form with assets on the left and equities on the right. It may also be presented in report form, in which case it is called a statement of financial position. Although there is some variation in this form, the normal practice is to present first the current assets, from which total is deducted the total of the current liabilities. This establishes the net working capital. Investments, net fixed assets, and deferred charges are added to the net working capital to produce total assets less current liabilities. From this total the long-term debt is subtracted to produce the final figure which is termed variously "net assets," "net investment," "owners' equity" or some similar caption. This amount is then broken down in a supporting schedule to show the component parts of the owners' equity section. This type of statement is illustrated in Exhibit 18-1.

Exhibit 18-2

Schedule A1

THE GENERAL CORPORATION

Statement of Owners' Equity

December 31, 1961 and 1960

	1961	*1960*
Preferred stock, $4.50 cumulative, $25 par		
Authorized, 2,500 shares		
Issued and outstanding, 1,022 shares	$ 25,550	$ 25,550
Common stock, $0.50 par value		
Authorized, 500,000 shares		
Issued and outstanding, 282,794 shares	141,397	141,397
Premium on stock	929,950	929,950
Retained earnings, Exhibit B	2,315,564	2,271,588
Total owners' equity, Exhibit A	$3,412,461	$3,368,485

In preparing the schedule shown in Exhibit 18-2, the auditor has access to a considerable variety of terms and descriptions in use today. He is free to choose those he believes best suited to the situation. There

is a general trend away from the use of "net worth" or "capital stock and surplus." Regardless of the precise terminology, the supplementary schedule should set forth clearly the sources of the net assets fully explained by descriptive titles.

Retained income statement. All surplus accounts in which changes have occurred should be analyzed and presented in comparative statement form. All items should be so clearly captioned that there can be no mistaking the meaning of the descriptive material. The statement of retained income may include only dividend changes, profits, and appropriations of surplus or it may also include certain major nonrecurring items. The practitioner must make his own determination as to whether such items should be included in the operating statement or in retained income. Since there is as yet no general agreement among accountants as to which presentation is preferred, auditors may well be influenced to some degree by the wishes of the client. Until such time as there is general agreement as to the better method no one can blame companies for arraying the arguments which support their own particular method and for insisting that the weight of authority is sufficient to support their point of view. The point to be stressed is that if an item *is* charged or credited directly to retained income, the item should be so clearly described that there can be no possible misunderstanding of it.

The statement of retained income for The General Corporation is presented in Exhibit 18-3.

Exhibit 18-3

Exhibit B

THE GENERAL CORPORATION

Comparative Statement of Retained Earnings

For the Years Ended December 31, 1961 and 1960

	1961	*1960*
Balances, January 1	$2,271,588	$2,001,088
Net income, Exhibit C	274,809	501,333
	$2,546,397	$2,502,421
Less: Dividends declared and paid		
On preferred stock, $4.50 per share	$ 4,599	$ 4,599
On common stock, $.80 per share	226,234	226,234
Total dividends	$ 230,833	$ 230,833
Balances, December 31, Schedule A1	$2,315,564	$2,271,588

If there are other types of surplus accounts they should be presented in statement form when changes have taken place, otherwise such pres-

entation is not necessary. Most changes in such accounts occur in connection with capital stock issues.

The income statement. The income statement, or operating statement, should be presented in as much detail as is possible. Space limitations often force the use of major totals only, leaving the details to be supplied in supporting schedules. Such a statement is shown in Exhibit 18-4 for The General Corporation.

Exhibit 18-4

Exhibit C

THE GENERAL CORPORATION

Comparative Income Statement

For the Years Ended December 31, 1961 and 1960

	1961	*1960*
Net sales	$8,643,301	$8,695,080
Less: Cost of goods sold		
Inventory, January 1	$1,452,615	$1,114,410
Cost of goods manufactured, Schedule C1	6,022,580	6,496,886
	$7,475,195	$7,611,296
Inventory, December 31	1,157,478	1,452,615
Cost of goods sold	$6,317,717	$6,158,681
Gross profit	$2,325,584	$2,536,399
Selling expenses, Schedule C2	$1,115,230	$1,057,868
General expenses, Schedule C3	680,770	598,392
Total operating expenses	$1,796,000	$1,656,260
Net operating profit	$ 529,584	$ 880,139
Nonoperating expense, net	85,775	21,306
Net income before taxes	$ 443,809	$ 858,833
Federal income taxes	169,000	357,500
Net income, Exhibit B	$ 274,809	$ 501,333

A form of income statement seen frequently in published reports is the "single-step" statement. This statement combines all items of income, regardless of source, in a first section and all expenses in a second section. A single subtraction is made to arrive at net income. In addition many single-step statements are prepared on a functional rather than on a natural account basis. The income statement of The General Corporation has been recast in Exhibit 18-5 in single-step form.

Since this statement is prepared largely on a functional basis, much of the information normally used by analysts and credit grantors is not available. It is an easily read statement and one that persons not trained

Exhibit 18-5

Exhibit C

THE GENERAL CORPORATION

Comparative Income Statement

For the Years Ended December 31, 1961 and 1960

	1961	*1960*
Revenues		
Net sales	$8,643,301	$8,695,080
Other income, net	53,765	57,739
Total revenues	$8,697,066	$8,752,819
Costs and expenses		
Materials, supplies, and services purchased	$3,386,472	$3,246,578
Wages and salaries, including fringe benefits	4,469,970	4,350,495
Depreciation and amortization	257,275	217,868
Interest and debt expense	139,540	79,045
Federal income taxes	169,000	357,500
Total costs and expenses	$8,422,257	$8,251,486
Net income, Exhibit B	$ 274,809	$ 501,333

in accounting are able to understand with a minimum of difficulty. While this type of statement is rather common in published reports to stockholders, it is probable that most auditors' reports follow the orthodox treatment of the operating accounts.

The combined statement of income and retained income represents a compromise between those who champion the all-inclusive income statement and those who support the "current operating" theory with its concomitant charges and credits directly to retained income. In this combined statement all the transactions for the year are shown. Direct entries to surplus are made in the surplus section of the statement. Anyone reading the statement is forced to take cognizance of such items. This is not true if the surplus statement is presented separately, when it may well be ignored by the reader. A combined statement for The General Corporation is presented in Exhibit 18-6.

Supporting schedules. As a general rule each major statement should be complete on one page. This often means that only items of major significance will appear on the statement and that each major total is supported by a schedule showing the details of the total. For example, plant and equipment is often shown on the balance sheet as one item with a supporting schedule similar to Exhibit 11-5 (page 307). The number of schedules needed to support the balance sheet items must be a matter for the auditor to decide in each situation.

Exhibit 18-6

Exhibit B

THE GENERAL CORPORATION

Comparative Combined Statement of Income and Retained Income

For the Years Ended December 31, 1961 and 1960

	1961	*1960*
Net sales	$8,643,301	$8,695,080
Less: Cost of goods manufactured and sold, Schedule B1	6,317,717	6,158,681
Gross profit	$2,325,584	$2,536,399
Selling and administrative expenses, Schedule B2	1,796,000	1,656,260
Net operating profit	$ 529,584	$ 880,139
Nonoperating expense, net	85,775	21,306
Net income for year, before taxes	$ 443,809	$ 858,833
Federal income taxes	169,000	357,500
Net income for year	$ 274,809	$ 501,333
Retained earnings, January 1	2,271,588	2,001,088
	$2,546,397	$2,502,421
Less: Dividends declared and paid	230,833	230,833
Retained earnings, December 31, Schedule A1	$2,315,564	$2,271,588

Supporting schedules for the income statement ordinarily are prepared for cost of goods manufactured or cost of goods manufactured and sold, selling expenses, and general or administrative expenses. Each schedule should appear separately, that is, there should not be more than one schedule to a page. Some auditors like to show the details of the non-operating items in the income statement. Others prefer showing the net income or expense on the statement with a supporting schedule detailing the individual items. The amount of space available, the number and materiality of the items, and the auditor's wishes will be determining factors in deciding which method to follow.

The funds statement. Many audit reports present for the client's information a statement of sources and application of funds. This statement may be included with other financial statements or it may be included in the text of the long-form audit report. Its use is generally dependent on the client's ability to read and interpret the financial statements. If the client has had sufficient training and experience in reading statements to be able to interpret them intelligently, the funds statement may be deleted. If he is so unfamiliar with statements as to ask why his cash balance does not equal the net income for the year, the funds statement would probably be helpful to him.

As a help to stockholders many companies publish a funds statement in the annual report to stockholders. Most stockholders, it may be assumed, have little if any accounting training and so will benefit greatly from the presentation of this statement.

A funds statement for The General Corporation, based on the preceding statements, is shown in Exhibit 18-7. In addition to the data given in the statements, $80,055 of fixed assets were scrapped.

Exhibit 18-7

THE GENERAL CORPORATION

Statement of Sources and Application of Funds

For the Year Ended December 31, 1961

Sources of funds	
Long-term debt: Debentures issued	$1,071,000
Operations	
Net income	$ 274,809
Add: Depreciation and amortization	257,275
Total from operations	$ 532,084
Total funds provided	$1,603,084
Application of funds	
To long-term debt: Payments on mortgages	$ 1,273
To owners: Dividends paid	230,833
To purchase of assets	
Investments	15,138
Plant and equipment	567,247
Deferred charges	11,376
To increase in net working capital	777,217
Total funds applied	$1,603,084

Referencing. Each major statement and supporting schedule should be indexed and cross-referenced. Exhibits A, B, and C for The General Corporation illustrate this point. The particular system used is not of great importance but the full use of some system is. The statements should be referenced to supporting schedules and to each other and the supporting schedules should be referenced to the major statements.

QUESTIONS AND PROBLEMS

1. List the steps necessary in completing the audit, after the last account has been analyzed, up to the preparation of the financial statements.

2. Why should the audit program be reviewed after all the audit work has been done?

3. In what three places should the reviewer expect to find adjusting journal entries?

4. Distinguish between an adjusting journal entry and a reclassification entry.

5. What qualities would the reviewer look for in reviewing a working paper supporting a balance sheet account?

6. Why should the adjusting journal entry column of the working trial balance be footed before the extensions are made?

7. Why are referencing and cross referencing the working papers so important?

Exhibit 18-8

GOLDSTONE, INC.

Comparative Balance Sheets

As of December 31, 1961 and 1960

	1961	*1960*
Assets		
Current assets		
Cash	$ 17,742	$ 3,772
U.S. securities	31,000	21,000
Accounts and notes receivable (net)	56,248	45,268
Inventories	82,073	85,894
Prepayments	5,575	4,700
Total current assets	$192,638	$160,634
Investments	25,000	25,000
Fixed assets	$392,583	$291,179
Less: Accumulated depreciation	269,761	167,436
Book value	$122,822	$123,743
Total assets	$340,468	$309,377
Liabilities and Equity		
Current liabilities		
Accounts payable	$ 46,532	$ 51,929
Bank loans	30,000	50,000
Accrued liabilities	4,022	1,140
Estimated income tax payable	6,000	21,481
Total current liabilities	$ 86,554	$124,550
Stockholders' equity		
Capital stock	$150,000	$100,000
Premium on stock	20,000	—
Total contributed by stockholders	$170,000	$100,000
Retained earnings	83,906	84,827
Total stockholders' equity	$253,906	$184,827
Total liabilities and equity	$340,460	$309,377

8. Why are single-purpose balance sheets dangerous for the auditor?

9. What general principles should be followed in preparing financial statements?

10. What is a "single-step" income statement?

11. What advantages are inherent in the combined income and retained income statement?

12. Why are comparative statements more meaningful than single statements?

13. What purpose does the funds statement serve?

14. Comparative balance sheets and the income statement for Goldstone, Inc., are presented in Exhibits 18-8 and 18-9. In addition to the balance sheet data you need the following figures:

Depreciation, $139,243
Dividends paid, $15,000
Cost value of fixed assets sold, $36,948
Accumulated depreciation thereon, $36,918

Prepare a statement of sources and application of funds for the year ended December 31, 1961.

Exhibit 18-9

GOLDSTONE, INC.

Income Statement

For the Year Ended December 31, 1961

Net sales			$511,431
Cost of goods sold			368,527
Gross profit			$142,904
Operating expenses			
Selling expenses		$64,902	
Administrative expenses		64,586	129,488
Net operating profit			$ 13,416
Nonoperating items			
Gain on sale of fixed assets		$ 5,875	
Interest income		1,708	
Miscellaneous		1,368	
		$ 8,951	
Interest expense	$ 987		
Write down of inventory	3,959	4,946	4,005
Net income for year, before taxes			$ 17,421
Estimated tax, 1961		$ 6,000	
Over provision in 1960		2,658	3,342
Net income			$ 14,079

Chapter 19

THE AUDITOR'S REPORT (SHORT FORM)

IMPORTANCE OF THE AUDIT REPORT

The auditor's short-form report is the end result of the examination. Some clients receive a long-form report in addition to the short form, but it is in the short form (sometimes called the auditor's certificate) that the auditor expresses his opinion as to the fairness of the client's financial statements.

The auditor has spent days, weeks, or months examining the client's business records. He has been inquisitive and has asked many searching questions, some of which the client may have thought irrelevant. He has upset the office routine despite his attempt to dovetail his work into that of the client. All this investigating, examining, and questioning has been done so that he could write the two short paragraphs of the report.

Importance to third parties. The auditor's report, if unqualified, is a stamp of approval placed on the client's financial statements. The report says in effect "We have examined these statements and, in our opinion, as professional independent accountants, they fairly present the client's financial position and results of operations." It matters not to the auditor whether the financial position and/or the results of operations are good, bad, or indifferent. His report deals with the results as he found them.

Analysts, investors, credit managers, and other interested persons place great reliance on the auditor's report. Their varying interests are sometimes adverse, but in all cases they need the financial data provided by management and they know that if the auditor's opinion is attached, they may rely on the fairness of the statements. Decisions are made, based on the statements, concerning actions to be taken affecting the client. Unless the auditor's report is attached to the statements, they may be

discounted to a considerable degree. These third parties depend on the audit report to call attention to any deviations from the application of generally accepted accounting principles or to any lack of consistency in the application of these principles that might make the statements misleading in any respect.

In addition, the outsiders rely on the auditor to follow generally accepted auditing standards and to perform enough audit procedures to enable him to express an opinion. In other words, he is expected to do an adequate job in examining and in reporting.

Importance to the client. The client with a large business probably has enough confidence in his accounting staff to rely on the statements they prepare. For his purposes, then, the audit report is of importance primarily because of its impact on third parties. Where a professional management operates the business the audit report is important because it confirms to the board of directors the reliability of the statements. There are other purposes for having an audit made, enumerated in Chapter 1, but the reasons given above constitute the primary importance of the audit report to the client with a large business.

For smaller businesses the short-form report is important because it indicates to management that the statements are fair and may reliably be used in making managerial decisions. For a very small business the report is important because it is the client's only source of financial statements.

Importance to the auditor. As the public accounting profession has grown in size and stature, the auditor's report has become of increasing importance. Its significance has grown to clients and to outsiders, as well as to the auditor.

The importance that the profession attaches to the report is evidenced by the fact that the American Institute of Certified Public Accountants makes reference to it in its *Rules of Professional Conduct.* Rule 5 states that:

> In expressing an opinion on representations in financial statements which he has examined, a member may be held guilty of an act discreditable to the profession if
>
> *a.* He fails to disclose a material fact known to him which is not disclosed in the financial statements but disclosure of which is necessary, to make the financial statements not misleading; or
>
> *b.* He fails to report any material misstatement known to him to appear in the financial statement; or
>
> *c.* He is materially negligent in the conduct of his examination or in making his report thereon; or

d. He fails to acquire sufficient information to warrant the expression of an opinion, or his exceptions are sufficiently material to negative the expression of an opinion; or

e. He fails to direct attention to any material departure from generally accepted accounting principles or to disclose any material omission of generally accepted auditing procedure applicable in the circumstances.

Each time he signs an audit report the auditor stakes his reputation as to the quality of the audit and of the report. If the report is inaccurate, incomplete, or misleading, not only does he lay himself open to possible suspension or expulsion from his professional societies, but he also subjects himself to possible suits for damages. These suits may be initiated by the client or by injured third parties who placed reliance on the report. It is no wonder, then, that great pains are taken to write a report that is clear, concise, and complete.

SECURITIES AND EXCHANGE COMMISSION REQUIREMENTS

Several specific requirements have been set forth by the Securities and Exchange Commission to be included in audit reports for companies reporting to it. These requirements have been included in the short-form report recommended by the American Institute of Certified Public Accountants. The specific requirements are as follows:

The report must be dated; the date may appear at the top or bottom of the report but it must be there. The letter must be addressed specifically to the client; therefore, it is essential that the auditor determine when he takes the engagement exactly who is engaging him. It may be the company, represented by the president or treasurer; it may be the board of directors, represented by a director or by an auditing committee; or it may be the stockholders, represented by an auditing committee. In rare cases it may not be the examinee at all, but a bank, a supplier, or someone interested in buying the company.

The statements examined must be specifically identified, both as to title and as to time. Failure to identify the statements makes the report completely meaningless, particularly if it becomes detached from the statements. The statements are specified in the first paragraph of the two-paragraph report or in the last sentence of the one-paragraph report.

The auditor must state whether or not the audit was made in accordance with generally accepted auditing standards. The standards were discussed in Chapter 1, and the reader should have a fair idea at this point as to their importance and application. The statement should also be

made that the examination included such tests of the accounting records and such other auditing procedures as the auditor, in his professional judgment, considered necessary and applicable under the circumstances. It should be noted that generally accepted auditing standards apply to every engagement but that audit tests and procedures are modified to fit the particular circumstances. Procedures may and do vary but standards should not. If any generally accepted auditing procedures applicable in the circumstances have been omitted, they must be set forth.

The auditor should express an opinion as to the fairness of the statements. The opinion covers not only the financial position at the year end but also the results of operations for the year under review. Presumably all reports prepared for the Securities and Exchange Commission would contain such an opinion. Reports containing no opinion will be discussed in a later section.

The report must also contain a statement indicating whether or not the client applied generally accepted accounting principles in the preparation of the statements. The auditing student should note carefully that there are two "generally accepted" statements in the report. In the scope paragraph "generally accepted *auditing standards*" are mentioned, and in the opinion paragraph "generally accepted *accounting principles*" are noted. The auditor should also state that the accounting principles have been applied consistently with the preceding year. Any inconsistencies should be fully explained.

Finally, the report should be manually signed. Since it is the auditing firm which takes the responsibility for the report, it is signed with the firm name rather than the name of the person primarily responsible for the examination.

These then are the requirements set forth by the Securities and Exchange Commission. While they apply specifically to reports filed by companies subject to SEC jurisdiction, their inclusion in the report suggested by the Institute has brought widespread acceptance of the basic principles involved.

THE SHORT-FORM REPORT

The auditor's short-form report suggested by the Committee on Auditing Procedure of the American Institute of Certified Public Accountants has been under study and modification since 1917. As conditions have changed, the report has been revised to reflect them. Prior to 1933 the auditor's report was rather generally called a certificate and the opinion

paragraph began "We certify . . . ." This phrase carried the implication of a warranty which the accountant could not truthfully make. Since that time the words "In our opinion" have become generally accepted. As conditions change in the future, it is anticipated that the suggested short-form report will again be modified.

The following report is the most recently adopted revision of the suggested form:

> We have examined the balance sheet of the XYZ Company as of December 31, 19— and the related statement(s) of income and retained income for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.
>
> In our opinion the accompanying balance sheet and statement(s) of income and retained income present fairly the financial position of the XYZ Company at December 31, 19—, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

It should be noted that this report is incomplete since it is neither dated, addressed, nor signed. The first paragraph of the report is called the scope paragraph. In it the auditor indicates the coverage of his examination. He indicates what he has examined (the financial statements identified) and the breadth and depth of his examination (following generally accepted auditing standards and applying all necessary auditing procedures). Any person reading this report is entitled to believe that there was proper preparation for the examination; that the system of internal control was studied and evaluated; that competent professional auditors examined the statements, each one doing the type of work for which he is professionally qualified by education, training, and experience; that all work was done which was deemed necessary under the circumstances; that there was proper supervision and review of the work done; and that all information necessary to make the statements not misleading has been disclosed.

In the second (opinion) paragraph the auditor indicates whether or not he thinks the statements are fair. Although this is only an opinion, it is the opinion of a professional man, duly trained and qualified to express such an opinion. Thus the opinion carries great weight. There are many variances and alternatives in generally accepted accounting principles. Two companies comparable in size and operations might have quite different results because of such variations. Nonetheless the auditor's opin-

ion gives to the reader some satisfaction that the company has not put into use any practices which are not generally accepted. Since consistency in application of principles is vital for purposes of comparison, the auditor must also indicate that such consistency existed or else point out the inconsistency.

Variations from the Suggested Short-form Report

The universality of the short-form report might suggest that it is a fixed, standard report to be used at all times. This is not the case. Despite the wide acceptance of the report in its basic form, full disclosure of any variance from normal is a requisite. The financial statements are the expressions of management, and if management insists on certain treatments they must be permitted. The auditor has full opportunity in his report to indicate anything which he feels is sufficiently incorrect or unusual to require disclosure. The audit report is the auditor's vehicle for expressing his opinion of the financial statements and of the client's practices with which he disagrees.

There are three basic types of variations in the short-form report: (1) explanations, (2) qualifications, and (3) disclaimers. These will be discussed in the following paragraphs.

Explanations. Explanations may appear in the scope paragraph, an intermediate paragraph, or the opinion paragraph. They may deal with the scope of the examination, with any item of material interest, or with treatment of an item inconsistent with the preceding year. In many instances the explanation is in the nature of additional information given for purposes of full disclosure. The important point to be noted is that the explanation does not affect the auditor's opinion of the fairness of the statements. If his opinion is changed, then it is a qualification rather than an explanation. In indicating some audit procedure that was not followed or in explaining some change in the client's accounting practices, the auditor is merely giving additional information. He still feels that the statements fairly present the financial position of the company.

Confirmation of accounts receivable is a generally accepted auditing procedure, yet in certain situations it is impossible to obtain responses to confirmation requests. If no positive result is obtainable from a specific procedure it should be omitted from the audit program. The confirmation of receivables is usually of such great importance that failure to apply the procedure must be noted in the report. This explanation usually is made in the scope paragraph and often reads as follows: " . . . such other auditing procedures as we considered necessary in the

circumstances except that it was not practicable to obtain confirmation of the balances due from departments of the United States Government, as to which balances we have satisfied ourselves by other means." Since satisfaction as to the balances was received, failure to confirm had no effect on the auditor's opinion. However, if the auditor was not able to satisfy himself as to the fairness of the balances of accounts receivable, he might have to qualify his opinion or disclaim any opinion. The materiality of the amounts is of prime importance in determining his choice. For example, if the company has receivables of $10,000,000 including $3,000 due from the U.S. government, failure to confirm this particular receivable would hardly call for an explanation since it is so insignificant. Similarly if the client refused to permit circularization of the receivables, all of which amounted to less than 1 per cent of total current assets, it is doubtful that the auditor would feel constrained to qualify his opinion or even to note the omission of a generally accepted auditing procedure. It is only where the disclosure might have an effect on an intelligent reader's interpretation and judgment of the statements taken as a whole that disclosure is required.

Explanations made in an intermediate paragraph usually have to do with changes in accounting practices with which the auditor agrees (no qualification), with changes with which he may disagree (perhaps a qualification), with some matter which limits the scope of the examination, or some question to which the auditor cannot reasonably obtain an answer (qualification probably necessary). Thus the intermediate paragraph may be an explanation of some matter not affecting the opinion or it may be an explanation of a qualification.

An example of this type of explanation follows:

> During the year the company changed its method of valuing inventories from first-in, first-out, to last-in, first-out, with a resulting decrease in net income of $126,500. We approve this change in valuation method.

The new method of valuing inventories had no effect on the auditor's opinion of the fairness of the statements. Since the change in method means that the statements are not consistent with the preceding year, this inconsistency must be disclosed. This is usually done in the last sentence of the report as follows: " . . . applied on a basis consistent with the preceding year except as noted in the preceding paragraph."

The auditor may choose to place the explanation on the face of the statements, in footnotes to the statements, or in the body of the audit report. The decision is made on the basis of the materiality of the item

and the amount of explanation needed. When footnotes are used there should be a reference on the balance sheet against the account involved directing the reader's attention to the footnote. Following is an example of an explanatory footnote:

4% Bond Payable, due 1978 (Note 7) $10,000,000

Note 7: The bond indenture restricts the payment of dividends from sources other than net income earned since the date of the bond issue, January 1, 1958. At December 31, 1961, there were available $1,467,852 of such earnings.

This type of explanatory remark has little to do with the fairness of the statements but it is important in gaining a full understanding of the financial position. Footnotes of this nature are rather common in published statements and are considered to be an integral part of the statements. Their use should be limited, however, to matters of importance. Two or three pages of long, involved footnotes (and this is not uncommon) serve to confuse rather than enlighten the reader of the statements.

Qualifications. On some engagements the auditor is not able to form a clear opinion of the reasonableness of the financial statements as a whole. This may be due to restrictions placed on the work of the auditor by the client or it may, in rare cases, be due to a confused situation in which information necessary for the formation of an opinion is just not available. Failure to gain a clear opinion on one account or portion of an account does not necessarily mean that the auditor is prevented from expressing an opinion on the statements as a whole. It does mean that he may have to qualify his opinion with respect to the unclear items.

Probably the most common causes of qualifications are the restrictions placed on the auditor with respect to accounts receivables and inventories. Particularly in smaller engagements it is not uncommon for the client to refuse permission to circularize the accounts and/or to observe and test the inventory taking. These two audit procedures are generally considered to be of such importance that their omission may be cause for qualification of the auditor's opinion. As in all the auditor's work, the materiality of the items is a factor of major importance. Another consideration is whether or not the situation permits the application of other procedures which will satisfy the auditor as to the reasonableness of the account balances.

An explanatory remark relating to failure to obtain confirmation on receivables due from the government was illustrated earlier in this chapter. If the auditor is not able to send confirmation requests to *any* of the cus-

tomers and if the accounts receivable are material, all paragraphs of the report are affected. An illustrative report for this situation follows:

. . . necessary in the circumstances, except as described below.

At the company's request we did not seek confirmation of balances due from customers. Since we were not able to satisfy ourselves by other means as to the reasonableness of these balances we are not able to express any opinion concerning them.

In our opinion, except with respect to accounts receivable, the accompanying statements fairly present. . . .

Qualifications may occur because of limitation of the auditor's work, because of a clouded situation, or because the auditor disagrees with the client concerning one of the accounting practices followed. For example, the company may account for fixed assets and take depreciation on the basis of index numbers rather than on a cost basis. The auditor disagrees with this practice because it is not yet generally accepted and states in an intermediate paragraph:

The company annually adjusts its plant and equipment to reflect the change in the Bureau of Labor Statistics wholesale price index, and charges depreciation on the adjusted balances. Such a practice is not yet generally accepted. The net income for the year is $123,320 less than it would have been had depreciation been computed on a cost basis.

In our opinion, except as noted above, the accompanying statements fairly present . . . in conformity with generally accepted accounting principles, except as noted in the preceding paragraph, applied on a basis consistent with the preceding year.

If this were the year in which a change to an index number basis were made it would be necessary to modify the consistency phrase to indicate the change in practice. It is difficult to find examples in published reports of unreconciled disagreements between the auditor and the client so serious that the auditor qualifies his report. Often the mere indication that the report will have to be qualified is enough to convince the client that the practice should be changed. This threat should not be used indiscriminately or it will soon lose its effectiveness. Ordinarily the auditor should be able to marshal other arguments to show the client the wisdom of changing the disputed practice.

When a report is filled with qualifications it becomes meaningless and of no value. This matter is specifically dealt with in rule 5(d) of the *Rules of Professional Conduct.* The auditor must decide on the basis of the number and materiality of his qualifications whether or not he is

justified in expressing an opinion. If, for example, the auditor was prohibited from circularizing receivables and from observing the inventory taking and these two assets comprised 80 per cent of the current assets and 50 per cent of total assets, it would appear unwise to offer any opinion on the financial statements as a whole.

Disclaimers. If a situation arises where the auditor feels that his work has been restricted to such a degree that he cannot express any opinion on the statements he should make a positive statement to that effect. The importance of the auditor's report and opinion is so great that he should never leave any doubt in the reader's mind as to how much responsibility he accepts. He should be equally explicit in indicating where he has taken no responsibility or in denying an opinion. He should never leave the reader wondering whether or not he approves the presentation. To this end he should then either express an opinion, unqualified or qualified, or deny an opinion. For example, in the situation cited in the preceding paragraph the auditor might phrase his report as follows:

> . . . considered necessary in the circumstances except as noted below.
>
> At the company's request we have not sought confirmation of amounts due from customers, nor have we observed the inventory taking or made the usual tests of physical quantities. Because of the materiality of accounts receivable and inventory and because of the restrictions placed upon the scope of our examination, we are not able to express any opinion as to the fairness of these assets or of the financial statements as a whole.

It is perfectly proper for the auditor to undertake an engagement with these restrictions as long as the client is aware of the fact that no opinion will be issued. Ordinarily an auditor is able to determine when the engagement is taken whether or not he will be able to issue an opinion. If he has not determined this and restrictions are later placed on his work, he should immediately discuss with his client the effect of the restrictions on his work and on his report. It is of the utmost importance both to the auditor and to the client that there be a clear understanding as to the result of the engagement.

The possibility exists that the client does not need or want a formal opinion. Instead he may want the auditor to report in some detail his findings in certain areas of the examination other than receivables and inventory. It may also be that the audit report may never be seen outside of the company premises. Regardless of this possibility the auditor should protect himself and third parties by making a proper disclaimer.

The remainder of the report may then be used to bring to the client the information that he sought and to make any additional comment as

to the fairness of the accounts other than receivables and inventory. The auditor must always be careful in making these comments to say nothing that would mitigate or deny the disclaimer.

Statements without audit. Auditors are sometimes called upon to prepare financial statements, either monthly or annually, for their clients. Such work is a proper part of the independent public accountant's responsibilities and is a service to clients whose businesses are so small that they do not have competent accounting help. The auditor must make certain, in his work and in his presentation of the statements, that he in no way implies that an examination was made. This is usually accomplished by typing across the top of each statement "Prepared from the books without audit."

POST–BALANCE SHEET TRANSACTIONS

On thinking back over the procedures followed in examining the accounts, the student will recall that although the audit is made as of the end of the client's fiscal year, several procedures were applied in the succeeding year. In each case the purpose of the procedure was to validate the year-end balance of an account.

It is rather generally accepted that the auditor has some responsibility for recognizing certain events occurring after the balance sheet date. Much of the work of the examination is done in the new fiscal year. These questions then arise. For what is the auditor responsible? For how long is he responsible? How does he ascertain the events subsequent to the date of the balance sheet?

These subsequent events may be divided into two major groups: those which have a direct bearing on balance sheet accounts as at the year end and those which affect the accounts at a later date. It is rather obvious that the first type of event must be recognized by an adjustment of a balance sheet account. For example, the auditor has examined the allowance for doubtful accounts. It has been provided on a basis of specific account balances and appears reasonable. One morning while working on another phase of the accounts he discovers that a large customer for whom no provision was made has been forced into bankruptcy proceedings. There is no question but that the auditor would again review the allowance for doubtful accounts and have the client make provision for the anticipated loss, even though the event occurs in the new year.

In making his examination of the financial statements the auditor must

bring to bear all his skill, professional ability, and *knowledge* in forming his opinion of the reasonableness of the statements. This does not mean his knowledge at the balance sheet date. The knowledge must be applied all the time that he is on the engagement. All accounts affected by such knowledge must be adjusted to reflect it.

In addition to events having a direct effect on the accounts as at the balance sheet date, there may be numerous others which may have an indirect effect or an effect at a later date. To illustrate, in March of the new year, while the auditors are still examining the records, a disastrous fire occurs, causing extensive damage in excess of the insured value and halting operations for probably two or three months. Here there is no question of the propriety of the year-end balances, but there is a serious loss in the new year and possibly a greater loss from the suspension of operations. Although the financial statements under review are not affected, it is certain that the succeeding year is affected. Full disclosure requires that the information about the fire be reported. This is usually accomplished through a footnote to the balance sheet. There are many types of events in this general category which the auditor must consider for disclosure purposes.

It is still not definitely determined how long after the balance sheet date the auditor is to be held responsible for post–balance sheet events. The most reasonable assumption is that the last day the auditor spends in the client's office should be the ending date for his responsibility. Many auditors date their reports as of the last day of field work. Some auditors feel that the responsibility exists until the day the reports are delivered to the client. This appears to be an extreme.

In several places in this text procedures have been mentioned which carried the examination into the succeeding year. The cutoff statement, the examination of books of original entry for the new period, and the examination of invoices in the new period are a few of those mentioned. In addition to these ordinary procedures the auditor should take specific steps to review the post–balance sheet transactions. The major source of information should be the officers of the company. By questioning them, after indicating the purpose of the questioning, he should obtain all the facts necessary to permit an adequate evaluation. With these events as with the financial statements, management is primarily responsible. Ordinarily the officers will become aware of any such transactions or events before the auditor does. It is management's responsibility to see that the auditor has this information.

Additionally the auditor should review the corporate minutes for meet-

ings subsequent to the balance sheet date. If it is late enough in the year that interim statements have been prepared, he should review these. If not, he should review the books of original entry as far as they have been carried in the new year to take note of any transactions such as have been described.

When he has been informed of, or has discovered, additional factual data, it is the auditor's responsibility to discuss the information with management. The task is to decide on the importance of the item and to determine whether or not it requires adjustment or annotation of the statements.

If the client fails or refuses to make such adjustment or annotation, the auditor is in the same position as he is with respect to the information contained within the year. He must judge for himself whether it is now necessary to qualify his report or to present therein the additional information. Here again materiality plays a vital part in his decision. Particularly in the area of post–balance sheet events the auditor is not interested in insignificant items.

LETTER TO MANAGEMENT

When the engagement agreement indicates that the short-form report and the financial statements are all that the auditor submits to the com-

Exhibit 19-1

January 29, 1962

Mr. Richard James, President
The James Manufacturing Company
1814 Michigan Avenue
Columbus, Ohio
Dear Mr. James:

In connection with our examination of the financial statements of your company as of December 31, 1961, you have asked us to comment on any items we think should be brought to your attention. We believe the following situations are worthy of your consideration.

1. Our review of your operations indicates the need for an average cash balance of $20,000. Analysis of the company's bank statements reveals that at no time during the year did the cash balance fall below $50,000. Not only is there a possible loss involved in carrying such a high cash balance because the account is only insured for $10,000, there is also an actual loss since $30,000 of these funds could be earning interest. We suggest that you consider the advisability of investing some of the excess cash.

2. We wish to call to your attention the upward trend in worthless accounts receivable. Not only is the absolute amount increasing, as might be expected with

Exhibit 19-1 (Continued)

the increase in sales, but the percentage of write-offs to sales is also increasing. During the past five years the rate of write-off has risen from 0.45 to 0.75 per cent of sales. The average rate for your industry is 0.54 per cent. We have not attempted to determine the causes of the increase but feel that you should be informed of the situation so that a study may be made to determine the causes.

3. You may recall our discussion of the inventory in which it was necessary to effect a considerable write down of inventory, both in items and in dollars, because of obsolescence. After reviewing the entire inventory situation it is our belief that the obsolescence is caused primarily by overstocking, in turn caused by purchasing in too large quantities in order to take advantage of volume discounts. The costs incurred in warehousing the inventory and the losses taken in devaluation soon overcome the savings brought about by the volume discounts.

4. The investment in stock of the Harris Manufacturing Company was purchased for income-producing reasons rather than any purpose associated with the operations of your business. We would like to point out that the return on this investment has, for the past two years, been less than 1 per cent. Your management team might well consider whether this investment is fulfilling its purpose.

5. We would once again like to stress the value to be gained by the installation of a plant ledger for purposes of gaining better control over fixed assets than you now have. During our examination we discovered $5,000 worth (cost) of fixed assets that had been removed from the plant but had not been recorded. The loss that you were able to take after these dispositions had been recorded resulted in a tax savings of $750. While the installation of a plant ledger involves considerable effort, its maintenance takes little time and produces valuable results.

6. Our review of the work in accounts payable disclosed that a rather sizable number of purchase discounts were lost due to failure to present the vouchers for check preparation until after the discount period had passed. This fact is determinable only through an extensive review of invoices. We suggest that successful control over purchase discounts may be obtained through the use of a purchase discounts lost account in place of the purchase discounts taken account that you now are using. The change-over would require a change in the method of recording invoices. The net cost of purchases after discount would be recorded as the cost of the purchase and the liability to the vendor. We recommend the use of this account. Its use will not prevent missing a discount, but it will immediately bring to the notice of management that fact that one was missed and that routines are not being properly observed by the clerical staff. At present this information is not easily available.

7. On one of our trips to the factory we noticed an employee using a grinding wheel without wearing safety goggles. We called this to the attention of the foreman but he did not appear to be impressed. Since we know that you have, as part of your internal control, a rule requiring the use of safety goggles in such a situation, we thought you should be apprised of this lack of compliance.

If we can be of assistance to you in any of the above matters feel free to call on us.

Very truly yours,

pany, a separate letter to management may be written. This letter accompanies but is not a part of the formal audit report. In it the auditor will inform management of his findings and of any suggestions he may have that may be of benefit to the company. Weaknesses in internal control, suggestions for improving the accounting system, and suggestions for possible savings are typical of the items that might be included in such a letter. Exhibit 19-1 is illustrative of points that might be included.

QUESTIONS AND PROBLEMS

1. Why is the audit report of significance?

2. Why is rule 5 of the *Rules of Professional Conduct* of the AICPA so important to the practicing certified public accountant?

3. What does the Securities and Exchange Commission require in the auditor's report?

4. Distinguish between a qualification and an explanation.

5. What is meant by a qualified opinion? What are some of the circumstances which make qualification necessary?

6. Write a standard short-form report for a client who has changed from fifo to lifo, with a consequent decrease in profit of $20,000. You approved the change.

7. What is a disclaimer? Under what circumstances should it be used?

8. A prospective client has called you to discuss making an examination of his records. He says he does not want you to circularize the customers and that he will give you a certificate covering inventories so that you need do no work on physical quantities.

Should you refuse to take the engagement? Assuming that these assets comprise a material portion of total assets, would you express an opinion on the financial statements?

9. A prospective client has called upon you to prepare his financial statements. Although you are expected to make any adjustments you find necessary, you are not to make an examination of the books. Would you accept the work? How would you protect yourself if you did?

10. You have completed your audit and have now learned that one of the banks in which your client had sizable deposits has closed its doors. What would your action be if:

1. You had not yet written your report?
2. You had written the report but it had not yet been typed?
3. The report had been typed and was ready for delivery to your client?
4. You had delivered the report to the client?

11. What are the two general types of post–balance sheet events the auditor must consider?

12. Name five audit steps that the auditor takes in the normal conduct of his examination that take him into the records of the new year?

13. What special steps should the auditor take in searching for post-balance sheet events?

14. The following is an actual report (disguised) noted recently:

"I have examined the accounting records of the ABC Company for the year ended December 31, 1961, and have prepared from them the above statement."

This report was signed by a CPA. The balance sheet was presented on the left-hand side of a double sheet, with a statement of profit and loss on the right-hand side. The report appeared under the profit and loss statement.

List all errors of omission and commission. Do not rewrite the report.

15. Why is the short-term audit report no longer called a certificate?

16. In what three places may explanatory material be placed?

17. Write a short-form report for American Wholesalers, Inc., as of December 31, 1961, in which, at the client's request, the inventory taking was not observed nor were tests of physical quantities made. Inventories comprised 70 per cent of current assets and 55 per cent of total assets. The company changed depreciation rates, at the suggestion of the Internal Revenue Service, with a resultant increase in net profit of $20,000.

18. Write a short-form report in which you indicate disagreement with your client. Inventories have been valued at market prices by this client, instead of the lower-of-cost-or-market method used in preceding years. Inventories are not material enough to warrant a disclaimer.

Chapter 20

THE AUDITOR'S REPORT (LONG FORM)

The suggested short-form report illustrated in the preceding chapter may be expanded as the need arises by insertion of any number of explanatory paragraphs between the scope and opinion paragraphs. These paragraphs may include information of different types which the auditor wants to bring to the attention of management. They may vary from two or three paragraphs to ten to fifteen pages.

PURPOSE OF THE AUDIT REPORT

The purpose of any report is to communicate ideas from one person to another. The audit report is no different from other reports. In it the auditor presents his findings and ideas about the business.

For a very small company the report usually will be relatively short since there will be little to discuss. In small membership associations not for profit it may well be that the short-form report will suffice. However, in even the smallest commercial companies there will usually be some items in intervening paragraphs. As the business grows management needs more and more answers to managerial problems. Often the clerical staff is not large enough or competent enough to provide the information necessary for the satisfactory solution of these problems. The auditor attempts to fill the gap and to provide in his audit report the data needed by management. As the company growth continues the client finds it advisable to engage specialists on a full-time basis to perform much of the data gathering and interpreting that the auditor had done. Ultimately the short-form report will suffice for this client since the specialists will supply all the data, leaving to the auditor only the expression of his opinion on the fairness of the statements.

In most audits the auditor's primary responsibility is to the owners

of the business. In a small and some medium-sized companies the owners are also the managers. The responsibility then is to these owner-managers and the audit report should furnish information which will be helpful to them. In large companies where owners are generally divorced from company management the responsibility still is to the owners and is fulfilled by the presentation of the short-form report. In addition, management may desire and request a long-form report, which the auditor is happy to supply since it should help to protect and increase the owners' investment.

WRITING THE REPORT

The report should be written as soon as possible after the audit engagement is completed. While the report contains much information of continuing importance it also contains some data that lose value as time passes. Moreover, the auditor should be better informed concerning the business and the engagement soon after completion than at any other time. Intervening events and other work will dim his memory and becloud the background necessary for the most meaningful report.

Since the purpose of the report is to communicate ideas, it should be written in such a way that the thoughts and ideas have the same meaning for both the writer and the reader. The report is of little value if the reader doesn't understand it. The following rules may be helpful in report writing:

1. Do not pad. Say what you want to say in as few words as is possible to express your idea clearly.
2. Do not use stilted language. This makes the report difficult to read and understand.
3. Do not use "weasel words." If you believe something, let your reader know it. For example, instead of writing "The allowance appears adequate," write "We believe the allowance is adequate."
4. Keep your language free from ambiguities. It is important to both the auditor and the reader that only single meanings be attributable to what is written.
5. Do not use technical jargon. The reader probably does not know what "vouch" means to the auditor, but he should understand "examine the documents underlying the transaction."
6. Do not use the word "client" in the report. Refer to the client as "the company" or "management," or use an official's title.

Preferably the senior in charge of the examination should write the report. He is the one person who has the best background and knowledge

for the task. Despite the auditor's efforts to include in his working papers all the data necessary for a complete report, there remains much background material he has accumulated in his mind during the examination that is of value in his writing. It seems only logical that his information should be used. Some auditors prefer that the report be written by a report-writing department. When this is done the auditor must include such background material in the working papers.

There are exceptional cases in which the audit report is written in the auditor's office; however, it is generally written in the client's office. The beginning auditor particularly will find this helpful, for until he has gained some experience he will probably fail to include in the working papers all the information and data that he needs. Some clients prefer that the report be written in the auditor's office so that there is absolutely no opportunity for employees to see the report. It is usually possible, however, for the auditor to use a private office where he may have both seclusion and access to the company records. There is not much question but that a better report can be prepared in the client's office than in the auditor's.

Report writing is difficult even for the experienced auditor. One of the hardest problems is determining what to include and what to exclude. Clearly everything that is relevant and material should be included. The irrelevant and unimportant should be excluded. Materiality is not just a matter of the dollar amount; if the item is such that it would affect the judgment of the reader it should be included.

The audit report should not be merely a detailed listing of the audit steps followed in making the examination. Many of these procedures will be meaningless to the reader and most of them will be of little interest. Many auditors feel that reporting by exception is the best plan to follow. Thus, if no findings were made there would be little in the report except the short form and the statements. The author believes that each situation must be judged on its own merits and each report should be tailored to fit the client's desires and needs. At the beginning of each new engagement the client should be consulted to determine what type of information he wants in the report. The auditor knows what his firm includes as standard items in all reports. The combined material then will comprise the report. The client may express ignorance as to what he wants, in which case the auditor should determine what he thinks the client needs.

REVIEW OF THE REPORT

After the report has been completed it should be reviewed by a supervisor or a partner. This review should take place in the client's office so

that any questions requiring reference to source documents or to any of the client's personnel may easily be answered. The report should be reviewed for grammar, calculation, substantiation by the working papers, and general conformity with firm standards as to format and content. Thus the reviewer must be someone familiar with the client's business as well as with firm policies. The review of the report and working papers should be sufficiently intensive that the reviewer is satisfied that the examination was made in accordance with generally accepted auditing standards.

After the report has passed this review it should be reviewed with the client. Any portions of the report not wanted by the client may be deleted, if the auditor agrees. The auditor's report is his responsibility, just as the financial statements are the responsibility of management. If the auditor feels strongly that some point should be covered in the report, the client may object, but he cannot very well insist on its deletion. There are, however, many areas where the client's wishes may govern. Even for those points on which the auditor is adamant, it is good policy to have the client on notice that the material to which he objects is going to appear in the typed report.

After the review with the client has taken place the report is turned over to the firm's clerical staff where it is duplicated by typing, printing, multilithing, or some other form of duplication. As many copies are made as are needed for the client and the auditor. Where no specific number is requested five copies are often made, three being given to the client, one retained for the audit firm's permanent file of reports, and one being retained for use in next year's examination.

When the report has been typed or printed it is proofread. All arithmetical computations should be recalculated. All references should be traced to the material cited to see that there is agreement between the references. For example, the net income should be traced to the same amount on the retained income statement. Errors of all kinds are noted and the report returned to the typing department where corrections are made, after which it is resubmitted for a proofreading of corrections. The copies are then assembled and turned over for a final review and the affixing of the firm signature. The reports are then bound and the required number of copies delivered to the client either personally or by mail.

Extreme care must be taken to make certain that nothing appears in the long-form report that would tend to vitiate, negate, or contradict the importance of the short-form report. Additional information, explana-

tions, and other data included in the long form should in all cases support the financial statements and the auditor's opinion concerning them.

If schedules or data which the auditor has not examined are included in the report, he should make clear that these have been supplied by the client and that they have not been subjected to examination. Thus, the auditor should accept responsibility only for what he has done and should carefully designate that which he has accepted without audit.

CONTENTS OF THE REPORT

Long-form audit reports come in a variety of sizes. Each firm has its own particular size paper which it prefers. Similarly there are varying formats for the contents of the report. Within each firm there is usually a standard form for material to be included and the manner in which it is to be presented. As between firms there is a considerable variation in the manner of presentation. Generally, however, by one means or another the following information is presented:

1. The short-form report
2. Comments on changes in the financial position
3. Comments on operations
4. Comments on the balance sheet
5. The financial statements

If the audit report is more than a few pages long it should be prefaced by a table of contents. This enables the reader to find any particular bit of information with ease.

The Short-form Report

The long-form report should contain the expression of the auditor's opinion of the fairness of the financial statements. Some firms use the short form as an introductory letter. When this is done, the short-form report is signed in the usual place and the firm signature does not appear again in the report. Other firms use the scope paragraph as an introduction to the long-form report. The opinion paragraph is included as the final paragraph of the long-form report and is signed at that point. Placement is a matter of firm policy and does not change the intent or meaning of the short-form report.

Comments on Changes in Financial Position

In a first audit some auditors choose to precede this section with a section on the history of the company. The text deals with such matters

as the date and state of incorporation, the original capital structure with succeeding changes in capitalization, location of plants, products manufactured, and other historical data. This section is usually omitted after the first report.

In commenting on the changes in financial position the auditor should point out the changes in the sections of the balance sheet. As an aid in interpretation and exposition it is customary to present condensed comparative balance sheets with an increase-decrease column. This might be set up as shown in Exhibit 20-1.

Exhibit 20-1

	1961	*1960*	*Increase (Decrease)*
Cash	$ 449,334	$ 435,110	$ 14,224
Net receivables	1,753,435	1,828,484	(75,049)
Inventories	2,694,863	2,626,786	68,077
Prepayments	66,288	63,859	2,429
Total current assets	$4,963,920	$4,954,239	$ 9,681
Less: Current liabilities	1,782,781	2,550,317	(767,536)
Net working capital	$3,181,139	$2,403,922	$ 777,217
Investments and deposits	258,318	243,180	15,138
Plant and equipment (net)	2,152,402	1,842,430	309,972
Deferred charges	56,890	45,514	11,376
Total assets less current liabilities	$5,648,749	$4,535,046	$1,113,703
Less: Long-term debt	2,236,288	1,166,561	1,069,727
Owners' equity	$3,412,461	$3,368,485	$ 43,976

A supplemental schedule might then point out the causes of the change in owners' equity as follows:

Net income before depreciation	$532,084
Less: Depreciation and amortization	257,275
Net income, Exhibit C	$274,809
Less: Dividends paid	230,833
Increase in owners' equity	$ 43,976

These schedules were prepared from the statements of The General Corporation, presented in Chapter 18. If the auditor is not disposed to use this type of schedule, he may wish to prepare a statement of sources and application of funds to present the causes of the changes in financial position. It is important that the auditor point out the major changes that have taken place and where possible present the underlying causes

of the changes. In some cases the causes may be undeterminable, while in others they may be rather apparent to the auditor. A note of caution should be sounded here. It is essential that the entire story be obtained before attempting any interpretation. The apparent cause of the change may itself have been brought about by factors not so readily observable. The auditor must be extremely careful to make certain that he has all the necessary information before attempting to interpret causes of changes.

If unsatisfactory financial conditions have developed the auditor may be in a position to aid his client. For example, given the anticipated operational data, he may be able to prepare a cash forecast for the succeeding quarter or two. He may also be able to suggest methods of increasing the cash balance if such is necessary or desirable. He may consider for the client, presenting both the advantages and disadvantages, the possibility of discounting his accounts or notes receivable, the advisability of increasing the collection effort, or the feasibility of restricting inventory purchases until a better cash balance is obtained. He may even wish to consider with the client the advisability of deferring the solution of current financial problems by obtaining some long-term financing. It is not good business practice to issue long-term debt to solve current financing troubles but in some situations it is the practical solution. An example might be cited in which the client extended his physical plant at a too rapid rate, financing only through internal sources. The new plant has not yet reached operating productivity and current operations are not providing sufficient funds to finance the new facility and also maintain satisfactory operating balances. A long-term loan here would enable the client to settle his current problems and probably give him a sufficient backlog of cash to carry him until the new plant is in full production.

In his discussion of the financial position the auditor should bring into his report the balance sheet ratios and relationships that help to illustrate the points he is making. These should be interwoven into the text of the report as needed. An isolated ratio is rather meaningless. When compared with the preceding year's ratio it may help to explain or point up some change in position. Normally it is the change that is important, be it good or bad. If industry-wide ratios and relationships are available the client's position may be compared with these guideposts. Here again the comparison may indicate weak, or weakening, areas in the client's financial position.

Particularly for clients with small businesses, the auditor may be of

great value in this area of interpretation. In many ways, like the doctor of preventive medicine, he can advise with his client on steps to take in operating his business which will prevent future financial difficulties. Interpretation is an art requiring a keen analytical mind and a broad business background. The competent auditor has both of these attributes, but much of the time he does not apply them to the area of financial position interpretation. Not all clients need this service, but many of them do need it, and the auditor should use his full talents in serving his clientele. The day is past when a successful auditor concerns himself only with the audit phase. The area of business consultation has become so popular that it must be added as a part of continuing engagements. The auditor has become, in the eyes of a host of men who own small businesses, a doctor of business. The auditor's task is to educate his clients to call upon him as soon as the first signs of financial troubles appear. He can and should make a start upon this educational task by studying the financial statements carefully and interpreting to his client the danger signals that appear therein.

Comments on Operations

Here again it is usually convenient to prepare a condensed comparative income statement with an increase-decrease column. This statement should include both dollars and percentages. The percentages in the increase-decrease column are calculated with the preceding year's amounts as the base. Hence the percentages in the final column do not foot. In computing percentages for this column it sometimes happens that the base is so small that an astronomical percentage is the result of the calculation. Rather than using a fantastic figure (which is meaningless) it is wise to use none at all. The income statement for The General Company is presented in this form in Exhibit 20-2.

From the information in this tabular presentation and from the other data he has available, the auditor should point out the major changes that have taken place. Wherever possible he should discuss the basic causes responsible for the changes, remembering that there are often many factors involved in any single change. He must be certain that he has all the necessary information before he makes any judgments as to causes of changes. The auditor should avoid repeating in his discussion the information he has presented in the comparative statements. Presumably the client can read and digest this information himself. If he can point out the underlying reason for the changes he will be performing a real service for his client.

Exhibit 20-2

	1961		*1960*		*Increase (Decrease)*	
	Amount	*Per cent*	*Amount*	*Per cent*	*Amount*	*Per cent*
Net sales	$8,643,301	100.0%	$8,695,080	100.0%	$ (51,779)	(0.6)%
Cost of goods sold	6,317,717	73.1	6,158,681	70.8	159,036	2.6
Gross profit	$2,325,584	26.9%	$2,536,399	29.2%	$(210,815)	(8.3)
Selling expenses	$1,115,230	12.9%	$1,057,868	12.2%	$ 57,362	5.4
General expenses	680,770	7.9	598,392	6.9	82,378	13.8
Total	$1,796,000	20.8%	$1,656,260	19.1%	$ 139,740	8.4
Net operating profit	$ 529,584	6.1%	$ 880,139	10.1%	$(350,555)	(39.8)
Nonoperating expense (net)	85,775	1.0	21,306	0.2	64,469	—
Net income before taxes	$ 443,809	5.1%	$ 858,833	9.9%	$(415,024)	(48.3)
Federal income taxes	169,000	2.0	357,500	4.1	(188,500)	(52.8)
Net income	$ 274,809	3.1%	$ 501,333	5.8%	$(226,524)	(45.2)%

If costs are available or easily obtained, a presentation of the contribution of the various products to gross profit is usually received with interest. This is particularly true where some items are contributing losses. It may be necessary to carry the items to fill out a line or to retain customer goodwill, but it is desirable to know just how much they are costing in terms of gross margin. The major value of such a study is that it highlights the items of little or no profit and enables management to determine what their course should be. It might be possible to raise the selling price or to cut costs elsewhere.

The auditor ordinarily is not a production engineer and is not trained in production techniques. It is not necessary to be so trained to suggest at times ways in which the client can cut costs or make other savings. The outsider's view plus keen observation and some imagination often will be sufficient to produce worthwhile suggestions for savings. Once a policy has been instituted it is natural to follow it without much thought. Conditions change and what was once a good policy may now be a poor one. For example, at one time it might have been the best policy to burn waste paper. The price of waste paper might rise to a point where it would be profitable to bale and sell it. The auditor, coming in from the outside, can often spot items such as this that may result in savings

to the client. He should constantly be on watch for such possibilities as he makes his examination.

Many ratios and relationships existing between the income statement and the balance sheet may be introduced in the discussion of operations. As with the balance sheet discussion, these ratios should be woven into the story rather than being presented in tabular form. Earnings per share, inventory turnover, accounts receivable turnover, and turnover of fixed assets are some of the relationships that might be used. While comparison with last year presents the basic point of departure, a comparison of some of the major operating ratios with the industry average is also generally helpful. For each engagement the auditors should make a study of the operating statements and of the operations of the company and decide on what to say that will be of greatest benefit to the client.

Comments on the Balance Sheet

In this section of the report the auditor should comment on the major accounts in the order in which they appear on the balance sheet. His comments should be, in the main, of three types. He will want to discuss (1) major findings that he has made, (2) points of interest concerning the accounts that will be helpful to the client, and (3) some of the major verificational steps he has taken. Certainly the report should not contain a listing of detailed procedures. This would make most dull reading for the client and would be of no help to him. Many auditors feel, however, that for their own protection the major steps should be indicated.

So also the discussion of findings should be confined to those of major significance. The auditor has three means of communicating with his client. He may discuss problems verbally, which he does with respect to incorrect procedures and other items of minor importance; in many cases these items may be corrected immediately. If the finding is of more importance the auditor may discuss it with the client and then write a letter to management so that he is on record as having pointed out the problem and suggested alternative methods. Finally, the matter may be so material that the auditor will want it to become a part of his formal report of the examination. There is a considerable latitude as to which of these methods he uses. The auditor has the final voice in determining what ultimately appears in his report but often he will agree with the client as to the deletion of some portion of the report. If there is disagreement between the two as to the handling of an item, it is good practice to include it in the report, giving both sides of the problem and the

auditor's reasons for his disagreement with the current method of handling.

The comments and suggestions in the following paragraphs are illustrative of the type of information that might appear in this section of the report. Each engagement will have its peculiar problems and situations to be discussed. If the auditor has included in his working papers all vital information, the report writing task is eased. As he goes through the papers for each account, the points to be included in the report should be rather obvious.

Cash in banks and on hand. Normally the auditor will indicate that he has received direct confirmation from the various depositories of the bank balances at the balance sheet date and that he has reconciled those balances with the book balances. Some audit reports include the bank reconciliation but this should be included only if the client requests it. It is customary to state that, for the test periods, all checks written were examined and that all receipts were traced into bank statements. If there is more than one bank and the balances do not appear individually on the balance sheet, it would be possible to include here a schedule of balances. Obviously if there are very many bank accounts this would not be done.

It is customary to indicate the balances of imprest cash funds and to indicate that they were counted. Again, if there are a number of funds it might be desirable to schedule them. If some of the funds were not counted but certificates were received in support of them, this might be indicated although if this is a customary practice with this client it is not essential.

When auditing cash the auditor should review the cash balances to determine whether or not unnecessarily large cash balances are maintained. If he found this to be the case, the desirability of putting some of these funds into interest-bearing investments might be mentioned. The client should decide on what type of investment to make. The auditor has done his duty when he calls attention to an unsatisfactory condition.

Most bank accounts are insured for $10,000. If the client only uses one bank and continuously carries a balance many times this amount, attention might be called to the possibility of loss and the desirability of spreading the risk by opening one or more additional accounts. This would need to be balanced against the possible additional service charge expense.

If the auditor has noticed the lack of any safeguards in the cash system he might want to mention them here. Some auditors make remarks on

internal control in the audit report. Others write a separate letter to management concerning their findings and suggestions concerning the internal control system.

Notes receivable. It is customary for the auditor to indicate that he examined all the notes receivable that were on hand and that he received confirmation or verified by other means those not available for his examination. Since it is customary in examination of commercial enterprises to seek positive confirmation of all notes receivable, he should indicate the success of this step.

Notation should be made of any notes past due with an indication whether they were collected during the audit period. There should also be some comment as to the basis of valuation of these past-due notes, as well as the current ones.

If notes were discounted at the balance sheet date the details should appear here with a comment as to whether or not they were paid when due if the due date was within the audit period. If some were not paid the company's liability to the bank should be mentioned, even though it was reflected in the accounts. The contingent liability on those not due by the completion of the examination should also be disclosed.

It is sometimes helpful to indicate how the notes arose. If they were taken in connection with the original sale they presumably are better, creditwise, than if they arose through the conversion of accounts receivable.

Accounts receivable. Since the confirmation of accounts receivable is a generally accepted auditing procedure, it is customary to indicate in the discussion of accounts receivable the basis of requesting confirmation and the results. For example, if positive requests were sent to all customers, a statement might be included that "We sent requests to all (128) customers asking them to confirm the balances due to the company ($84,682). Of those sent out, 111 (87 per cent) were returned, thus positively confirming $78,086 (92 per cent) of the total amount due at the balance sheet date." If negative-type requests were used the statement might read "We have sent requests to about 10 per cent of the customers asking that they write to us if the balance shown on the monthly statement was incorrect. All answers received were satisfactorily adjusted." If no requests were sent, an explanation should be made as to why this procedure was not followed. If alternative methods were followed by the auditors to satisfy them as to the balances due, this should be mentioned, without listing the actual procedures used.

In situations where the accounts receivable were aged it is often help-

ful to show a comparative schedule of the results of the aging. The schedule might be set up as shown in Exhibit 20-3.

Exhibit 20-3

	1961		*1960*	
	Amount	*Per cent*	*Amount*	*Per cent*
Not yet due	$23,408	53.3%	$18,274	50.8%
1–30 days past due	10,095	23.0	7,950	22.1
31–90 days past due	4,750	10.8	4,676	13.0
4–6 months past due	1,681	3.8	1,475	4.1
Over six months	4,006	9.1	3,597	10.0
Totals	$43,940	100.0%	$35,972	100.0%

It is also helpful to indicate how much has been collected on receivables to the end of the audit. If there are relatively few accounts it is possible to eliminate easily those collections in payment of the new year's transactions, leaving those that apply to the year-end balances. Such a statement might read, "Collections to January 15 of December 31, 1961, balances amount to $15,666. Of this amount $2,858 was paid on unconfirmed balances, leaving $6,360 unconfirmed and unpaid." If there are very many accounts it usually is not feasible to attempt to separate collections of old balances from collections of new business. Instead the total collections might be compared with those for the comparable period of the preceding year.

A comment on the turnover of accounts receivable might be helpful. This is computed by dividing accounts receivable by sales to determine the percentage of total sales uncollected. A more understandable method is to determine the number of days' sales in accounts receivable. In either method, of course, comparison should be made with the preceding year and/or with industry averages.

Any unusual points should be discussed. For example, if one customer owes a large part of the total balance due it should be disclosed. If amounts due from officers and employees are included in trade receivables the amount should be shown if it is at all significant, even though it arose out of sales transactions. The same reasoning applies to amounts due from subsidiary and affiliated companies, the amount and status of the accounts being disclosed in the text of the report.

The basis of the composition of the provision for doubtful accounts receivable should be disclosed, as should its coverage—both notes and accounts receivable, or just the accounts receivable. The auditor should indicate whether he believes the provision is reasonable in light of his evaluation of the accounts receivable. It sometimes is informative to disclose how much has been written off during the year as being uncollectible. If the accounts are reserved on an individual account basis, the specific accounts and amounts written off might be listed in the report.

Inventories. Normally the auditor will indicate that he was present during the counting of the inventory and observed (not supervised) the inventory taking. If he was not present he must justify his absence or perhaps qualify his report. In any case he should indicate here why he did not observe the inventory taking, if he did not. If inventories are widely separated geographically he should indicate that the observation was on a test basis. He should also make a general statement to the effect that sufficient test counts of quantities, tests of the clerical accuracy, and tests of the pricing were made to satisfy him as to the general accuracy of the inventory.

The auditor should also indicate that he has received from management a general statement as to inventories covering physical quantities and values, ownership, liens, recognition of obsolete merchandise, and so on.

If there is inventory on consignment or in public warehouses a statement should be made indicating that confirmation of the inventories has been received. While inventories consigned in to the company are not the property of the client and do not appear on the balance sheet, it might be worthwhile to discuss them at this point in the report.

In his review of inventories and the purchasing procedure the auditor may have observed certain unhealthy situations or poor practices. He might well discuss these matters at this point in the report. Such items as consistently large differences between physical counts and perpetual inventory records, apparent overstocking of materials, poor inventory turnover, and poor buying practices might be discussed here. Critical comments should be accompanied by suggested alternatives. Destructive criticism alone will be of little help to the client, who may be perfectly willing to correct some fault but may not know how best to make a correction without help.

Prepayments. Somewhere in his report the auditor should discuss the client's insurance coverage. Some auditors discuss it in this section of

the report, while others present a full listing of coverages and risks, with a discussion, as a final section of the report. Mention should be made of any apparent under- or overcoverages and of any hazards not covered which a prudent businessman normally would insure against.

If the prepaid items have been shown as one amount on the balance sheet it would be well to schedule them here. Any unusual items may be commented on with a discussion as to their source and nature. Otherwise a statement to the effect that the prepayments are valid carry-forward items and that the auditor has verified the amount to be deferred is all that is necessary.

Investments. If any temporary investments or marketable securities are included in the current asset section, the discussion of these items would come at an earlier point in the comments on the balance sheet accounts. The report should indicate that the auditor examined and counted the securities. If they were not available for his examination they should have been confirmed to him. It is customary to indicate the official capacity of the person who observed the count.

If security transactions play an important part in the company's operations, it may be helpful to prepare a schedule indicating the securities sold during the year and the gain or loss on each. If security transactions are not material it is satisfactory just to indicate what securities were bought and sold. A sentence should be included stating that the auditor has examined the transactions, determined that they were properly authorized, and verified the calculations.

If the client's business is small and does not have adequate accounting help, the auditor may want to comment on any unusual situations that have developed in the investment portfolio. For example, if a certain security was purchased because of its high dividend rate and the dividends have recently been passed, the auditor might feel it incumbent upon him to bring this to the attention of the client. Ordinarily he is in no position to suggest substitute securities but should leave that to the investment counselor. Primarily the auditor's duty is to report when investments are not fulfilling the purposes for which they were acquired.

The audit report should disclose the basis of valuation of the securities, which is dependent on the purpose for which the securities are bought. Ordinarily securities classified as current assets will be valued at the lower of cost or market while those classified as long-term investments will be carried at cost. For each class of security the report should indicate which basis was used.

If a controlling interest is owned in one or more companies the

report should disclose the basis for exclusion of any securities from the consolidated statements. Custom holds that all companies should be included in the consolidation except those which are not akin to the client's chief line of endeavor or those in which some special factors may make it unwise to include them in the over-all picture.

Where the client owns investments other than stocks or bonds, or where securities are held in special funds either by the client or by a trustee, it is customary to give a short description of the investment and its purpose and to indicate the major audit steps applied in the examination. Special-purpose investments of this nature should be examined not only for verification purposes but also to determine whether or not they are fulfilling the special purpose for which they were acquired. This is one added service the auditor can perform for his client which may not have been done by anyone else.

Increases in cash value of insurance on officers' lives should be scheduled. A statement should be included indicating that the insurer confirmed the cash value of the policies, the fact that there were no loans outstanding on the policies, and the fact that the company was the irrevocable beneficiary of the policies. If one of the insured personnel died during the year it would be good practice to include a schedule showing the proceeds, the cost, and the gain on the policy.

Plant and equipment. Two possibilities are open to the auditor with respect to reporting the changes in plant and equipment items. If the company is small and has few fixed asset changes it is convenient to present a schedule in the text of the report showing these changes, with pertinent discussion. For a company with many plant items it is usually a better plan to present a separate schedule of plant, equipment, and depreciation changes, similar to Exhibit 11-5 (page 307), as a supporting schedule for the plant and equipment amount shown on the balance sheet.

It is customary to indicate that the auditor has verified the changes in the plant and equipment accounts, even though the verification was done on a test basis. A statement should be included indicating the auditor's opinion as to the adequacy of the depreciation charge and of the accumulated depreciation. If the company is using an accelerated depreciation plan for part or all of its assets, the plan should be explained and the difference in depreciation charges noted. If changes in depreciation methods have been made during the year, the change should be explained and the auditor's opinion modified to indicate the inconsistency in application of accounting principles.

A statement should be included as to the basis of valuation of the plant and equipment items. Normally this valuation is on a cost basis. If an appraisal has been made and recorded, a complete explanation should be given in the report, with a schedule showing old and new bases and the net change. In succeeding years reference should continue to be made to the appraisal until all the appraised assets have been removed from the books.

In situations where a major construction program is under way, the report should contain a rather complete story of it. This could include a description of the types of facilities being constructed, the cost to date, and the proportion of completion. If the facts are available there might also be included the remaining amount for which the company is committed to complete the program.

Many companies have prepared long-term schedules of the anticipated replacement and renewal of plant facilities. If such plans are available it is often helpful to management to include a paragraph on the program for the next year or two, particularly if it is possible to indicate the amount of cash that will be necessary to keep the program up to date.

The report should contain a description of any plant assets that have been pledged as security for loans. The statement might include the book value of the assets pledged and the amount of the loan or bond issue. If this is the year in which the loan was made and there were restrictions as to the use of the funds obtained, the auditor should note whether or not the restrictions were observed.

Intangible fixed assets. If a new intangible has been acquired during the year the report should contain a short description of its nature and source and a statement as to the auditor's verification. Where no new assets have been acquired it is usually adequate to note the method of amortization and the consistency of its application.

Some companies either do not recognize intangible fixed assets in their records or carry them at a nominal value. In such cases, particularly with smaller companies, it is often a wise plan to include in the audit report a schedule of patents or other intangibles even though no dollar value is attached. The schedule might indicate the date the patent was granted, the patent number, the description, and the date of expiration. Thus management has brought to its notice each year the details of these important though unrecorded assets.

If there has been litigation concerning the patents during the year it should be reported here. The estimate of the company's counsel as to the final disposition of the case might also be noted, although such an

estimate is apt to be an optimistic one. The auditor must also consider whether or not a footnote with respect to the contingent liability is necessary for the statements.

Deferred charges. On many balance sheets deferred charges are shown as one amount. Depending on the number and nature of these items it might be well to schedule them in this section of the report. Since deferred charges by their very nature are nonrecurring, it is a good plan to report rather fully on all new charges set up during the year. The report should include a statement as to the proposed amortization of the charges. Any unusual actions taken by the board of directors concerning the deferred charges should be noted. The auditor should indicate that he has verified the charges, that he agrees with the deferral, and that the amortization plan is reasonable.

Notes payable. Since notes payable should be separated on the balance sheet into trade notes and bank loans, the discussion of them should also be separated. If a considerable number of bank loans have been made it might be well to schedule these loans to indicate the activity in this account. Such a schedule follows, taken from Exhibit 13-2 (page 343).

Exhibit 20-4

	Date borrowed	*Date paid or due*	*Amount*	*Interest rate*	*Interest paid*
World State Bank	11/ 1/60	2/ 1/61	$ 20,000	4%	$ 200.00
County National Bank	11/15/60	1/15/61	30,000	4½	225.00
World State Bank	12/ 1/60	3/ 1/61	25,000	4	250.00
State National Bank	1/15/61	4/15/61	40,000	4	400.00
World State Bank	3/ 1/61	6/15/61	20,000	4	233.33
First National Bank	5/ 1/61	7/ 1/61	25,000	3¾	156.25
Second National Bank	7/ 1/61	12/ 1/61	10,000	4¼	141.67
County National Bank	9/ 1/61	1/ 1/62	50,000	4½	750.00
World State Bank	10/ 1/61	12/ 1/61	40,000	4	266.67
State National Bank	11/15/61	1/15/62	30,000	4	200.00
First National Bank	12/ 1/61	3/ 1/62	20,000	3¾	250.00
Second National Bank	12/15/61	3/15/62	10,000	4	100.00
Total			$320,000		$3,172.92

The purpose of such a schedule is to indicate to management the total borrowing for the year and the cost of the borrowed money. This often is something of a surprise and may cause a little tightening of the controls over the borrowing process.

If such a schedule is considered unnecessary the report should contain at least the details of the notes still outstanding, with an indication of those that have been paid to the completion of the examination. The auditor should indicate that he found authorization for the notes, that the funds were received, and that the banks have confirmed the details of the indebtedness. If any assets have been pledged as security for these notes they should be described. Notation should also have been made in the section in which the assets were discussed.

Trade notes may or may not be scheduled depending upon their importance. It is customary to indicate that the auditor sought confirmation of the notes and reviewed the authority for issuing the notes. It is usually of some interest to indicate how the notes arose, whether from the purchase of materials and supplies or of fixed assets, and whether they were given as part of the original transaction or because the company had difficulty in paying the account when it came due.

If the auditor finds a long history of note issuing because of financial difficulty, he might want to suggest some means of alleviating the difficulty. Borrowing from banks in order to take advantage of discounts is usually good financial practice but may be only transferring difficulty in this case. It may be that credit terms are too loose or that there is not enough permanent capital in the business, or perhaps the company is expanding rapidly and the difficulty will work itself out.

It is also customary to indicate the payments made on trade notes after the year end, particularly if the notes are past due. There should be a discussion of all past-due notes.

Accounts payable. The request for confirmation of accounts payable is rapidly becoming a generally accepted auditing procedure. The auditor should indicate whether or not he followed this procedure and, if not, what general procedures he did follow to satisfy himself as to the creditors' balances. If any old unpaid accounts are on the books they should be mentioned, with the reasons for nonpayment and the probable disposition.

If one or more creditors are owed relatively large amounts of the total liability, it is good practice to list the companies and the amounts. If amounts are included in trade accounts payable due to affiliated or unconsolidated subsidiary companies they should be set forth separately here.

If he has not discussed it elsewhere, the auditor might bring to the attention of the client the matter of discounts missed, either through a lack of organization or because of poor financing. He might set forth the advantages to be gained through the use of a discounts lost account.

Often this section of the report is closed with a statement that the auditor, by means of various audit procedures, has satisfied himself that all major trade accounts payable have been recognized and recorded. This hardly seems necessary but it is used by a number of auditors.

Other current liabilities. If any of the remaining current liabilities is of a relatively material amount or of unusual importance the auditor may consider it necessary to comment about it, briefly or at length. Otherwise most of these accounts, which represent normal accruals and miscellaneous liabilities, may be covered in a general statement. The auditor might indicate that he has examined the liabilities and that he has computed the amounts of all accruals. If there is a current maturity of long-term debt the reader may be referred to the section on long-term debt.

Usually the federal income tax payable is one of the largest of the current liabilities. As such, it requires special comment. The auditor should indicate whether the estimate is based on the client's calculation (or return) or on the auditor's estimate of the liability based on a tentative tax return prepared by him. He should also indicate whether or not any taxes for prior years are included in the estimated liability.

Long-term debts. If the client has long-term indebtedness on the balance sheet the audit report should contain a complete description of it. The date of issue, interest rate, maturity date, and type of security behind the debt should be mentioned, as should any serial features or sinking fund requirements.

Bond indentures often contain restrictive provisions, such as the necessity of maintaining a certain current ratio or a restriction against the declaration and payment of dividends except under stipulated conditions. All such restrictive provisions should be noted in the audit report.

The auditor should indicate that he has received confirmation from the trustee as to the outstanding indebtedness of a bond issue. If the debt is a long-term bank loan or long-term mortgage notes issued to an insurance company, the payee of the notes should have confirmed them.

There should be included in the report a statement indicating whether or not the company is complying with the accounting provisions of the indenture. The auditor must be careful to avoid making statements concerning the legal aspects of the indenture, but the accounting provisions are his field and he should comment on the compliance or lack of it.

It is also customary to indicate the status of interest payments. Often the trustee will indicate to what date interest has been paid. In his examination the auditor should have verified this information against the

book records and so should be in a position to make a statement as to the status of interest payments.

Contingent liabilities. There should be a section in the report in which there is full reporting of any contingent liabilities disclosed by the examination. In addition, the auditor and the client must decide on whether the contingencies are material enough to be appended to the financial statements.

Either when discussing the federal tax liability or at this point, the auditor should indicate the year through which the tax returns have been audited and accepted. If there has been a proposed deficiency assessment applicable to later years it should be discussed here. It is dangerous for the auditor to attempt to forecast the outcome of the proposed assessment unless the client has decided to accept it, in which case it should be reported as a current liability.

In this section the auditor should indicate that he has received from management a representation as to liabilities. He might state briefly the points on which management has put itself on record with respect to the liabilities.

Proprietorship. If the client has undergone a material change in capital stock structure during the year there should be a complete reporting of the facts. In some instances it might be helpful to present a comparative schedule of the old and new structures. Reference should be made to the authorization for the change and to the verification of funds received.

Where no change has taken place and where a registrar and transfer agent are employed, it is sufficient to indicate that confirmation of the stock issued and outstanding has been received. It should be noted that such confirmed amounts agree with the company's records.

In reporting on companies which maintain their own stock records, the auditor should indicate briefly the procedures followed in the examination of the stock records. These would include examination of the stock certificate book and a reconciliation with the stockholder's ledger.

Any treasury stock transactions should be reported. The statement should indicate that the authorization for the transactions was examined, that the proceeds or disbursements were traced to the records, and that any stock on hand was examined.

If a stock option is available to officers and key employees it should be disclosed and reported here. The details of the arrangement should be given, with the facts as to the amounts already exercised, the amount still available, and the expiration date of the agreement.

If the client is a sole proprietor or a partnership it is customary to report any major additions to or deductions from the proprietorship accounts. Other than this a general statement that the changes in the accounts have been examined and verified is all that is necessary.

All major changes in surplus accounts should be discussed, reference being made to the related statements. Appropriations of retained income (or their return) should be noted.

If the only changes are in the retained income account and consist only of net income and dividends, it is sufficient to refer the reader to the statement of retained income. Some auditors, however, like to present here a listing of dividends declared and paid during the year. If dividends are shown in total only in the retained income statement it is satisfactory to show the details in this section of the report. If nonrecurring charges and credits have been made to retained income they should be reported in full.

Somewhere in the report it is customary to present the book value and the earnings per share. If this has not been done earlier in the report it could be shown at this point.

This concludes the text portions of some audit reports. As indicated earlier, some auditors like to follow the comments on the balance sheet with a listing of the insurance policies and a general discussion of the insurance coverage. Others like to conclude the report with a statement thanking the client and his staff for their cooperation during the examination. Such a statement appears unnecessary.

ILLUSTRATIVE LONG-FORM REPORT

The example of a long-form report in Exhibit 20-5 will illustrate some of the points discussed above. The student should recognize that each report will differ from all others. Each report is written to fit the wants and requirements of the particular client. This report is based on the statements of The General Corporation, as shown in Chapter 18.

Exhibit 20-5

February 16, 1962

To the Board of Directors and Stockholders
The General Corporation
Columbus, Ohio

We have examined the statement of financial position of The General Corporation as of December 31, 1961, and the statement of income and retained income for the year then ended. Our examination was made in accordance with generally

Exhibit 20-5 (Continued)

accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying statements present fairly the financial position of The General Corporation as of December 31, 1961, and the results of its operations for the year then ended, in accordance with generally accepted principles of accounting applied on a basis consistent with the preceding year.

Arthur Jones & Company (L.S.)

The remainder of this report contains, in addition to the financial statements, our comments regarding the major balance sheet accounts and other items of importance disclosed during our examination which we believe require discussion. These items are reviewed under the following headings:

Comments on changes in financial position
Comments on operations
Comments on the statement of financial position
Financial statements

COMMENTS ON CHANGES IN FINANCIAL POSITION

We present below a condensed comparative statement of financial position for The General Corporation.

	1961	*1960*	*Increase (Decrease)*
Cash	$ 449,334	$ 435,110	$ 14,224
Accounts receivable (net)	1,753,435	1,828,484	(75,049)
Inventories	2,694,863	2,626,786	68,077
Prepaid expenses	66,288	63,859	2,429
Total current assets	$4,963,920	$4,954,239	$ 9,681
Less: Total current liabilities	1,782,781	2,550,317	(767,536)
Net working capital	$3,181,139	$2,403,922	$ 777,217
Investments and deposits	258,318	243,180	15,138
Plant and equipment (net)	2,152,402	1,842,430	309,972
Deferred charges	56,890	45,514	11,376
Total assets less current liabilities	$5,648,749	$4,535,046	$1,113,703
Less: Long-term debt	2,236,288	1,166,561	1,069,727
Owners' equity	$3,412,461	$3,368,485	$ 43,976

The change in owners' equity was brought about by the following causes:

Net income, before depreciation	$532,084
Less: Depreciation and amortization	257,275
Net income, Exhibit C	$274,809
Less: Dividends declared and paid	230,833
Increase in owners' equity	$ 43,976

Exhibit 20-5 (Continued)

The working capital has been increased $777,000. This has been brought about by an increase of $1,071,000 in 5½ per cent sinking fund debentures due in 1970. The proceeds from the sale of these bonds were used to purchase additional plant and equipment and to reduce notes payable to banks currently maturing. The rapid expansion of the company's physical facilities over the past three years has brought about the present financial structure. Under normal conditions it is poor business practice to solve current financial problems by issuing long-term debt. However, in this instance the poor current structure was caused by the expansion program and the attempt to finance it entirely from internal sources and short-term borrowing. Since the program is now virtually complete it is to be anticipated that the demand for funds will be less than it has been in prior years and that funds may now start to be accumulated for the payment of the long-term debt. Net income represents a return on owners' equity of about 8 per cent. Dividends to owners took about 85 per cent of net income. As the new facilities reach full operating performance it is to be expected that net income will increase and will result in a better rate of return which will, in turn, provide more funds for payment of long-term debt.

The working capital ratio has increased from 1.98 to 1 to 2.78 to 1. This increase, too, was brought about primarily by the substituting of long-term debt for current debt.

COMMENTS ON OPERATIONS

There is shown below a condensed comparative statement of operations. Although we did not make a detailed examination of operating transactions, we have, by various tests and procedures, satisfied ourselves that the statement fairly presents the results of operations for the years shown.

	1961		*1960*		*Increase (decrease)*	
	Amount	*Per cent*	*Amount*	*Per cent*	*Amount*	*Per cent*
Net sales	$8,643,301	100.0%	$8,695,080	100.0%	$ (51,779)	(0.6)%
Cost of goods sold	6,317,717	73.1	6,158,681	70.8	159,036	2.6
Gross margin	$2,325,584	26.9%	$2,536,399	29.2%	$(210,815)	(8.3)
Selling and administrative expense	1,796,000	20.8	1,656,260	19.1	139,740	8.4
Net operating profit	$ 529,584	6.1%	$ 880,139	10.1%	$(350,555)	(39.8)
Nonoperating expenses, net	85,775	1.0	21,306	0.2	64,469	—
Net profit before taxes	$ 443,809	5.1%	$ 858,833	9.9%	$(415,024)	(48.3)
Federal income taxes	169,000	2.0	357,500	4.1	(188,500)	(52.8)
Net income for the year	$ 274,809	3.1%	$ 501,333	5.8%	$(226,524)	(45.2)%

Exhibit 20-5 (Continued)

The slight decrease in sales was accompanied by an increase in cost of goods sold. This increase was brought about primarily by the increased cost of labor, as indicated in the following schedule of manufacturing costs.

	1961		*1960*		*Increase (decrease)*	
	Amount	*Per cent*	*Amount*	*Per cent*	*Amount*	*Per cent*
Material	$1,237,694	19.6%	$1,244,054	20.2%	$ (6,360)	(0.5)%
Labor	3,321,965	52.6	3,165,562	51.4	156,403	4.9
Manufacturing expenses	1,758,058	27.8	1,749,065	28.4	8,993	0.5
Total	$6,317,717	100.0%	$6,158,681	100.0%	$159,036	2.6%

These increased costs had not been reflected in increased sales prices by the year end. A new schedule of sales prices was issued early in 1962. The increase in selling and administrative expenses was due generally to the increased costs of all goods and services and was not confined to any particular account.

COMMENTS ON THE STATEMENT OF FINANCIAL POSITION

In the following paragraphs we comment on the major assets and liabilities of the company as of December 31, 1961, in the order in which the accounts appear on the comparative statement of financial position, Exhibit A.

Cash on hand and in banks—$449,334

The above amount is composed of the following balances:

Petty cash	$ 25,000
County National Bank	286,715
State National Bank	104,778
Payroll bank account	32,841
Total as above	$449,334

We counted the funds on hand ($18,000) and received certifications from custodians of funds at branches ($7,000). Our examination of cash included the examination of checks written and tracing of receipts into bank statements for selected periods. We received confirmation of the bank balances directly from the depositories and reconciled these amounts with the book balances. Our report for last year indicated that there was a considerable lag between receipts and deposits. This unsatisfactory condition has been remedied.

Accounts receivable, net—$1,753,435

The accounts receivable are composed of the following items:

Trade accounts receivable	$1,831,515
Allowance for doubtful accounts	78,080
Net as above	$1,753,435

Exhibit 20-5 (Continued)

We have satisfied ourselves that there are individual accounts receivable totaling the gross amount shown above. We have corresponded with all the customers as to the correctness of their balances. Of these, 346 replies (81 per cent) confirmed balances amounting to $1,587,742, or 86.7 per cent of the total amount due. Receipts in January, 1962, included $133,462 from customers who did not answer our requests for confirmation.

We have reviewed the aging of accounts receivable made by your staff. The aging produced the following results:

	1961		*1960*	
	Amount	*Per cent*	*Amount*	*Per cent*
Not yet due	$ 896,715	49.0	$ 853,712	44.5
1–30 days past due	673,303	36.7	687,920	35.9
2–6 months past due	157,061	8.6	239,410	12.5
7–12 months past due	83,684	4.6	102,802	5.4
Over 1 year past due	20,752	1.1	33,870	1.7
Totals	$1,831,515	100.0	$1,917,714	100.0

This schedule indicates the improvement that has been made in the collection effort. In 1961 85.7 per cent of the accounts were billed in November and December as opposed to 80.4 per cent in 1960. Furthermore the number of days' sales in receivables were reduced from seventy-nine to seventy-six. While this is commendable, the effort should be increased, since the average days' sales in receivables for your industry is only fifty-eight.

During the year under review accounts in the amount of $24,680 were written off as uncollectible. We believe the allowance provided is adequate.

Inventories—$2,694,863

The inventories are composed of the following:

Finished goods	$ 981,462
Work in process	78,520
Raw materials	1,616,201
Factory supplies	18,680
Total	$2,694,863

We were present at the annual inventory taking and observed the processes employed. In addition, we made sufficient tests of physical quantities, clerical accuracy, and pricing to satisfy us as to the general accuracy of the inventory amounts. The control over inventories is adequate. A careful scrutiny is made annually to determine the necessity of writing down obsolete materials or unsalable finished products.

We have received from the president a statement setting forth in some detail

Exhibit 20-5 (Continued)

the methods used in determining inventory quantities and values, and certifying that the inventory has been fairly and properly valued, that all the inventory recognized is the property of the company, that there are no liens thereon, and that proper provision has been made for old and obsolete items.

Prepaid expenses—$66,288

The prepaid expenses are listed below:

Unexpired insurance	$38,462
Inventory of supplies	15,315
Prepaid interest	6,246
Prepaid advertising	6,265
Total as above	$66,288

We have satisfied ourselves that the amounts shown are reasonable and are proper deferrals. We reviewed the insurance policies and believe that the coverage is adequate.

Accounts payable and accrued items—$879,624

Our review of these items included confirmation of balances due from a selected number of major suppliers. As a result of our examination we are satisfied that all significant trade liabilities have been included in the above amount.

Income taxes payable—$257,200

We have reviewed the estimate of federal taxes payable prepared by the company's tax department and believe it to be a reasonable estimate of the total liability due the federal government. Income tax returns have been reviewed by the Internal Revenue Service through the year 1958. There are at present no proposed additional taxes. On the basis of our review of the tax returns for the years 1959 and 1960 we believe that no additional taxes will be successfully levied against the income of those years.

Notes payable to banks—$624,632

We have received confirmation of the details of the following notes from the holders thereof:

Payee	*Date due*	*Amount*
First National Bank	2/1/62	$100,000
Second National Bank	3/1/62	100,000
State National Bank	5/1/62	100,000
First National Bank	8/1/62	124,632
Second National Bank	10/1/62	100,000
State National Bank	12/1/62	100,000
Total		$624,632

Exhibit 20-5 (Continued)

The indebtedness to banks has been reduced by almost $500,000 during the year as a result of the issuance of additional debentures.

Investments and deposits—$258,318

Investments have been made as follows:

The Special Corporation (100 per cent owned)	$100,000
Sinking fund	155,008
Miscellaneous deposits	3,310
Total as above	$258,318

The stock of the Special Corporation was purchased five years ago for $100,-000. The statements of this company are not consolidated with those of The General Company because The Special Corporation is engaged in a field of endeavor quite foreign to that of The General Corporation. At December 31, 1961, the capital stock and retained income of The Special Corporation amounted to $286,-542. We reviewed the audited statements of The Special Corporation prepared by James and Jones, Certified Public Accountants.

A sinking fund has been set up in connection with the sinking fund debenture bond issue. The details of balance shown above were confirmed to us by the trustee of the fund. Earnings of $5,008 were added to the fund during the year under review.

Plant and equipment, at cost—$3,474,382

Allowance for depreciation—$1,321,980

An extensive renewal and expansion of plant facilities has taken place during the past three years. In that time $1,782,647 has been expended in the purchase of new machinery and equipment. The program is now virtually finished, the company being committed for an additional $95,000 to complete the modernization and expansion. Originally the intent was to finance the work from earnings and funds previously accumulated. Costs were greater than was anticipated and short-term borrowing was used as a stopgap until the sinking fund debentures were issued. As the new facilities are completed and production is increased the company expects the resulting earnings to be sufficient to pay current dividends and to add substantial sums to the sinking fund.

We have reviewed the additions and dispositions in the plant and equipment accounts and are satisfied that they are proper. The changes in these accounts are set forth in Schedule A2.

Charges for depreciation have been made on the same basis as in prior years. We believe that the depreciation reasonably measures the allocable cost of plant and equipment for the year and that the accumulated depreciation is also reasonable.

Long-term debt—$2,236,288

During the year additional 5½ per cent sinking fund debenture bonds were issued in the amount of $1,071,000. Proceeds from this issue were used to reduce

Exhibit 20-5 (Continued)

current notes payable to banks and to pay for the additional plant items purchased. These bonds are due in 1970.

We have received confirmation from the trustee of the sinking fund debentures as to the balance outstanding, the details of the issue, and the details of the sinking fund. We have also received confirmation from the trustee of the 3½ per cent promissory notes and from the mortgage holders of the balances of these accounts.

Owners' equity—$3,412,461

We have received independent confirmation from the registrar and the transfer agent of the amount of company stock issued and outstanding. The only change in ownership accounts occurred in the retained earnings account. Details of the changes in this account are shown in Exhibit B.

INDEX

Account, analysis of, 80
Accountant, public (*see* Auditors, independent)
Accountants, certificate, 469
  junior and senior, 24
  liability of, common law, 32
    statutory law, 32
      defenses against, 33
Accounting, auditor's knowledge of, 15
Accounting machines, effect on audit, 22
Accounting Review, 19
Accounts payable, 349
  aging, 354
  audit of, 103
    major objectives in, 353
  balance sheet classification, 363
  comments in long-form report, 503
  confirmation of, 359
  examination of new-year transactions, 361
  internal control, 350
    purchasing procedures, 350
  purchase commitments, 360
  purchase discounts, 362
  search for unrecorded invoices, 358
  tests of transactions, 357
  use of creditors' statements, 359
  variations in accounting for, 349
    cash basis, 350
    purchase journal, 349
    voucher system, 349
Accounts receivable, 147
  aging, 150, 166
  aging results, 167
  allowance for cash discounts, 171
Accounts receivable, alternative procedures, 162
  audit of, 147
    major objectives in, 149
  audit procedures, 150
  balance sheet presentation, 172
  balancing of subsidiary ledgers, 148
  circularization, 157
    at other than balance sheet date, 162
  comments in long-form report, 496
  confirmation procedure, 160
    results of, 165
  confirmation request, control over, 162
    discrepancies, 163
    illustrated, negative, 161
      positive, 159
    negative, 158
    positive, 158
  consignment accounts, 172
  credit balances, 173
  discussion with credit manager, 168
  examination of control account, 155
  internal control, 147
  postings, test of, 156
  proof of subsidiary against control, 150
    adjustment of control, 155
    procedure where ledger is out of balance, 154
  receipts after year end, 167
  sales cutoff, 156
  tests, of sales records, 155
    of sales returns, 157
Accrued interest receivable, notes, 197

Accrued liabilities, 364
  and other liabilities, 371
  payroll taxes, 368
  state and local taxes, 369
  wages and salaries, 364
Accumulated depreciation, audit procedures, 304
Adjusting journal entries, 72
  distinguished from reclassification entries, 72
  review of, 453
Advances, by customers, 373
  to salesmen, 248
    confirmation of, 248
  to subsidiary companies, 277
Advertising, rule prohibiting, 27
Advertising expense, 440
Agenda sheet, review of, 453
Aging, accounts payable, 354
  accounts receivable, 150, 166
All-inclusive income statement, 412
Allowance for doubtful accounts, accounts written off, 169
  adequacy of, 169
  discussion with credit manager, 169
  evaluation of provision, 169
  notes receivable, 195
American Accounting Association, 19
American Institute of Certified Public Accountants, 18
Analysis method, 79
Application of funds statement, 465
Applied burden, test of, 437
Appraisal by internal auditor, 2
Appraisals, 288
Appropriations of surplus, 415
Arrangements with client, 38
Attorney's bills, 390, 445
Audit, beginning of, 38
    first tasks, 47
    interview with client, 38
    supplies necessary, 47
    work to be done by client's staff, 43
  completion of, 452
Audit procedures and techniques, accounts payable, 353
  accounts receivable, 150
  accumulated depreciation, 304
  buildings, 293
  capital stock, 405
Audit procedures and techniques, cash, 124
  deferred charges, 329
  intangible fixed assets, 324
  inventories, 216
  land, 292
  long-term debt, 382
  machinery and equipment, 296
  notes payable, 339
  notes receivable, 189
  partnership accounts, 399
  petty cash, 120
  prepaid expenses, 238
  revenue and expense, 429
  single proprietorship account, 394
  stocks and bonds, 257
  tangible fixed assets, 292
Audit program, 61
  advantages, 62
  disadvantages, 63
  illustration, 63
  review of, 453
Audit sample, 90–92
Audit working papers, 63
  account analysis, 79
  adequate, qualities of, 179
  completion of, 452
  contents of, 67
  destruction of, 86
  filing of, 86
  illustrative, account analysis, 80
    adjusting journal entries, 76, 77
    advertising, 441
    agenda sheet, 69
    aging schedule, 151
      accounts payable, 356
    allowance for doubtful accounts, 171
    audit program, general data, 68
      petty cash, 63
    bank reconciliation, 132
    bank transfers, 138
    block proof of sales, 433
    bonds payable, 386
    capital stock confirmation request, 409
    cash summary, 139
    changes in partners' capital, 402
    cost of goods sold, 436, 438
    discount on serial bonds, 323
    disposition of fixed assets, 298

Audit working papers, illustrative, engagement memorandum, 46
income tax worksheet, 374
interest expense, 448
inventory certificate, 230
error sheet, 227
price tests, 225
sheet, 222
test counts, 219
investments, stocks and bonds, 261
leasehold improvements schedule, 320
machinery, and allowance for depreciation, 300
and equipment, 297
miscellaneous administrative expense, 446
mortgage notes receivable, 269
notes payable schedules, 341, 343
notes receivable schedules, 191, 193
payroll summary, 366
payroll tax accounts, 370
plant rearrangement, 330
proof of cash transactions, 134
proprietorship account, 395
referencing and cross referencing, 85
retained income, 414, 416
sales, 431
statement of changes in owner's equity, 399
stock certificate stubs, 408
stocks, and bonds, lower-of-cost-or-market schedule, 265
schedule, 259
summary, of accounts receivable ledgers, 153
of fixed assets, 307
treasury stock, 411
unexpired insurance, analysis of, 239, 241
schedule of policies, 243
vouchers payable, 355
withdrawals schedule, 397
working balance sheet, 73
working operating statement, 75
working trial balance, 71
indexing of, 81, 456
microfilming of, 86
ownership of, 87
permanent file, 86
Audit working papers, preparation of, 74
purposes of, 64
referencing and cross referencing of, 84, 457
reliance on prior year's papers, 66
review of, 455, 457
standard items included in, 78
working trial balances, 68
completion of, 456
Auditing, cash disbursements, 104
cash receipts, 98
by comparison, 427
definition of, 1
engagement memorandum, 46
fees, 25
functional, accounts payable, 103
accounts receivable, 96
cash disbursements, 104
cash receipts, 96
purchasing, 101
sales, 95
general journal, 107
general ledger, 108
interim work, 45
internal, 2
major objectives in (*see* Major objectives in auditing)
marking client's records, 109
materiality in, 35
payroll, 106
preliminary work, 45
records of original entry, 88
sales, 95
sales discounts, 101
sales records, 96
standards and procedures, of field work, 35
general, 34
of reporting, 35
terminology, explanation of, 88
testing techniques, 89
types of audits, 24
vouchers, 103
Auditors, classes of, 1
definition of, 1
fees, 41
independent, 3
as business consultants, 9
confidential relationship with client, 31
as directors, 31

Auditors, independent, functions, 5
large businesses, 9
expression of opinion, 10
as representative of directors and owners, 10
review system of internal control, 10
medium-sized businesses, 7
expression of opinion, 8
managerial services, 9
preparation of tax returns, 9
review of internal control system, 8
small businesses, 5
aid to bookkeeper, 5
discovery of errors, 5
expression of opinion, 7
managerial services, 6
statement preparation, 6
negligence of, 32
noncertified, 4
place in our economy, 4
scope of activities, 4
organization of office, 22
qualifications of, 15
selection of, 38
short-form report, 11
(*See also* Certified public accountant)
internal, 1–3
opinion, rules regarding expression of, 28, 29
report, long-form, 485
comments, on balance sheet, 494
on changes in financial position, 489
on operations, 492
illustration, 506
purpose, 485
review of, 487
writing of, 486
short-form, 11, 469
disclaimers, 478
explanations, 474
qualifications, 476
SEC requirements, 471
standard form, 473
statements without audit, 479
variations from standard, 474
selection of, 38

Balance sheet, 461
accounts payable, 363
accounts receivable, 172
audit, 25
capital stock, 412
cash, 140
fixed assets, 306
notes payable, 345
notes receivable, 197
surplus, 418
Bank (*see* Cash)
Billing of client, 25
Block proofs, cost of goods sold, 435
sales, 433
Block sample, 90
Bond discount and premium, adjustment of, 387
Bond indenture, 383
verifying accounting provisions of, 385
Bonds payable (*see* Long-term debt)
Bonus and tax problem, 442
Buildings, 286
audit procedures and techniques, 293
cost principles, 286
when constructed by client, 286
when constructed by outsider, 286
when purchased, 286
dispositions of, 296
identification charts, 293
Burden, test of, 437

Calculated risk, 236
Capital stock, audit procedures, 405
balance sheet presentation, 412
comments in long-form report, 505
confirmation, 408
treasury stock, 410
Cash, audit of, 113
importance of, 113
major objectives in, 118
audit procedures, 119, 124
balance sheet presentation, 140
bank balances, confirmation of, 125
bank reconciliation, 132
bank transfers, 137
check examination, 129
comments in long-form report, 495
cutoff, 135
cutoff statement, 132

Cash, disbursements, audit of, 104
  discounts granted, 128, 171
  footings, 125
  on hand awaiting deposit, 124
  holding cash books open, 135
  internal control, 114
  kiting, 137
  overdrafts, 140
  proof, of bank debits and disbursements, 130
    of cash transactions, 134
    of receipts and deposits, 126
  receipts, audit of, 98
    and deposits, 126
    unrecorded, 137
  reconciliation, 132
  restricted balances, 140
  simultaneous count of cash and securities, 119
  summary, 138
  unusual checks, 130
  write-off of old checks, 131
Cash basis accounting, 350
Cash value of life insurance policies, confirmation, 274
Certificate, of auditor (*see* Auditors, report)
  inventory, 229
  liability, 390
    illustration, 391
Certified public accountant, 12
  examination, 14
    awards, 15
    causes of failures, 14
  regulation of, 12
  requirements for, 12
Charter, examination of, 94
Checks, examination of, 104
Clean surplus theory, 412
Co-insurance, 242
Combined income and retained income statement, 464
Comparative financial statements, 459
Confirmation, accounts payable, 359
  accounts receivable, 157
  advances, to salesmen, 248
    to subsidiary, 277
  capital stock, 408
  cash in bank, 125
  cash value of life insurance policies, 274
Confirmation, definition of, 89
  deposits, 279
  long-term debt, 384
  mortgage notes receivable, 270
  notes payable, 342
  notes receivable, 192
  request, standard form, 126
  securities not on hand, 263
  sinking funds, 278
Consigned inventories, 219
Consignment accounts receivable, 172
Consistency, revenue and expense, 428
Consolidation of subsidiary companies, 276
Contingency, reserve, 415
Contingent fees, 29
Contingent liabilities, 388, 389
  comment in long-form report, 505
Contributions, 445
Control (*see* Internal control)
Copyrights, 319
Corporate charter, 94
Corporate equity accounts, 402
  auditing, major objectives in, 405
  internal control, 403
  transfer agent, 403
Cost of goods sold, 229
  block proofs, 435
  tests of records, 435
Credit balances in accounts receivable, 173
Creditors' statements, use of, 359
Current maturities of long-term debt, 372
Current operating theory, 412
Customers, advances by, 373

Data processing, electronic, effect on audit, 22
Deferred charges, 327
  audit procedures, 329
  auditing, major objectives in, 328
  comments in long-form report, 502
  internal control, 327
  organization expense, 331
Deferred credits to income, 373
Denial of opinion, 478
Depletion, 305
Depreciation, 299
  audit procedures, 304

Depreciation, comparative table of methods, 303
  definition of, 299
  on investment property, 273
  methods, 301
    comparative table, 303
    fixed percentage of reducing book value, 303
    straight-line, 301
    sum-of-years'-digits, 302
    units of production, 301
    working hours, 302
Destruction of working papers, 86
Direct costing, 207
Disclaimers, 478
Disclosure, 459
Discounts granted, 128
Dividends paid, 414
Dividends payable, 372
Donations, 445

Electronic data processing, effect on audit, 22
Engagement memorandum, 46
Errors in audit samples, 93
Ethics of profession, 27
Events subsequent to balance sheet date (*see* Post–balance sheet transactions)
Exchanges of fixed assets, 287
Expense advances, 248
Expenses, audit objectives, 427
  auditing, 439

Federal income tax payable, 373
Fees, 25, 41
  contingent, 29
  forwarding, 30
FICA taxes, 368
Filing working papers, 86
Financial statements, 458
  all-purpose versus single-purpose, 458
  balance sheet, 461
  combined income and retained income, 464
  disclosure, 459
  funds statement, 465
  general principles, 459
Financial statements, income statement, 463
    single-step, 463
  price-level index, 459
  referencing, 465
  retained income statement, 462
  statement of owner's equity, 461
  supporting schedules, 464
Fixed assets, 284
  intangible, 317
    amortization, 326
    audit procedures, 324
    auditing, major objectives in, 324
    comments in long-form report, 501
    copyrights, 319
    goodwill, 321
    internal control, 322
    leaseholds and leasehold improvements, 319
    major classes, 317
    patents, 318
    secret processes, 321
    valuation, 317
  tangible, 284
    auditing, major objectives in, 291
    balance sheet presentation, 306
    basic cost principles, 285
      appraisals, 288
      buildings, 286
      land, 285
      machinery and equipment, 287
    buildings, audit procedures, 293
      dispositions, 296
      identification charts, 293
    classification as to consumption, 284
    comments in long-form report, 500
    definition of, 284
    depletion of, 305
    depreciation, 299
      definition of, 299
    internal control, 289
    land, audit procedures, 292
    machinery and equipment, 296
    miscellaneous considerations, 306
    rental-purchase options, 287
    retirements, search for, 305
Fraud, forms of, 57
  lapping, 98
Full disclosure, 459
Funds statement, 465

General audits, 25
General journal, audit of, 107
General ledger, audit of, 108
Goods in transit, 219
Goodwill, 321
  cost principle, 322
  definition of, 321
  erroneous charges, 322

Income, and expense, 426
    other, 447
  retained, 412
Income statement, 463
Income tax, federal, 373
Indenture, bond, 383
Independence, 31
Independent auditor (*see* Auditors)
Indexing working papers, 81, 456
Insurance coverage, review of, 246
Intangible fixed assets (*see* Fixed assets)
Interest expense, long-term debt, 385
  proof of, 334
Interest income, notes receivable, 197
Interim work, 45
  inventories, 204
Internal auditing, definition of, 2
  growth of, 2
  objectives of, 2
Internal auditor, 1–3
  functions of, 3
  independence of, 3
  as part of management team, 2
  place in organization, 3
Internal control, 49
  accounts payable, 350
  accounts receivable, 147
  auditor's evaluation of, 57
  auditor's review of, 50
  basic principles, 50
  cash, 114
    disbursements, 116
    receipts, 115
  corporate equity accounts, 403
  deferred charges, 327
  definition of, 49
  intangible fixed assets, 322
  inventories, 214
  investments, 256
  long-term debt, 380
Internal control, notes payable, 338
  notes receivable, 188
  operating accounts, 426
  petty cash, 114
  prepaid expenses, 235
  questionnaire, 52–57
  tangible fixed assets, 289
  time of review, 51
Interview with prospective client, 38
Inventories, 202
  audit importance, 202
  audit procedures, 216
  auditing, major objectives in, 216
  balance sheet presentation, 229
  certificate, 229
  clerical accuracy, 222
  comments in long-form report, 498
  comparison with previous year, 226
  consigned goods, 219
  cost of goods sold, 229
  costing methods, 206
    actual cost, 206
    average cost, 206
    direct costing, 207
    first-in, first-out, 206
    last-in, first-out, 207
    standard cost, 207
  cutoff, 203
  elimination of interdepartment profits, 228
  error sheet, 226
  goods in transit, 219
  hollow squares, 217
  interim work, 204
  internal control, 214
  observation of, 216
  possible future losses, 231
  preliminary work, 202
  pricing of, 223
  proof of subsidiary to control, 219
  purchase commitments, 228
  recording test counts, 218
  responsibilities, of accountant, 210
    joint, 213
    of management, 212
  review of client's instructions, 202
  "set-asides," 157
  taken at other than balance sheet date, 205
  tests of quantities, 217

Inventories, tracing of counts, into final records, 221
  to perpetual records, 219
 use of proper unit of measurement, 203
 valuation, 208
  cost, 208
  lower-of-cost-or-market, 208
  net realizable value, 209
  retail-inventory method, 210
 in warehouses, 221
Investments, 254
 audit procedures, 257
 auditing, major objectives in, 257
 cash value of life insurance policies, 274
 comments in long-form report, 499
 deposits, 279
  confirmation of, 279
 internal control, 256
 joint responsibility for control of, 256
 mortgage notes receivable, 267
 noncurrent, 254
 real estate owned, 271
 sinking funds, 278
  earnings on, 279
 stocks and bonds, 257
 subsidiary companies, 276
  advances to, confirmation of, 277
 temporary, 254
 types of, 254
 valuation, noncurrent, 255
  temporary, 255
Invoices, efficiency in processing, 352

Journal of Accountancy, 18
Junior accountants, responsibilities of, 24

Kiting, 59, 137

Land, 285
 audit procedures and techniques, 292
 cost principles, 285
Lapping, 58
Lawsuits, pending, 389
Leasehold, bonus under, 319
Leasehold improvements, 319
 amortization of, 319
Legal and accounting expense, 444
Letter to management, 481
Liabilities, accrued (*see* Accrued liabilities)
 availability of data on, 352
 contingent, 388
  letter to attorney, 389
  pending lawsuits, 389
  purchase and sales commitments, 389
 long-term, 380
Liability of accountant, 32
Liability certificate, 390
 illustrated, 391
Life insurance, cash surrender value, 274
Long-form report, 485
Long-term debt, 380
 audit procedures, 382
 auditing, major objectives in, 382
 comments in long-form report, 504
 confirmation of, 384
 current maturities, 372
 discount and premium, 387
 interest expense, 385
 internal control, 380
 recording in public office, 385
 treasury bonds, 387
 vouching proceeds of, 383

Machinery and equipment, 287
 audit procedures and techniques, 296
 cost principles, 287
 examination of related maintenance accounts, 298
 exchanges, 287
 proof of existence, 299
 rental-purchase options, 287
Major objectives in auditing, accounts payable, 353
 accounts receivable, 149
 cash, 118
 corporate equity accounts, 405
 deferred charges, 328
 intangible fixed assets, 324
 inventories, 216
 investments, 257
 long-term debt, 382
 notes payable, 339
 notes receivable, 189
 prepayments, 237

Major objectives in auditing, revenue
and expense, 427
tangible fixed assets, 291
Management, letter to, 481
Management representations, inventory, 229
liabilities, 390
Management services, 6
Marking of client's records, 109
Matching theory, 428
Materiality in auditing, 35
Mechanical equipment, effect of use of, 21
Microfilming working papers, 86
Minutes, examination of, 94
Mortgage notes receivable, 267
confirmation of, 270
examination of documentary evidence, 268
scheduling, 268
verification of income, 271

NAA Bulletin, 19
National Association of Accountants, 19
Natural business year, 205
Nonfinancial records, corporate charter, 94
corporate minutes, 94
examination of, 93
Notes payable, 337
audit procedures, 339
auditing, major objectives in, 339
balance sheet presentation, 345
comments in long-form report, 502
confirmation of, 342
internal control, 338
post–balance sheet transactions, 345
proof of interest, 344
protection of paid notes, 342
scheduling, 340
unused notes, 342
Notes receivable, advantage of, 188
audit procedures, 189
auditing, major objectives in, 189
balance sheet presentation, 197
comments in long-form report, 496
confirmation request, to holder, 192
illustrated, 195
to maker, 192
definition of, 188
Notes receivable, discounted, 390
dishonored, 196
doubtful, 195
examination of notes on hand, 190
interest on, 197
internal control, 188
nontrade, 197
prove subsidiary against control, 189
renewed, 196
secured by collateral, 190
tests of details of note transactions, 194
verification of beginning balance, 189
written off, 196

Officers' salaries, bonus and tax problem, 442
On-the-job training, 48
Operating statement, 463
Operational review, 427
Organization of public accountant's office, 22
Organization expense, amortization, 331
Organizations, professional, 17
Other current liabilities, 363
comments in long-form report, 504
Other income and expense, 447
Overhead, audit of, 437
Owners' equity (*see* Corporate equity accounts; Partnership; Sole proprietor)
Ownership of working papers, 87

Partial audits, 25
Partners, responsibilities of, 23
Partnership, 399
agreement, audit of, 399
audit procedures, 399
approval of withdrawals, 400
division of profit, 401
statement of changes in equity, 401
Patents, 318
amortization of, 319
costing, 318
development of, 318
infringement of, 318
Pay checks, distribution to employees, 365
Payables, long-term, 380
major problems, 337

Payroll, audit of, 106
  padding, 59
  summary, 365
  survey of function of, 364
  taxes accrued, 368
Permanent file, 86
Petty cash, adjustments to, 123
  audit procedures, 120
  audit program, 63
  borrowing from, 122
  cash count, 120
  internal control, 114
  shortages, 123
  surprise count, 123
  test of details, 123
Physical inventories, 202
Post–balance sheet transactions, 479
  accounts payable, 361
  notes payable, 345
  sales, 432
Preliminary interview discussion items, 38
  audit fee, 41
  condition of records, 40
  confirmation of various accounts, 42
  date for audit report to be completed, 40
  interim work, 45
  inventory observation, 42
  period examination is to cover, 39
  purpose of audit, 39
  scope of examination, 39
  tour of plant, 40
  where auditor is to work, 40
  why change of auditors is desired, 39
  work to be done by client's staff, 43
Prepaid expenses, 235
  advances to salesmen, 248
  audit procedures, 238
  auditing, major objectives in, 237
  internal control, 235
  inventories of supplies, 247
  prepaid interest, 246
  prepaid rent, 247
  unexpired insurance, 238
Prepaid insurance (*see* Unexpired insurance)
Prepayments, comments in long-form report, 498
Private ledger, 108
Professional organizations, 17
  American Accounting Association, 19
  American Institute of Certified Public Accountants, 18
  National Association of Accountants, 19
Professional publications, 18
Profit and loss statement, 463
Property, plant, and equipment (*see* Fixed assets, tangible)
Proprietorship, comment in long-form report, 505
Proprietorship accounts, 394
Public accountant (*see* Auditor, independent; Certified public accountant)
Public accounting firm, organization of office, 22
Public accounting profession, 19
  ethics, 27
  factors causing increase in, 20
  history, 19
Purchase commitments, 228, 389
  examination of, 360
Purchase discounts, lost, 362
Purchase journal, 349
Purchases, variations in accounting for, 349
Purchasing procedures, 350
Purposes of audit working papers, 64

Qualified reports, 476
Questionnaire, internal control, 52–57

Real estate owned, 271
  depreciation, 273
  verification of income, 273
Receiving records, examination of, 360
Reclassification entries, 72
Reconciliation of bank account, 132
Referencing, financial statements, 465
  working papers, 457
Registrar, 403
Rent expense, 440
Rental-purchase options, 287
Repairs and maintenance, 444
Report of auditor (*see* Auditors, report)
Reserve, contingency, 415
  secret, 417
  surplus, 415

Retained income, 412
  long-form report comments, 506
Retained income statement, 462
Revenue and expense, 426
  audit procedures, 429
  auditing, major objectives in, 427
  consistency, 428
  cost of goods sold, 435
    overhead, 437
  internal control, 426
  review of operations, 427
  sales, 429
  selling and administrative expenses, 439
Review, of audit working papers, 455, 457
  of operations, 427
Rules of professional conduct, 27

Sales, audit procedures, 429
  block proof, 433
  cutoff, 430
  deferred or delayed billing, 433
  set-asides, 157, 432
  tests of records, 155, 429
Sales cutoff, 156
Sales discounts, audit of, 101
Sales records, audit of, 96
Sales returns, test of, 435
Salesmen's commissions, 439
Sample, block, 90
  requirements of, 92
  statistical sampling, 91
Sampling techniques (*see* Testing techniques)
Secret processes, 321
Secret reserve, 417
Senior accountants, responsibilities of, 24
  training juniors, 48
Short-form report, 11, 472
  inclusion in long-form report, 489
Single proprietorship, 394
  audit procedures, 394
    approval of withdrawals, 396
  statement of changes in equity, 398
Single-step income statement, 463
Sinking fund confirmation, 278
Sole proprietorship, 394
Sources and application of funds statement, 465
State and local taxes accrued, 369
Statement of financial position, 461
Statements without audit, 479
Statistical sampling, 91
Stock, certificate book, 404
  dividends, 267
  registrar, 403
  rights, 267
  splits, 267
  transfer agent, 403
Stockholders' ledger, 407
Stocks and bonds, audit procedures, 257
  bonds sold "flat," 267
  examination of certificates, 260
  market values, 264
  not on hand, confirmation of, 263
  quotations, 264
  receivable, collateral for, 262
  release, 262
  scheduling, 258
  stock dividends, 267
  stock rights, 267
  stock splits, 267
  valuation, 264
  verification of income, 266
  vouching transactions, 263
Subsidiary companies, consolidation of, 276
Supervisor, responsibilities of, 23
Supporting schedules, 464
Surplus, 412
  all-inclusive income statement, 412
  appropriations, 415
  balance sheet presentation, 418
  current operating theory, 412
  dividends paid, 414
  long-form report comments, 506
  reserves, 415

Tax-free exchanges, 287
Taxes, federal income, 373
Terminology, 88
Testing techniques, account analysis, 91
  block sample, 90
  statistical sampling, 91
Time reports, 26
Trade marks, 321
Transfer agent, 403
Travel and entertainment, 439
Treasury bonds, 387

Treasury stock, 410
  comments in long-form report, 505

Unclaimed dividends, 372
Unclaimed wages, 367
Unemployment taxes, 368
Unexpired insurance, 238
  co-insurance, 242
  examination of policies, 242
  scheduling policies, 240
Unrecorded cash receipts, 137
Unrecorded liabilities, search for, 358

Valuation, accounts receivable, 168
  cash value of life insurance policy, 275
  goodwill, 322
  inventories, 208
  investments, noncurrent, 255
    temporary, 255
  notes receivable, 195
  stocks and bonds, 264
Voucher, definition of, 88
  examination of, 103
  missing, 103
Voucher system, 349

Wages and salaries, 364
  accrued, 364
  of officers, 442
  tests, 365
Withdrawals, 396
  approval of, 396, 400
  effect of expensing, 400
  effect of failure to record, 398
  as expenses, 397
Working balance sheet, 73
Working operating statement, 75
Working papers (*see* Audit working papers)
Working trial balance, 71
  completion of, 456
Writing of auditor's report, 486