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**AUDITING
PROCEDURE**

THE WILEY ACCOUNTING SERIES

EDITED BY

HIRAM T. SCOVILL, A.B., C.P.A. (ILL.)

FUNDAMENTALS OF GOVERNMENTAL ACCOUNTING. By *Lloyd Morey* and *Robert Phillip Hackett*.

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AUDITING PROCEDURE

by

De Witt Carl Eggleston

ME., C.P.A., LL.B.

Member of firm of
Wilfred Wyler & Co.

THIRD EDITION

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Third Edition

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PREFACE

On numerous occasions the author's acquaintances, among the members of the accountancy profession, have urged him to prepare a third edition of his *Auditing Procedure* which would include explanations of the best current practices employed by independent accountants in the verification of accounts. The position held by the author for several years as chairman of the Committee on Accountants' Office Procedure for The New York State Society of Certified Public Accountants afforded him an opportunity for exchanging ideas and information regarding accounting matters, including auditing procedures, with prominent independent accountants who are actively engaged in the practice of their profession.

The author's store of knowledge regarding the verification of accounts is embodied, for the benefit of interested persons, in this book, which will be found to be a textbook for students of accountancy and also a reference book for independent accountants who are engaged in public practice. The book is a practical manual and presents generally accepted procedures which can be adapted readily to meet the requirements of any auditing engagement. Numerous illustrative audit programs are presented, together with explanatory matter

in order to clarify various items contained therein. Time-saving methods employed in the verification of accounts are included in the material presented. Use of tests, in place of detailed check-
 explained in a manner that can be understood readily by
 The office procedure generally found in well-organized busi-
 nesses is explained in connection with the various methods and Bal-
 Questions to be answered by the accountants
 auditing engagement, regarding the routine
 the company being audited, are included in
 which are presented in the body of the book: Shortage. Balance Sheet

The so-called "short" and "long" form
 certificates, together with a statement
 Securities and Exchange Commission
 explained and discussed in a manner
 students and practitioners. Various
 erally rendered by independent

47
 69
 79
 96

comprehended by each class is described in considerable detail. These explanations should remove any doubts as to the distinctions which exist between different services, such as "general audit" and "detailed audit."

The book contains material relevant to the management of an independent accountant's office. Explanations of the methods employed in the preparation, indexing, and filing of accountants' working papers should prove helpful. Throughout this book the practice has been followed of presenting illustrative audit working papers, with proforma transactions recorded thereon, as supplementary to the text material.

The arrangement of the body of the text follows that of the accounts in the conventional form of balance sheet and income and surplus statement. Uses of analytical reviews of accounts as a means of studying relationships, trends, and ratios are explained and illustrated. Pertinent data that may be included in the long form of audit reports is presented as indicative of the sort of information that may be helpful to readers of reports. Illustrative audit reports, accompanied by independent accountant's working papers, are included in the book.

Ethics of the accountancy profession are dealt with, and, in the appendix, the rules of professional conduct of The New York State Society of Certified Public Accountants and of the American Institute of Accountants are presented.

Review questions are appended to each chapter for use as a means of checking up on one's understanding of the subject matter. In addition, at the end of the book there are 152 general auditing review

s.

Author takes this opportunity of expressing his appreciation of the numerous contributions by members of the accountancy profession, who have aided in the development of this technical accounting knowledge, much of which is embodied in this edition of *Auditing Procedure*. Correspondence from all sources, and letters will be answered promptly.

CONTENTS

CHAPTER	PAGE
1 INTRODUCTION	1
Auditors and Auditing. Accountants' Reports and Certificates. Examination of Accounting Records. Auditing Standards. Necessary Auditing Procedures. Internal Control. Qualifications in Certificates. Opinion of Independent Accountants. Certified Public Accountants. Societies of Accountants. Misstatements of Material Facts. Errors of Commission and Omission.	
2 ACCOUNTING SERVICES AND RELEVANT MATTERS	18
Service Classifications. Engagement Records. Confirmation of Engagements. Letter of Instructions to Client. Engagement Cost Records.	
3 INDEPENDENT ACCOUNTANTS' WORKING PAPERS	28
Permanent File of Working Papers. Arrangement and Indexing of Current Working Papers. Sizes of Working Sheets. General Ledger Trial Balance and Working Sheet. Independent Accountants' Adjustment Entries. Grouping Sheets. General Procedure for Handling Confirmations. Accountant's Time and Expense Records. Report of In-Charge Accountant on Assistant. Procedure Followed upon Completing Report. Accountant's Check List. Preservation of Working Papers. Ownership of Working Papers.	
4 CHECKING VOUCHERS, ADDITIONS, AND POSTINGS	47
Internal Control. Program of Audit. Books of Original Entry. Vouching Entries. Failure to Distinguish between Capital and Revenue. Error of Commission. Additions. Postings. Proof of Cash Statement.	
5 CASH ON HAND	69
Program of Audit. Undeposited Receipts. Cash Funds on Hand. Balance Sheet Treatment.	
6 CASH ON DEPOSIT	79
Program of Audit. Bank Reconciliations. Second Bank Reconciliation. Bank Confirmations. Concealment of Cash Shortage. Balance Sheet Treatment. Sundry Observations.	
INVESTMENT SECURITIES	96
Program of Audit. Examination of Securities. Confirmation of Investment Securities. Book Value of Investment Securities. Market Quotation Values of Investment Securities. Declared Dividends Receivable. Accrued Interest Receivable. Balance Sheet Treatment.	

CHAPTER	PAGE
8 NOTES RECEIVABLE	108
Program of Audit. Examination of Notes Receivable. Examination of Note Debtors' Accounts. Checking Payments Made by Borrowers. Valuation of Collateral. Confirmation of Notes Receivable. Accrued Interest Receivable. Balance Sheet Treatment.	
9 ACCOUNTS RECEIVABLE	118
Program of Audit. Accounts Receivable Trial Balance. Aging Customers' Accounts. Circularization of Customers. Lapping. Collection Period. Balance Sheet Treatment.	
10 INVENTORIES	138
Program of Audit. Inventory Instructions. Observance of the Inventory Taking. Making Selective Test Checks. Goods Held on Consignment. Goods on Consignment Outside. Goods in Transit. Inventory Prices. Market Price Quotations. Obsolete Goods. Supplies Inventories. Principles of Inventory Valuation. Receiving Book. Inventory Turnover Rate. Gross Profit Percentage Test. Inventory Certificates. Balance Sheet Treatment.	
11 LAND	158
Program of Audit. Cost of Land. Verification of Land Accounts. Suburban Development Properties. Natural Resource Properties. Balance Sheet Treatment.	
12 DEPRECIABLE AND INTANGIBLE ASSETS	166
Program of Audit. Changes in Depreciable Asset Accounts. Changes in the Intangible Asset Accounts. Vouching Additions. Balance Sheet Treatment.	
13 MISCELLANEOUS ASSETS	178
General Procedures. Program of Audit. Vouching Significant Charges to Miscellaneous Asset Accounts. Verification of Loans and Advances Receivable. Checking Allocations of Expenses to Accounting Periods. Confirmation of Miscellaneous Assets. Balance Sheet Treatment.	
14 CURRENT LIABILITIES	190
Several Current Liabilities Described. Program of Audit. Examination of Subsequent Transactions. Accruals Payable Accounts. Miscellaneous Liability Accounts. Circularization of Creditors. Sundry Audit Schedules. A Mixed Control Account Situation. Liability Certificate. Balance Sheet Treatment.	
15 NONCURRENT LIABILITIES AND DEFERRED CREDITS	207
Program of Audit. Changes in Mortgages and Bonds Payable Accounts. Funded Debts. Confirmations of Mortgages and Bonds Payable Accounts. Deferred Credit and Unrealized Profit Accounts. Balance Sheet Treatment.	

CONTENTS

ix

CHAPTER	PAGE
16 RESERVES Depreciation Reserves. Amortization Reserves. Reserves for Maintenance. Reserves for Contingencies. Detection of Existence of a Secret Reserve. Program of Audit. Balance Sheet Treatment.	215
17 CAPITAL Capital Stock. Corporate Surplus. Violation of Generally Accepted Practice. Program of Audit. Changes in Capital Accounts. Balance Sheet Treatment.	230
18 SALES AND RETURNED SALES Internal Control. Examination of Sales Records. Income Statement Procedure.	244
19 SUNDRY REVENUES Rental Revenues. Membership Dues and Fees. Contributions. Admissions Sales. Securities Sales. Interest Income. Dividends Income. Sales of Salvage. Disposals of Depreciable Assets. Confirmation of Sundry Revenue Receipts. Income Statement Treatment.	253
20 PURCHASES AND RETURNED PURCHASES Internal Control. Examination of Purchase Invoices. Purchase Commitments. Income Statement Treatment.	260
21 PAYROLLS, EXPENSES, AND INTEREST Internal Routine. Examination of Payrolls. Supervising Pay-offs. Examination of Expense Accounts. Income Statement Treatment.	267
22 ANALYTICAL REVIEW OF ACCOUNTS Work Program. Sundry Relationships Discussed. Graphic Charts.	282
23 INDEPENDENT ACCOUNTANTS' REPORTS Short Form of Report. Interim Reports. Outline of Typical Audit Report. Financial Statements. Summary of Operations. Statistical Data. Comments Section. Miscellaneous Comments. Qualifications in Audit Reports. Independent Accountant's Opinion. Review of Report Draft. Format of Audit Reports.	288
24 ILLUSTRATIVE REPORT AND WORKING PAPERS—BOOK-PUBLISHING BUSINESS	303
25 ILLUSTRATIVE REPORT AND WORKING PAPERS—MANUFACTURER, INTERIM AUDIT experience in	conduct audits
26 ILLUSTRATIVE REPORT—MANUFACTURING COMPANY, ANNUAL examinations are made,	to form sound opin-
27 ILLUSTRATIVE REPORT—DEPARTMENT STORE, ANNUAL	

APPENDIX A 403
Statement on Auditing Procedure Issued by the Committee on Auditing Procedure of American Institute of Accountants.

APPENDIX B 404
By-laws of the New York State Society of Certified Public Accountants—Rules of Professional Conduct.

APPENDIX C 407
American Institute of Accountants—Rules of Professional Conduct.

APPENDIX D 410
General Review Questions.

INDEX 420

CHAPTER 1

INTRODUCTION

The independent accountant, after completing an audit, is in a position to render a certificate covering his findings. Mention is made of the period covered by the audit. An assertion is included, in the certificate, that a review has been made of the company's internal control system and of the accounting procedures followed. A brief statement of the scope of the audit is made. Any qualifications which are applicable to the execution of the engagement or to the company's accounts are introduced. Finally, the independent accountant renders his opinion regarding the company's financial statements and the basis on which the accounts have been kept. Professional ethics is observed by independent accountants. Material facts are neither omitted nor misstated.

The Industrial Revolution emphasized the need for more comprehensive figures on the operation and financial condition of business enterprises. Concentration of capital in large undertakings necessitates the preparation of especially accurate financial statements for the information of managements, stockholders, credit grantors, and others. Both large and small enterprises quite generally seek assistance and guidance from professionally trained accountants in the preparation of balance sheets, statements of income and surplus, special financial reports, and tax returns.

Auditors and Auditing. An independent accountant, or auditor as he is frequently called, is one who engages in the public practice of accounting; performs services which involve the examination and verification of financial transactions; prepares financial statements and certifies financial statements; or who, holding himself out to the public as a qualified accountant, renders professional services relating to accounting matters. Preparation of the tax returns required for filing with various tax bureaus occupies a good part of the time of members of the accountancy profession.

Examination of accounts and their verification by means of approved procedures is generally referred to as "auditing." Independent accountants, in view of their background, training, and experience in accountancy matters, are especially well qualified to conduct audits of commercial and nonprofit organizations. Examinations are made, for the most part, in order to enable the auditors to form sound opin-

ions regarding the accounts and financial statements of the companies for which accounting services are performed. Professional accountants have developed a technique that enables them to determine the reliability and accuracy of accounts in an efficient manner. Independent accountants, as the title indicates, do their work without supervision by clients. The outside accountants assume full responsibility for their work and for the reports and certificates which they render upon completion of engagements.

Judgment is necessarily exercised by independent accountants in the application of generally accepted auditing procedures to each engagement. Audit programs are directed towards the detection of errors of both commission and omission. Errors of omission are much more frequently encountered than errors of commission. An examination of a company's accounts usually develops the necessity for some adjustment entries in order to make the accounts conform to approved standards of accounting.

There has been considerable agitation by professional accountants, and the Securities and Exchange Commission, regarding the desirability of having independent accountants appointed by a company's stockholders in order to permit the accountants the necessary degree of independence. It is quite generally felt that when outside auditors are appointed by the company's board of directors, or by the officers, the same freedom of action may not obtain as when the appointment is made by the stockholders.

Many companies, particularly the larger ones, have, in addition to independent accountants, a staff of internal auditors whose duties usually comprise the continuous verification of financial transactions and the preparation of frequent financial reports. Such auditors do their work in accordance with the instructions formulated by their employers. Accounts of branch offices are quite generally examined and verified by the company's internal auditors. Transactions in a large commercial hotel are usually proved daily. Sales of a retail department store are generally checked currently by audit clerks. A company's internal auditors sometimes maintain control over the prenumbered forms of financial stationery, such as bank checks, sales tickets, merchandise transfer slips, and inventory sheets.

Accountants' Reports and Certificates. Reports, upon the completion of an examination of accounts by independent accountants, are generally rendered to clients. These reports furnish information regarding a company's accounts and related matters and are usually accompanied by financial statements, the most common forms of which are balance sheets and statements of income and surplus. The short

forms of reports which are, for the most part, intended for publication are generally called "accountants' certificates." A balance sheet accompanied by the certificate of the outside auditor is referred to as a "certified statement." Accountants' reports vary considerably as to contents and length, in order to meet the requirements of various engagements.

Professional accountants have devoted considerable attention to the manner of presenting the short form of audit reports, or accountants' certificates, which accompany financial statements. The certificates generally contain a description of the scope of the audit, period of time covered by the operating accounts, statements of any qualifications applicable to the examination or exceptions taken to the accompanying financial statements which have been examined, and finally an expression of opinion regarding the company's financial statements. The "opinion paragraph" of the certificate generally asserts that the statements have been prepared from properly kept records, maintained on a consistent basis and conforming to generally accepted principles of accounting. An illustrative certificate is presented herewith for consideration and analysis.

ACCOUNTANTS' CERTIFICATE

JAMES WHITE AND Co.
ONE WALL STREET
NEW YORK, N. Y.

CERTIFIED PUBLIC ACCOUNTANTS

January 20 (year)

The Blank Company
100 Broad Street
New York, N. Y.

We have examined the balance sheet of The Blank Company as of December 31 (year) and the related statement of income and surplus for the year ended that date. We have reviewed the accounting procedures of the Company, and have examined its accounting records and other evidence in support of such financial statements. Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances. Our examination included all auditing procedures we considered necessary, which procedures were applied by tests to the extent we deemed appropriate in view of the system of internal control.

In our opinion, the accompanying balance sheet and the statement of income and surplus fairly present the financial condition of the Company as of December 31 (year), and the results of its operations for the year ended that date, in conformity with generally accepted accounting principles and practices applied on a basis consistent with that of the preceding year.

Very truly yours,
(Signed) JAMES WHITE AND Co.

Accountants' certificates and their acceptability to the Securities and Exchange Commission were investigated and reported upon by the Committee on Auditing Procedure of the American Institute of Accountants. The Committee's report, which includes an accountants' certificate, is very illuminating. (See Appendix A.)

Examination of Accounting Records. It is regarded as normal auditing procedure for an independent accountant, when making such an examination as will enable him to form an opinion regarding a company's financial statements, to review the accounting routine and records of the enterprise under audit. The company's "standard practice instructions," if there are such for the guidance of its accounting personnel, are read critically in order to ascertain whether adherence to them should give the results expected from an up-to-date accounting system. Samples of any of the company's special accounting forms, together with descriptions of their use, are frequently filed for reference with the independent accountant's working papers. Employment by the company of columnar books of original entry indicates that an effort has been made to reduce the labor required in posting the general ledger. Wide use of controlling accounts shows that the localization of errors has been provided for. Availability of mechanical office devices to the company's employees is evidence of a progressive policy in handling the accounting work and office routine.

The examination of a company's accounting methods and practices, for an initial audit, often precedes active work on the engagement. It will be noted that the illustrative accountants' certificate previously presented includes, as a part of the general description of the examination made, a statement by the independent accountants that they ". . . have reviewed the accounting procedures of the Company."

Independent accountants conduct a comprehensive verification of the accounts which are set forth in the financial statements to which their certificates relate. Minutes of the corporation's board of directors are read, and any financial matters mentioned therein are checked to the books of account. Adequacy of reserve accounts is investigated. An analytical study of the company's operating accounts is made, by means of statistical methods. Changes in the capital accounts are looked into. Tax correspondence files are read for the purpose of ascertaining whether there are any contingent liabilities for taxes. That an examination of the company's accounts was made is indicated by the independent accountants' certificate which normally contains the assertion by the accountants that they ". . . have examined its accounting records and other evidence in support of such financial statements."

Auditing Standards. Descriptions of normal auditing procedures are found in the various publications of professional societies of independent accountants and in published writings of members of the accountancy profession. Firms of public accountants adopt procedures for the guidance of the members of their professional staffs. Frequently these procedures are contained in cumulative loose-leaf binders which can be carried, for ready reference, in the accountants' brief-cases. Special programs are prepared to meet the requirements of particular auditing engagements and specific accounts. Recognition is given to accounting practices applicable to the particular trade. The certificate of the independent accounting firm usually contains the statement, "Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances. . . ."

Necessary Auditing Procedures. The examination of a company's accounts and related records is usually made without any undue limitation being placed by the client upon the scope of the auditing engagement. All procedures regarded as necessary to meet the requirements of the situation are applied in the verification of the accounts which appear on unqualified certified financial statements. The assertion in the illustrative certificate that the examination ". . . included all auditing procedures we considered necessary" indicates that, in conducting the audit, there were no omissions of standard practices, as, for example, the circularization of customers.

Internal Control. A division of responsibility among the members of a business enterprise in such a manner that collusion on the part of two or more employees is necessary in order to effect or conceal a shortage of cash or merchandise is regarded as a desirable safeguard. A separation of responsibilities in such a manner that cashiers are not assigned to bookkeeping work, or persons having contact with cash or merchandise do not have contact with the general or subsidiary accounting records, including the accounts receivable, is looked upon as a preventive against misappropriation of cash or merchandise. An inquiry into the assignment of duties among the personnel of the business is necessary as a means of determining the effectiveness of the system of internal control. Independent accountants take cognizance of any examinations made by a company's internal auditors. Inquiry is made as to the frequency of visits to branches, the extent of the verification of accounts, and the contents of reports rendered.

The extent to which tests may be substituted for the complete checking of vouchers, additions, postings, and other items is determined, to a considerable extent, by the results of the study made of the company's internal control and check system. Independent accountants'

working papers show the extent of the examination of vouchers, checking of additions and postings, confirmation of accounts by circularization, and the general work of verification if a question should arise at any time regarding the scope of the audit. Names of the accountants who did the work are also recorded in the working papers.

The certificate of an independent accountant usually contains a statement at the end of the first paragraph that reads, “. . . which procedures were applied by tests to the extent we deemed appropriate in view of the system of internal control,” thus indicating to the reader that a survey has been made by the outside auditors of the company’s internal control system and its effectiveness.

Qualifications in Certificates. Limitations on the scope of an examination of accounts and the approximate amounts involved by such restrictions are ordinarily mentioned in the accountants’ certificate. The examination, for example, of the accounts of the company’s foreign branches may not have been included in the auditing engagement.

Any significant lack of conformity by the company to generally accepted principles of accounting is looked upon as an exception that ought to be commented upon in the certificate, such as the omission or understatement of one or more reserves. A change made in the basis on which the company’s income is computed makes it necessary to include a qualification in the certificate. It may be that the company changed the basis employed for computing depreciation provisions to be recorded in its accounts in order to conform to rates which are acceptable to the Bureau of Internal Revenue, in connection with the preparation of the company’s returns of taxable income.

Omission of any qualification in the independent accountants’ certificate indicates that there were no undue restrictions upon the auditors in the execution of the engagement, no significant reservations regarding the procedure followed in making the examination, and no exceptions noted with respect to the manner in which the financial statements were prepared.

Opinion of Independent Accountants. Independent accountants, after having completed their examination, are in a position to check and review critically the company’s financial statements. Consideration is given to the manner in which the statements are presented. All information necessary to enable readers to study important relationships in the company’s accounts should be found in the balance sheets, statements of income and surplus, and supporting schedules which are certified. One ought, for example, to be able to see at a glance the relation between the total of the current assets and the total of the current liabilities. The comment in the balance sheet, usually

made parenthetically, on the basis employed in valuing the inventory, is checked. A review is made of the manner of presentation of the company's capital structure.

The company's statement of income is reviewed, and the arrangement of items is carefully considered. Readers should be able to see the amount of income from the company's operations and the net income, after all taxes, which was transferred to Surplus account. Percentages of cost of sales to sales and of selling and administrative expenses to sales ought to be readily ascertainable.

Footnotes to financial statements, inasmuch as they are regarded as an integral part thereof, are studied from the point of view of accuracy and comprehensiveness.

Certified financial statements are prepared in accordance with established accounting conventions, which are, of course, subject to change and modification from time to time as increased emphasis is placed upon accounting practices by credit grantors, the Securities and Exchange Commission, various taxing bureaus, and the accountancy profession.

The last paragraph of the independent accountants' certificate usually contains the opinion of the auditors which states that the company's exhibits and schedules referred to fairly present its financial condition and results of operations ". . . in conformity with generally accepted accounting principles and practices applied on a basis consistent with that of the preceding year."

A further discussion and explanation of independent accountants' reports will be found in Chapter 23.

Certified Public Accountants. Some time ago, public accountants who had the interests of the profession and the public at heart secured legislation whereby certificates are issued to qualified persons who meet prescribed requirements. These certificates give holders the right to style themselves "Certified Public Accountants" or, sometimes, "Registered Accountants." Registered accountants are found in states which have laws providing for two classes of public accountants. The Certified Public Accountant movement which began in New York State has spread to all the other states of the United States, the territories, and the District of Columbia.

Regulations pertaining to the practice of accountancy by Certified Public Accountants in New York State are contained in article 57 of the Education Law of New York. It provides that Certified Public Accountant certificates shall be issued upon application to any United States citizen residing in New York State, or having a regular place of business therein, who is twenty-one years of age or over, of good moral

character, who submits satisfactory evidence of academic and professional qualifications, and who passes the required examination. Candidates for examination now have to present evidence of completion of a satisfactory course of study in a college or school of accounting that maintains a satisfactory standard, and of having previously completed an approved four-year high-school course or its equivalent. The requirements of other authorities issuing Certified Public Accountant certificates are substantially the same as those of New York State, except where the law provides for two classes of certificates.

Societies of Accountants. A number of the holders of Certified Public Accountant certificates issued by New York State, in 1897, formed a membership corporation, known as The New York State Society of Certified Public Accountants. The purposes of the Society are

to cultivate, promote, and disseminate knowledge and information concerning accountancy and subjects related thereto; to establish and maintain high standards of integrity, honor, and character among Certified Public Accountants; to furnish information regarding accountancy and its practice, and methods thereof to its members, and other persons interested therein, and the general public; to protect the interests of its members and the general public with respect to the practice of accountancy, to promote reforms in the law; to provide lectures, and to cause the publication of articles, relating to accountancy and the practice and methods thereof; to correspond and hold relations with other organizations of accountants, both within and without the United States; to establish and maintain a library, and reading rooms, meeting rooms and social rooms for the use of its members; to promote social intercourse among its own members and between its own members and the members of other organizations of accountants and other persons interested in accountancy or related subjects; and to do any and all things which shall be lawful and appropriate in furtherance of any of the purposes of the Society.*

A person holding a New York State Certified Public Accountant certificate is eligible for election as a member in The New York State Society of Certified Public Accountants. Provision is made, in addition to regular members, for associate, life, and honorary members. Activities of the Society, which now has about five thousand regular members, are quite numerous; its committees promote various projects which are deemed to be of benefit to the accountancy profession as well as to the public. The legislation committee, for example, keeps informed regarding proposed legislation affecting the interests of Certified Public Accountants and makes recommendations regarding amendments to existing laws and new legislation. The Society has adopted rules of professional conduct for the guidance of its members. (See Appendix

* From the *Year Book* of The New York State Society of Certified Public Accountants.

B.) Societies of Certified Public Accountants in other states have similar objectives, regulations, and activities.

The American Institute of Accountants is a national organization that was founded in 1916 by taking in the members of several existing organizations. Subsequent to January 1, 1936, only those persons are admitted who hold a Certified Public Accountant certificate issued by legally constituted authorities of a state or territory of the United States or the District of Columbia. Provision is made for associate members of the Institute.

The rules of the American Institute of Accountants provide that persons who furnish satisfactory evidence of education may qualify for the Institute's examination, and upon passing they are elected to membership. According to recent reports, examinations are held in forty-six states and territories. The Institute's ratings are accepted, in most of the states and territories where the examinations are given, as a basis for granting Certified Public Accountant certificates.

The Institute, which now has approximately ten thousand members, holds regional meetings, cooperates with local societies, and takes an active part in national accountancy matters. The Institute has adopted a set of rules of professional conduct for the guidance of its members. (See Appendix C.) There is much similarity between the rules of the Institute and those of the New York State Society. A qualified practitioner cannot plead ignorance for failing to abide by the ethics of the profession. Rules of accounting societies ordinarily provide that members may not certify to a financial statement which contains a misstatement of a material fact (i.e., an error of commission) or omits a statement of a material fact (i.e., an error of omission). Other requirements will be seen from a perusal of the rules. Reports of violations of rules of professional ethics are investigated by the society to which the member belongs, and penalties are meted out when the occasion warrants.

Misstatements of Material Facts. Some companies, lacking professional guidance, believe that they are issuing correct balance sheets when there are omissions of offsetting asset and liability items. Those who do this are prone to argue that, inasmuch as the company's net worth is not affected, no one is injured by the misstatement of material facts. It will be noted that, in Form 1, The Blank Company's balance sheet understates the inventory by \$250,000 and understates the accounts payable by a similar amount. The effect of these errors of commission is to improve the current ratio and thereby mislead credit grantors and others regarding the true state of the company's finances. It is generally recognized by the accountancy profession that all in-

MISSTATEMENT OF MATERIAL FACTS—ILLUSTRATED

THE BLANK COMPANY

NAME *Accounts Payable*

DATE	CHARGE	DATE	CREDIT
(YEAR) 1931		(YEAR) Dec. 31	
" 31	✓ 175,250.00	<i>Balance</i>	472,100.00
	457,600.00	" 31	160,750.00
	632,850.00		632,850.00
		(YEAR) Jan. 1	457,600.00
		<i>Balance</i>	

THE BLANK COMPANY INVENTORY SUMMARY DECEMBER 31 (YEAR)	
RAW MATERIAL	\$ 385,210.00
WORK IN PROCESS	670,250.00
FINISHED GOODS	489,640.00
TOTAL	\$ 1,545,100.00

THE BLANK COMPANY BALANCE SHEET DECEMBER 31 (YEAR)	
ASSETS	
CASH	\$ 275,000.00
ACCOUNTS RECEIVABLE	680,150.00
INVENTORY	1,295,100.00
TOTAL CURRENT ASSETS	\$ 2,250,250.00
LIABILITIES	
CURRENT LIABILITIES	
ACCOUNTS PAYABLE	\$ 207,600.00
NOTES PAYABLE	400,000.00
ACCUALS PAYABLE	142,500.00
TOTAL CURRENT LIABILITIES	750,100.00
Ratio of current assets to current liabilities 1 to 3	

Conclusion:

The under statement of the inventory by \$250,000.00 and the under statement of the accounts payable by \$250,000.00 as at December 31 (Year), constitute mis-statements of material facts.

James White January 20 (Year)

FORM 1

SOME MISSTATEMENTS OF MATERIAL FACTS - ILLUSTRATED

THE BLANK COMPANY BALANCE SHEET DECEMBER 31 (YEAR)	
ASSETS	LIABILITIES
CURRENT ASSETS	CURRENT LIABILITIES
CASH	ACCOUNTS PAYABLE
ACCOUNTS RECEIVABLE, NET	NOTES PAYABLE
INVESTMENTS	ACCUMULATED DEPRECIATION
INVENTORY	
TOTAL CURRENT ASSETS	TOTAL CURRENT LIABILITIES

Conclusions: The Accounts Receivable account improperly includes \$400,000.00 subscriptions receivable to the company's preferred stock. The Investments account improperly includes \$60,000.00 of the company's preferred treasury stock.

*James White
January 31 (year)*

THE BLANK COMPANY DECEMBER 31 (YEAR) INVESTMENTS	
400	Alby, Inc. \$ 40,000.00
600	The Blank Company Preferred Stock 60,000.00
1000	Day Corporation 45,175.00
	Total \$ 145,175.00

THE BLANK COMPANY ACCOUNTS RECEIVABLE TRIAL BALANCE DECEMBER 31 (YEAR)	
Ames & Son	32,720.00
Brown, Inc.	4,800.00
Col. A. (preferred stock subscription)	400,000.00
Denny & Bros.	16,200.00
Wills & Wills Total	12,700.00
Less reserve for bad debts	772,125.00
Remainder	99,605.00
	672,520.00

FORM 2

voices covering goods to which the company has title should be recorded and all goods owned by the company should be included in the inventory at the balance sheet date.

An analysis of a company's accounts, by an outside auditor, frequently brings to light some strange situations. In Form 2, it will be seen that the company's balance sheet shows Accounts Receivable, Net, \$672,520, whereas preferred stock subscriptions of \$400,000 should have been excluded and presented separately. The company's investments appear on the balance sheet as \$145,175, whereas the \$60,000 preferred treasury stock should have been excluded therefrom and exhibited as an item by itself, preferably in the capital section of the balance sheet. Before the independent accountant can render a certificate without qualifications, when such a condition is encountered, corrections must be made so that the balance sheet does not contain any misstatements of material facts.

Errors of Commission and Omission. The independent accountant encounters many unusual entries for which satisfactory explanations are frequently difficult to obtain. Such a condition of affairs is revealed in Form 3, where the auditor reported that "President J. Blank of The Blank Company withdrew, apparently for his own use, \$200,000 of the company's funds which were improperly charged to the Reserve for Depreciation account." It is necessary for the auditor to obtain an explanation of such a situation and make appropriate adjustments to the company's accounts. In the instant case a transfer of the \$200,000 to the President's personal account, with his sanction, would apparently be in order.

Many accounting abuses have to do with entries to Surplus accounts. The management of a business is sometimes actuated by a desire to keep extraordinary transactions out of the current Profit and Loss account and so disposes of these transactions by a charge, or credit, to the company's Surplus account. Such a situation is set forth in Form 4, where the \$60,000 loss (\$100,000 cost, less \$40,000 depreciation) which was sustained in the abandonment of partially depreciated machinery was improperly recorded. The charge should have been made to an appropriately named income account, such as Profit and Loss on Disposal of Fixed Assets.

Omission of a liability from a company's balance sheet constitutes a violation of the accounting principle that all liabilities should be presented. In the case illustrated in Form 5, it is apparent from the conclusion reached by the independent accountant that the company had omitted a liability for additional New York State taxes which would be imposed on the basis of an increase in the company's net income

ERROR OF COMMISSION - ILLUSTRATED

THE BLANK COMPANY

ACCOUNT Reserve for Depreciation of Machinery

DATE (YEAR)	CHARGE	DATE (YEAR)	CREDIT
Dec 1	Cash 75	Jan. 1	1,792,400.00
" 31	Balance	Dec. 31	310,000.00
		Jan. 1	2,102,400.00
		Jan. 1	1,902,400.00

Conclusion - President J. Blank of The Blank Company on December 1 (year) withdrew, apparently for his own use, \$200,000.00 of the company's funds which was improperly charged to the Reserve for Depreciation account.

*James White
January 5 (year)*

First National Bank
NEW YORK
DATE Dec 1 (year)
PAY TO J. B. Blank \$ 200,000.00
Two hundred thousand and 00/100 DOLLARS
J. B. Blank PRESIDENT
THE BLANK COMPANY

J. B. Blank
THE NEW YORK
CLEARING HOUSE
DECEMBER 31 (YEAR)

FORM 3

OMISSION OF A MATERIAL FACT - ILLUSTRATED

THE BLANK COMPANY
BALANCE SHEET
DECEMBER 31 (YEAR)

ASSETS	
CURRENT ASSETS	
CASH	\$ 275,250.00
INVENTORY	1410,500.00
TOTAL	\$ 1685,750.00
OTHER ASSETS	4500,200.00
TOTAL	\$ 6,185,950.00

LIABILITIES	
CURRENT LIABILITIES	
ACCOUNTS PAYABLE	\$ 510,000.00
ACCRUED EXPENSES	175,450.00
TOTAL	\$ 685,450.00
NET WORTH	5500,500.00
TOTAL	\$ 6,185,950.00

Conclusion - Accrued additional (year) New York State franchise tax of \$6,000.00 (6% of \$100,000.00) was omitted from the company's December 31 (year) balance sheet. James W. Hite February 10 (year)

THE BLANK COMPANY
YEAR ENDED DECEMBER 31 (YEAR)
NEW YORK STATE (YEAR) FRANCHISE TAX RETURN

Schedule G. CHANGE IN NET INCOME BY FEDERAL GOVERNMENT:
Has the net income reported to the Federal Government by reporting corporation been changed and not previously reported

NAME *The Blank Company*

1 Year Ended *12/31 (YEAR)* *12/31 (YEAR)*

2. Net Income as finally determined *None* *100,000.00*

Increase in net income agreed to by taxpayer.

FORM 5

ERROR OF OMISSION - ILLUSTRATED
THE BLANK COMPANY
PURCHASE JOURNAL

MONTH	DATE	NAME	ACCOUNTS PAYABLE	MERCHANT DISC	SUPPLIES	ADMINISTRATIVE EXPENSE	SELLING EXPENSE	GENERAL EXPENSE	GENERAL LEDGER ACCOUNT	AMOUNT
	(YEAR) Dec. 1									
	" 5	Brady, Inc.	1,048.70			1,048.70				
	" 5	Albott	316.80		316.80					
	" 20	Flynn & Sons	22,750.00	22,750.00						
	" 31	Winn Bros	7,310.50	7,310.00						
		Total	31,426.00	30,060.00	316.80	1,048.70				104

NILES, INC.
 NEW ORLEANS, LA.
 December 20(14)

TERMS NET 30
 SOLD TO:
 The Blank Company
 Fall River, Mass

50,000 lbs uplands
 middlings @ 20¢ \$10,000.00

THE BLANK COMPANY
 RECEIVING DEPT. 2
RECEIVED
 DEC. 31 (YEAR)
 BY *J. Long*
 RECEIVING CLERK

Conclusion - The December 20 (Year) purchase invoice of Niles, Inc., for \$10,000.00, covering cotton received in warehouse on December 31 (Year), was omitted from the December (Year) purchase journal.

James White
 January 20 (Year)

FORM 6

as determined by the federal government. Unless the company's balance sheet is adjusted so as to give effect to this additional liability, the independent accountant cannot issue an unqualified certificate.

An Error of Omission. For one reason or another, possibly through lack of internal control, all invoices for goods received during the accounting period may not have been entered in the company's purchase journal. A situation of this nature is illustrated in Form 6, where the December (year) purchase journal of The Blank Company does not contain an entry of the invoice of Niles, Inc., for cotton received on December 31 (year). The conclusion reached by the independent accountant does not indicate that there were any extenuating circumstances, and so an adjustment entry, charging the Merchandise Purchases account, and crediting the Accounts Payable account, for \$10,000 is in order.

REVIEW QUESTIONS

1. Why do credit grantors, and others, have a greater degree of confidence in certified financial statements than in uncertified ones?

2. Are certificates of independent accountants necessarily worthless if they contain qualifications?

3. What is the significance of the statement, in the certificate of a firm of independent accountants, "An examination of the company's accounting records was made"?

4. Should the certificate of independent accountants indicate that the examination made by them included all auditing procedures deemed necessary?

5. What is the object of a reference, in the independent accountants' certificate, to the company's system of internal control?

6. What importance should be attached to the opinion of an independent accountant that the financial statements certified to were prepared in conformity with generally accepted accounting principles and practices?

7. Why is it regarded as necessary that financial statements be prepared on a basis that is consistent with that of the previous year?

CHAPTER 2

ACCOUNTING SERVICES AND RELEVANT MATTERS

Details of each accounting engagement are recorded for the information of partners and staff. Any special requests of clients are found in the record of engagements. Letters confirming engagements are sent to new clients. Instructions are furnished to clients regarding the procedure to be followed in preparing for the forthcoming audit. A record is kept of the cost of each engagement.

Arrangements made by independent accountants for the rendering of services to their clients are quite generally recorded in loose-leaf books. All important information pertaining to the services required by clients is ordinarily ascertained at the time engagements are taken. It is highly desirable that the record of each accounting engagement be sufficiently comprehensive to prevent any misunderstanding with respect to the nature and scope of the work to be performed. Copies of engagement records should be furnished to any of the accounting firm's branch offices which are to participate in the execution of the work and also to the in-charge accountants who are assigned to the respective locations where work is to be performed. Each engagement accepted by a firm of independent accountants with a large practice should be consecutively numbered for reference purposes. The annual audit of Company XY for the current year, for example, would not bear the same engagement number as the annual audit for the same company the following year.

Service Classifications. The following definitions cover the major classes of services rendered by independent accountants.*

1. Detailed audit. This service covers the verification of all balance sheet accounts by means of standard audit procedures; the substantiation of all transactions, including the vouching of all expenditures; checking of all books of original entry and general ledger accounts; and tracing of all financial matters mentioned in the minutes of the board of directors to the books of account. The independent accountant's certificate which accompanies a financial statement after the making of a detailed audit is usually not qualified.

* For a further discussion, see "Tentative Classification of Accountancy Services," published by The New York State Society of Certified Public Accountants.

2. **General audit.** This service comprises the verification of all balance sheet accounts by means of standardized auditing methods. Accounts included in the income and surplus statements are verified by means of selective tests and by a limited amount of detailed checking. Expense accounts are scrutinized to see whether they appear regular in all respects. Journal entries are scanned to see whether they contain any unusual adjustments of accounts that need investigating. Such financial matters as are mentioned in the minutes of the board of directors are checked to the accounting records.

An analytical review of the operating accounts for the period covered by the audit is made by means of a study of comparisons, trends, and ratios. Income statement accounts are compared with those of several years immediately preceding the year under audit, and all significant variations are inquired into. The trend in the gross-profit percentage figures is observed, and any abnormal changes are investigated. The rate of inventory turnover is compared with that of previous years for the purpose of determining whether there have been any substantial variations. The trend in the collection period, where goods are sold on credit, is studied to ascertain whether there has been any significant change therein. Reports made by the company's internal auditors are reviewed, and the findings are noted.

Independent accountants' certificates which are furnished with statements after the making of a general audit quite frequently contain the qualification, "without making a detailed audit of the transactions." Naturally minor irregularities, when concealed in the accounts, may escape detection when a general audit instead of a detailed audit is made.

3. **Examination of financial condition.** This service comprehends the verification, by means of standard audit procedures, of all balance sheet accounts, and also an examination of transactions near the balance sheet date that may have a bearing on the company's financial condition. The statement of income and surplus is reviewed to see whether it contains any unusual features. The balance sheet which is submitted as a result of an examination of financial condition is accompanied by the independent accountant's certificate. If the accountant's report contains a statement of income and surplus, such a statement is qualified as having been "prepared from the books of account, without auditing the transactions for the period."

4. **Securities and Exchange Commission engagements.** This service comprehends the preparation of financial statements, accompanied by accountants' certificates, for submission to the Securities and Exchange

Commission. The Commission's requirements regarding financial statements are very technical, and so its rules and regulations must be meticulously observed. Ordinarily the reports for submission to the Securities and Exchange Commission are prepared by a company's independent accountants after completion of the regular, annual audit.

5. Tax returns. This service comprises the preparation of various tax returns and conferences with clients regarding their tax problems. Tax returns must be prepared in accordance with the tax laws which are applicable thereto and the regulations of the respective tax authorities. Advice is furnished clients, when requested, as to the effect of tax laws on their financial affairs.

6. Cost or accounting systems installations. This service comprehends the devising and installation of cost systems in industrial plants and general accounting methods in offices. Frequently the accounting system is correlated with a modern budgetary control plan. This variety of service is oftentimes referred to as "constructive accounting" and is frequently requested after a survey of a company's records by the independent auditors.

7. Advice on accounting matters. This service is very general in nature and covers the rendering of advice to clients on accounting matters. Quite frequently conferences are arranged at which the company's executives review accounting and financial matters with their independent accountants in order to benefit from the independent accountants' wide experience.

8. Miscellaneous services. Audits of specific accounts (cash, securities, payroll, and manufacturing costs). Investigations of special matters. Preparation of financial statements from books and records without audit. Budgetary control plans. Other services as may be required.

An engagement to serve a client may include several services, such as a general audit of the accounts, preparation of tax returns, and advice on accounting matters.

Engagement Records. The name of the company to be served, together with the state of incorporation, should be mentioned in the record of the accounting engagement. Usually the client is the same as the company for which services are to be performed. However, there may be one or more subsidiary companies which are included in an auditing undertaking. A section of an engagement record might read as follows:

Name of client. The Blank Company, 100 Broad Street, New York, N. Y. It has a wholly owned subsidiary which is known as Blank & Co., Inc., 10 Main Street, Brooklyn, N. Y. Both companies are incorporated in New York.

The location, or locations, where services are to be performed ought to be stated. An instruction such as the following one might be found in an engagement record:

Services are to be performed at the client's office at 100 Broad Street, New York, N. Y., and at the office of its subsidiary, Blank & Co., Inc., 10 Main Street, Brooklyn, N. Y.

The service classification, or classifications, as for example, "1, Detailed audit for (year)," "4, Securities and Exchange Commission Form 10 K, exhibits and schedules for (year)," and "5, Tax returns," should be stated in the engagement record. A description of each tax return which the client desires to have prepared ought to be listed in the following manner:

1. Federal corporation income tax return for the year ended December 31 (year), due to be filed by March 15 (year).
2. New York State franchise tax return for year ended December 31 (year), due to be filed by May 15 (year).
3. New York City return of excise tax on gross receipts for privilege year ended June 30 (year), due to be filed by June 15 (year).

Information regarding the various tax returns which clients want to have prepared is needed so that lists of the returns which must be furnished for filing before certain specified dates, such as March 15, April 15, May 15, and so on, may be maintained. As tax returns are sent to clients they should be checked off from the respective lists.

The date that the audit report is wanted by the client should be stated in the engagement record. It is quite likely that the certified statements are required in time to be embodied in the company's annual report to its stockholders. It is desirable to mention, in the engagement record, the date of the company's annual stockholders' meeting.

The record of the engagement should contain a statement of the number of copies of the audit report wanted by the client and to whom reports are to be addressed and delivered. Accountants' reports are addressed in various ways, such as to the company's stockholders, the company's board of directors, the company's president, or directly to the company.

The approximate date when work is to be commenced, together with the estimated number of accountants required of each class, ought to be stated. Information regarding the approximate dates when services are required and the estimated number of accountants to be assigned is needed by the accounting firm's chief of staff who is responsible for

arranging the assignments. A section of an engagement record for The Blank Company might appear as shown below:

Services on the engagement are to be commenced with cash work at the Company's New York City office at the close of business on December 31 (year). Services covering the supervision of inventory taking at the Company's Brooklyn plant are to be continued through January 2 and 3 (year). One in-charge accountant and six assistants will be required. Work on the audit should be resumed about January 15 (year), at which time the company expects to have the inventory completed and its books ready for audit. One in-charge accountant and four assistants will then be required for a period of approximately six weeks.

The arrangement that is made with the client regarding the fee to be paid for accounting, tax, and other services should be stated. It may be the understanding that monthly bills for services are to be rendered as the work progresses. A section of an engagement record to audit the books of The Blank Company might read as follows:

Services are to be billed at per diem rates of \$50 for supervising partner, \$35 for in-charge accountant, and \$20 for juniors. Bills for the audit service are to be rendered at the completion of the audit; bills for the tax service, after delivery of the tax returns.

Any special request of a client ought to be mentioned in the engagement record. It may be that the client expressed a preference for comparative figures in the financial statements included in the audit report. A section of the engagement record for The Blank Company might contain the following comment:

President Brown desires that the company's financial statements be made comparative with the preceding year and show increases and decreases. Vertical columns of percentages should be introduced into the comparative income statements, net sales being shown as 100.

The engagement record of a stock brokerage firm may mention that the client called the auditor's attention to the provisions of the firm's fidelity bond requiring that customers' accounts be confirmed by circularization. Furthermore, the record might state that the auditors are to send out second requests if any customers do not reply to the first request for a confirmation. Also, there may be an instruction that a second bank reconciliation is to be prepared subsequent to the date of the financial statement.

Further items of information which should be included in an engagement record are as follows:

Name of stock exchange, if any, on which securities of the company are listed. Practice followed by company in the publication of its certified financial statements. Brief description of business of company to be audited. Date when previous service was rendered and classification of service. Name of partner or

other person taking engagement. Person from whom engagement was taken and date taken.

It is expected that, throughout the course of an accounting undertaking, the in-charge accountant will refer from time to time to the engagement record so that none of the instructions contained therein will be overlooked.

Confirmation of Engagements. When an independent accountant accepts an engagement to make an audit, or to render some other service, he enters into a contractual relation with his client. Care should be taken, by using clear phraseology, to see that the agreements are readily understandable by the contracting parties. Inasmuch as formal contracts are seldom employed by independent accountants, the understanding regarding services to be performed for a client is quite frequently embodied in a letter confirming acceptance of the engagement. It is particularly desirable that the letter confirming acceptance of an auditing engagement that is to be conducted for a new client be quite specific. The reason for this precaution is that frequently clients fail to understand distinctions between different service classifications.

The introductory paragraph of a letter to a client, accepting an auditing engagement, might read somewhat as follows:

(Date)

The Blank Company
100 Broad Street
New York, N. Y.

Attention of Mr. Alfred Brown, President

DEAR SIRS:

This letter will confirm our understanding of the arrangements made today, at a conference between your president, Mr. Alfred Brown, and our Mr. Bruce White, regarding an audit. We shall proceed to make a general audit of the books of The Blank Company and of its wholly owned subsidiary, Blank & Co., Inc., for the year ending December 31 (year). It is our understanding that the audit report is required by March 20 (year).

A letter to a client, confirming an engagement to make a general audit, might contain the following paragraph after the introduction:

The general audit which we are to make will be sufficiently comprehensive in scope to enable us to certify to the consolidated balance sheet and to the consolidated income and surplus statement of The Blank Company and its subsidiary. However, the audit will not be so extensive as necessarily to disclose all concealed irregularities, especially if relatively small in amount.

For a letter confirming an engagement to make a limited examination of a company's financial condition the following paragraph meets the needs of the situation:

The examination of financial condition which we are to make will be sufficiently comprehensive to enable us to certify to the consolidated balance sheet of The Blank Company and its subsidiary. On account of limitations placed upon the engagement we shall not be able to certify to the consolidated income and surplus statement.

Any special services, such as the preparation of financial statements to be filed with the Securities and Exchange Commission, or tax returns to be prepared, should be covered in the letter confirming an auditing engagement.

It is desirable that the understanding regarding rates to be charged for accounting services be stated in the letter.

With regard to continuing engagements where the scope of accounting services remains approximately the same from year to year it is quite probable that the letter confirming the acceptance of an auditing engagement will be deemed unnecessary. It is likely that the relationship existing between the client and the partner taking the engagement is sufficiently close to make it improbable that any misunderstanding will arise that cannot be readily straightened out.

Letter of Instructions to Client. Before commencing work on an auditing engagement, it is a good plan to ask the client to prepare certain schedules and also letters requesting the confirmation of accounts. The schedules, after checking to supporting records, are properly included among the audit working papers. All letters requesting confirmations should be checked and mailed by the independent accountant.

The list of matters to be attended to by a client should be embodied in a letter of instructions. This procedure enables the client's personnel to proceed with the required work before the arrival of the outside auditors. The opening paragraph of a letter of instructions might read as follows:

(Date)

The Blank Company
100 Broad Street
New York, N. Y.

Attention of Mr. Alfred Brown, President

DEAR SIRs:

In connection with the audit which we are preparing to make of the books of The Blank Company, and its subsidiary, for the year ended December 31 (year), the following matters should be given your attention:

Instructions must necessarily be prepared to fit the requirements of each auditing engagement. Several illustrative instructions that meet the needs of typical situations are presented herewith:

1. On December 31 (year), we shall arrange to have our representative accompany one of your officers to the Company's safe deposit box, for the purpose of examining your investment securities.

2. A copy of the December 31 (year) accounts receivable trial balance, showing the accounts properly aged, should be prepared for our use.

3. A schedule of notes receivable as of December 31 (year) should be prepared showing for each note: date of note, maker, payee, endorsements, principal amount, maturity, interest rate and dates, and interest accrued.

4. A schedule of mortgages receivable as of December 31 (year) should be prepared showing for each mortgage: date of mortgage, mortgaged premises, maker, principal amount, maturity, interest rate and dates, amortization rate and dates, and interest accrued.

5. A schedule of investment stocks as of December 31 (year) should be prepared showing for each security: number of shares, name of stock, dividend rate and dates, amount of dividends received during audit period, and location of stock certificates.

6. A schedule of investment bonds as of December 31 (year) should be prepared showing for each security: face value of bonds, name of bond, interest rate and dates, amount of interest received during the audit period, and location of bonds.

7. A schedule of additions to fixed assets, for year ending December 31 (year), should be prepared showing for each item: date acquired, vendor, description, cost, and location in plant.

8. A schedule should be prepared of insurance policies in force as of December 31 (year) showing for each policy: the number, insurance company, risk insured, period covered, expiration date, premium paid, and amount of unexpired premium at the balance sheet date.

9. A schedule should be prepared of notes payable as of December 31 (year) showing for each note: the date made, payee, maker, endorsers, face amount, interest or discount, and maturity.

10. A trial balance of the accounts payable ledger as of December 31 (year) should be furnished us.

11. A trial balance of the expense ledger as of December 31 (year) should be prepared for us.

Good results are secured by putting the audit instructions for the end of the year's work in the form of a set of "standing audit instructions," thereby doing away with the necessity of writing a detailed letter regarding the procedure to be followed each year.

Engagement Cost Records. Information regarding the cost of executing accounting engagements can readily be ascertained by maintaining a Cost Ledger in the manner illustrated in Form 7. The ordinary procedure is to open a cost account for each engagement that is entered into. Cost accounts can be referred to most readily when arranged alphabetically by clients' names. Direct costs of performing engagements consist largely of payroll and traveling expense charges that are reported by members of the accounting organization. It will be noted, by referring to Form 7, that invoice 120 covered the first three

charges, as indicated by the letter "a" in the check mark columns. Data concerning costs of accounting services which have been billed permit the preparation by the accounting firm of periodic income statements. Small firms of accountants can get along with a record of only the time spent by the respective members of the organization on the various accounting engagements.

REVIEW QUESTIONS

1. To what extent should an engagement record contain instructions for making an audit?
2. What is the responsibility of the in-charge accountant with respect to the instructions contained in the engagement record for an audit?
3. Should preferences of clients for the form and content of audit reports be found in the respective engagement records?
4. Where should the firm's tax accountant look for information regarding the tax returns that are required to be prepared for clients?
5. Under what conditions should auditing engagements be confirmed?
6. Mention some of the schedules that a company might prepare, to good advantage, in advance of the time that active work is commenced on an auditing engagement.

CHAPTER 3

INDEPENDENT ACCOUNTANTS' WORKING PAPERS

Working papers which are used on an engagement are kept together and indexed for ready reference. Uniform sizes of work sheets are employed in order to facilitate filing. The general ledger trial balance contains cross references to the analyses in support of the various accounts. Grouping sheets show which accounts are combined for statement purposes. The accountants' "check list" provides for a brief summary of the work done on the audit. Working papers are the property of the independent accountant.

Information desired regarding the accounts and other matters contained in an auditor's report ought to be available in the audit working papers. While the independent accountant is engaged on assignments, the working papers, audit programs, and the accounting firm's printed stationery should be kept under the independent accountant's control. If one of the accountants cannot arrange to remain on duty while the others take their lunch hour, all working papers ought to be placed in the accountants' bags and the bags locked. Working papers should be carried by independent accountants in their locked bags when going to and fro between the firm's and clients' offices. If several days are to elapse between the time that preliminary work on an engagement is done and the date when work is to be resumed, the bags of working papers should be safeguarded by returning them to the accounting firm's office. Working papers used on an engagement should be turned in with the audit report to the firm's office and reviewed systematically by the partner who is responsible for the engagement or by someone authorized by him to do this work. Permission for an examination of accountants' working papers by an outsider, as for example a credit grantor, should be secured from the client.

Permanent File of Working Papers. Audit working papers, in addition to the usual analyses of accounts and relevant data, frequently include information of permanent interest, such as the following items:

1. Copy of the corporation's certificate of incorporation.
2. Copy of the corporation's bylaws, or excerpts therefrom, covering such items of information as date of annual stockholders' meetings, manner of electing directors, appointment and duties of officers, and organization of committees.

3. Copy of bond indenture, or excerpts therefrom, covering such matters as the authorized issue of bonds, property pledged, and name of trustee.

4. Copy of corporation's stock listing application, if its capital stock is listed on a stock exchange.

5. Copy of articles of copartnership, or excerpts therefrom, covering such items as provisions of the partnership agreement regarding profit sharing arrangements, partners' salaries, interest on capital, procedure to be followed in the event of a change in the firm's membership or of dissolution.

6. Data regarding contracts with employees, bonus agreements, profit sharing arrangements, stock-purchase plans, and matters of a similar nature.

7. Memoranda, dictated by an executive of the company, of the terms of verbal understandings of a financial nature.

8. Explanations of the company's accounting procedures and of any unusual accounts that will aid in the execution of future engagements.

9. Memoranda of methods employed in handling accounts of affiliates and basis for determining which subsidiaries are to be excluded from a consolidated financial statement.

Good results are secured by maintaining a cumulative index of the contents of each "permanent file" folder. Additions, whenever found necessary, ought to be made to the permanent file of working papers. The in-charge accountant should indicate that he reviewed the permanent file at the time of making each audit.

Arrangement and Indexing of Current Working Papers. A system for filing and indexing the working papers which were prepared during an accounting engagement is necessary so that any analysis can be quickly found when wanted. Following are some essentials of an adequate filing procedure.

1. On the outside of a manila folder, containing the independent accountant's working papers for an audit, should be written a description of the contents thereof in the manner indicated below:

The Blank Company
Year Ended December 31 (year)

General Ledger Trial Balance
Analyses 1 to 35, inclusive

2. If it is found that analysis sheets supporting the general ledger trial balance make a folder unwieldy, one or more additional folders should be employed.

3. An index to the various folders of working papers used on an engagement can be placed on the inside cover of the first folder.

4. A description of each analysis, or working sheet, ought to be written at its top as follows:

The Blank Company
Year Ended December 31 (year)

Notes Receivable Schedule — Analysis No. —

5. When a large sheet is folded in order to make it conform to the size of a single sheet, the description of the working sheet should be repeated on the outside.

6. It is helpful, in finding working papers, to have the analysis numbers written on both the front and the back.

7. Working sheets pertaining to one analysis should be paged consecutively in the following manner:

Sheet 1 of 3

Sheet 2 of 3

Sheet 3 of 3

8. If there are several different working sheets which pertain to one analysis number they should be indexed on the outside of a folded double sheet and placed inside. The inventory papers might be listed as follows:

- a. Inventory certificate.
- b. Inventory summary.
- c. Inventory audit program.
- d. Physical inventory tests.
- e. Inventory price tests.

9. Usually the analysis numbers assigned to working papers follow the order of the accounts on a classified general ledger trial balance. The analysis number, upon completion of the audit of an account, should be circled on both the working sheet and the general ledger trial balance. A glance at the circled analysis numbers on the general ledger trial balance, during the progress of an audit engagement, will show on which accounts there still remains work to be done.

10. The contingent liabilities working sheet is advantageously placed after the last balance sheet account analysis and numbered accordingly. Satisfactory results are obtained by fastening the company's liability certificate to the contingent liabilities sheet.

11. It is desirable that the upper left-hand corner of working sheets be left blank in order to permit the stapling together of papers, if it is desired to do so.

12. Confirmations of accounts should be checked to the respective analyses to which they apply. A notation ought to be made on each confirmation letter indicating that this procedure has been followed. Then the confirmation letters should be attached to the respective working sheets. Data confirmed in a letter that is fastened to another analysis sheet should be cross referenced, as for example:

Contingent liabilities working sheet. For confirmation of the contingent liability on commercial letters of credit, see First National Bank confirmation attached to Analysis 1.

13. If the confirmations which are applicable to an account are numerous they may be placed in an envelope, bearing a description of its contents, and filed with the working papers. This is the procedure which is likely to be desirable for accounts receivable confirmations.

14. Accountants' tick marks, indicating work done in connection with the verification of accounts, should be explained on the analysis sheets. Differences in meanings of tick marks can be indicated by using pencils containing various colored leads or by varying the designs of tick marks employed on a work sheet.

15. Analyses of accounts should show the adjustment entries, with reference numbers, and final balances.

16. The practice should not be followed of abbreviating words used in accountants' working papers. Names of companies ought, of course, to be written correctly as, for example, "The Jones Co., Inc.," the abbreviation being due to adhering to the legal name of the enterprise.

17. Each analysis sheet should be signed, preferably in the upper right-hand corner, by the accountant who prepared it. Working papers, executed by assistants, ought to be signed by the in-charge accountant when he reviews them. Signatures should be followed by the dates when papers were signed.

18. Miscellaneous working papers not supporting any particular account are best placed in a "Miscellaneous Working Papers" folder, the contents of which should be indexed on its front side. Papers contained in such a folder might be as follows:

- a. Engagement record.
- b. Copies of correspondence with client.
- c. General audit program.
- d. Excerpts from minutes of meetings of stockholders, board of directors, and finance committee.
- e. Tax data.
- f. Analytical review of accounts.
- g. Insurance coverage.
- h. Copy of company's financial report.
- i. Reconciliation between outside auditor's and company's report.
- j. Notes of in-charge accountant.
- k. Accountants' time sheets.
- l. Accountants' general check list.

Sizes of Working Sheets. Uniformity in the sizes of sheets of paper used for accountants' working papers is desirable in order to facilitate filing. The following sizes of working sheets and folders give good results:

1. Single sheets, $8\frac{1}{2}$ inches \times 14 inches:
 - Ruled horizontally for use in writing drafts of report comments and miscellaneous notes, made up in pads.
 - Ruled horizontally with box heading and two journal columns.
 - Ruled horizontally with box heading, six and eight amount columns.
2. Double sheets, 14 inches \times 17 inches:
 - Ruled horizontally with box heading, twelve and sixteen amount columns.
3. Wider sheets can be made by pasting double sheets together.
4. Columns for amounts should be ruled with spaces for monetary units.
5. Manila folders, 10 inches \times $14\frac{1}{4}$ inches.
6. Specially printed forms of working papers ought to conform to the standard sizes adopted.

It is advantageous to print the upper right-hand corner of accountants' working papers in the following manner:

Prepared by — Date —
Reviewed by — Date —

General Ledger Trial Balance and Working Sheet, Form 8. The usual practice is to make use of a working sheet, such as shown in Form 8, as an aid in preparing financial statements and in closing the company's general ledger. Adjustment entries are recorded on the working sheet. The advantage of this procedure is that the end-of-the-period adjustment entries can be determined upon before finally making them in the company's general journal.

When the audit of an account has been finished and the necessary adjustment entries, if any, have been entered on the General Ledger Trial Balance and Working Sheet, the final balance of the account can be ascertained. After completing the audit of the general ledger accounts, the balances of the accounts ought to appear either in the "balance sheet," or in the "income and surplus" sections of the working sheets. There should remain no suspense, or mixed, accounts that require classification.

The most satisfactory procedure is to enter the asset, the liability, and the capital accounts on the working sheet in the order in which they appear on the company's balance sheet. In the first section are entered the ledger balances to the "asset" accounts, including valuation reserves. The second section contains the ledger balances to the liability and capital accounts.

The third section of the working sheet follows the balance sheet accounts and contains the "Profit and Loss accounts—Credit Balances," while the fourth section contains the "Profit and Loss accounts—Debit Balances." Usually the last section is the most voluminous because of the relatively large number of expense accounts which are generally carried.

After making such adjustment entries as are found necessary, the adjusted balances of accounts appearing on the working sheet show the company's final balance sheet accounts and income and surplus accounts. Usually groups of some of the accounts on the final trial balance have to be totaled when preparing the company's financial statements. On account of this condition it is a desirable practice, when arranging working sheets, to leave a gap after each group of accounts so that the group totals may be entered.

The following procedure should be employed for handling the General Ledger Trial Balance and Working Sheet:

1. Transfer column totals from Section 4 (Profit and Loss columns—Debit Balances) to Section 3 (Profit and Loss accounts—Credit Balances). Subtract the lesser total from the greater total in order to arrive at the net income, or net loss, for the period covered by the audit as per books and as finally adjusted.

THE BLANK COMPANY
GENERAL LEDGER TRIAL BALANCE AND WORKING SHEET
 PERIOD Year ended December 31 (Year)

PREPARED BY *J. White* 1/2/24
 REVIEWED BY *C. Smith* 1/2/24

FOLIO	ACCOUNT	FINAL (DATE)	PER LEDGER (DATE)	ADJUSTMENTS		FINAL (DATE)	MEMORANDUM	ANALYSIS NUMBER
				CHARGE	CREDIT			
	<i>Assets</i>							
A 1	Cash on deposit	275,000	380,000			380,000		①
A 2	Imprest cash fund	2,000	2,000			2,000		②
A 3	Notes receivable	75,000	110,000			110,000		③
A 4	Accounts receivable	600,000	750,000			750,000		④
L 10	Reserve for bad debts	(6,000)	(5,000)		① 2,500	(7,500)		⑤
A 5	Loans receivable	45,000	10,000			10,000		⑥
A 6	Investment securities	200,000	205,000			205,000		⑦
A 7	Inventory	1,200,000	950,000			950,000		⑧
A 8	Land	100,000	100,000			100,000		⑨
A 9	Depreciable assets	1,005,000	1,175,000			1,175,000		⑩
L 11	Reserve for depreciation	(570,000)	(560,000)		② 75,000	(635,000)		⑪
A 10	Prepaid expenses	16,000	18,500			18,500		⑫
	<i>Total</i>	2,942,000	3,135,500		77,500	3,058,000		

FORM 8

2. Enter the surplus, or deficit, balances at the beginning of the period covered by the audit, in the third section, together with any charges or credits to surplus or deficit account, during the period covered by the audit as per books and as finally adjusted. Calculate the end-of-period balances to surplus, or deficit, account as per books and as finally adjusted. The final balance to the surplus, or deficit, account should be entered in the second section (Liability and Capital accounts), after which the respective column footings on the second section should agree with those on Section 1, excluding the adjustment column totals.

3. The final balances on the General Ledger Trial Balance and Working Sheet are next transferred to the company's balance sheet and income and surplus statement.

4. It is helpful to provide a column, in the manner illustrated in Form 8 (see first amount column), on a general working sheet for filling in the final ledger balances from the preceding audit papers. Comparisons can then be made readily between the final balances for the current period and those for the previous period.

5. Accounts on the general ledger trial balance that are supported by analyses are best numbered consecutively, the analysis numbers appearing at the right-hand side of the working sheet. When the examination of an account has been finished, the analysis number should be circled, as previously mentioned, in order to indicate that the audit of the account has been completed.

6. Use ought to be made of the first vacant line at the end of the second section (Liability and Capital accounts) of the General Ledger Trial Balance and Working Sheet, for the contingent liabilities analysis reference number.

Clients should be asked to arrange their general ledgers with the asset and liability accounts in the same order that these accounts appear on their balance sheets, followed by the Profit and Loss accounts—Credits, and then the Profit and Loss accounts—Debits. This plan of procedure facilitates the preparation of the classified general ledger trial balance.

A good opportunity is afforded the accountant, while taking off the general ledger trial balance, for inspecting the accounts and noting any unusual features for future investigation.

Independent Accountants' Adjustment Entries. It is a desirable practice for the in-charge accountant, at the time active work is commenced upon an audit engagement, to review the adjustment entries made at the time of the preceding audit. Some of the previous adjustments may reveal the existence of unusual situations that require careful consideration each time the books are closed.

Numerous reclassification entries made to adjust the accounts, frequently referred to as "report entries" in contradistinction to those to be placed upon the company's books, are often entered by independent accountants in their working trial balances. Such entries are for the working sheets only and are not reflected in the accounts of the com-

panies under audit. It may be necessary to make an entry to classify, as a current liability, the portion of a long-term debt that matures during the year following the balance sheet date. Report entries are quite generally made in order to transfer accounts receivable credit balances from the Accounts Receivable controlling account to an appropriately named liability account. Frequently a reclassification entry is made to close out a General Expense account and set up detailed expense accounts in the manner in which they are presented on the company's income statement. By making reclassification adjustment entries the final account balances on the General Ledger Trial Balance and Working Sheet will be the same as those that appear on the company's financial statement.

All the independent accountant's adjustment entries, other than reclassification entries made for report purposes, should be reviewed with an executive of the company's organization who should then authorize their entry into the company's general journal. Placing the entries on the books is a necessary procedure so that there will not be any discrepancy between the final results as shown by the company's books and the independent accountant's report. Explanations should accompany all adjustment entries. It should be remembered that adjustment entries may be referred to many years after they have been made.

Frequently some of the adjustment entries are marked, "To be reversed at beginning of next period." Entries that are subsequently reversed usually cover the accrual, as at the balance sheet date, of entries that were entered in the books subsequently thereto. The procedure is illustrated below:

ADJUSTMENT JOURNAL ENTRY

(To be reversed at beginning of following year)

December 31 (current year)

J-55

Selling Expense	1,350	
Accounts Payable		1,350
Entry to charge former account for Christmas candy boxes given to buyers, covered by invoice not entered in books until following year.		

Adjustment journal entries should be numbered consecutively, for reference purposes, when entering them on the Trial Balance and Working Sheet. After being recorded on the working sheet, the adjustment

entries ought to be checked off by means of an auditor's tick mark. Usually the independent accountant's adjustment entries are filed with the Working Sheet for convenience in making reference to them.

Grouping Sheets. The necessity frequently arises for grouping several accounts, in the "Final Trial Balance" column, for presentation in financial exhibits and schedules. Use of separate sheets for the purpose of grouping accounts facilitates the checking and reviewing of accountants' reports. Groups of accounts ought to be arranged in the order that group totals appear in the company's balance sheet and income and surplus statements, for convenience in reference. Accounts which are entered on grouping sheets should be indicated by means of appropriate notations at the right-hand side of the general ledger trial balance, as for example, "See grouping sheet." It will be clear, by following this procedure, that the respective balances have not been transferred directly to the report exhibits or schedules. A typical section of a grouping sheet might appear as follows:

SOCIAL SECURITY TAXES			
G.L.	112	Federal old age benefit	\$ 4,000
G.L.	140	Federal unemployment insurance	1,200
G.L.	163	New York State unemployment insurance	10,000
G.L.	170	Connecticut unemployment insurance	800

Total			\$16,000

By exercising care in the arrangement of accounts in the company's general ledger trial balance, so that related accounts will be brought together, the use of grouping sheets can be minimized.

Excerpts from minutes of meetings of stockholders, boards of directors, and finance committees should be checked to the accounts. The working sheets, containing the respective excerpts, should indicate that this has been done. In the Excerpts from Minutes of Board of Directors, Form 9, the manner of verifying the transactions mentioned in the excerpts is indicated. Notes should be made, in connection with the examination of minutes, of any financial matters (ordinarily requiring action by the board of directors) which were reflected in the accounts and omitted from the minutes.

General Procedure for Handling Confirmations. It is usually advisable, in advance of beginning active work on an auditing engagement, to prepare confirmation requests covering items such as the following:

1. Bank accounts, including direct and indirect liabilities.
2. Selected debtors' accounts.

PREPARED BY J. White, Jr.
REVIEWED BY J. C. Smith, Jr.

THE BLANK COMPANY
YEAR ENDED DECEMBER 31, (YEAR)
EXCERPTS FROM MINUTES OF BOARD OF DIRECTORS

January 10 (Year) meeting:
 Present - Messrs Brown, Gray, Black, Smith, Green, Ray, and Clay. Checked to schedule of directors' fees
 Salaries of officers for (Year) authorized: Checked to executives' payroll schedule
 President, A. Brown, \$25,000 Treasurer, F. Black, \$20,000.
 Vice president, C. Gray, \$15,000 Secretary, B. Green, \$10,000.
 Lease of Main Street Garage at \$1,000 a month for period leased from others
 5 years from February 1 (Year) authorized.
 February 10 (Year) meeting:
 Quarterly dividend on common stock of 1½% Checked to surplus schedule
 authorized, payable March 1 (Year) to stockholders
 of record on February 10 (Year)

James White
June 30 (Year)

3. Deposits with utility companies.
4. Capital stock accounts—registrars.
5. Mortgages payable.
6. Funded debt.
7. Significant purchase commitments.
8. Market prices of selected materials.
9. Insurance coverages and values of unexpired insurance premiums.

Reference should be made to the confirmations obtained at the time of the preceding audit, and the confirmations list should be enlarged, or reduced, to meet the needs of the situation.

Confirmation requests should be mailed by the independent accountant in envelopes bearing the accounting firm's corner card (return address). A letter mailed to a fictitious person, or company, in an envelope bearing the auditing firm's corner card will be returned by the Post Office Department marked, "undelivered" or "not at address given." A dishonest employee of the client, if a fictitious confirmation request should be returned by the Post Office to the client (where confirmations are mailed in a client's envelopes), could abstract the letter from the incoming mail. Then, after completing and signing the confirmation letter, it could be returned to the independent accountant in the self-addressed envelope provided for the purpose.

Accountants' Time and Expense Records. Each accountant working on an engagement ought to maintain a record that shows the apportionment of his time to the various phases of the audit. Descriptions of work done should generally conform to items in the audit program. The in-charge accountant, after completing work on an engagement, should summarize, according to major audit program classifications, the time spent by all of the accountants. The accountant's time records and summaries ought to be filed with the audit working papers.

Accountant's time summaries that were used on previous engagements for a client are very helpful when planning and carrying on the work of the current engagement. These time records constitute a guide as to the length of time previously taken on various portions of the work.

In addition to the time records filed in working papers, accountants find it desirable to allocate their productive time according to the engagements on which they work for the information of the firm's bookkeepers. Usually time is reported in the manner indicated in the Accountant's Time Report, Form 10, in days (of seven hours each) and hours. A record of the overtime to be credited to accountants who work in excess of the standard number of hours is readily ascertainable from

the time report sheets. Unassigned time should be reported as such. The period covered by accountant's time reports varies; frequently they cover a week or ten days.

Expenditures by accountants for traveling expenses, when out of town on assignments, should be recorded in expense books provided for the purpose. The name of the engagement to which expenses are to be charged should be indicated. Train or boat fares, together with expenses incurred while en route, should be entered separately from hotel bills. The practice is quite generally followed of recording each day's expenses (hotel bills, meals, and tips) separately so that it will be apparent whether the firm's per diem allowance has been exceeded. It is necessary that, if two or more out-of-town clients are served by an accountant on one trip, expenses be apportioned on the basis of the productive time chargeable to each client. Receipted hotel bills ought to be attached to expense reports.

"Unassigned time" should be designated as such on the accountants' time reports. Separate columns are provided for computing the labor costs. After this has been done, the labor costs for the week are recapitulated by engagements.

Report of In-Charge Accountant on Assistant. The report shown in Form 11 is suitable for use by large accounting firms. It is employed by the in-charge accountants for reporting on their assistants. The office file of reports on any assistant furnishes a good indication of how well he is regarded by the various in-charge accountants under whom he has worked. These files of reports are generally referred to when considering semisenior, or junior, accountants for promotion or re-engagement for the busy season.

Procedure Followed upon Completing Report. The Report Sheet, Form 12, is designed to be filled out by the in-charge accountant and placed on top of the report draft when it is turned in to the accounting firm's office, together with the working papers, for review. Provision is made for listing any confirmations still to be received before releasing the report for typing. The reviewer's signature shows who reviewed the working papers and checked the report. Space on the Report Sheet is provided for recording the name of the client's representative with whom the report was reviewed.

Accountant's Check List. The check list is intended for the in-charge accountant's use in making a general review of the working papers, after completing an audit. Important omissions, such as failure to obtain a liability certificate, which might otherwise be overlooked, are thus brought to light. Answers to the questions ought to be sufficiently

**REPORT OF IN CHARGE ACCOUNTANT
ON ASSISTANT**

NAME OF ASSISTANT *John Smith*

EXCELLENT	76% - 100%	AVERAGE	26% - 50%
GOOD	51% - 75%	POOR	0% - 25%

	%
ABILITY	85
ACCOUNTING THEORY	80
ACCURACY	80
ADAPTABILITY	75
ALERTNESS	75
APPEARANCE	85
AUDITING PROCEDURE	60
DIPLOMACY	70
INITIATIVE	75
JUDGMENT	65
NEATNESS OF WORK	80
PERSONALITY	85
PUNCTUALITY	90
SPEED	75
TOTAL (AVERAGE 77%)	1080

SPECIAL COMMENTS

Mr. Smith is ready to take the C.P.A. examination

Henry Grey

March 1 (year)

IN CHARGE ACCOUNTANT

DATE

REPORT SHEET

CLIENT <i>The Blank Company</i>	ENGAGEMENT NUMBER 476
DATE WORK COMPLETED <i>March 2 (Year)</i>	DESCRIPTION OF REPORT <i>Examinations with statements</i>
DATE REPORT WANTED <i>March 10 (Year)</i>	NUMBER OF COPIES OF REPORT WANTED 5
IN CHARGE ACCOUNTANT <i>Henry Grey</i>	REPORT HOW BOUND <i>Side</i>

CONFIRMATIONS STILL TO BE RECEIVED

None

WORKING PAPERS REVIEWED AND CHECKED AS TO ADEQUACY OF AUDIT PROCEDURE AND ACCURACY OF FIGURES : REPORT CHECKED AS TO ACCURACY OF ASSERTIONS AND FIGURES

BY *James Ball* DATE *March 5 (Year)*

REVIEWED WITH CLIENT'S REPRESENTATIVE,

MR. *Frank Brown, Pres.* BY *James Ball*

comprehensive to be readily understood by the supervising partner. A typical check list follows:

1. Have confirmations and any other data still required, before rendering the report, been listed on the Report Sheet, Form 12?
2. Was the draft of the audit or other report reviewed by an executive of the company?
3. Were the independent accountant's adjustment entries placed upon the books?
4. Were excerpts made from minutes of the meetings of stockholders, board of directors, and finance committee?
5. Was the permanent file of working papers reviewed and brought up to date?
6. Do the working papers contain supporting data for all statements and assertions contained in the audit report?
7. Are all working papers signed by the accountant who did the work and by the in-charge accountant?
8. Was the adequacy of the insurance coverage investigated?
9. Was an analytical review made of the company's operations, and were any significant variations, as compared with the preceding year, explained?
10. Has the company complied with the regulations of the stock exchange on which its securities are listed?
11. Have the accounts been kept in accordance with generally accepted principles of accounting?
12. Have the accounts been kept on a basis consistent with that followed during the preceding year?
13. Does the company make a practice of publishing certified financial statements? If so, have arrangements been made to obtain a printer's proof for checking before publication and a copy after publication?
14. Were any irregularities discovered during the course of the examination of the accounts?
15. Were any weaknesses found in the company's system of internal control and check?
16. Were confirmations received of all bank balances?
17. To what extent were notes and accounts receivable confirmed?
18. Were discrepancies reported by customers, as a result of circularization, investigated?
19. Was the collectibility of slow and doubtful notes and accounts receivable reviewed with the company's credit manager?
20. Was the necessity of a reserve for discounts, rebates, and allowances, investigated?
21. Was the adequacy of the reserve for bad debts determined, in view of the present examination and past experience?
22. Does the average collection period for the current year compare favorably with that of the preceding year?
23. Have accounts with officers and employees, other than current trade accounts receivable, consignors, and affiliated enterprises, been excluded from the accounts of trade debtors on the balance sheet?
24. Were market quotation values ascertained for marketable securities?
25. Does the company follow the practice of taking up profits, or losses, on investments in subsidiary corporations?

26. Are investment stock certificates not in the name of the company properly endorsed?

27. Were dividends received on investment stocks checked to a dividends service?

28. Do minutes of the board of directors contain authorizations for purchases and sales of securities?

29. Were confirmations received from insurance companies of the cash surrender values of life insurance policies, together with policy loans, and the probable refunds on mutual fire insurance policies?

30. Does the inventory certificate show the main classes of the inventory and whether based upon a physical count or book records?

31. Was the inventory valued at "lower of cost or market"?

32. Was any substantial amount of obsolescence found to exist in the inventory?

33. Does the inventory turnover rate compare favorably with that of the preceding year?

34. Were any substantial adjustments made, either during the period covered by the audit or at closing date, in order to bring the inventory controlling accounts into agreement with physical inventories?

35. Have intercompany profits been eliminated from inventories?

36. Were capital expenditures authorized by the board of directors?

37. Are detail records of fixed assets kept in such a manner as to meet the requirements of the Bureau of Internal Revenue?

38. Was any change made by the company, during the period covered by the audit, in its depreciation policy as compared with the preceding year?

39. Do the working papers show the amount of fully depreciated property?

40. Do the company's records correctly show the gain or loss on sales and disposals of fixed assets?

41. Are patents and copyrights being amortized over their respective lives?

42. Does the company follow the practice of removing, from the accounts, the values of abandoned patents and copyrights?

43. Are loans from banks authorized by the board of directors?

44. For what period, subsequent to the date of the balance sheet, were expenditures examined for the purpose of ascertaining whether there were any unentered liabilities as of the date of the balance sheet?

45. Were all liabilities payable within one year after the balance sheet date treated as current liabilities?

46. Was a liability certificate obtained?

47. Was a confirmation of the company's capital stock secured from the registrar?

48. Were there any changes in the company's capital structure during the audit period?

49. Have capital stock and surplus of subsidiary corporations, at dates of acquisition, been eliminated against the parent company's investments?

50. Has mention been made on the balance sheet of dividends in arrears on preferred stock?

51. Do the working papers show the composition of the company's surplus?

The accountant's check list should be signed by the in-charge accountant and by the supervising partner after making his review.

Particular importance attaches to the answers to questions 11 and 12, in the foregoing check list, because of a statement generally contained in the independent accountant's certificate. The second paragraph of the certificate, presented in Chapter 1, contains the independent accountant's opinion that the financial statements were prepared, ". . . in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year."

A statement covering any significant departures from generally accepted principles should be prepared by the in-charge accountant. An estimate ought to be made of the amount of change that, if regarded as being relatively important, would be brought about in the company's figures if generally accepted accounting principles had been followed and applied consistently.

Preservation of Working Papers. An auditor ought to keep his working papers in case he should be called upon to answer questions regarding any financial statements, reports, tax returns, and so on, that he has prepared. An independent accountant's working papers ordinarily contain the pencil, or ink, draft of the accountant's report to the client. It appears advisable for an independent accountant to preserve his working papers until after the running of the statute of limitations for any legal actions that might be brought against him.

Ownership of Working Papers.* After reviewing the case of *Ipswich Mills v. William Dillon et al.*, decided by the Supreme Court of Massachusetts on July 5, 1927, and that of *Sockockinsky v. Bright, Grahame & Co.*, decided by the Mayor's and City of London Court on November 2, 1938, Mr. Leonard Price summarized the situation, with respect to the ownership of accountants' working papers, in these words:

It follows, accordingly, that the accountant's work papers should be his own property. He contracts to furnish the client a financial report, or tax return, but not the means by which such report or return is prepared. The public accountant may, if he has performed his services negligently, be answerable either to his client or to third parties for his shortcomings. It is vital, therefore, that he be permitted to retain copies of reports and returns prepared by him and the working papers in support thereof, so as to be in a position to protect himself in the event of any subsequent criticism of the quality of his work.

With reference to the length of time that working papers should be kept, Mr. Price's observations are of interest:

If the working papers are to be retained as a protection against possible suit, they should outlive the statute of limitations, with respect to actions which may be brought against the accountant. In New York the statute of limitations with

*"Ownership of Accountants' Working Papers," by Leonard Price, C.P.A., *The New York Certified Public Accountant*, May, 1940.

respect to negligence actions is three years; with respect to actions arising out of contracts not under seal, or for fraud, six years; and for various actions in equity, ten years.

REVIEW QUESTIONS

1. What procedure should be followed if a credit grantor requests permission to examine an independent accountant's working papers?
2. Mention five items of information of sufficient permanence to make it worth while to keep them in a special audit folder.
3. What procedure should be followed when a confirmation of an account is received?
4. Mention some of the advantages in preparing a General Trial Balance and Working Sheet.
5. How can the accounts be most advantageously arranged in the general ledger?
6. In what way can the use of grouping sheets be minimized?
7. What is the purpose of keeping a record of the time that accountants spend on each engagement?
8. Describe the purpose of an audit report sheet.
9. Mention some of the advantages of a printed audit check list.
10. For how long a period should an independent accountant retain his working papers?

CHAPTER 4

CHECKING VOUCHERS, ADDITIONS, AND POSTINGS

A review is made of the division of responsibility among the personnel in the company's office. Vouchers in support of bookkeeping entries are scrutinized as to their regularity in every respect. Document files of consecutively numbered accounting forms are examined in order to ascertain whether the files are complete. Payrolls are checked. Signatures on vouchers and payrolls are verified. Postings to general ledger accounts are checked. Additions of books of original entry, journals, and general ledger accounts are proved. Comparisons between bank statements and cash book entries are made. All the work above mentioned is done to the extent deemed necessary in view of the company's internal control system.

A division of duties and responsibilities, among a company's personnel, in such a manner that collusion is required on the part of employees in order to conceal a cash shortage is regarded as highly desirable. Irregularities which have been committed by an employee working alone have been more numerous than those which have been perpetrated by employees working in collusion. The systematic recording of cash and other financial transactions, without errors of omission or commission, is necessary in order that the accounts may reflect the company's correct financial position and the results of its operations.

Most business enterprises imprint each purchase invoice received with a rubber "voucher stamp" on which provision is made for the signatures of persons who approve the respective invoices for payment. Usually the approvals cover such items as the quality and quantity of goods received, prices, computations, and terms of payment. Retail department stores generally follow the practice of pasting an apron voucher form on the bottom of each purchase invoice. This apron contains spaces for signatures of persons who approve the items shown thereon and also for recording the payment date, the discount to be taken, and the net amount to be paid.

The office routine employed in many business enterprises provides for a continuous check on the additions in books of original entry, journals, and ledgers. Any discrepancies in addition of cash books are expected to be brought to light when the monthly bank reconciliation statements are prepared. Use of columnar books of original entry, such

as a multicolumn purchase journal, furnishes a convenient means for proving the addition of the total column against the total of the cross addition of the distribution columns. Agreement of the totals of trial balances of subsidiary ledgers, such as the accounts receivable ledger, with balances to the respective related general ledger controlling accounts is depended upon largely for a check on the additions of the former. Agreement of the total debit with the total credit balances in the general ledger trial balance, barring intentional falsification of items, indicates that the general ledger accounts have been correctly added. Each company usually has in operation various systems for localizing errors in addition that meet its particular requirements.

A chart of general ledger accounts is generally adopted and followed as a guide in making distributions and postings to the accounts in the general ledger. This is a desirable procedure in order that the accounts may be maintained in a consistent manner. General ledger account classification codes are usually indicated on vouchers, in books of original entry, and in journals for guidance and reference.

Internal Control. Consideration must be given to the company's internal control system in determining how extensively the verification of vouchers, additions, and postings may be made by means of selective tests. Independent accountants usually rely, to a considerable extent, upon test-checking portions of the records of the company under audit. Considerable reliance can usually be placed upon the accuracy of records where the company's personnel includes internal auditors whose duties comprehend the verification of vouchers, additions, and postings.

The degree of internal control that exists in a company's office can be ascertained by inquiring into the duties of each employee in the accounting department and the procedure followed in recording financial transactions. An investigation into the internal control situation should be made at each location where the company maintains an office and keeps books of account. Control at the company's home office may be good, but that at one or more of the branches may be weak. It is necessary that, on return annual engagements, the system of internal control and check be reviewed in order to determine whether any significant changes have taken place since making the previous survey. Inquiry ought to be made as to whether conditions in effect at the time of making the investigation exist during the remainder of the year. A situation that is generally good may become entirely unsatisfactory during the vacation period.

The internal control is usually found to be good where those employees who have contact with cash do not do any bookkeeping work. A person who is authorized to withdraw funds from the company's bank

on his sole signature is regarded as having contact with cash. In small office organizations, because of the difficulty in separating the duties of handling cash records from the other bookkeeping work, the internal control is likely to be weak.

Program of Audit. A general program of audit for the verification of vouchers, additions, and postings subject to such modifications as may be required after giving due consideration to the company's system of internal control, is presented herewith.

PROGRAM OF AUDIT

1. Internal control.

a. Cash.

- (1) Write a brief outline of the duties of each member of the company's accounting department personnel, including supervisory executives.
- (2) Classify the internal control situation with respect to each member as either "good" or "bad." Where there is a complete separation between the duties of the cashier and those of the bookkeepers, the situation is classified as good.
- (3) Classify the internal control situation on the whole as good, bad, or mixed. If the situation is good in some respects and bad in others, it is regarded on the whole as being mixed.
- (4) Summarize important findings resulting from the survey of the company's system of internal control of cash.

b. General.

- (1) Ascertain whether sales and shipments are properly synchronized and the means employed for maintaining control over sales.
- (2) Inquire into the sources of the company's revenues, other than regular sales, and into the procedure followed in exercising control over them.
- (3) Investigate the company's procedure for making purchases, receiving goods, and approving purchase invoices.
- (4) Look into the company's payroll procedure and the method employed for exercising control over payroll disbursements.
- (5) Is a chart of general and expense ledger accounts consistently followed in classifying financial transactions?

2. Vouching entries and relevant matters—books of original entry, journals, and payrolls.

a. Detailed audit.

- (1) Examine vouchers and supporting data for all entries; check distributions made to ledger account classifications. (See Chapter 6, "Cash on Deposit," for method of examining bank vouchers.)
- (2) Examine files of consecutively numbered accounting documents and records to ascertain whether any data are missing.

b. General audit.

- (1) Examine vouchers and supporting data for all entries for four nonconsecutive months including the last month of the year. Check distributions made to ledger account classifications, unless a different procedure is determined upon after giving due consideration to the requirements of the particular audit engagement. When making the

CHECKING VOUCHERS, ADDITIONS, AND POSTINGS

selection of months, choose three nonconsecutive months, other than the last month, that differ from those covered the preceding year, unless otherwise determined. Verify authenticity of approvals which appear on documents examined. (See Chapter 6, "Cash on Deposit," for procedure applicable to the examination of bank accounts.)

- (2) Inspect files of consecutively numbered financial records for the purpose of ascertaining whether the files appear to be complete.
- (3) Read agreements and contracts which pertain to the company's financial transactions.
- (4) Check the minutes of the company's board of directors to the accounting records.
- (5) Confirm, by circularization, significant items of sundry revenues.
- (6) Verify the income received on listed investment securities by reference to a standard financial service.
- (7) Make an analysis of changes which took place in the company's personnel during the period covered by the audit.
- (8) Supervise on some pay day, without previous announcement, the paying off of the company's employees.
- (9) Scrutinize expense accounts, for the accounting period under review, as to their apparent regularity.
- (10) Review important journal entries.
- (11) Examine transactions subsequent to the balance sheet date for the purpose of detecting the omission of transactions from the accounting period under review.
- (12) Make an analytical review of the company's operating accounts.
- (13) Review any reports on file that have been prepared by the company's internal auditors during the period under audit.
- (14) Audit procedures.
 - See Chapter 18, "Sales and Returned Sales."
 - See Chapter 19, "Sundry Revenues."
 - See Chapter 20, "Purchases and Returned Purchases."
 - See Chapter 21, "Payrolls, Expenses, and Interest."
 - See Chapter 22, "Analytical Review of Accounts."

3. Verification of additions.

a. Books of original entry and journals, including payrolls.

- (1) Detailed audit—verify all additions.
- (2) General audit—verify additions for four selected months of the year. Select nonconsecutive months that differ in the various records so that the entire year is covered by the verification of additions in one or other of the company's books of original entry, journals, and payrolls, unless otherwise determined after giving due consideration to the requirements of the particular engagement. If there are distribution columns, verify the addition of the total column and the cross footings for the selected months, unless it is otherwise decided.

b. General ledger.

- (1) Verify additions of all accounts not analyzed.
- (2) Prove final balances of all accounts not analyzed.

c. Trial balances of general and subsidiary ledgers—verify additions.

- d. For audit program covering the verification of the computations of the inventory, see Chapter 10, "Inventories."

4. Checking postings—general ledger.

- a. Detailed audit—check all postings to the accounts.
- b. General audit—check all postings for four nonconsecutive months, including the last month of the year, unless it is otherwise determined after giving due consideration to the requirements of the particular audit engagement. Vary the months selected for checking postings, other than the last month of the year, from those selected for the examination of vouchers and supporting data, unless it is otherwise determined.

A considerable amount of the checking of vouchers, additions, and postings, and analyses of accounts can be done at interim dates in advance of the close of the year. Working papers frequently contain a running analysis of the General Expense account, the information being required for the company's annual report. The vouching of a goodly portion of the additions to the fixed asset accounts, particularly in the case of industrial enterprises, can oftentimes be done to good advantage before the end of the year.

5. Proof of Cash Statement.**a. Detailed audit.**

- (1) Prepare a proof of cash statement for each month of the year and in addition for the first month after the balance sheet date.
- (2) Ascertain wherein deposits and withdrawals of cash, as shown by bank statements, differ from receipts and disbursements as recorded in the cash book.

b. General audit.

- (1) Prepare a proof of cash statement for four nonconsecutive months of the year, including the last month of the year, and in addition for the first month after the balance sheet date. In making the selection of three nonconsecutive months exclusive of the last month of the year, the practice should be followed of selecting different months from those for which the additions of the cash books were verified, unless it is otherwise determined after giving due consideration to the requirements of the particular engagement.
- (2) Ascertain wherein deposits and withdrawals of cash, shown by bank statements, differ from receipts and disbursements as recorded in the cash books for the months for which the proof of cash statement is made.

See Form 18, Proof of Cash Statement (cash transactions for four consecutive months are summarized, instead of those for four nonconsecutive months, in order to simplify the illustrations of a proof of cash statement).

Preparation of a proof of cash statement for the month following the balance sheet date is regarded as a desirable procedure in order to detect errors of commission that result from an effort to conceal prior irregularities.

Books of Original Entry. The books of original entry most frequently encountered, when making audits, are as follows: cash receipts, cash disbursements, petty cash, sales, returned sales, purchases, returned purchases, payroll, notes receivable, notes payable, general journal, and special journals, such as commissions and royalties journals. Designs of the forms used for books of original entry are usually adapted to meet the requirements of the particular business.

Vouching Entries. Establishment of the authenticity of approvals, in connection with the examination of vouchers in support of book-keeping entries, is of the utmost importance. If vouchers cannot be located, the company should be asked to secure duplicate copies thereof; they should then be approved. It is essential that journal entries bear approvals of persons other than those who prepared them. If journal vouchers, or journal entries, are not found to have been approved, it is a desirable practice for the independent accountant to request that they be approved by an executive. If the company's procedure regarding vouchers does not furnish adequate safeguards, the situation should be brought to the client's attention.

It may be decided, when conducting a general audit, that only purchases in excess of \$10, or \$25, need be vouched. Perhaps the examination of expenditure vouchers in excess of \$25 will cover a large portion of the total amount of the expenditures and will necessitate the inspection of only a small part of the documents.

Inasmuch as it is ordinarily deemed undesirable to reveal to the client the exact amount of checking done, the independent accountant ought to exercise judgment in the manner in which tick marks are made on the vouchers examined. Only in the case of detailed audits, where the practice is followed of inspecting all documents, does it appear advisable to imprint each voucher examined with a rubber stamp.

Alterations of significant items on payment vouchers, or failure on the part of the company's employees to produce vouchers for examination, ought to be regarded with suspicion. The independent accountant should bear in mind the possibility of concealing a fraudulent payment by using an old voucher with a changed date. It is often an easy task for a dishonest cashier to make alterations in purchase invoices without much fear of the subterfuge being detected.

The informality with which petty cash funds are frequently disbursed makes it necessary to examine vouchers in support of the payments with particular care. One can readily understand the ease with which the amount written only in numerals on a petty cash voucher can be raised, and the addition pocketed by a dishonest custodian of the

petty cash box. Considerable amounts of money sometimes clear through petty cash funds during the course of a year. A fraudulent voucher for a petty cash disbursement is illustrated in Form 13. The conclusion reached by the independent accountant was that the December (year) vouchers included a copy of a voucher for \$248.88 which had already been entered. Auditors usually make an effort to have all petty cash vouchers signed by someone who is higher in authority than the custodian of the imprest cash fund.

It is frequently necessary, in connection with the vouching of bookkeeping entries, to analyze mixed accounts. Usually it is preferable to arrange for the client's staff to make necessary analyses of accounts and then to check the work. If an analysis is of minor importance it can generally be marked, "Company's analysis accepted without verification." Additions of all analyses should be verified by the independent accountant.

Accounts which have been closed out during the audit period ought to be inquired into. It may be found, upon investigation, that one or more of the accounts was erroneously closed.

Copies of any especially important journal entries should be made for future reference. Adjustment of book inventory controlling accounts to agree with physical inventories, if significant in amount, should be inquired into. Entries covering charges to Capital Surplus account merit investigation; ordinarily such transactions are found authorized by the board of directors. Dividend entries in the journal should be in agreement with the minutes of the board of directors.

Bookkeeping errors, such as unintentional mistakes in the classification of expenditures, are referred to as errors of omission in contradistinction to intentional irregularities, as, for example, the padding of payrolls, which are described as "errors of commission." Errors of omission, in connection with entries of expenditure vouchers in books of original entry, are generally traceable to a lack of proper understanding of the distinction between capital and revenue, while errors of commission are usually perpetrated for the purpose of concealing irregularities.

Failure to Distinguish between Capital and Revenue. Unless accounts are maintained in accordance with accepted principles of accounting, it is quite likely that the desired results will not be secured therefrom. Failure, for example, to observe the distinction between capital and revenue is illustrated in Form 14. An invoice for a motor truck was improperly included under Merchandise Purchases instead of being charged, in the general ledger column of the company's purchase journal, to the Motor Truck account. Failure to make a proper

DISCOVERY OF SHORTAGE IN PETTY CASH-ILLUSTRATED

THE BLANK COMPANY
 YEAR ENDED DECEMBER 31 (YEAR)
 ANALYSIS OF PETTY CASH VOUCHERS FOR DECEMBER (YEAR)

PREPARED BY J. White
 REVIEWED BY B. Smith

ADVERTISING	CHRISTMAS PRESENTS	ENTERTAINING	FREIGHT EXPRESS	MISCELLANEOUS	POSTAGE	STATIONERY	OVER TIME	TRAVELING
16 25	1000 00	66 75	75 25	16 10	10 00	112 50	75 00	10 75
12 50	1500 00	100 00	248 88	1 25	100 00	75 20	66 00	120 50
10 50	4000 00	50 00	110 50	2 75	25 00	66 40	85 20	85 25
40 75	15500 00	72 10	66 25	18 50	75 00	1460 00	226 20	90 10
80 00		4 75	81 00	20 50	120 00	70 25		20 60
Recapitulation		13 10	200 50	16 60	330 00	2010 00		327 20
Advertising	80 00	306 70	116 00	7 50		3794 35		
Christmas presents	15500 00		25 00	21 00				
Entertaining	306 70		12 50	24 00	⊗ Bondstition - An apparent cash shortage			
Freight & Express	1579 76		210 00	7 50	8948 88 was concealed, by including it in the			
Miscellaneous	260 70		75 00	125 00	Petty cash disbursements a hand written			
Postage	330 00		110 00	260 70	copy of a freight voucher, for this amount,			
Stationery	3794 35		⊗ 2488 88		already included in the petty cash			
Overtime	226 20		1579 76		expenditures.			
Traveling	327 20							
Total	8454 91							
							James White	
							February 15 (Year)	

FAILURE TO DISTINGUISH BETWEEN CAPITAL AND REVENUE - ILLUSTRATED

MONTH *April (Year)* THE BLANK COMPANY PURCHASE JOURNAL PAGE 75

DATE	NAME	✓	ACCOUNTS PAYABLE	MERCHANDISE PURCHASES	GENERAL EXPENSES	SELLING EXPENSES	ADMINISTRATIVE EXPENSES	GENERAL ACCOUNT	LEDGER AMOUNT
	Forward		169,335.00	88,720.00	14,750.00	12,155.00	6,500.00		47,210.00
Apr. 1	B. Lue Co.		1,250.00	1,250.00					
" 2	Acme Truck Co.		5,000.00	5,000.00					
" 20	Green Brothers		16,210.00	16,210.00					
	Total		191,795.00	111,180.00					

ACME TRUCK CO.
CHICAGO, ILL. APRIL 2 (YEAR)

SOLD TO
THE BLANK COMPANY
NEW YORK, NY
One 5 Ton Acme Truck \$ 5,000.00
5175273

THE BLANK COMPANY
RECEIVED
APRIL 2 YEAR
BY *B. Brown*
RECEIVING CLERK

Conclusion:
Inclusion of a motor truck in the Merchandise Purchases account indicates a lack of understanding of the distinction between capital and revenue.
James White
April 30 (Year)

FORM 14

FAILURE TO DISTINGUISH BETWEEN CAPITAL AND REVENUE - ILLUSTRATED

ACCOUNT *S. S. Alpha*

DATE		CHARGE	
<i>Mar. 31</i>	<i>Cost</i>	<i>CD-609</i>	<i>5000,000.00</i>
<i>" 31</i>	<i>Bonus for Early Delivery</i>	<i>CD-609</i>	<i>60,000.00</i>

DATE		CREDIT
		<i>✓</i>

**S.S. ALPHA
AUDIT NOTES**

Except from contract with Beta, Inc., for construction of S.S. Alpha.

Bonus for early delivery: Delivery of S.S. Alpha shall be made by May 31 (Year) and a bonus of \$1,000.00 per day shall be paid by the buyer for early delivery.

James White
June 10 (Year)

**S.S. ALPHA
ADJUSTMENT JOURNAL ENTRY
MARCH 31 (YEAR)**

Deferred Bonus \$ 60,000.00

S.S. Alpha \$ 60,000.00

Entry to transfer bonus paid for early delivery of S.S. Alpha to former account. Said bonus to be spread over the operations of the S.S. Alpha for the period from March 31 (Year) to May 31 (Year). James White June 10 (Year)

Conclusion - A. Bonus paid for early delivery of a steamship is usually regarded as a charge against the operations of the Steamship for the bonus period (in the instant case from March 31 (Year) to May 31 (Year)) and not as additional cost of the Steamship.

FORM 15

distinction between capital and revenue results in misleading financial statements as illustrated in Form 15, where the independent accountant came to the conclusion that the bonus paid for the early delivery of the S. S. Alpha should have been treated as a charge against the operation of the steamship for the bonus period (in the instant case from March 31 [year] to May 31 [year]), and not as additional cost of the vessel. The necessary adjustment journal entry to correct the company's books is presented.

Error of Commission, Illustrated. The audit program which is followed by an independent accountant generally provides for the examination of journal vouchers. Particular attention is directed to entries which have an effect on the profit showing. In Form 16 a situation is presented where the write down of the Reserve for Depreciation of Buildings account was credited to the Sales account. The conclusion reached by the independent accountant was that the credit to Sales account was erroneously made. It should have been made to an appropriately named income account and shown in the Additions to Income section of the statement of income and surplus. Otherwise anyone analyzing the company's income would be misled as to the amount of the sales, although the net result of operations would not be affected.

Additions. Preservation of adding-machine tapes which are prepared by the independent accountant is frequently deemed to be desirable in case the question should ever arise as to whether certain additions of the company's records were verified. This is particularly important for tapes of additions of trial balances on which the amounts have been checked to the respective accounts in subsidiary ledgers. A description should be written on each adding-machine tape which is to be preserved. Tapes, unless so short that they can be pasted on a working sheet, ought to be folded in such a manner that the totals will be visible without the necessity of unfolding them, and then they should be placed in envelopes bearing descriptions of the contents. The accountants who prepared the tapes should sign them. The ease with which nonadd and nonprint keys on many listing machines can be used makes it unsafe to rely upon adding-machine tapes which have been prepared by the company's personnel. The cents column, when verifying additions by hand, can generally be omitted with safety and additions can be begun with the dollars columns. There is little likelihood that errors of commission will be concealed in the cents columns. Audit programs and working papers should show what additions were verified.

Compensating errors in addition, when discovered, should be regarded with suspicion. It is more likely than not that they will be found to

ERROR OF COMMISSION - ILLUSTRATED

THE BLANK COMPANY

ACCOUNT

Sales

DATE	(YEAR)	CHARGE	✓	DATE	CREDIT
Dec. 31	1999	2,100,000.00			
				<i>Sales</i>	35
<p><i>Conclusion - A reduction of \$500,000.00 in the Reserve for Depreciation of Buildings was improperly credited to Sales account.</i></p> <p><i>James White, January 10 (Year)</i></p>					
				<i>Sales</i>	271
				<i>Sales</i>	305
				" 31	J-75
					210,000.00
					180,000.00
					500,000.00
					2,100,000.00

THE BLANK COMPANY

ACCOUNT *Reserve for Depreciation of Buildings*

DATE	(YEAR)	CHARGE	✓	DATE	CREDIT
Dec. 31	1999	500,000.00			
				<i>Balance</i>	J-75
				<i>Provision for Depreciation</i>	J-80
				" 31	
					4,275,000.00
					325,000.00
					5,600,000.00
				<i>Balance</i>	
					5,100,000.00

have been caused, at least in some instances, by efforts on the part of bookkeepers to force balances.

Overfooting payrolls serves to conceal the misappropriation of payroll funds. The care which is generally exercised to keep payroll records confidential, and under lock and key, often makes the detection of irregularities rather unlikely unless the payrolls are examined by internal auditors or independent accountants.

Fraud-conscious independent accountants will be quick to grasp the implications involved when they discover that the cash receipts book is incorrectly footed. Remittances from cash customers, especially if in currency, may have been pocketed by a dishonest employee and the irregularities concealed by underfooting the cash receipts. It appears that cashiers often feel safer when they enter all receipts (particularly when prenumbered sales slips are in use) than when they omit the recording of pilfered receipts, in case someone should have occasion to look up the entry of a particular cash sale. A method employed by some dishonest cashiers for covering up cash shortages is to overfoot the cash disbursements book in the manner illustrated in Forms 17-1 and 17-2. The conclusion reached by the independent accountant was that an apparent cash shortage of \$10,000 had been concealed by overfooting the general expense and bank checks columns in the cash disbursements book. Sometimes footings of books of original entry are found to be in pencil, in which case the bookkeepers who are responsible for the respective records should be asked to ink in the footings before their verification by the independent accountant.

Postings. Amounts posted to general ledger accounts from books of original entry and journals, during the period covered by the audit, should be checked or tested in order to verify the existence of underlying records. Absence of supporting records for entries in ledger accounts is a situation that needs inquiring into. Checking of entries in subsidiary ledgers may usually be dispensed with if all the amounts posted to the respective controlling accounts are checked and the authenticity of the entries in the books of original entry has been verified by adequate test and scrutiny. Furthermore the trial balances from the detail ledgers should be in agreement with the corresponding controlling accounts. Various audit procedures are employed for testing the accuracy of the accounts in subsidiary ledgers, such as the circularization of customers in connection with the verification of accounts receivable. It is desirable that, during the time that postings are being checked, the ledgers should not be released from the auditor's control.

DETECTION OF ERROR IN ADDITION OF CASH DISBURSEMENTS BOOK-ILLUSTRATED

THE BLANK COMPANY
CASH DISBURSEMENTS BOOK

PAGE 197

DATE	NAME	ACCOUNTS PAYABLE	DISCOUNTS RECEIVED	PAYROLL	SOCIAL SECURITY TAXES	GENERAL EXPENSE	GENERAL LEDGER ACCOUNT	GENERAL LEDGER AMOUNT	BANK CHECKS NO.	BANK CHECKS AMOUNT
	BROUGHT FORWARD	57200.00	1175.00	9500.00	200.00	6300.00		38,000.00		109,625.00
31	<i>Bacon & Co</i>	1000.00	20.00						762	980.00
31	<i>See Bkts.</i>					3500.00		44,000.00	770	350.00
	CARRIED FORWARD	66500.00	1200.00	12000.00	420.00	7500.00		128,380.00		

THE BLANK COMPANY
CASH DISBURSEMENTS BOOK

PAGE 198

MONTH December (Year)

DATE	NAME	ACCOUNTS PAYABLE	DISCOUNTS RECEIVED	PAYROLL	SOCIAL SECURITY TAXES	GENERAL EXPENSE	GENERAL LEDGER ACCOUNT	GENERAL LEDGER AMOUNT	BANK CHECKS NO.	BANK CHECKS AMOUNT
	BROUGHT FORWARD	66500.00	1200.00	12000.00	420.00	17500.00		44,000.00		138,380.00
31	<i>170-443 E. 20th</i>									
31	<i>Allan & Co.</i>	6100.00	150.00						761	5,950.00
	TOTAL	77240.00	2,100.50	15070.00	725.00	18075.00		451,000.00		153,343.50

FORM 17-PART 1

Making postings directly to ledger accounts, without supporting entries in books of original entry or journals, is a practice which should be censured. Crediting numerous accounts receivable, deemed

DETECTION OF ERROR IN ADDITION OF CASH DISBURSEMENTS BOOK-ILLUSTRATED

THE BLANK COMPANY			
YEAR ENDED DECEMBER 31 (YEAR)			
NOTES ON VERIFICATION OF ADDITIONS			
<i>Cash disbursements book :</i>			
	<i>Per. Cash</i>	<i>Should</i>	<i>Over-</i>
	<i>Book</i>	<i>Be</i>	<i>footing</i>
<i>Page 198 Cash Disbursements</i>			
<i>Book :</i>			
<i>General expense column</i>	17 500.00	7 500.00	10 000.00
<i>Bank checks column</i>	138 380.00	128 380.00	10 000.00
<i>Conclusion :</i>			
<i>An apparent cash shortage of \$10,000.00</i>			
<i>was concealed by over footing the "general</i>			
<i>expense" and the "bank checks" columns \$10,000.00</i>			
<i>each. The balance to the general ledger Cash</i>			
<i>in Bank account, after posting the cash</i>			
<i>disbursements book, was in agreement with</i>			
<i>the bank balance (reported by the bank) as</i>			
<i>reconciled by the Company's cashier</i>			
<i>(See FORM 17 PART 1.)</i>			
<i>James White</i>			
<i>March 10. (Year)</i>			

FORM 17-PART 2

uncollectible, and charging the total amount thereof directly to the Bad Debts Expense account is a practice that appears to be used sometimes for the purpose of making it difficult for anyone to check the entries. Some bookkeepers close the general ledger directly from work sheets without the formality of making journal entries, presum-

ably in order to save the time required to close the books. This is a practice which should not be countenanced.

Proof of Cash Statement. Transactions which have been entered in the cash book, but which do not appear on the bank statement, and vice versa, can readily be brought to light by the preparation of a Proof of Cash Statement, such as the one illustrated in Form 18. If the company follows the practice of depositing each day's cash receipts in the bank, the deposits as shown on bank statements should agree with the recorded cash receipts. If the company pays all bills by means of bank checks, the withdrawals shown on its bank statements should reconcile with the recorded cash disbursements, after taking into consideration the outstanding bank checks at the end, and beginning, of each month covered by the proof of cash statement.

Explanations should be secured for all differences between the cash receipts reported on bank statements and those recorded in the cash book. This is usually a simple task because of the general practice of depositing cash receipts intact. An excess in the deposits on a bank statement over the receipts entered in the cash book, for the corresponding period, may be due to the redeposit of a debtor's check. Here the bank's debit memorandum covering the charge back of the "N.S.F." (not sufficient funds) check ought to be inspected. The excess of disbursements in a cash book, over the adjusted withdrawals on a bank statement, may arise from the issuance of a duplicate check to a creditor to take the place of the one which was reported not to have been received and on which payment was stopped. When this situation is encountered, the bank's advice acknowledging receipt of instructions to stop payment on the check should be examined.

An explanation that offsetting items in the receipts and disbursements sections of a proof of cash statement are "exchanges" should not be accepted without scrutinizing supporting data. The deposit by a dishonest cashier of a remittance from a customer whose account had been written off as a bad debt and the withdrawal of a corresponding amount, on a bank check payable to the cashier, or to someone else and endorsed by the cashier, should arouse the independent accountant's suspicions.

One of the purposes of making a proof of cash statement is to ascertain whether all transactions recorded on the bank statement were entered in the cash book, and vice versa. Any transactions which appear in one record, but not in the other, require investigation in order to detect whether the cash records have been subjected to manipulation. Detection of irregularities by means of a proof of cash statement is illustrated in Form 19, where the independent accountant

THE BLANK COMPANY
The First National Bank
 PREPARED BY J. M. H. (G)
 REVIEWED BY B. S. (G)

PROOF OF CASH STATEMENT

YEAR AND MONTH	RECEIPTS			DISBURSEMENTS					BANK OVER (UNDER)
	BANK	CASH BOOK	BANK OVER (UNDER)	BANK	ADD % CHECKS DEDUCT. AT END OF MONTH	ADJUST. BANK	CASH BOOK	BANK OVER (UNDER)	
<i>(year)</i> March	3,710	3,710		7,500	450	310	7,640	7,640	
April	6,500	6,600	① 100	8,205	610	450	8,365	8,465	① 100
May	8,220	8,220		9,575	1,700	610	10,665	10,615	② 50
June	9,100	9,050	③ 50	6,650	425	1,700	5,375	5,375	
Total	27,530	27,580	(50)	31,930	3,185	3,070	32,045	32,095	(50)
① Check No. 1,400 issued to replace No. 1,720 lost and cancelled.									
② Check from A. H. Miller & Co. returned by bank, "N. Y." and recredited.									
							Bank Cash Book		
				Balance, March 1 (year)		98,210	97,900		
				Receipts		27,530	27,580		
				Total		125,740	125,480		
				Disbursements		31,930	32,095		
				Balance, June 30 (year)		93,810	93,385		

FORM 18

DETECTION OF IRREGULAR CASH TRANSACTIONS - ILLUSTRATED

First National Bank
1200 BROAD STREET
NEW YORK

STATEMENT FOR JUNE (YEAR)		DEPOSITS
DEPOSITOR The Blank Company "Special"		CHECKS
May 31	Balance	14,750 00
June 5	200.00	100.00
June 8	350.00	500 00
June 10	137.45	200.00
June 15	240.10	137 45
June 20	155.00	365.00
June 22	416.40	1,000 00
June 24	66.75	110 75
June 27	42.50	1,566 75
June 29	110.00	2,000 00
June 30	60.00	55 50
June 30	Balance	17,105 00

Proof of Cash Statement

Receipts for June (Year):

Deposits per bank \$ 5,370.45
Receipts per cash book 5,000.00

Bank over cash book \$ 370.45

Disbursements for June (Year):

Checks per bank \$ 3,015.45

Plus 1/2 checks June 30 (Year) 60.00

Total \$ 3,075.45

Less 1/2 checks May 31 (Year)

Remainder - disbursements 100.00

as adjusted \$ 2,975.45

Disbursement per cash book 2,605.00

Bank over cash book \$ 370.45

Conclusion - Recoveries of \$ 370.45 on customer's accounts which had been previously written off as bad debts were deposited in the Company's "Special" bank account and then withdrawn by the cashier, H. Black (who has power to sign checks) apparently for his personal use. James White, July 20, (Year).

FORM 19

DETECTION OF CASH BOOK MANIPULATIONS - ILLUSTRATED

THE BLANK COMPANY
 NAME *Cash in Bank Account*

DATE	FOL	CHARGE	DATE	FOL	CREDIT
(YEAR) Dec. 31		212 175 00	(YEAR) Dec. 31	G-70	725 225 00
Dec. 31	G-55	873 250 00	Dec. 31		360 200 00
(YEAR) Jan. 1		1085 425 00			1085 425 00
		360 200 00			

Conclusion - An apparent cash shortage of \$3,500.00 was concealed by omitting from cash book record of the withdrawal on December 15 (year) of \$35,000 and by improperly excluding an old outstanding check, No. 6610, for a corresponding amount from the December 31 (year) list of outstanding checks. Checks may be signed by the Company's Cashier, H. Black, without a counter signature.

James White
 January 10 (year)

Proof of Cash Disbursements for December (year)
 Disbursements per bank \$ 732,100.00
 Plus 9/8 checks 12/31 (year) \$ 11,500.00
 Total \$ 743,600.00
 Less 9/8 checks 11/30 (year) \$ 14,875.00
 Remainder \$ 728,725.00
 Disbursements per cash book 725,225.00
 Bank over cash book — \$ 3,500.00
 disbursements

DETECTION OF CASH BOOK MANIPULATIONS - ILLUSTRATED

THE BLANK COMPANY

NAME *Cash in Bank Account as Adjusted by Outside Auditor*

DATE	FOL.	CHARGE	DATE	FOL.	CREDIT
(YEAR) <i>Nov. 30</i>			(YEAR) <i>Dec. 31</i>		
<i>Balance</i>		<i>212 175 00</i>	<i>Disbursements</i>	<i>C-70</i>	<i>725 225 00</i>
<i>Dec. 31</i>	<i>C-55</i>	<i>873 250 00</i>	<i>"</i>		<i>3 500 00</i>
			<i>"</i>		<i>356 700 00</i>
		<i>1085 425 00</i>			<i>1085 425 00</i>
(YEAR) <i>Jan. 1</i>		<i>356 700 00</i>			

Bank Reconciliation by Cashier
 Balance per bank ^{12/31}(Year) \$368,200.00
 Less 9/5, check No. 7500 8,000.00
 Balance per cash book ^{12/31}(Year) \$360,200.00

Bank Reconciliation by Outside Auditor
 Balance per bank ^{12/31}(Year) \$368,200.00
 Less 9/5 checks: 3,500.00
 Old - No. 6610 \$ 3,500.00
 Current - No. 7500 8,000.00 11,500.00
 Balance per cash book ^{12/31}(Year) \$356,700.00
as adjusted by auditor

Summary of Bank Statement - December (Year)
 (Year) *First National Bank*
 Nov. 30 Balance \$ 22,705.00 Dec. Checks \$ 732,100.00
 Dec Deposits 873,250.00 Dec. 31 Balance 368,200.00
 Total \$1100,300.00 Total \$1100,300.00

NOTE - COMPANY OMITTED OUTSTANDING CHECK FOR \$3,500.00 FROM LIST OF OUTSTANDING CHECKS AND ALSO ENTRY OF WITHDRAWAL OF \$3,500.00 FROM DISBURSEMENTS, THUS EFFECTING COMPENSATING ERRORS.

James White January 10, (Year)

FORM 20-PART 2

came to the conclusion that the cashier had misappropriated recoveries of \$370.45 on customers' accounts which had been written off as being deemed uncollectible.

The deposits which made up the above-mentioned amount were as follows:

June 10	\$137.45
June 22	110.75
June 24	66.75 (included in deposit of \$1,566.75)
June 30	55.50
	\$370.45
	\$370.45

Checks which were drawn for the above amounts will be found on the bank statement form under the same dates as the respective deposits. The checks offset deposits of \$370.45, and if the cashier should ever be interrogated about the above-mentioned items he would undoubtedly reply that the offsetting amounts represent "exchange checks." Here the company made a practice of depositing receipts intact.

A further illustration of the use of a proof of cash statement in bringing to light cash irregularities is presented in Forms 20-1 and 20-2. Disbursements per bank for December (year) exceeded recorded expenditures by \$3,500 as shown. The independent accountant was led to the conclusion, from his examination, that the embezzlement was concealed by excluding from the list of outstandings an old bank check for \$3,500. This is an example of a compensating error of commission.

REVIEW QUESTIONS

1. How extensive should the examination of expenditure vouchers be, where there is an effective system of internal control in the company's accounting department?

2. Do situations arise where expenditure vouchers for all months of the year should be examined at the company's branches, but only those for selected months at the company's head office?

3. What procedure ought to be followed when the petty cash vouchers examined lack approvals, although the bank reimbursement check is properly signed.

4. Are pencil footings in books of original entry acceptable?

5. Is it permissible for an independent accountant to accept adding-machine tapes which have been prepared, covering additions, by the company's personnel?

6. What significance would you attach to compensating errors in additions on the receipts and disbursements sides of the cash book?

7. To what extent, when verifying footings by hand, may the addition of cents columns be omitted?
8. Under what conditions should all postings to general ledger accounts be checked?
9. What purpose is served in making a proof of cash statement and in adding the cash book for the month subsequent to the balance sheet date?
10. Distinguish between errors of omission and commission.

CHAPTER 5

CASH ON HAND

Examination of petty and special cash funds is made simultaneously with the verification of undeposited receipts and investment securities, in order to detect any manipulation of cash on hand. Cash funds are compared with the related ledger accounts. Undeposited receipts are checked against the company's records thereof and deposited under the independent accountant's control. Cashed checks, not issued by the company, which are held in cash funds are either deposited or cashed under the outside auditor's control and observation. Post-dated bank checks in with the cash are verified in the same manner as notes receivable. Petty cash vouchers and cash items are examined for the purpose of determining their validity. Verification of cash on hand is made, preferably, at the balance sheet date and also at some unannounced time, in order to inject the element of surprise into the examination.

For the purpose of expediting the disbursement of petty cash amounts in a business, a fund is usually created under the control of a reliable employee. Such a fund, under the "imprest system," is maintained at a fixed amount and reimbursed from time to time. This plan facilitates the verification of the fund. Custodians of cash funds are responsible therefor and are usually covered by fidelity bonds.

Receipts of cash from customers and other general sources are generally deposited intact daily in the bank. Quite frequently they are recorded in the cash book as of the day of deposit. Any cash received, under this plan, subsequent to the time that the day's deposit is made up is treated as belonging to the next day's business. This practice facilitates checking recorded receipts to the deposits reported on bank statements.

Cash registers are extensively employed for the purpose of obtaining a record of cash receipts. Clerks who open mail are sometimes assigned the duty of making a "check list" of remittances. Internal control is secured by having a third person compare the mail clerk's check lists of receipts with the cashier's records thereof.

Efforts are usually made to avoid mixing office funds with undeposited receipts of cash or employing undeposited receipts for making payments. Delay in depositing cash in the bank is generally regarded with disfavor as it affords the cashier an opportunity for manipulating the funds in his custody.

Program of Audit. A general program of audit for the verification of cash on hand serves as a guide so that no essential phases of the examination will be overlooked; modifications may be made to meet the needs of local conditions. A general program for the audit of cash on hand is presented herewith.

PROGRAM OF AUDIT

1. Make a simultaneous examination of all cash, notes receivable, and securities.
2. Examine all undeposited cash receipts on hand at the time of the cash count. (See Form 21, Undeposited Receipts Schedule.)
3. Check the items of undeposited receipts to the company's records thereof.
4. Have undeposited receipts deposited without leaving the independent accountant's control.
5. Arrange to examine any deposits held, at the time of the cash count, in the night depository box of a bank.
6. Examine all change and cash funds. (See Form 23, Imprest Cash Fund Schedule.)
7. Cashed bank checks, contained in the cash funds, should be either cashed at bank, or deposited, under the independent accountant's control.
8. Indicate whether vouchers covering advances of cash, or expenses to be reimbursed, are properly approved.
9. Verify whether company bank checks, included in the cash funds, appear in the list of outstanding bank checks as of the date of the examination.
10. Examine any special funds in the custody of the cashier.
11. Examine any unclaimed wages which are being held. (See Form 24, Unclaimed Wages Schedule.)
12. Check all cash funds and unclaimed wages examined, to the company's records thereof.
13. Cash on hand questionnaire.
 - a. Are cash receipts recorded by someone, other than the cashier, before entry in the cash book?
 - b. Are cash receipts deposited intact?
 - c. Is a regularly constituted "imprest petty cash fund" used for making all petty cash payments?
 - d. Are cashed checks deposited?
 - e. Are employees who have contact with cash covered by a fidelity bond?

Undeposited Receipts. Simultaneous examination of all cash, notes receivable, and securities is regarded as essential in order to prevent substitutions. These items should not leave the independent accountant's control until their inspection has been completed. All undeposited receipts on hand at the time of the cash count ought to be examined and listed.

It is necessary that items of undeposited receipts be checked to the company's records thereof. If the receipts have not been entered

in the cash book, at the time of the count, they may nevertheless have been recorded elsewhere. Undeposited receipts on hand in the office of a finance company specializing in making small loans can generally be checked to entries on the loan cards of the respective borrowers. Cash receipts on hand from tenants of a housing project can usually be checked to duplicate copies of paid rent receipts. Collections turned in by driver-salesmen can ordinarily be compared with their daily route reports. Contributions received by a charitable agency can generally be checked to duplicates of receipts issued to the respective contributors. Undeposited receipts ought to be checked to the cash book, before completion of the audit, in order to ascertain whether they were properly entered therein. Inquiry should be made into the reason for any undue delay in recording cash receipts.

All undeposited receipts should be deposited in the bank without leaving the independent accountant's control. Otherwise substitutions may be made by a dishonest cashier, without detection, in order to cover up a cash shortage. An extra copy of the bank deposit ticket ought to be stamped by the bank and retained by the auditor. Items on the bank deposit ticket should be checked to the cash book in order to ascertain whether any changes were made in the composition of the deposit.

The authenticity of any postdated checks on hand should be verified by inspection of the payees' correspondence files or by communicating with the makers or endorsers. Any company checks on hand, among the undeposited receipts, ought to be checked to the list of outstanding bank checks, if such a list is available, as at the date of the cash count.

Consideration should be given, if bank vouchers are not to be examined at a later date, to the desirability of requesting the bank to notify the independent accountant if any of the checks deposited under his control were subsequently returned because of their uncollectibility.

A record of the undeposited receipts on hand in the office of a housing project is illustrated in Form 21. The composition of the receipts is shown at the left-hand side of the form, while on the opposite side are listed the copies of paid rent receipts examined. The program followed by the independent accountant is indicated in the lower portion of the schedule. The record presented is merely suggestive, inasmuch as undeposited receipts have to be set forth in a manner that meets the requirements of the particular situation.

Cash Funds on Hand. Usually the items which make up imprest or other cash funds are examined in the following order: currency, cashed bank checks, I.O.U.'s, expense vouchers, and miscellaneous items.

THE BLANK COMPANY
YEAR ENDED DECEMBER 31, (YEAR)

PREPARED BY *J. White*
REVIEWED BY *J. White*

UNDEPOSITED RECEIPTS SCHEDULE December 31 (Year)

Bills:		Duplicate tenants' receipts in cash	
	Amount	Drawer covering undeposited receipts	Amount
10's	100.00	Address	Tenant
5's	50.00		
1's	4.00	154.00	Apr 16, 42 High St., B. Ames ♂ 75.00 *
Coins:			Apr 14, 135 Elm St., N. Bailey ♂ 50.00 *
Half dollars	1.00		Apr 1 A, 27 Pine St., Mr. Conant ♂ 80.00 *
Checks:			Apr 31, 4 Oak Ave., L. Lane ♂ 110.00 *
B. Ames, Apr 16, 42 High St.	75.00		Apr 1, 42 High St., J. Earl ♂ 60.00 *
Mr. Conant, Apr 1 A, 27 Pine St.	80.00		Apr 13, 61 Oak St., P. Fair ♂ 45.00 *
L. Lane, Apr 31, 4 Oak Ave.	110.00	265.00	Total
		420.00	420.00 *

↓ Checked to duplicate deposit ticket, stamped by bank (date) herewith.

* Checked to cash receipts book

♣ Checked to tenants' rent register

James White

December 31, (Year)

FORM 21

Company reimbursement bank checks, when contained in the funds examined, should if possible be checked to the list of outstanding bank checks as of the date of the cash count.

Frequently the practice is followed of furnishing various persons among the company's personnel with a portion of the general imprest cash fund. The company's telephone operator may be given money for use in making "postage-due" payments to postmen; the receiving clerk may be supplied with cash for paying express charges; the store-keeper may be furnished with a fund for use in making sundry cash purchases, and so on. The company's cashier includes the receipts on hand from custodians of subfunds with the general imprest cash fund vouchers. Independent accountants must exercise judgment as to which subfunds should be examined. It is desirable, if subfunds are not examined, to obtain receipts from the custodians thereof as at the verification date.

It often happens that independent accountants find cashed bank checks held in an imprest cash fund at the time of the count. The proper procedure is to deposit these checks in the company's bank, under the auditor's control, in order to establish their collectibility. The bank should be requested to notify the auditor if the checks are returned marked "insufficient funds." A situation is illustrated in Form 22, where the auditor reached the conclusion that a cash shortage had been concealed by means of "no-good" checks which were held in the imprest cash fund.

It is a desirable practice to review, with an executive, any I.O.U.'s and vouchers for advances to employees and others. The record of the inspection of expense vouchers should indicate whether they were properly approved. If a portion of the petty cash fund is on deposit in a bank, such a bank account ought to be reconciled in the usual manner, and the final balance appearing on the bank statement should be verified by correspondence with the depository.

Any special funds in the custody of the cashier, such as a Christmas party fund, require examination. Unless they are verified a shortage in the regular fund, concealed by means of a transfer from a special fund, might go undetected.

The Imprest Cash Fund Schedule, Form 23, illustrates the manner of recording the count of a cash fund. In the lower portion of the form is shown the audit program followed by the independent accountant. It will be noted that the cash count indicates the existence of a shortage to which the custodian agreed. It is unnecessary, inasmuch as the examination of cash is made in the presence of the cashier,

DETECTION OF "N.G." CASHED CHECKS - ILLUSTRATED

THE BLANK COMPANY IMPREST CASH FUND COUNT DECEMBER 31 (YEAR) 5 PM	
COINS	72.500
BILLS	1775.00
CASHED CHECKS:	
12/31 (Year) A. Midas	5000.00
12/31 (Year) B. Croesus	2500.00
TOTAL	10,000.00
<i>James White</i>	
<i>December 31 (Year)</i>	

Conclusion:
An apparent cash shortage of \$7,500.00 was concealed by two "N.G." checks which were held in the imprest cash fund. James White January 12 (Year)

First National Bank
 1,200 BROAD STREET
 NEW YORK

JANUARY 10 (YEAR)

Messrs White & White
 75 West 42nd Street
 New York

Dear Sirs:

The checks of A. Midas for \$5,000.00 and of B. Croesus for \$2,500.00 which were deposited on January 2 (Year) have both been returned, marked "Insufficient Funds"

Very truly yours,
John Fox
 Vice-president

FORM 22

THE BLANK COMPANY
YEAR ENDED DECEMBER 31 (YEAR)

PREP BY J.W.H. 1/28
REV'D BY B.B.M. 1/29

IMPREST CASH FUND SCHEDULE

Time of count 5 P. M. December 31, 1940

Custodian, Frank Grey

Currency:

Bills 2,016.00

Coins:

Rolls 121.00

Loose 171.00 2,308.00

Cashed checks:

(Date) B. Brown, First National Bank No. 770 * 50.00

(Date) C. Green, Dr. No. 711 * 60.00

(Date) P. Hale, Second National Bank, No. 65 * 25.00 135.00

Advances:

(Date) D. Black, I.O.O., employe ϕ 20.00

(Date) H. Grey, I.O.O., employe ϕ 100.00 120.00

Expense vouchers:

(Date) Postage, not approved ϕ 50.00

(Date) Supper, money - do do ϕ 10.00

(Date) Entertainment do do ϕ 100.00

(Date) Carfare do do ϕ 10.00 170.00

Company reimbursement check

(Date) First National Bank No. 722 $\$$ 265.00

Total 2,998.00

Shortage - see adjustment ϕ 2.00

Total ϕ 3,000.00

Count of \$2,998.00 agreed to

Frank Grey, custodian

\checkmark Checked to bank reconciliation statement

* Cashed at bank under control

ϕ Reviewed with C. Coanul, treasurer

\oplus Checked to general ledger

James White

December 31, (Year)

THE BLANK COMPANY
YEAR ENDED DECEMBER 31 (YEAR)

PREP BY *J. White*
REV'D BY *G. White*

UNCLAIMED WAGES SCHEDULE

WEEK ENDED	EMPLOYEE NUMBER	NAME	OCCUPATION	AMOUNT
<i>(year)</i>				
<i>Dec. 28</i>	<i>6</i>	<i>E. Amos</i>	<i>Carpenter *</i>	<i>45</i>
<i>Dr.</i>	<i>11</i>	<i>E. Brown</i>	<i>Dr. *</i>	<i>45</i>
<i>Dr.</i>	<i>40</i>	<i>D. Cory</i>	<i>Dr. *</i>	<i>45</i>
<i>Dr.</i>	<i>45</i>	<i>F. Dean</i>	<i>Electrician *</i>	<i>47</i>
<i>Dr.</i>	<i>48</i>	<i>B. Earl</i>	<i>Dr. *</i>	<i>47</i>
<i>Dr.</i>	<i>71</i>	<i>A. Fair</i>	<i>Dr. *</i>	<i>47</i>
<i>Dr.</i>	<i>74</i>	<i>J. Grey</i>	<i>Machinist *</i>	<i>40</i>
<i>Dr.</i>	<i>80</i>	<i>J. Hoyt</i>	<i>Dr. *</i>	<i>40</i>
<i>Dr.</i>	<i>92</i>	<i>G. Kane</i>	<i>Dr. *</i>	<i>40</i>
<i>Dr.</i>	<i>96</i>	<i>H. Lamb</i>	<i>Plumber *</i>	<i>45</i>
<i>Dr.</i>	<i>97</i>	<i>K. Marks</i>	<i>Dr. *</i>	<i>45</i>
<i>Dr.</i>	<i>112</i>	<i>M. Morris</i>	<i>Dr. *</i>	<i>45</i>
<i>Dr.</i>	<i>125</i>	<i>L. Otto</i>	<i>Steamfitter *</i>	<i>48</i>
		<i>Total</i>		<i>579</i>
<p><i>↓ Checked to Armoured Car Service Company's list of unclaimed wages</i></p> <p><i>* Checked to payroll</i></p> <p><i>George White</i> <i>December 31 (year)</i></p>				

to secure his signature to the count when it is in agreement with the controlling Imprest Cash Fund or other account.

The Unclaimed Wages Schedule, Form 24, shows the manner in which any unclaimed wages on hand at the time of the cash count are recorded. Workers on a building construction project may not have been present, owing to the inclemency of the weather, on the last pay day. Items of unclaimed wages should be checked, to such supporting records as are available, in a manner such as that illustrated in the accompanying form.

The usual practice, when wages are distributed by an armored car service company, is for the company to make a list of the unclaimed wages and turn the envelopes back, together with the list, to a responsible officer or executive. Receipts are obtained from employees to whom the unclaimed wages are subsequently delivered. The independent accountant should find that the unclaimed wages on hand agree with the recorded undelivered wage envelopes for which receipts from employees have not been obtained.

A notation ought to be made in the working papers to the effect that there were no special funds, or unclaimed wages on hand, if such was found to be true at the time of the cash count.

The procedure for the examination of the cash on hand has to be modified if the verification is not made until after the balance sheet date. It is important to establish the fact that no irregularities exist at the date of the cash count. An inspection should be made of the cash book for the purpose of ascertaining whether any changes took place in the established amounts of the funds between the balance sheet date and the time of the audit; funds may have been augmented, or reduced, by bank transfers.

Holding the cash book open after the balance sheet date is a practice which should not be countenanced by the independent accountant. The last receipts that are properly taken into the accounts, at the end of the period covered by the audit, are those on hand at the close of business on the balance sheet date.

A fraud-conscious auditor should be alert to the implications involved when a cashier appears unduly concerned about the examination of the cash on hand. Surprise cash counts ought to be conducted whenever conditions indicate the desirability of making them.

Balance Sheet Treatment. Even though the cash on hand includes some noncash items, if they are relatively minor, such as postage stamps, transportation tickets, and so on, it is oftentimes inadvisable to upset the company's accounts by making a reclassification of the cash on hand at the balance sheet date.

REVIEW QUESTIONS

1. Why does active work on an auditing engagement generally commence with a verification of cash?
2. What purpose is served by counting undeposited cash receipts on hand?
3. What steps ought to be taken when cashed bank checks, issued by the company under audit, are included among the undeposited receipts?
4. Is the checking of undeposited receipts to the cash book regarded as a necessary procedure?
5. What is the object in having undeposited receipts, on hand at the time of the cash count, deposited under the independent accountant's control?
6. What action should be taken when the imprest cash fund contains a company reimbursement check?
7. Describe the program which should be followed when the imprest cash fund contains cashed bank checks issued by the company under audit.
8. Indicate the procedure that should be followed when the imprest cash fund consists of both cash on hand and cash on deposit in a bank.
9. Outline the procedure in the verification of I.O.U.'s, and vouchers covering advances to employees, contained in the imprest cash fund at the time of the count.
10. What purpose is served by examining unclaimed wages or special funds on hand at the time the imprest cash fund and undeposited receipts are verified?

CHAPTER 6

CASH ON DEPOSIT

Bank accounts are confirmed and reconciled as at the balance sheet date. Checks are scrutinized as to their regularity in every respect. Second bank reconciliation statements are prepared, primarily, in order to ascertain whether the practice of kiting is being indulged in. Checks which had not cleared by the time the second reconciliation statements were prepared are investigated. Deposits in transit as at the balance sheet date are confirmed. Proper recording, in the cash book, of all charges and credits on the current bank statement is verified. Special deposits are confirmed. Any adjustment entries in Cash in Bank ledger accounts are investigated. The audit of a company's bank cash is extended to cover transactions during the month following the date of the balance sheet in order to bring to light entries made to conceal existing irregularities.

Business enterprises generally make a practice of clearing cash transactions through banks. This procedure furnishes an independent check on a company's cash records. The making of payments to creditors by means of bank checks is regarded as a desirable procedure. Returned bank checks furnish evidence of payments having been made to the respective payees.

The banks selected as depositories for corporate funds are usually designated in the minutes of the company's board of directors. Similarly, officers, or other persons, empowered to withdraw company funds from banks are generally authorized in the minutes to do so. The requirement by a company that bank checks must bear two authorized signatures is looked upon as a safeguard because in order to conceal an irregularity in bank disbursements at least two persons must be in collusion. Checks on a partnership's bank accounts are signed with the firm name by one of the general partners. Inquiry should be made by the independent accountant, if any of the company's bank accounts are carried in the names of employees, whether the funds will become available to the company upon the resignation or death of the respective employees.

Program of Audit. Procedures for the verification of cash on deposit need to be pretty comprehensive. The following program is presented for guidance and reference.

PROGRAM OF AUDIT

1. Secure at first hand the bank statements and accompanying vouchers for the last month of the period covered by the audit.

2. Verify additions of bank statements, if there is any suspicion of irregularities therein.

3. Compare bank vouchers, if there is any indication of irregularities, with entries on the accompanying bank statements.

4. Check returned bank checks and bank debit and credit "memos" to the cash book. Checks dated prior to the current month may be checked to the previous month's bank reconciliation statement.

5. Examine endorsements on returned bank checks.

6. Investigate any bank checks outstanding over two months.

7. Check amounts of deposits, as recorded in cash book, for last few days of audit period to bank statement. Test check bank deposit tickets to cash receipts book.

8. Check amounts of deposits, as shown by cash book for first few days of subsequent period, to bank statement on which reported. If a bank statement is not available for the purpose, check the deposits to the bank pass book in which they are entered.

9. Prepare an adding-machine tape of the deposits, consisting of the several items of cash received, as entered in the cash book, of the last two business days of the period covered by the audit for use later in checking verified deposit tickets, of the last two days, when they are received from the bank.

10. Verify the sequence of check numbers, as shown by cash book, for the last month of the audit period and the first month subsequent thereto.

11. Examine check books to ascertain whether any checks with higher numbers than those of the checks last entered therein have been removed.

12. Investigate any entries, other than those from the medium of cash books, in the general ledger Cash account.

13. Prepare a bank reconciliation statement, in the usual manner, for each bank account, commencing with the balance shown by the bank to be on deposit at the balance sheet date.

14. If a second bank reconciliation statement subsequent to the balance sheet date is not to be prepared, as is usually true in interim audits, investigate the outstanding checks.

15. Examine, as to regularity, the company's bank reconciliation statement made at the close of the month immediately preceding the month for which the bank reconciliation statement is independently made.

16. Compare the opening bank balance on the current bank statement with the closing bank balance on the preceding one.

17. Prepare a second bank reconciliation statement, subsequent to the first one which was made at the balance sheet date, whenever a certified balance sheet is to be rendered.

18. Inspect bank certificates of deposit on hand, and check them to the company's records thereof.

19. Mail confirmation requests for verification of bank balances and liabilities to the company's depositaries. Furnish duplicate deposit tickets, for the last two business days of period covered by the audit, to banks for verification. (See Form 27, Bank Confirmation.)

20. Check, to the company's records and audit working papers, all information furnished by banks. Investigate any discrepancies between items on verified deposit tickets and the respective recorded receipts.

21. Confirm any special cash deposits with brokers, agents, or others.

22. Ascertain whether there are any restrictions on the withdrawal of funds on deposit.

23. Cash on deposit questionnaire.

a. Are all disbursements, other than those from petty cash, made by means of bank checks?

b. Are bank checks printed on safety paper and prenumbered?

c. Is a check protector machine used for writing amounts on bank checks?

d. Are two signatures required on bank checks?

e. Are payrolls prepared by some other person than the one who distributes the pay to employees?

f. Are employees paid by bank checks?

g. Are bank accounts reconciled by some person other than the cashier?

If the cash is not examined until subsequent to the balance sheet date, it is necessary to count the cash on hand, reconcile the bank accounts, and verify transactions intervening between the balance sheet date and the examination date. A statement, accounting for changes in cash accounts between balance sheet and examination dates, should be prepared, and confirmations of bank balances as at both dates ought to be obtained.

The practice is sometimes followed by business enterprises of keeping the only record of cash on deposit in the company's check book. Under this procedure, the check book cash balance is incorporated directly in the general ledger trial balance. Care should be exercised, whenever the company's check books are relied upon for information regarding bank balances, to include the examination of the check book balances in the audit program.

Examination by the independent accountant of entries in the general ledger Cash account, from sources other than the cash book, is looked upon as a necessary procedure. Journal entries restoring amounts of old outstanding checks on which payment has been stopped are not infrequent.

Bank Reconciliations. Bank vouchers and statements for the last month of the fiscal year should be obtained unopened, preferably directly from the bank, in order to insure that they have not been tampered with. Irregularities have sometimes been concealed by the expedient of removing fraudulent vouchers and substituting old canceled bank checks with altered dates for them. The proper procedure, if there is any suspicion of the existence of irregularities in bank vouchers or statements, is to scrutinize returned vouchers with particular care, check the vouchers to the bank statements, and also

verify the additions on the bank statements. All of a company's bank accounts should be verified simultaneously, as a precautionary measure in the detection of shortages.

Redeposit of a customer's check will result in the transaction being recorded a second time on the bank statement, although generally entered but once in the cash book. Investigation should be made of any offsetting amounts that appear on the bank statement but not in the cash book, unless such items merely represent the correction of errors made by the bank (frequently marked "EC" on bank statements, meaning error corrected). An explanation by the cashier that offsetting amounts on a bank statement represent exchange transactions ought not to be accepted unless vouchers, or other items which are satisfactory, are presented in support thereof. Embezzlements have been effected by the deposit of checks, received from customers whose accounts had been previously written off as uncollectible, and the subsequent withdrawal of corresponding amounts of money by a cashier who had the power to sign checks.

The independent accountant should observe, when examining canceled bank checks, whether the signatures appearing thereon correspond to those of persons who are authorized to sign checks. Any bank checks drawn to the order of creditors with whom the company would not ordinarily do business ought to arouse the auditor's suspicions. Checks, other than those drawn for payroll purposes, bearing double endorsements merit investigation. Dishonest cashiers have perpetrated embezzlements by the simple expedient of drawing checks to the order of regular creditors and then, after having them signed, arranging for a confederate to cash the checks. Any checks that were voided during the period covered by the audit ought to be inspected in order to verify that they are not outstanding.

Inquiries should be made by the independent accountant regarding efforts that have been put forth by the company in ascertaining whether payees received checks that had been outstanding more than two months at the balance sheet date. The investigation may reveal that some, or all, of the old outstanding checks have never been mailed. A method sometimes employed in order to embezzle funds is to refrain from canceling the entry for a voided check and then to withdraw funds corresponding to the amount of the voided check by means of a fraudulent one. "Stop payment" bank advices received during the period covered by the audit should be examined. Ordinarily they cover the stoppage of payment on old outstanding checks which were issued to payees who cannot be located.

Certification of a check by a bank does not pay an obligation unless the check is made available to the respective creditor. Inquiry ought to be made by the independent accountant as to whether unreturned certified checks, issued before the balance sheet date, are still in the company's possession. A good method for keeping track of unreturned certified checks is to make a memorandum, on bank reconciliation statements, of the outstanding certified bank checks.

Any deposits in transit to the bank (deposits entered in the cash book but not credited by the bank) at the balance sheet date can readily be ascertained by checking the deposits, made during the last few days of the period covered by the audit, from the cash book to the bank statement. If the bank statement for the succeeding month is not available, as is usually true in interim audits, the checking can be done to the company's bank book. Usually deposits appear in the bank pass book under the same dates as those on bank statements. Exceptions must be looked for; sometimes banks accept deposits after regular banking hours and report them on depositors' statements as of the following business day.

The practice is sometimes followed by various enterprises of keeping the cash book open, after the balance sheet date, in order to raise the cash balance. An illustration of the detection of an overstatement of cash in bank is presented in Form 25, where deposits made subsequent to the balance sheet date were included in the cash balance, whereas only those checks on hand for deposit at the close of business on the last day of the accounting period should be included in the cash. The adjustment journal entry required to correct the situation is presented.

Bank reconciliation statements, prepared by independent accountants, ordinarily commence with the balance reported by the bank to be on deposit as at the balance sheet date. The reason for this procedure is that banks maintain internal check systems and that the reported balances are nearly always correct. After entries have been made of reconciling items, principally outstanding bank checks and bank debit and credit "memos," the amount of the cash on deposit as shown by the company's records should be computed. Any necessary adjustment entries ought to be made by the independent accountant, as, for example, where bank debit or credit memos have not been entered by the cashier. Dates, or the period, of payment by the bank of outstanding checks ought to be indicated on the reconciliation. The outside auditor should recommend that payment be stopped on old outstanding checks, unless a satisfactory explanation can be obtained for not doing so, and the amounts thereof charged back to the Cash

DETECTION OF AN OVERSTATEMENT OF CASH IN BANK - ILLUSTRATED

THE BLANK COMPANY BANK RECONCILIATION STATEMENT DECEMBER 31, (YEAR)	
First National Bank.	15,100 00
Cash on deposit, per bank	
Plus deposits in transit - (deposits entered in cash book but not credited by bank until after Decem- ber 31 (1 year).	
Deposited Jan. 2 (subsequent year)	14,750 00
" " 3 " "	28,195 00
" " 4 " "	30,241 00
Total	88,286 00
Less outstanding checks: (Per list (details not shown here))	10,465 00
Balance per cash book	77,821 00

Conclusion - The cash book was kept open for three days after close of year. James White, January 15 (Year)

THE BLANK COMPANY AUDITOR'S EXAMINATION OF UNDEPOSITED BANK CHECKS ON HAND AT CLOSE OF BUSINESS ON DECEMBER 31 (YEAR)			
DATE OF CHECK (YEAR)	MAKER	PAYEE	AMOUNT
Dec 30	Ames & Son	Company	1,050 00
" 30	Gale, Inc.	"	2,000 00
" 31	Long & Co.	"	3,010 00
" 31	Martin Brown	"	175 00
" 31	Wright Stone	"	3,415 00
	TOTAL		9,650 00

THE BLANK COMPANY YEAR ENDED DECEMBER 31 (YEAR) ADJUSTMENT JOURNAL ENTRY	
Accounts Receivable	63,536.00
Cash in Bank	63,536.00
Deposits in transit 73,186.00	
Less checks on hand	
for deposit 12/31 (year) 9,650.00	
Remainder	63,536.00

Entry, to adjust accounts for remittances received subsequent to 12/31 Year and erroneously included in the cash in bank at 12/31 Year.

account; the credit is usually made to Miscellaneous Income account. Any special bank accounts, such as those carried for the purpose of paying bond interest and dividends, should be included in the bank reconciliations. The balance in a "special" bank account may represent unrepresented bond interest coupons.

Verification of cash on deposit includes an inspection of the cash book for the period covered by the audit, in order to ascertain whether all checks have been accounted for. Voided bank checks ought to be examined, in order to determine that they were not outstanding. Examination of the check book should be made, to ascertain whether all used checks have been properly recorded. Unless this procedure is followed, one or more checks may have been removed and used without entries having been made therefor. The practice, if encountered, of changing the number on a prenumbered bank check and using it in place of one that has been voided should be censured.

It is regarded as correct auditing procedure to investigate outstanding checks when a second bank reconciliation statement is not to be prepared. The examination of outstanding checks should be sufficiently comprehensive to determine whether expenditures covered by the respective checks were regular in every respect. An inspection of creditors' invoices, or other supporting documents such as tax returns, which were settled by the outstanding checks generally meets the needs of the situation. Inquiry as to whether payments were made to regular creditors of the company, for relatively minor amounts, is all the investigation that is generally required.

Second Bank Reconciliation. Ordinarily the making of a second bank reconciliation statement is depended upon, in order to detect whether there were any unentered outstanding checks at the balance sheet date. Cash shortages have sometimes been concealed by drawing a check for exchange of funds between banks, say on the balance sheet date, and recording the deposit made that day but not the withdrawal. Payment of the exchange check will not be made by the bank upon which it is drawn until after the close of the current accounting period. The effect of this procedure is to augment the total of the reported bank balances as of the balance sheet date. Existence of outstanding bank checks, the entry of which was delayed until after the balance sheet date, will be discovered when they turn up at the time a second bank reconciliation statement is prepared. Some insurance companies' fidelity bonds that are issued to stock brokers specify that the insured is to instruct the independent accountants to make a second bank reconciliation. Whenever a balance sheet is to be certified to, the making of a second bank reconciliation is regarded as a necessary

DETECTION OF EXISTENCE OF "KITING" OF BANK CHECK- ILLUSTRATED

THE BLANK COMPANY
YEAR ENDED DECEMBER 31 (YEAR)
RETURNED BANK CHECKS COMPARED WITH PRIOR OUTSTANDINGS

LIST OF OUTSTANDING FIRST NATIONAL BANK CHECKS AS AT JUNE 30 (YEAR)		CANCELLED FIRST NATIONAL BANK CHECKS, BEARING DATES PRIOR TO JULY 1 (YEAR), INCLUDED WITH THE JULY (YEAR) BANK VOUCHERS		REMARKS
DATE OF CHECK (Year)	CHECK NUMBER	DATE OF CHECK (Year)	CHECK NUMBER	
	AMOUNT		AMOUNT	
May 2	117.50	June 15	1,112.00	<i>Conclusion :</i> Check No. 7599, for \$100,000.00, was drawn on the First National Bank under date of June 30 (year) and deposited in the Second National Bank in order to cover up a shortage in the latter bank account. The check was not entered in the June (year) cash disbursements and consequently it did not appear among the list of First National Bank checks outstanding at June 30 (year). James Whit August 10 (year)
June 15	1,112.00	June 30	6,750.00	
June 30	6,750.00	" "	40,100.00	
" "	40,100.00	" "	27,200.00	
" "	27,200.00	" "	50,000.00	
" "	50,000.00	" "	100,000.00	
	Total 125,279.50		Total 225,162.00	
⊗ Deposited in Second National Bank on June 30 (year)				

procedure. If any bank checks are discovered, among the following month's vouchers, that bear dates prior to the close of the period covered by the audit and that were not listed as outstanding as at the balance sheet date, the situation should be investigated. It may be that the process of "kiting" bank checks in order to cover up a cash shortage has been indulged in, as illustrated in Form 26. The investigation made by the independent accountant led him to the conclusion, as reported, that a check for \$100,000 had been kited.

Bank Confirmations. The generally accepted auditing procedure is to send a Bank Confirmation request, such as the one illustrated in Form 27, to each of the company's depositaries, in order to obtain a confirmation of the cash on deposit, direct and contingent bank liabilities, and any collateral held by the bank, as at the balance sheet date. Direct bank liabilities consist, for the most part, of notes payable to the bank. Time loans may have been discounted with the bank or secured demand loans may be interest-bearing obligations. Confirmation of the collateral held by a bank as security for a loan is just as important as the amount of the loan. Banks in which deposits were made during the current year, although no funds were on deposit at the balance sheet date, should be included in the circularization, inasmuch as the company might be indebted to them. Even though bank statements are obtained first hand, it is nevertheless the practice to provide in audit programs for confirming all bank accounts.

The practice should be followed, when circularizing a savings bank, of giving the depositor's account number for the bank's convenience in locating the particular account. Information should be requested, when writing to closed banks, regarding the amount of the company's cash on deposit that is available for withdrawal.

Duplicate copies of bank deposit tickets for the last two business days of the audit period should be furnished the bank for verification. It is necessary, in the event that duplicate copies of the last two days' bank deposit tickets cannot be secured, to request the bank to furnish copies for certain specified days. If the bank reconciliation statement happens to show any deposits entered in cash book, but not credited by bank, these deposits in transit should be confirmed. This is a necessary procedure although the "in-transit" items have been checked to the respective bank pass book.

Unused balances of commercial letters of credit represent a contingent liability, the amount of which should be reported upon by the company's depositaries. It may be that, at the balance sheet date, drafts have been drawn against letters of credit by the company's

BANK CONFIRMATION

The First National Bank.
1,200 Broad Street
New York, N. Y.

December 31 (Year).

DEAR SIRs :

IN CONNECTION WITH AN EXAMINATION OF OUR ACCOUNTS NOW BEING MADE BY MESSRS WHITE & WHITE, CERTIFIED PUBLIC ACCOUNTANTS, WILL YOU PLEASE COMPLETE THIS CERTIFICATE AND MAIL IN ENCLOSED ENVELOPE.

The Blank Company.
James Blank, Pres.

MESSRS WHITE & WHITE,
 75 WEST 42ND STREET
 NEW YORK, N. Y.

DEAR SIRs :

WE HEREBY REPORT THAT AT THE CLOSE OF BUSINESS ON *December 31 (Year)* OUR RECORDS SHOWED THE FOLLOWING BALANCES TO THE CREDIT OF *The Blank Company*

AMOUNT	NAME OF ACCOUNT	REMARKS

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 *December 31, (Year)*

AMOUNT	DATE OF LOAN, ETC.	DUE DATE	INTEREST RATE PAID TO	DESCRIPTION

CONTINGENT LIABILITIES AS ENDORSER OF NOTES DISCOUNTED AND /OR AS GUARANTOR, ETC., AT THE CLOSE OF BUSINESS ON *December 31, (Year)*

AMOUNT	MAKER	DATE OF NOTE	DUE DATE	REMARKS

YOURS TRULY

DATE

traveling salesmen and that advices covering the transactions have not been received by the bank.

Upon receipt of replies from banks to requests for confirmation of deposits, and other items of information, the data contained therein ought to be checked to the audit working papers. It is regarded as essential that items listed on the verified bank deposit tickets of the last two, or more, business days of the period covered by the audit be checked to the cash book in order to ascertain whether the composition of the deposit tickets corresponds with that of the recorded receipts. Any discrepancies require investigation. They may be due to the lumping together of two or more deposit items in the cash book where the remittances were received from one customer. Sometimes each day's cash sales are recorded in detail in the cash book but are combined on the bank deposit tickets. An explanation of the reason a customer pays one bill with two checks can oftentimes be obtained from an examination of the correspondence files. Perhaps the first check received from the customer was returned by the company because the customer took an excessive amount of discount. Later the customer may have sent back his original check, together with another remittance for the discount, in payment of his indebtedness.

When checking verified bank deposits for the last two or more business days of the audit period, consideration must be given to the nature of the company's records. The deposit tickets, for a company which employs driver-salesmen, can generally be checked against the routemen's daily reports. The widespread practice of depositing cash receipts intact facilitates the checking of bank deposits to the cash records.

The independent accountant who checks bank confirmations should indicate thereon that he has done so. Usually the bank confirmation letters, after being checked, are attached to the respective bank reconciliation statements to which they are related.

A dishonest employee sometimes pads the company's bank account by the deposit of a "no-good" check on the last day of the accounting period in order to cover up a cash shortage. Detection of the existence of such a situation is illustrated in Form 28. The independent accountant concluded that an apparent cash shortage was concealed by the deposit of an uncollectible bank check. The company's depository reported that the check had been returned by the drawee marked "insufficient funds."

Concealment of Cash Shortage. By charging the Sales Discount with an unjustified amount at the time of entering cash received from a customer, the debit to the Cash account can be made correspondingly

DETECTION OF INFLATION OF BANK BALANCE BY DEPOSIT OF "NG" CHECK--ILLUSTRATED

DEPOSITED WITH	
October 31 (Year)	
First National Bank	
1200 BROAD STREET	
NEW YORK	
By Cole & Son, New York	
COINS	37550
BILLS	42,500 00
CHECKS :	
	1,110 00
⊗	12,000 00
	3,705 25
	61,300 00
TOTAL	120,990 75

⊗ Conclusion - Dr. apparent cash shortage of \$12,000.00 was concealed by the deposit of an "NG" check for that amount. The Company's Cashier, B. Black, was the maker. James White, November 18, (year).

First National Bank

1200 BROAD STREET
NEW YORK

NOVEMBER 15 (YEAR)

Messrs White & White
75 West 42nd Street
New York

Dear Sirs:
The check of B. Black for \$12,000.00 which was deposited by Cole & Son on October 31 (Year) has been returned by drancee marked "Insufficient funds." All other checks in the October 31 (Year) deposit have been collected.

Very truly yours,
Henry Pole
Comptroller

FORM 28

lower. The cashier, therefore, can retain for his personal use an amount of cash equal to the excess charge to the Sales Discount account.

It is necessary, if there is any indication of the practice of overstating the discounts allowed customers, to extend the scope of the investigation.

Independent accountants often make a test check of bank deposit tickets against entries in the cash receipts book for the purpose of ascertaining whether entries on deposit tickets correspond with those in the cash receipts record. The primary reason for this procedure is to detect whether cash shortages have been concealed by overstating the discounts allowed. This situation is illustrated in Forms 29-1, 29-2, and 29-3, where the independent accountant concluded that an apparent cash shortage of \$32.09 had been concealed by overstating the discounts allowed. It should be observed, in this connection, that amounts listed on bank deposit tickets are assumed to agree with items deposited.

Balance Sheet Treatment. Only cash subject to withdrawal may be properly shown as "cash on deposit" in the current assets section on a balance sheet. Demand certificates of deposit may be included with the cash on deposit. However, time certificates of deposit should be presented as a separate item on a balance sheet. Cash in banks, when subject to any sort of restrictions, ought to be shown as a non-current asset. Companies having branches in other countries are quite likely to have funds on deposit in foreign banks where exchange restrictions are in effect. Tenants' rental deposits should be kept in a special account when the laws of the local jurisdiction require that such deposits be banked separately. Mention is sometimes made, in a footnote on the balance sheet, of rates of exchange employed in converting bank balances on deposit in foreign countries. This is a desirable practice where there is both a free, and an official, rate of exchange prevailing.

An inquiry will usually reveal that, when checks drawn in excess of the bank balance cause an apparent overdraft, the checks had not been mailed inasmuch as it is unusual for domestic banks to permit overdrafts. Since obligations to creditors cannot be regarded as having been paid by the mere act of drawing bank checks, it is the proper procedure to reverse the entries for checks which had been drawn, but not mailed, at the balance sheet date. When an overdraft is covered by cash on deposit in other banks, it is permissible to show on a balance sheet the net amount of cash on deposit.

DETECTION OF OVERSTATEMENT OF DISCOUNTS ALLOWED CUSTOMERS-ILLUSTRATED

THE BLANK COMPANY											
PAGE 40											
CASH RECEIPTS BOOK											
MONTH <i>May</i> (Year)											
DATE	CUSTOMER	ACCOUNTS RECEIVABLE		DISCOUNTS ALLOWED	CASH SALES	GENERAL LEDGER		NET CASH			
		FOL	AMOUNT			ACCOUNT	FOL AMOUNT				
1	<i>Abbott & Co.</i>	2	375 00					375 00			
1	<i>Burns & Son</i>	4	1250 50	25 00				1225 50			
1	<i>Coconut Bros</i>	1	37 25	75				36 50			
1	<i>Degan & Witt</i>	5	1675 10	50 00				1625 10			
1	<i>Emily, Inc</i>	7	750 50	20 10				730 40			
1	<i>Frank & Fine</i>	4	3500 25	80 50				3419 75			
1	<i>Holmes Bros</i>	13	410 00	82 00				401 80			
1	<i>Cash sales</i>				175 50			175 50			
1	<i>First National Bank</i>						<i>Notes Payable</i> 66	5000 00			
	<i>Total</i>		7998 60	184 55	175 50		5000 00	12989 55			
			<u>2</u>	<u>18</u>	<u>30</u>		<u>12</u>	<u>1</u>			

Renewals of loans receivable immediately after the balance sheet date, which were paid off just before that date, should be investigated. It may be found that a substantial loan receivable from an officer was

DETECTION OF OVERSTATEMENT OF DISCOUNTS ALLOWED CUSTOMERS-ILLUSTRATED

DEPOSITED WITH <i>First National Bank</i> 1200 BROAD STREET NEW YORK DATE <i>May 1 (Year)</i> BY <i>The Blank Company</i>		
COINS		
BILLS		
CHECKS - List		
checks separately		
	375	00
	1,225	50
	36	50
	1,641	60
	735	49
	3,430	25
	401	80
	143	41
TOTAL	7,989	55

FORM 29-PART 2

recorded as having been paid on December 31, thereby removing the item from the balance sheet. However, if the loan was renewed on January 2 one could hardly consider the transaction as bona fide in all respects. The correct procedure here would be to show the loan as a receivable at the balance sheet date.

DETECTION OF OVERSTATEMENT OF DISCOUNTS ALLOWED CUSTOMERS-ILLUSTRATED

THE BLANK COMPANY
YEAR ENDED DECEMBER 31 (YEAR)
TEST CHECK OF BANK DEPOSIT TICKETS TO CASH RECEIPTS BOOK

PREPARED BY J. Blank, Jr.
 REVIEWED BY G. Blank, Sr.

PER CASH RECEIPTS BOOK		PER BANK DEPOSIT TICKET OF MWI (YEAR)	COMPARISON BETWEEN CASH BOOK AND BANK DEPOSIT TICKET		REMARKS
DATE OF RECEIPT	CUSTOMER		NET CASH		
May 1 (Open)	Albott & Co.	375 00			Conclusion - Inc. apparent cash shortage of \$32.09 was concealed by overstating the dis-
"	Burns & Son	1 225 50	1 225 50		
"	Coconut Bros	36 50	36 50		(16 50)
"	Degan & Witt	1 625 10	1 641 60	Under	
"	Emily, Inc.	730 40	735 49	Under	(5 09)
"	Frankel & Fine	3 419 75	3 430 25	Under	
"	Holmes Bros	401 80	401 80		(10 50)
"	Cash sales	175 50	143 41	Over	
	Total	7 989 55	7 989 55		James White February 15 (Open)

ANALYSIS OF CUSTOMERS' REMITTANCE STATEMENTS				
	Degan & Witt	Emily, Inc.	Frank & Fine	Total
Accounts Receivable	4,675 10	750 50	3,500 25	5,925 85
Discounts Allowed	33 50	15 01	70 00	118 51
Net Cash	1,641 60	735 49	3,430 25	5,807 34
Per Cash Book	1,625 10	730 40	3,419 75	5,775 25
Discrepancy	16 50	5 09	10 50	32 09

FORM 29-PART 3

Sundry Observations. A keen-minded auditor will naturally be on the alert for any indications of the existence of cash irregularities. Failure of the cashier to take an annual vacation should arouse the independent accountant's suspicions. Embezzlements have sometimes come to light when a new cashier took over the work of a former employee who had been able to conceal cash shortages as long as his employment continued. An offer of assistance by the company's cashier in making the audit is a situation that should not go unnoticed. Keeping the accounting books under lock and key, whenever not actually in use, is an unusual procedure on the part of the cashier, or other employee, to say the least. Experience shows that irregularities are more likely to occur in a company's cash than elsewhere, which is a condition of affairs that should be borne in mind by the independent accountant.

REVIEW QUESTIONS

1. Explain the reason for obtaining first hand the unopened envelopes which contain bank statements and canceled bank checks.
2. What procedure should be followed in the examination of bank "debit memos"?
3. What significance would you attribute to offsetting items which appear on a bank statement but not in the cash book?
4. Describe the method of verification where an entry of a deposit appears in the cash receipts book on the last day of the month but is not shown on the bank statement for that period.
5. What purpose is served by comparing details of bank deposit tickets for the last two business days in an accounting period with entries in the cash receipts book?
6. What is the object in examining entries in the general ledger Cash account?
7. What significance would you attribute to a situation in which an un-entered bank check for \$10,000 was drawn June 30 (year) on Bank A and deposited the same day in Bank B?
8. What purpose is served by making, subsequent to the balance sheet date, a second bank reconciliation statement?
9. Outline the procedure that ought to be followed, with respect to outstanding checks in a bank reconciliation statement, when a second reconciliation statement is not to be made.
10. Mention the items that should be contained in the request sent a bank for a confirmation of the balance on deposit, etc.
11. What significance would you attribute to the practice, if encountered, of keeping the cash book open several days after the balance sheet date?
12. Mention several situations that should arouse an auditor's suspicions regarding the possible existence of cash irregularities.

CHAPTER 7

INVESTMENT SECURITIES

Stocks, bonds, and mortgages in the company's possession at the balance sheet date are examined by independent accountants. Securities held outside are confirmed by correspondence with the custodians thereof. Marketable securities are valued at market quotation prices; other securities are valued on the basis of such information as is available. The information about mortgage investments is verified by correspondence with the respective mortgagors. Accrued interest receivable on interest-bearing investments is test-checked. Reserves are provided for the purpose of writing down the current investment securities to market quotation values.

Usually investment securities are recorded, when acquired, at cost. Often, for control purposes, the investments in stocks, bonds, and mortgages are entered at their face value in one account and the premium paid is entered in another one; for accounting purposes discount is frequently regarded as a negative premium. An arbitrary value per share, under this system of control, is assigned to no-par-value stocks. (A share of no-par-value stock which was purchased for \$12 might be recorded at an arbitrary value of \$10 and a premium of \$2.) The total face value of the securities in the portfolio of a company which employs this system should correspond to the balance of the respective ledger control. Investment trusts and financial companies, because of the magnitude of their portfolios, often maintain a separate controlling account for each class of securities owned in order to facilitate the localization of errors when an examination of the securities is made.

Financial institutions, such as mutual savings banks, generally expect to hold their interest-bearing investments until maturity, and so they quite frequently employ the "investment basis" of accounting, according to which premiums are amortized and discounts accumulated. Bond and mortgage investments, under this procedure, reach par on the books at the time of maturity.

Mortgage investments are frequently classified according to the property which is held as security, such as real estate, chattel, and collateral. Second real estate mortgages are generally held by the sellers of properties who accepted them in partial payment for the

parcels of property sold. The special feature of a mortgage is that the owner may acquire the property, pledged as security, by means of foreclosure proceedings if the debtor fails to meet his obligations under the terms of the indenture. Fire insurance policies, on mortgaged real estate, are generally held by the respective mortgagees as a means of safeguarding their interests.

Business houses and institutions frequently protect their investment securities by arranging with a trust company to keep them in a "custody" account. The custodian then attends to the collection of income and principal amounts when they are due.

Program of Audit. The following audit program is presented as a general guide to be followed in the verification of investment securities. Consideration must, of necessity, be given to any special conditions which are encountered and the audit program amended accordingly.

PROGRAM OF AUDIT

1. Secure a schedule of investment securities. (See: Form 30, Investment Securities—Stocks Schedule; Form 31, Investment Securities—Bonds Schedule; Form 32, Mortgages Receivable Schedule.)
2. Ascertain location of the company's investment securities.
3. Examine investment securities in the possession of the company.
4. Confirm, by correspondence, the investment securities which are not in the company's possession.
5. Ascertain the basis which is employed in carrying investment securities on the ledger.
6. Ascertain whether the full contract price of partly-paid-for investment securities has been recorded.
7. Ascertain whether stock dividends received during the period covered by the audit were properly recorded.
8. Ascertain whether subscription rights received during the audit period, whether exercised or sold, were charged for a portion of the original cost of the respective stocks.
9. Ascertain whether any investment securities are being held for others.
10. Confirm all significant facts regarding mortgages receivable.
11. Examine fire insurance policies on improved properties securing mortgages receivable.
12. Ascertain the quoted market value of marketable stocks and bonds. Inquire into the value of the remainder of the investment securities.
13. Refer to balance sheets of affiliated companies in order to ascertain the book values of the respective capital stocks.
14. Check transactions in the company's investment accounts, during the period covered by the audit, to the authorizations contained in the minutes of the board of directors.
15. Check transactions in the investment accounts, during the period covered by the audit, to advices on file from financial agents.
16. Verify the amount of the declared dividends receivable, if it is the company's practice to treat them as an asset, as of the balance sheet date.

17. Verify accrued interest receivable, on interest-bearing investment securities, as of the date of the balance sheet date.

18. Verify the gains and losses on sales of investment securities during the period covered by the audit. (See Chapter 19, "Sundry Revenues.")

19. Verify the income earned on investment securities during the period covered by the audit. (See Chapter 19, "Sundry Revenues.")

20. Investment securities questionnaire—large audit engagements:

a. Are investment securities adequately safeguarded?

b. Are monthly statements received from custodians of the company's investment securities?

c. Does the company maintain an effective system of internal control over its investment securities and the income from them?

Examination of Securities. The physical examination of a company's investment securities should cover all the stocks, bonds, and mortgages owned and on hand at the balance sheet date and should be made in the presence of one or more representatives of the company under audit. One member of a team of independent accountants generally inspects and calls the securities to the other member who checks them to the investment schedules which have been prepared by the client for the purpose. Care is required in the verification of the descriptions of the securities as well as the number of shares of stocks and face values of bonds and mortgages. It is not the proper auditing procedure, in lieu of inspecting securities, to accept a certificate from an officer of the company, stating that the stocks, bonds, and mortgages which belong to it are in his custody. The examination of a company's securities should ordinarily be made, either at the close of business on the balance sheet date, or at the time of commencing business on the next business day.

The Investment Securities, Stocks—Schedule, Form 30, is designed for showing changes which took place in the investment stocks accounts, during the period under audit, as well as the final balances at the balance sheet date. Provision is also made for indicating the location of the company's stock certificates. This work sheet can be extended to permit the gains and losses on sales of shares of stocks to be shown. The audit procedure followed by the independent accountant in the verification of the company's investment stocks is set forth in the lower portion of the schedule.

Descriptions of capital stocks should cover any preferences to which owners are entitled. Stock certificates ought to be either made out in the company's name, endorsed in blank, or accompanied by powers of attorney. It is preferable that stock certificates be made out in the company's name so that it will receive the dividends to which it is

PREPARED BY J. White, Esq.
REVIEWED BY J. White, Esq.

THE BLANK COMPANY
Year Ended December 31 (Year)
INVESTMENT SECURITIES, STOCKS - SCHEDULE

DESCRIPTION	DIVIDENDS		TAX STATUS	BEGINNING BALANCE		ADDITIONS		DEDUCTIONS		FINAL BALANCE		MARKET QUOTATION VALUE	DIVIDENDS RECEIVED FOR PERIOD	LOCATION OF STOCKS	EXAMINATION OR VERIFICATION
	RATE	DATES		SHARES	AMT	SHARES	AMT	SHARES	AMT	SHARES	AMT				
Corporation H. Co.	7	J. J.	(1)	100	10,000			100	10,000			11,000 [†]	700	Trust	✓
Corporation L. Co.	7	J. J.	(1)	400	50,000					400	50,000	48,000 [†]	2,800	D.	✓
Corporation P.	5	J. J.	Trust			500	43,000			500	43,000	42,500 [†]	1,250	D.	✓
Corporation Q.	4	A. O.	D.			1,000	69,000			1,000	69,000	70,000 [†]	2,000	D.	✓
Total				500	60,000	1,500	112,000	100	10,000	1,900	162,000	171,500	6,750		
				Information furnished by Company											
(1) 2% Tax paid															
↓ Security checked & confirmation from the Trust Trust Co. Trust															
⊙ Checked to find balance in preceding years working papers															
* Checked to brokers' advices															
† Checked to published quotations															
				James White, February 15, (Year)											

entitled when paid by the corporations which issued the respective certificates. Otherwise, it is necessary for the real owner to send due bills to the owners of record for the dividends paid. Then too, if a stock certificate is not in the company's name, difficulty may be experienced in having it transferred to the company because of the existence of some lien, such as one for an unpaid assessment.

The Investment Securities, Bonds—Schedule, Form 31, shows the procedure followed by the independent accountant in making an examination of bonds or confirming their whereabouts by correspondence with the holders thereof. A feature of this work sheet is the provision made for showing changes which took place, during the period covered by the audit, so as to facilitate checking transactions in the bond investment accounts to advices from brokers or financial agents. The schedule can be extended to permit the gains and losses on sales of bonds during the period covered by the audit to be shown.

Coupons, attached to bonds, should be examined in order to ascertain whether the ones next due are still intact. Any uncut past-due bond coupons usually indicate that the issuing companies have defaulted in making interest payments. Registered bonds ought to be either made out in the company's name, endorsed in blank, or accompanied by powers of attorney. Cognizance should be taken of any warrants that may be attached to bonds or any data stamped thereon. Consent of bondholders to the extension of the maturity date, or to a reduction of the interest rate, may be found stamped across the face of a bond. A notation ought to be made for future reference, on the bonds schedule, of any tax-free covenants appearing on the bonds examined.

It is advisable, if the company's investment securities are not too numerous, to record the serial numbers of stock certificates and bonds for reference in the event that it should be necessary at some future date to identify those previously examined. Verification of serial numbers of stock certificates and bonds, in the case of a business concern with incidental investments, a trust, or an estate, enables the auditor to detect the sale of a security after one audit and purchase of a similar one before the next examination. Meanwhile the dishonest trustee, or employee, could use the money for personal use and pay personally the amount of interest or dividends to the rightful owner. About the only means of detecting such illegal borrowing of funds is the checking of serial numbers. However, it is impracticable, in the audit of financial enterprises with large portfolios of investment securities, to record certificate and bond numbers.

PREPARED BY J. White
REVIEWED BY J. White

THE BLANK COMPANY
Year Ended December 31 (Year)
INVESTMENT SECURITIES, BONDS - SCHEDULE

DESCRIPTION	INTEREST RATE DATES	MATUREITY		BEGINNING BALANCE		ADDITIONS		DEDUCTIONS		FINAL BALANCE		MARKET QUOTATION VALUE	ACCRUED INTEREST END OF PERIOD	LOCATION OF BONDS	EXAMINATION OR VERIFICATION
		PAR	AMT	PAR	AMT	PAR	AMT	PAR	AMT	PAR	AMT				
Corporation X	5	1/1	Year	1,000	1,000					1,000	1,000	1,000	2.500 [†]	Vault	✓
Corporation X	5	1/1	Year	4,000	4,150 [⊙]			4,000	4,150	6,000	6,000	6,000	50.00 [†]	Vault	✓
Corporation Y	5	1/1	Year			6,000	6,100			3,000	2,900	3,000	62.50 [†]	Vault	✓
Corporation Z	5	1/1	Year	8,000	8,140 [⊙]	6,000	6,100	4,000	4,150	10,000	10,000	10,000	137.50		
Total															
← Information furnished by Company															
✓	Security examined														
⊙	James White, December 31 (Year)														
*	Checked to find balance in preceding year's ending papers														
†	Checked to broker's advice														
+	Checked to published quotation														
⊕	Checked Company's computation														
	James White, February 15 (Year)														

THE BLANK
Year-Ended Form
MORTGAGES RECEIVABLE

LOCATION OF PROPERTY	MORTGAGOR		INTEREST		AMORTIZATION		MATURITY
	NAME	ADDRESS	RATE	DATES	AMOUNT	DATES	
① #1000 Cedar St. ↓	B. Doyle ↓	Hotel Alton	5 ↓	J. J. ↓	1,000 ↓	J. J. ↓	Jan 1 Year ↓

COMPANY
for 31 (Year)
SCHEDULE

PREPARED BY J. White, Jr.
REVIEWED BY B. O'Neil, Jr.

BALANCE AT BEGINNING	CHARGES	CREDITS	BALANCE AT END	INTEREST ACCRUED		INTEREST RECEIVED				TOTAL	
				BEGINNING	END	FIRST	SECOND	THIRD	FOURTH		
* 90,000		2,000	88,000	* 2,250	2,200 †	2,250 †	2,225 †				4,475 †
* 100,000			100,000	* 2,500	2,500 †	2,500 †	2,500 †				5,000 †
* 200,000			200,000	* 5,000	5,000 †	2,500 †	2,500 †			5,000 †	10,000 †
* 370,000		2,000	368,000 †	* 9,750	9,700 †	7,250 †	7,225 †			5,000 †	19,475 †
	↓ Checked to mortgages				†	Checked to general ledger					
	⊗ Checked to cash book				⊙	Payment of taxes and insurance verified.					
	* Checked to final balance for (Year).				†	Appraisals examined					
	† Checked Company's calculations					James White, February 15, (Year)					

FORM 32

The Mortgages Receivable schedule, Form 32, provides for information regarding mortgage investments, including changes which took place in the respective accounts during the period covered by the audit. A feature of this schedule is the provision made, at the right-hand side, for recording interest received and accrued. The work sheet may be extended for the purpose of showing gains and losses on mortgages sold or liquidated by the mortgagors. Examination of real estate mortgages ought to be sufficiently comprehensive to indicate whether they were properly entered on the public records and whether the required transfer tax stamps were attached.

The company's records should show whether the real estate taxes on property securing mortgages receivable have been paid to date. Any tax arrearages diminish the mortgagee's equity in the mortgaged property. Then too, if the mortgagor fails to pay the property taxes, it may become necessary for the mortgagee to pay them in order to protect his own interests. It is within the scope of the independent accountant's duties to ascertain whether mortgagors made the amortization payments which are called for by the terms of the agreements.

Confirmation of Investment Securities. The normal procedure is to confirm, by correspondence, the investment securities which are in the custody of banks, trust companies, and others. Transfer agents who are holding stock certificates, at the time a company's securities are examined, should be furnished with the dates and numbers of their receipts for the certificates and requested to confirm that they had possession of the respective certificates at the balance sheet date. Even though the certificates were received subsequently, in the presence of the outside auditor, they should nevertheless be confirmed by the respective transfer agents as having been held by them at the time of the inspection, by the independent accountant, of the securities on hand. A dishonest cashier might, unless this procedure is followed, take a stock certificate, immediately after it had been examined by the independent accountant, to the transfer agent for transfer and later submit the new certificate as evidence of the existence of the one fraudulently shown by the records to have been "in transfer" when the securities on hand were originally inspected.

The statement received by a company from a stock brokerage firm, where an account is carried, for the last month of the audit period shows the position of the securities as well as the balance of the account. Nevertheless, it behoves the independent accountant to secure a confirmation of the client's balance and securities direct from the broker.

In addition to the inspection of a company's mortgages receivable all pertinent information regarding each mortgage is generally confirmed by correspondence with the mortgagors. Otherwise, unrecorded payments by mortgagors on account of principal may not be detected. Also, changes may have been made in the terms of the mortgages receivable that might not have been brought to the independent accountant's attention. Confirmation of junior mortgage participation certificates should be made by corresponding with the holders of the senior mortgages receivable.

Book Value of Investment Securities. Examination of advices, from stock brokers and financial agents, covering transactions recorded in the company's securities accounts during the audit period is necessary in order to ascertain whether entries were properly made in the books of account. Commissions paid brokers for purchasing securities are properly added to the cost thereof. On sales of securities, the commissions paid brokers, or others, are deducted from the proceeds. Transfer tax stamps are paid for by the seller and are treated as a deduction from the proceeds of sales. Ordinarily the minutes of the company's board of directors contain authorizations for the purchase and sale of investment securities; these authorizations ought to be checked to the transactions in the stock, bond, and mortgage accounts.

Care should be exercised to see that accrued interest receivable, purchased with interest-bearing investments, has not been included in the cost of the respective securities. The independent accountant ought also to ascertain whether accrued interest sold with investments has been treated as interest income and not as part of the proceeds of sales.

The cost of shares of stock, purchased through the exercise of stock rights, includes the allocated cost to them of a portion of the cost of the original shares on which the rights were received. Percentages employed, in the allocation of stock costs to the rights received, should be checked to a stock rights service publication.

Receipt by a company of a stock dividend, on the same class of stock as the dividend, has the effect of diluting the per share cost of the stock on which the dividend was received. Stock dividends received, during the period covered by the audit, ought to be checked to a dividends service publication, and the computation of the new per share costs should be verified.

The company's procedure for computing the cost of securities sold merits attention; the "specific-certificate-number," "average-cost," and

“first-in, first-out” methods are widely used. Whichever plan is adopted by the company ought to be followed consistently.

Market Quotation Values of Investment Securities. Market prices of the company’s stocks, bonds, and mortgages should be ascertained as at the balance sheet date. Reference ought to be made to published quotations for securities which are traded in on stock exchanges and “over-the-counter” markets. Special inquiries have to be made with respect to the market values of inactive investments. All the securities should be valued, from the best information available, at market quotation prices. Sometimes it is not possible to obtain information as to market prices of inactive securities; consideration must then be given to their valuation on the basis of the respective yields obtained thereon. Ordinarily real estate mortgages on which interest is not in arrears are regarded as being worth face value. Cognizance is sometimes taken of the value of dividends declared, on stocks owned by the company, at the balance sheet date but not received until afterwards. The prices of such stocks, at the balance sheet date, would be quoted “ex-dividend,” and so they are actually worth the quoted values plus the declared dividends.

Declared Dividends Receivable. Some companies, notably in the financial investment field, make a practice of recording dividends as soon as declared for the purpose of internal control. The recorded dividends declared, but not received, as of the date of the balance sheet should be checked to a dividends service publication. On preferred stocks, where there has been no change in the number of shares owned during the year, the amounts of the dividends declared but not received will generally be found to be the same at the end as at the beginning of the year. The Investment Securities, Stocks—Schedule, Form 30, can be extended so as to provide for showing the amounts of declared dividends receivable if these are treated as an asset on the balance sheet.

Accrued Interest Receivable. Information needed for the purpose of checking or making an original calculation of the accrued interest receivable, on bond investments, is contained in the Investment Securities, Bonds—Schedule, Form 31. Similarly, the data needed for verifying or computing the accrued interest receivable on mortgage investments will be found in the Mortgages Receivable schedule, Form 32. The accrued interest receivable, where there has been no change in the principal amount of an interest-bearing investment during a year, should ordinarily be the same at the end as at the beginning of the year. Tests, by the independent accountant, of the accuracy of se-

lected amounts of accrued interest receivable, as recorded by the company, may be all that is necessary for purposes of verification.

The practice is followed of amortizing premiums on interest-bearing securities purchased above par, and of accumulating discounts on those bought below par, by companies which employ the "investment basis" of accounting. Institutions having large interest-bearing investments often find this method of accounting necessary in order that their income may be accurately determined.

Balance Sheet Treatment. Marketable securities, for which quotations are readily obtainable, are usually shown at not more than their market quotation values in the current assets section of the balance sheet. Reductions from cost to market quotation value, when cost exceeds market quotation value, are generally accomplished by means of valuation reserves. This practice makes it unnecessary to disturb the costs of investment securities as recorded. The practice is quite frequently indulged in of mentioning parenthetically, on a balance sheet, the market quotation value of investment securities. Amortization payments which are receivable on mortgage investments within the year following the balance sheet date are properly classified as current.

A company's inactive securities are generally presented as a non-current asset at cost, less such valuation reserves as are applicable thereto. Investments in stocks of subsidiary corporations are often reduced, by means of valuation reserves, when the issuing company's book values of the shares of stocks owned in the respective companies indicate the necessity of doing so. An appropriate statement should be made, in a footnote to the balance sheet of a parent company, when the consolidated net worth exceeds the company's net worth; writing up the value of a company's investments is not deemed standard accounting practice. Investments in subsidiary corporations are, of course, eliminated when a consolidated balance sheet is prepared.

The practice is followed by some financial institutions, confining their investments largely to bonds and mortgages which are generally held until maturity, of stating the market quotation values in a supporting schedule. Interim market fluctuations of interest-bearing investments are not of much importance when the investments are expected to be held until maturity.

Partially paid-for securities, purchased on the deferred payment plan, should be shown at the full amounts of the purchase prices; unpaid balances of the subscription prices are a liability. Property taxes which are in arrears, on real estate pledged as security for mortgages receivable, may be mentioned in a footnote to the balance sheet.

REVIEW QUESTIONS

1. Why is it essential that securities be examined in the presence of a member of the personnel of the company under audit?
2. Should the certificate number on bonds and stocks be recorded when examining securities?
3. What examination should be made of the interest coupons which are attached to the bonds inspected?
4. What attitude would you take if the treasurer of the business under audit offered you a signed statement, in lieu of making the securities available for examination, certifying that the company's securities were in his custody at the balance sheet date?
5. Outline the procedure that should be followed with respect to the verification of certificates of stock reported to be held by transfer agents.
6. Explain the procedure that should be followed when verifying the genuineness of a real estate mortgage investment.
7. What is the purpose in examining the fire insurance policies on premises covered by a mortgage receivable?
8. How should market values of investment securities be ascertained?
9. What purpose is served in examining brokers' advices covering purchases and sales of securities during the period covered by the audit?
10. What significance would you attach to amortization payments on mortgage investments which are found to be in arrears?
11. Would you attach any significance to the real estate taxes being in arrears on real estate which is held as security for a mortgage receivable?

CHAPTER 8

NOTES RECEIVABLE

Notes receivable, together with any collateral held as security for them, are examined at the balance sheet date and also confirmed by correspondence with makers and endorsers. Collateral is valued and the credit standing of makers and endorsers of unsecured notes is investigated. Payments made by note debtors during the course of the audit are witnessed, and balances on pass books are checked against loan cards. Balances due from delinquent note borrowers are classified according to the periods of arrearages. Notes receivable are reviewed with the company's credit manager, and adequate reserves are provided for collection losses. Interest collections and accruals of interest on notes receivable are test-checked.

Time notes and demand notes receivable are generally recorded in a register which is maintained for the purpose. Maturity dates of time notes receivable and a description of collateral (such as stocks, bonds, warehouse receipts, and chattel mortgages) held as security for demand notes receivable are usually entered in the register. Where notes receivable are voluminous, as is true in many "small-loan" finance companies, they are usually recorded on cards which are arranged, unless the debtors are delinquent, according to the dates when the next installment payments become due. The notes receivable, any documents pertaining thereto, and reports of investigators, are generally filed in open-end envelopes either numerically according to the respective loan numbers, or alphabetically by borrowers' names. Some finance companies require that chattel mortgages held as security for notes receivable be notarized, and that each signature on notes, chattel mortgages, and wage assignments be witnessed by two persons. In order to make a wage assignment legal in the local jurisdiction, it frequently has to be signed by the spouse, if there is one, of the borrower. Notes receivable may or may not be interest bearing. Commercial banks generally hold borrowers' time notes receivable under discount. Trade acceptances receivable are noninterest-bearing evidences of indebtedness and are extensively employed in some lines of business.

Customers' notes which are held by mercantile enterprises, and which represent an extension of the time of payment of trade accounts

receivable, generally indicate a weakness in the ability of the makers of the notes to meet their financial obligations. An unusual increase in customers' notes receivable over those held at the preceding balance sheet date may, upon inquiry, be found to indicate an unfavorable financial condition. Bank credit men usually take the position that an unsecured note debtor ought to be free of all of his note obligations for a period of one or two months during the year in order that the loan receivable may be considered liquid.

Program of Audit. The program for the verification of notes receivable is summarized below for convenience in making reference thereto. Such modifications as are found to be necessary should be made in the program, in order to meet local conditions.

PROGRAM OF AUDIT

1. Secure a schedule of notes receivable. (See Form 33, Notes Receivable Schedule.)
2. Examine all notes receivable.
3. Confirm the existence of notes receivable held by collection agencies.
4. Ascertain by correspondence the notes receivable discounted.
5. Inspect collateral held as security for notes receivable.
6. Ascertain value of collateral inspected.
7. Examine wage assignments.
8. Witness the receipt of payments made by note debtors during the course of the audit.
9. Confirm by correspondence a selected list of note debtors.
10. Summarize results of circularization of note debtors. (See Form 34, Notes Receivable Circularization Statistics.)
11. Ascertain the company's experience with respect to the collection of notes receivable.
12. Review the notes receivable, as to their probable collectibility, with the company's credit manager.
13. Treat notes receivable which are not expected to be collected within a year as a noncurrent asset.
14. Ascertain whether the reserve for uncollectible notes receivable is adequate.
15. Verify the accrued interest receivable on interest-bearing notes receivable.
16. Notes receivable questionnaire—large audit engagements.
 - a. Are notes receivable adequately safeguarded?
 - b. Is the notes receivable register properly kept?
 - c. What are the principal sources of the notes receivable?

Examination of Notes Receivable. The Notes Receivable Schedule, Form 33, is intended for use when verifying a company's notes and acceptances receivable. The proper auditing procedure is to make a simultaneous examination of a company's notes receivable, investment securities, and cash, in order to prevent manipulations that might be indulged in for the purpose of concealing irregularities. A dishonest

THE BLANK COMPANY
 Year ended December 31 (year)
 NOTES RECEIVABLE SCHEDULE

PREPARED BY *John J. J.*
 REVIEWED BY *B. B. J. Jr.*

MAKER	ENDORSER	INTEREST RATE	DISCOUNT RATE	DATE OF NOTE	DUE DATE	AMOUNT OF NOTE	SECURITY		DOCUMENTS EXAMINED	DIRECT CONFIRMATION
							DESCRIPTION	VALUE		
<i>The Blue Company</i>	<i>None</i>	<i>6 *</i>		<i>6/15 (Spec) 1/15 (Spec)</i>	<i>1/15 (Spec)</i>	<i>5,000 *</i>	<i>None</i>		<i>Note</i>	<i>⊙</i>
<i>D.</i>	<i>D.</i>	<i>6 *</i>		<i>7/15 D *</i>	<i>7/15 D *</i>	<i>5,000 *</i>	<i>D.</i>		<i>Note</i>	<i>⊙</i>
<i>D.</i>	<i>D.</i>	<i>6 *</i>		<i>8/15 D *</i>	<i>7/15 D *</i>	<i>5,000 *</i>	<i>D.</i>		<i>Note</i>	<i>⊙</i>
<i>Brown & Co *</i>	<i>A. B. Brown *</i>	<i>6 *</i>		<i>7/15 D 1/1 D *</i>	<i>1/1 D *</i>	<i>10,000 *</i>	<i>200 shares common</i>		<i>Note</i>	<i>⊙</i>
<i>Cole & Co. †</i>	<i>None</i>	<i>6 †</i>		<i>10/1 D †</i>	<i>1/1 D †</i>	<i>4,000 †</i>	<i>None</i>		<i>Receipt for note</i>	<i>†</i>
	<i>Total</i>					<i>29,000</i>	<i>⊙</i>			
	<i>Information furnished by company</i>									
<i>✓</i>	<i>Checked to Company's notes receivable register</i>									
<i>⊙</i>	<i>Checked to general ledger controlling Notes Receivable account</i>									
<i>*</i>	<i>Checked to notes receivable examined</i>									
<i>†</i>	<i>Checked to confirmation</i>									
<i>‡</i>	<i>Reprint quotation value for New York Times</i>									
<i>⊙</i>	<i>Documents examined and found properly notarial, witnessed and signed</i>									
									<i>James White, February 15 (Spec)</i>	

employee might, unless this practice is followed by the independent accountant, submit certain marketable stocks or bonds, which are included in the company's investment securities, for examination and later resubmit them as collateral held for secured loans receivable. The inspection of a company's notes receivable, together with the securities held as collateral therefor, is sometimes made by a team of independent accountants, one member of which inspects the documents while the other checks the notes receivable schedule that has been prepared for the purpose. Care must be exercised in verifying descriptions of collateral, a great variety of which is sometimes encountered. If the descriptions are not correct, difficulty may be experienced in looking up the market prices of the various pieces of collateral.

Stock certificates and registered bonds held as collateral for notes receivable should be found endorsed or accompanied with powers of attorney. Life insurance policies ought to be inspected to see whether they are regular in every respect and accompanied with properly executed assignments.

Signatures of makers, comakers, and witnesses on borrowers' notes receivable ought to be scrutinized as to their apparent authenticity and freedom from alterations. Any irregularities in signatures, or omissions thereof, on borrowers' notes or loan documents, such as chattel mortgages and wage assignments, should be reported in his findings by the independent accountant. If a loan company's procedure requires that chattel mortgages be notarized, any exceptions to this procedure ought to be included in the auditor's report.

When an independent accountant commences work on the audit in a small loan company's office he should examine documents covering several recent loans, in order to ascertain whether the notes receivable, chattel mortgages, wage assignments, borrowers' applications, and investigators' reports are in order. It may be found that some of the loan documents bear the signature of only one witness whereas two may be required by the company. Such a situation indicates that the practice of having two persons witness the borrowers' signatures is not always observed. Quite likely the name of a second witness will be found to have been added, before completion of the audit, to some of the documents which were originally examined.

A selected list of notes receivable, acquired during the period covered by the audit, should be checked to the cash disbursements record. This procedure is followed in order to establish the authenticity of the original loans.

Examination of Note Debtors' Accounts. Examination of selected borrowers' loan cards, in a loan company's office, ought to include test

checking the allocation of payments by debtors between principal and interest. Apportionment to principal of an excessive amount of a borrower's remittance, if encountered, is an irregularity that should be reported upon by the independent accountant.

Collection data which are usually found entered on the reverse side of borrowers' loan cards, examined during the course of the audit of a loan company, should be scrutinized, and any apparent irregularities should be investigated. Indication of failure, for example, to contact a municipal employee from whom a remittance had not been received during the past six months would merit investigation. Acceptance of lesser payments from borrowers than those agreed upon ought to be inquired into. Perhaps a delinquent debtor had been induced to make a one-dollar payment in order to prevent the classification, in the reports made by the local branch to the loan company's home office, of his account as "slow."

Checking Payments Made by Borrowers. The practice should be followed, during the course of the audit of loan companies, of witnessing payments made by debtors. Balances shown in borrowers' pass books, in which collections are receipted for, ought to be compared with those appearing on the loan receivable cards of the respective note debtors. This procedure serves as a confirmation of the loans, on which payments were made during the course of the audit, and does away with the necessity of circularizing the respective borrowers in order to confirm their balances. Notes receivable from debtors who pay off the balances of their loans, during the audit, should be inspected to see whether the documents are in order in all respects before being delivered by the company to the respective payers.

Valuation of Collateral. The adequacy of collateral held for secured notes receivable should be determined. Prices of marketable stocks and bonds can be ascertained from the published quotations of securities sales. Cash surrender values of life insurance policies, held as security for loans receivable, should be ascertained by communicating with the companies which issued the respective policies. Often the assistance of the company's credit manager must be obtained in locating quotations for inactive securities and other collateral.

It is unnecessary to value securities, held as collateral for a loan, in excess of the minimum amount required by the regulations of the company under audit. Frequently the market quotation value of collateral is required by financial institutions to be at least equal to 125% of the principal amount of a secured loan. Insufficiently secured notes ought to be reported upon by the auditor in his findings.

With respect to unsecured notes receivable, generally payable at a given date, the proper procedure is to inspect the company's credit files which are maintained for the respective borrowers. Frequently the financial position of each unsecured note debtor will be found analyzed, as of a fairly recent date, on a printed financial statement form; this practice facilitates the work of investigating unsecured loans.

Confirmation of Notes Receivable. Normal auditing procedure requires that note receivable debtors be circularized for the purpose of confirming pertinent information regarding the company's notes receivable. Confirmation requests should provide for the verification of the collateral held as security for notes receivable. There is the possibility, unless note debtors are circularized, that irregularities, if such exist, will not be discovered. Payments may have been made by borrowers and not applied, by a dishonest cashier, to their respective note receivable accounts. Often debtors make substantial payments on their note obligations without withdrawing a portion of their collateral. An independent accountant will be alert to the possibility of a shortage in the marketable stocks and bonds on hand when those pledged by borrowers are considerably in excess of the company's requirements for the protection of a secured loan.

Notes receivable are usually quite numerous in loan companies, and so the circularization is generally restricted to a selected list of borrowers. The selection is best made in such a manner that the borrowers circularized will include debtors to whom loans were made during each quarter of the year, under audit, and some to whom loans were previously made.

The names of any debtors whose notes, collateral, wage assignments, or accounts were not found to be regular in every respect ought to be included in the list of borrowers whose note accounts are to be confirmed by circularization.

Inquiry ought to be made as to whether there are any debtors to whom the company objects to having requests sent for the confirmation of their accounts. A sufficient investigation of confidential loans should be made to satisfy the independent accountant of their regularity and authenticity.

The Notes Receivable Circularization Statistics, Form 34, provides for a summary of the information relating to the confirmation of note debtors' accounts. The action taken with respect to any exceptions reported by debtors who were corresponded with should be indicated in the independent accountant's working papers. An alert auditor will be quick to grasp the significance attached to replies by debtors

THE BLANK COMPANY
 Year Ended December 31 (year)
NOTES RECEIVABLE CIRCULARIZATION STATISTICS

PREPARED BY J. White & Co.
REVIEWED BY B. Bond & Co.

CONFIRMATION No.	MAKER	ADDRESS	BALANCE	NOT CONFIRMED	CONFIRMED		REMARKS
					No EXCEPTION	WITH EXCEPTION	
1	M. Ames	40 Lane Ave.	5,000		5,000		
2	N. Barry	50 Lombard Ave.	1,000		1,000		
3	O. Carr	60 Main St.	2,500		2,500		
4	P. Damon	70 North St.	3,000			3,000	"Paid December 31 (year)"
5	Q. Eames	100 East St.	1,250	1,250			
6	R. Frost	150 Cort Rd.	600		600		
7	S. Grey	200 Poplar St.	4,500		4,500		
8	T. Hope	310 Bond Ave.	3,000		3,000		
	Total circularized		20,850	1,250	16,600	3,000	
			100%	6%	79%	15%	
	Total notes receivable		104,250				
	% Circularized to total		20%				
		↓ Payment received January 2 (year)					

who state that payments had been made before the financial statement date. Statistics in the lower portion of Form 34 show the percentage of the notes receivable accounts circularized and the results obtained. Frequently, unless requests are followed up by second letters and telephone calls, as few as 50% of the debtors circularized reply.

Loan companies generally make a practice of analyzing the notes receivable according to the period of time which has elapsed since the respective debtors made their last payments. A test of the accuracy of these notes receivable collection reports should be made and the "slow" accounts reviewed with the office manager.

The independent accountant ought to include a statement, in the working papers, of his opinion regarding the collectibility of the notes receivable and the adequacy of the reserve for uncollectible notes receivable.

Accrued Interest Receivable. Information needed for the purpose of checking, or making an original calculation of, the accrued interest receivable on interest-bearing notes receivable is contained in the Notes Receivable Schedule, Form 33. Tests by the independent accountant of the accuracy of selected amounts of accrued interest receivable, computed by the company as of the balance sheet date, may be all that is required for purposes of verification.

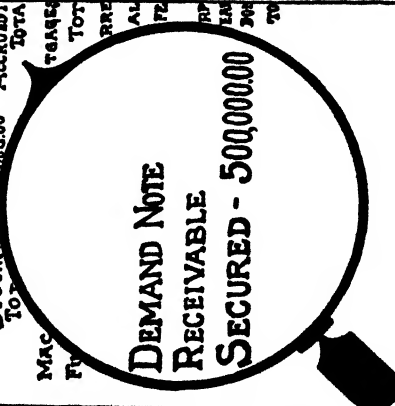
Balance Sheet Treatment. Notes receivable that mature within a year after the balance sheet date, or that are payable on demand, are usually classified as a current asset on the balance sheet. The review of the notes receivable with the company's credit manager may indicate that some of the notes that will become due within the next year and some of the demand notes should be classified as noncurrent. Although a note receivable is not past due, it may be a renewal of a previous note, in which case the probability of the note's being collected at its due date should be inquired into. Knowledge, on the part of the company's credit manager, of a note debtor's financial affairs may indicate that an extension of the time of payment of a time note receivable will probably be requested. Notes receivable from affiliated companies, officers, and employees should be stated separately on a balance sheet. Notes receivable from customers, because of the differences in the terms of payment as compared with trade invoices, ought to be presented as notes receivable on a balance sheet and not included in the accounts receivable.

Accounts are sometimes manipulated in order to improve the appearance of a company's balance sheet. This procedure is frequently spoken of as "window dressing" and is illustrated in Form 35. It will be noted that the collateral to the "Demand Note Receivable Secured—

FLAGRANT CASE OF "WINDOW DRESSING" - ILLUSTRATED

THE BLANK COMPANY BALANCE SHEET DECEMBER 31 (YEAR)		MILL WORK, INC. BALANCE SHEET DECEMBER 31 (YEAR)	
ASSETS CURRENT ASSETS \$ 150,000.00 INVESTMENTS: 225,000.00 BONDS 450,000.00 STOCKS TOTAL	LIABILITIES CURRENT LIABILITIES ACCOUNTS PAYABLE 100,000.00 NOTES PA ACCRUED TOTAL	ASSETS FACTORY PLANT, NET \$ 1,000,000.00 LESS MORTGAGE \$ 500,000.00 REMAINDER \$ 500,000.00 LIABILITIES DEMAND NOTE PAYABLE \$ 500,000.00 TO THE BLANK COMPANY \$ 500,000.00 CAPITAL STOCK: ISSUED \$ 1,000,000.00 LESS TREASURY STOCK (PLEASD AS SECURITY FOR NOTE PAYABLE TO THE BLANK COMPANY) 1,000,000.00 REMAINDER \$ 500,000.00 TOTAL	REMAINDER \$ 0 TOTAL \$ 500,000.00

Conclusion:
 The note receivable which is secured by the total out-standing capital stock of a company which has for an asset only a factory plant can hardly be regarded as "secured" in accordance with accounting conventions
 James White
 March 1 (Year)



\$500,000" consisted of the treasury stock of Mill Work, Inc. An examination of this corporation's balance sheet revealed that the only asset owned is a manufacturing plant which is pledged to secure a mortgage. If the \$500,000 note receivable is not paid, the holder can proceed to acquire the collateral which consists of all the capital stock of Mill Work, Inc. The independent accountant reached the conclusion that the note receivable could not be properly described as "secured." Furthermore, in view of the circumstances, the note receivable should not be classified as "current" on the balance sheet.

REVIEW QUESTIONS

1. Outline the procedure which should be followed in the examination of unsecured notes receivable on hand.
2. How should notes receivable, reported to be held by collection agents and others, be verified?
3. Mention the main points that ought to be borne in mind when examining chattel mortgages held as security for notes receivable.
4. What points should be observed when inspecting life insurance policies which are held as collateral for notes receivable?
5. Mention several matters which should be given consideration when examining wage assignments held as security for notes receivable.
6. Explain the method employed in the verification of balances due from note debtors who discharge their obligations in installments.
7. Is it regarded as a necessary procedure to confirm notes receivable by correspondence with the makers?
8. Is it deemed essential to confirm endorsements and guarantees of notes receivable?
9. Should an independent accountant accede to a client's request not to confirm customers' notes on the ground that the notes were inspected?
10. Of what significance is the maturity date of a time note receivable?

CHAPTER 9

ACCOUNTS RECEIVABLE

Trial balances of customers' accounts are checked to the accounts receivable subsidiary ledger and the accounts are verified by circularization in order to ascertain whether the practice of "lapping" is being indulged in. Accounts receivable are aged and overdue amounts reviewed with the company's credit manager. Credit files are examined in order to ascertain what action has been taken in collecting past-due accounts. The average collection period is compared with those of several preceding years and the trend is noted. Adequacy of the bad debts reserve is determined. Accounts receivable, other than trade accounts receivable, are excluded from the regular customers' accounts and shown under appropriate classifications on the balance sheet.

Extension of credit to customers necessitates the keeping of accounts receivable. These are usually maintained in a separate ledger which is operated as subsidiary to a controlling account. Statements of their accounts can be rendered to customers, and collections followed up, from the information which is contained in the accounts receivable ledger. The greater part of the cash receipts, in companies doing an extensive credit business, generally consists of remittances from charge customers. Cash sales, as a means of control, are quite frequently cleared through the customers' ledger.

The use of the term "accounts receivable" is generally restricted to the debts of trade customers. Claims against insurance companies, or railroads, cannot properly be classified as regular accounts receivable; neither should balances due from subscribers to a company's capital stock be so classified. Accounts with customers to whom goods have been sold on the deferred payment plan are generally referred to as installment contracts receivable in order to differentiate them from regular accounts receivable. Writing of the monthly accounts receivable trial balances in bound books is regarded as a safeguard, particularly in view of the widespread practice of using loose-leaf ledgers for keeping the customers' accounts.

Program of Audit. A comprehensive audit program should be followed in the verification of accounts receivable. It must be modified, after taking into consideration the company's system of internal control, general credit standing of customers, collection hazards of the

particular trade, and whether the customers' accounts are secured, guaranteed, insured, or pledged. A program for general guidance in the audit of accounts receivable follows.

PROGRAM OF AUDIT

1. Secure a copy of the accounts receivable (or installment contracts receivable) trial balance properly aged or analyzed. (See Form 36, Installment Contracts Receivable Schedule; Form 37, Secured Accounts Receivable Schedule.)
2. Check the accounts receivable trial balance and the agings of the accounts to the respective customers' accounts.
3. Verify the addition of the accounts receivable trial balance.
4. Compare total of accounts receivable trial balance with the related general ledger controlling account.
5. Confirm by circularization, after making a study of the situation, either all or a selected list of the accounts receivable.
6. Summarize the results obtained from the circularization of customers. (See Form 43, Accounts Receivable Circularization Statistics.)
7. Investigate exceptions reported by customers.
8. Review past-due accounts receivable with the company's credit manager.
9. Ascertain whether the sales book was promptly closed at the end of the accounting period.
10. Examine credit memos issued to customers for a period of several days after the balance sheet date.
11. Compare the average collection period for the current year with those of several years immediately preceding the current one.
12. Ascertain the value of collateral held as security for secured customers' accounts, and compute the customers' equities.
13. Confirm, by correspondence, the accounts receivable pledged with finance companies.
14. Analyze the accounts receivable control whenever it contains any accounts other than those due from trade debtors.
15. Inquire into the causes for the customers' credit balances.
16. Investigate the company's experience with respect to the collection of accounts receivable.
17. Ascertain whether the reserve for uncollectible accounts receivable is adequate.
18. Accounts receivable questionnaire—large audit engagements.
 - a. What are the usual terms of sale?
 - b. Does the company maintain a satisfactory credit and collection system?
 - c. Are drafts employed in making collections?
 - d. Are "deferred payment" accounts receivable kept according to the installment method of accounting?
 - e. Are assigned accounts receivable identified as such?
 - f. Have consignment accounts receivable been removed from the accounts receivable and any profits contained therein eliminated?
 - g. Is a record maintained over the collateral held as security for customers' accounts?
 - h. Are accounts receivable insured against losses from noncollectibility?
 - i. Is there an established procedure for writing off bad debts?

Accounts Receivable Trial Balance. Any lack of agreement between the total amount of the accounts receivable trial balance and the related general ledger controlling account should be viewed with suspicion by the independent accountant. Inquiry into the cause of a difference between the customers' ledger and the control has sometimes revealed that the accounts receivable have been subjected to manipulation. Not infrequently fraudulent transactions have been cleared through a "suspense" account in the subsidiary customers' ledger. Trial balance discrepancies are oftentimes carried in a "balancing" account with the expectation that related errors will be located in the normal course of business.

Aging Customers' Accounts. The purpose of aging accounts receivable is to ascertain amounts which have remained uncollected for an unduly long period of time. Consideration must, of necessity, be given to the company's credit terms. It is generally the practice to disregard accounts receivable which have been collected at the time the customers' accounts are aged. The most usual classification employed in aging accounts receivable is as follows: paid at time of examination; not due; 1 to 30 days past due; 31 to 60 days past due; and over 90 days past due. By following this procedure, past-due customers' accounts are brought to light.

An alternative method of preparing an agings schedule is to age all the accounts at the balance sheet date and then to show, in a separate column provided for the purpose, payments made by customers since the balance sheet date. When reliance is placed upon remittances reported to have been received subsequent to the balance sheet date, it is necessary to extend the verification of the cash transactions to include these subsequent collections.

Particular attention should be directed, when reviewing the agings of the accounts receivable, to old charges which remain unpaid although recent charges have been paid. The old charges may be disputed by the respective customers. An inquiry should be made as to the probability of collecting amounts representing notes receivable which were not paid at maturity and which were charged back to the respective customers' accounts receivable. If customers' accounts of relative importance are found to be considerably in arrears, the credit department's correspondence files of the respective debtors should be examined in order to see what efforts have been made to collect the accounts.

Deferred payment accounts in companies which make sales on the easy-payment, or budget, plan are often quite numerous. In order that the independent accountant's conclusions may be sound, regarding the condition of the installment contracts receivable accounts, a representa-

tive number of selected accounts should be analyzed, in the manner illustrated in the Installment Contracts Receivable Schedule, Form 36, according to the monthly periods in which the most recent remittances were received. Credit managers do not appear to be especially disturbed, by arrearages in installment contracts receivable accounts, as long as customers with gaps in the sequence of their remittances have resumed making payments. An inquiry ought to be conducted, when examining installment contracts receivable accounts, into the company's policy with respect to foreclosures when the goods sold to delinquent debtors are covered by chattel mortgages. It is well within the scope of an independent accountant's duties to ascertain the basis employed in the valuation of repossessed articles.

The independent accountant is interested, with respect to secured accounts receivable, in the adequacy of the value of the collateral held. Customers' accounts, such as those in a stock broker's office, are generally classified in the manner shown in the Secured Accounts Receivable Schedule, Form 37. It will be noted that the fully secured accounts are analyzed on the basis of the relative values of the collateral in the respective customers' accounts. All the accounts of a customer, when calculating the adequacy of the collateral, are considered as one account. Excess collateral is usually regarded as being held in safekeeping for the respective customers in whose accounts the collateral appears, and it is not available for use by the broker in borrowing funds. The schedule of secured accounts, illustrated herewith, shows the audit program followed.

Circularization of Customers. Confirmation of trade debtors' accounts by circularization is regarded as normal auditing procedure. Ordinarily confirmation requests are sent to a selected list of customers. The accounts to be circularized are usually chosen in such a manner as to represent a cross section of the accounts receivable, particular regard being paid to the larger balances. Accounts picked for circularization ought to be scattered in such a manner that the process of selection will not be apparent to anyone in the organization of the company under audit.

Requests for confirmation of customers' accounts should be accompanied by statements of the respective accounts. It is necessary, if monthly statements are not prepared in the normal course of business, to arrange to have them made up for the customers who are selected for circularization.

The customary procedure is for an executive of the company to sign the confirmation requests that are sent to customers. It is preferable to

THE BLANK COMPANY
Year Ended December 31 (Year)
INSTALLMENT CONTRACTS RECEIVABLE SCHEDULE

PREPARED BY *J. H. Smith*
 REVIEWED BY *C. Brown*

ACCOUNT NUMBER	CUSTOMER	LEDGER BALANCE	PERIOD IN WHICH LAST PAYMENT WAS MADE				REMARKS
			1 TO 30 DAYS	31 TO 60 DAYS	61 TO 90 DAYS	OVER 90 DAYS	
10001	L. Atwell	4,000				4,000	
10002	K. Beck	3,500	3,500				
10003	J. Cade	4,000		4,000			
10004	H. Downs	2,500	2,500				
10005	G. Eaton	1,000			1,000		
10006	F. Fennis	500	500				
10007	E. Gale	1,500		1,500			
10008	D. Kent	2,000			2,000		
10009	C. Lavin	3,500	3,500				
10010	B. Jackson	1,500	1,500				
	<i>Total</i>	24,000	11,500	5,500	3,000	4,000	
		100%	48%	23%	12%	17%	

PREPARED BY *J. M. H. J. H.*
REVIEWED BY *C. J. H.*

THE BLANK COMPANY
(Year Ended December 31 (Year))
SECURED ACCOUNTS RECEIVABLE SCHEDULE

CUSTOMER	LEDGER BALANCE	FULLY SECURED		PARTLY SECURED	NOT SECURED	REMARKS
		OVER 125%	UNDER 125%			
<i>A. Alberts</i>	<i>60,000</i>	<i>60,000</i> ⊕				
<i>J. Clayton</i>	<i>12,000</i>		<i>12,000</i> ⊕			
<i>C. Brown</i>	<i>9,000</i>			<i>9,000</i> ⊕		<i>Guaranteed by D. Diamond</i>
<i>E. Dayton</i>	<i>85,000</i>		<i>85,000</i> ⊕			
<i>D. Elson</i>	<i>18,000</i>	<i>18,000</i> ⊕				
<i>E. Falls</i>	<i>70,000</i>	<i>70,000</i> ⊕				
<i>A. Gray</i>	<i>6,000</i>			<i>6,000</i> ⊕		<i>Guaranteed by F. Bacon</i>
<i>Total</i>	<i>260,000</i>	<i>148,000</i>	<i>97,000</i>	<i>15,000</i>		
<i>↓ Checked to confirmation</i>						
<i>⊕ Checked Company's computations</i>						
<i>James White, February 15 (Year)</i>						

FORM 37

do this before the requests are finally checked to the independent accountant's circularization schedule.

It is necessary to secure the client's consent to the circularization of the customers whether the positive method that provides for a direct answer or the indirect method which asks only for a reply if the customer has an exception to report is employed. Any objection that may be raised by the company to the confirmation of customers' accounts can usually be overcome by explaining the reason for the procedure.

Replies received from customers to requests for the confirmation of their accounts may contain so many exceptions that it is deemed necessary to extend the circularization to cover all trade debtors. There may be a provision in the company's fidelity bond to the effect that, at least once a year, the firm's independent accountants shall be instructed to circularize all customers and in the event that replies are not received from some of the customers to send them second requests by registered mail.

ILLUSTRATIVE ACCOUNTS RECEIVABLE CONFIRMATION REQUEST

THE ALPHA CORPORATION
60 WALL STREET
NEW YORK, N. Y.

January 10 (year)

The Akron Company
Akron, Ohio

DEAR SIRS:

In connection with an examination of our accounts which is being made by Messrs. Blank & Blank, 800 Broadway, New York, N. Y., Certified Public Accountants, will you please confirm to them that your indebtedness to us amounted to \$1,750.00 at December 31 (year).

A self-addressed envelope is enclosed for use in mailing your reply.

Very truly yours,
(Signed) GEORGE ALPHA, PRESIDENT
The Alpha Corporation

Above correct:

An illustrative confirmation request of the positive form is presented herewith. Changes in the letter can be made to meet the requirements of the particular engagement. The customary practice, when sending out confirmation requests, is to enclose self-addressed envelopes for use by customers in mailing their replies to the independent accountants.

Often the procedure is employed of attaching positive confirmation requests to the monthly statements of the accounts of the respective customers. Mention should not be made, on the customers' statements, of remittances that have been received subsequent to the statement date. To do so might deter customers from reporting that payments had been made, before the balance sheet date, and result in failure to detect the existence of irregularities on the part of a dishonest employee.

The request, reading as follows, for the negative confirmation of an account receivable is either printed on a sticker or directly on the customers' statements. The negative method of confirming accounts receivable is frequently employed on engagements where the charge customers are very numerous, as in large retail department stores.

IMPORTANT

Please compare this statement with your records and report any discrepancies to our auditors, Messrs. Blank & Blank, Certified Public Accountants, 800 Broadway, New York, N. Y.

It may be deemed desirable, in some auditing engagements, to circularize the more important accounts by means of positive requests and the remainder by the negative method.

Various subterfuges are sometimes brought to light through the circularization of customers as illustrated in Form 38. The debtor, here, disavowed the account in no uncertain language. An investigation by the independent accountant revealed that no shipment of goods had been made to the pseudo customer.

Debtors sometimes claim that goods covered by the statement accompanying the confirmation request were received on consignment, that merchandise was rejected as not being up to standard, that the goods were damaged in transit, and so on. In Form 39, an account receivable situation is revealed where the customer claimed a rebate due on purchases for an amount at least equal to the balance of the account as at the balance sheet date. The independent accountant's conclusion was that the respective account receivable should be reduced by the rebate to which the debtor is entitled.

Resourceful embezzlers resort to all sorts of tactics in order to conceal cash shortages. One method is to delay the posting of a customer's remittance until after an accounts receivable trial balance has been drawn off, thus raising the total by the amount of the omitted item. This situation is illustrated in Form 40, where the April 30 (year) remittance from Lane & Sons was not posted until May 1 (year). Hence the balance to this customer's account was stated in the April 30 (year)

DETECTION OF FICTITIOUS ACCOUNT RECEIVABLE - ILLUSTRATED

THE BLANK COMPANY
ACCOUNT RECEIVABLE

NAME *Silk, Inc.* ADDRESS *100 Broad Street, New York* TERMS *2% 10 E.O.M.*

DATE	CHARGE	DATE	CREDIT
RECD <i>Dec. 26</i>	<i>10,000 00</i>		<input checked="" type="checkbox"/>

Conclusion - The account which purports to show \$10,000.00 receivable from Silk, Inc., is fictitious. An investigation revealed that no shipments of goods had been made to Silk, Inc.

*James White
January 10 (Year)*

Silk, Inc.
100 BROAD STREET
NEW YORK

Messrs White & White
75 West 42 nd Street
New York
Dear Sirs

In answer to the request of The Blank Company for a confirmation of statement showing \$10,000.00 due it by us, we beg to advise that we have never had any dealings with that company.

Very truly yours,
Silk, Inc.

January 5 (Year)

A BAD ACCOUNT RECEIVABLE SITUATION - ILLUSTRATED

ACCOUNT *Henry Hall* THE BLANK COMPANY 1600 Broadway, New York

DATE (YEAR)		CHARGE	DATE (YEAR)		CREDIT
Dec. 1	Balance	89,500.00	Dec. 31	Balance	94,000.00
" 20	Sale # 14675	4,500.00			
"		94,000.00			
Jan. 1	Balance	94,000.00			94,000.00

HENRY HALL
NEW YORK

January 10 (Year)

Messrs White & White
New York

Dear Sirs:

In response to the request of The Blank Company for a confirmation of the \$94,000.00 balance shown on the December 31 (Year) statement which was sent us, we hereby disclaim any indebtedness, inasmuch as we have at least that much rebate due us on our (Year) purchases.

Very truly yours,

Henry Hall

FORM 39

*Conclusion:
The \$94,000.00 account receivable from Henry Hall should be reduced by the rebate to which the debtor is entitled.*

*James White
February 10 (Year)*

DETECTION OF OVERSTATEMENT OF ACCOUNTS RECEIVABLE-ILLUSTRATED

THE BLANK COMPANY										ACCOUNT L-2
CASH RECEIPTS BOOK										TERMS
MONTH April (Year)										Net
DAY OF MONTH	CUSTOMER	FOL	ACCOUNTS RECEIVABLE	DISCOUNTS ALLOWED	CASH SALES	GENERAL LEDGER		NET CASH		
						ACCOUNT	FOL	AMOUNT	CASH	
	BROUGHT FORWARD		165105 00	2250 00	650 00			10 000 00	173505 00	
30	Lane Bros.	N-7	5250 00	105 00					5145 00	
30	Lane & Sons	L-2	1100 00						1100 00	
30	Will Inc	N-6	3750 00	75 00					3675 00	
	TOTAL		775205 00	2430 00	650 00			10 000 00	183425 00	

NAME		ACCOUNTS RECEIVABLE LEDGER		ACCOUNTS RECEIVABLE TRIAL BALANCE April 30 (year)	
Lane & Sons, 100 Broadway New York City		ACCOUNT L-2		TERMS Net	
DATE	CHARGE	DATE	DEBIT	CREDIT	
YEAR 1931 Mar. 30	Invoice # 9321	11 00 00	1100 00	1100 00	
Apr 12	Invoice # 10405	16 00 00	1600 00		
	2700.00				
			BROUGHT FORWARD	210405 00	
			Lane & Sons	2700 00	
			Morse & Bros.	1600 00	
			Will Inc	755 00	
			TOTAL	215460 00	

⊗ Conclusion - An apparent cash shortage of \$1,100.00 was concealed by not listing the accounts receivable to corresponding amount.
James White
February 15 (year)

trial balance as \$2,700, instead of the correct amount which was \$1,600 (\$2,700 minus \$1,100). Detection of situations of this sort is one of the reasons that normal auditing procedure calls for the circularization of customers.

Clients sometimes request the independent accountants not to circularize certain customers whose accounts are regarded as confidential. This situation is often encountered in a stock brokerage firm where accounts of traders who do not wish their identities revealed to anyone but the partner who handles their accounts are designated by numbers or symbols. If arrangements cannot be made to obtain confirmations of confidential accounts, the independent accountant should take whatever steps he finds necessary to satisfy himself of the genuineness of such accounts.

Confirmation of the collateral held as security for customers' accounts, as in a stock brokerage firm, is just as important as the verification of the balances of the accounts. The monthly statements furnished to their clients by stock brokers show the customers' "long" and "short" securities in addition to showing ledger balances. Numerous embezzlements reported by stock brokers to bonding companies have been due to the theft of securities by dishonest employees. Misappropriation of a customer's excess collateral, unless there is in existence a system of effective control and frequent audits, may go undetected for some time.

It is the practice in some lines of business to request debtors whose accounts are insufficiently secured to obtain guarantees. Then, in the event that a debtor whose account is guaranteed fails to meet his obligations, recourse can be had to his guarantor. The guarantees examined may be forgeries. Verification of guaranteed accounts necessitates that the guarantors be circularized. By this means a fictitious guarantee can be detected. A situation is illustrated, in Form 41, where the guarantor disavowed any financial responsibility for the respective debtor's account. The conclusion reached by the independent accountant was that the guarantee was fraudulent. Embezzlers have sometimes attempted to conceal a shortage in the securities in an account by making it appear that the account was guaranteed by another account which contained adequate collateral for both accounts.

Circularization of customers can be extended advantageously to include the larger accounts that were written off, either during or after the period covered by the audit, as being uncollectible. It may be found that some of the accounts, originally charged off as bad debts, had been paid before or subsequent to the balance sheet date by the

DETECTION OF FICTITIOUS GUARANTEE - ILLUSTRATED

THE BLANK COMPANY	
NAME	<i>John Doe</i>
GUARANTOR	<i>Richard Roe</i>
(YEAR)	<i>Dec. 31</i>
	<i>Balance</i>
	<i>✓ 15,250.00</i>
	<i>1,200 Broadway, New York</i>
	<i>1 Wall Street, New York</i>

THE BLANK COMPANY
100 BROAD STREET
NEW YORK DECEMBER 31 (YEAR)

Mr Richard Roe
One Pine Street
New York
Dear Sir:

Will you please confirm to our auditors, Messrs White & White, 400 Broadway, New York, that at the close of business on December 31 (year) you were guaranteeing the account of John Doe, with a debit balance of \$ 15,250.00.

Very truly yours,
The Blank Company

RICHARD ROE
ONE WALL STREET
NEW YORK January 3 (Year)

Messrs White & White
75 West 42nd Street
New York
Dear Sirs:

In answer to The Blank Company's request for a confirmation of a guarantee by me of the account of John Doe, I beg to advise that I have not at any time guaranteed the account of John Doe.

Very truly yours,
Richard Roe

Conclusion - Richard Roe's guarantee of the account of John Doe, held by The Blank Company, appears to be fraudulent.

J. White

FORM 41

respective debtors and that the money received had been pocketed by a dishonest employee.

Offers of assistance, by a member of the company's personnel, to secure signatures to requests for the confirmation of customers' accounts should not be accepted by the independent accountant. Likewise the offer of confirmations of accounts receivable which have been obtained by the company's internal auditors ought to be refused. Confirmations returned by customers directly to the client, instead of to the independent accountant, are not acceptable unless the authenticity of the signatures thereon is verified.

It is necessary to include in the circularization customers for whom goods were being held for shipping instructions at the balance sheet date. Invoices covering goods "billed and held," merely in anticipation of receiving orders from customers, cannot be properly treated as accounts receivable. Efforts to improve the profit showing sometimes consist in billing goods to customers from whom valid purchase orders have not been received, in the manner set forth in Form 42. It will be noted that the debtor disavowed having ordered the goods which were covered by the statement accompanying the confirmation request. The conclusion reached by the independent accountant was that, without a formal order for the goods, the account receivable from Gale Stores was not valid.

Debtors do not always sign confirmation letters properly, in which case it is necessary to return the letters with a request by the independent accountant that they be correctly signed. For example, the signature on a confirmation (in the case of a stock brokerage firm), by a customer's agent, is not acceptable unless the authority of the signer to sign can be established. The company's records may show that the customer has given a power of attorney over his account to the person signing the confirmation.

The practice is quite prevalent in some trades, particularly those which are engaged in exporting goods, of drawing drafts on customers. Drafts for collection at the date of the balance sheet are usually in the custody of collection agencies, generally banks, and ought to be confirmed as having been in their possession at the balance sheet date.

The tabulation, presented in Form 43, of Accounts Receivable Circularization Statistics illustrates the procedure followed in summarizing the results obtained from the circularization of customers. A glance at the schedule shows the supervising partner whether the accounting firm's policy, with respect to the number of accounts and the total amount thereof circularized, has been adhered to.

IMPROPER CHARGE TO ACCOUNT RECEIVABLE - ILLUSTRATED

NAME <i>Gale Stores Lake City, Mich.</i>			
DATE		CHARGE	CREDIT
<i>Dec. 30</i>	<i>* 14774</i>	<i>6,500.00</i>	<input checked="" type="checkbox"/>

SOLD TO:
 Gale Stores
 Lake City
 Mich.
 (Year)
 Dec. 31 Mtdse # 14774 \$ 6,500.00

THE BLANK COMPANY
 100 BROAD STREET
 NEW YORK December 31 (Year)

TERMS 60 days Net

GALE STORES
 LAKE CITY, MICH.
 Messrs White & White
 1200 Broadway
 New York
 Dear Sirs:
 Relative to the request of The Blank Com-
 pany for a confirmation of accompanying state-
 ment, please be advised that we have not yet
 issued a formal order for merchandise covered
 and may not do so for some time.
 Very truly yours,
Geo. Gale President

Conclusion:
 The "billing and holding" of merchandise
 for a customer without a formal order
 does not give rise to a valid account
 receivable.
James White
 March 1 (Year)

PREPARED BY *M. L. G.*
 REVIEWED BY *B. G. G.*
 SHEET 2 OF 2

THE BLANK COMPANY
 Year Ended December 31 (1920)

ACCOUNTS RECEIVABLE CIRCULARIZATION STATISTICS

CONFIRMATION No.	CUSTOMER	ADDRESS	BALANCE	NOT CONFIRMED	CONFIRMED		REMARKS
					NO EXCEPTION	WITH EXCEPTION	
1005	Brown Bros.	66 Cham St.	6,000			6,000	"Cash on 12/31 Year"
1006	Gray & Co. Inc.	50 West Ave.	1,500			1,500	"Goods returned 12/31 Year"
	Total sheet 2		7,500			7,500	
	Total sheet 1		552,500	56,000	420,000	76,500	
	Total		560,000	56,000	420,000	84,000	
			Statistics				
				Amount		Number of Accounts	
	Total accounts receivable			700,000			
	Confirmations requested:						
	Confirmations received:						
	No exceptions			420,000	75%	3,240	90%
	With exceptions			84,000	15%	216	6%
	No replies received			56,000	10%	144	4%
	Total confirmations requested			560,000	100%	3,600	100%
	Percentage of confirmations requested to total			80%			

FORM 43

Investigation ought to be made of letters returned to the independent accountants, undelivered by the post office, because addressees could not be located. For any requests that may have been sent debtors whose accounts had been written off as bad debts, the return of the letters marked "not at address given" is to be expected. However, with respect to other letters which are returned by the post office the company should be requested to furnish better addresses, and the requests for confirmation of accounts ought to be mailed again.

Exceptions reported by customers should be investigated, and any necessary adjustments should be made to the accounts. Many of the customers' exceptions pertain to remittances received by the company subsequent to the balance sheet date that the respective customers claimed to have mailed before that date. Likewise credits for returned goods, not entered by the company until subsequent to the balance sheet date, are often claimed by customers to have been due before that time. These "in-transit" items which are reported by customers require looking into.

Many debtors are prone to ignore requests to confirm their accounts. It is often deemed necessary, in view of this situation, to follow up unanswered letters. Numerous customers who failed to respond to the first communication will pay attention to those which are marked, "second request." Telephone calls can often be made with good results in securing action, in the confirmation of accounts, on the part of debtors.

Lapping. The term "lapping," as employed by accountants, refers to the use of a remittance from one customer to cover up a shortage in the account of another customer. Let it be assumed that the embezzlement of a company's funds by a dishonest bookkeeper causes a shortage in customer A's account. (This shortage must be covered up in order to prevent the company's credit manager, or someone else, from dunning customer A for the amount when it becomes past due.) The dishonest bookkeeper temporarily conceals the irregularity by crediting A's account with a remittance subsequently received from customer B, and so on ad infinitum. By this lapping procedure the shortage is transferred to a customer's account which is not yet due. A scrutiny of the customers' accounts will not reveal the existence of the subterfuge. Detection of the existence of lapping by means of replies received from customers is illustrated in Form 44. Here, the independent accountant came to the conclusion that remittances subsequently received from other customers had been applied to the credit of the account of John Stone & Co. Consideration must be given, when such a condition

DETECTION OF LAPPING THROUGH CIRCULARIZATION OF CUSTOMERS—ILLUSTRATED

BLAIR & SONS
 ACCOUNTS RECEIVABLE LEDGER
 100 Water St., New York

NAME *John Stone & Co*

DATE	CHARGE	DATE	CREDIT
(YEAR) <i>Oct. 7</i>			
#47.152	7,750.00	(YEAR) <i>Dec. 5</i>	
		C 2.51	7,750.00

JOHN STONE & CO.
 100 BROADWAY, NEW YORK CITY
 DECEMBER 2 (YEAR)

Messrs White & White
 75 West 42nd Street

Dear Sirs:

In reply to your request of November 30 (Year) for a confirmation of our account with Blair & Sons, we wish to inform you that on October 17 (Year) we paid our account in full and have our cancelled bank check which bears the debtor's endorsement.

Very truly yours,
John Stone & Co.
 John Stone & Co.

Conclusion:

An apparent cash shortage of \$7,750.00 was concealed by lapping. Remittances subsequently received from other customers were applied to the credit of the account of John Stone & Co.

James White
 December 4 (year)

FORM 44

is encountered, to extending the circularization to cover all the customers with balances to their accounts at the balance sheet date.

Collection Period. Information as to the number of days' charge sales that is represented by the accounts receivable at the balance sheet date is informative. Also the average collection period for the current year gives an indication as to the rapidity with which remittances are received. Collection period statistics should be compared with those for several years immediately preceding the current year. An explanation of any substantial deviation in the trend in the number of days' sales represented by the accounts receivable, or in the average collection period, should be sought from the company's credit manager. A lengthening of the collection period may be found to be due to a change in the company's credit policy. Perhaps some favored customers have been given special terms. Any flagrant abuses discovered in the granting of credit should be brought to the client's attention.

The review made of the company's collection experience and of the accounts receivable aging schedule constitutes a guide as to the necessity for a reserve for bad debts and the amount thereof. Working papers should contain a statement by the independent accountant regarding his opinion concerning the adequacy of the bad debts reserve. Any juggling of the reserve for uncollectible accounts, sometimes indulged in for the purpose of manipulating the profit showing, should not be countenanced by the independent accountant.

Balance Sheet Treatment. Only balances due from customers in the ordinary course of trade are properly presented as regular accounts receivable on a balance sheet. Notes receivable, on account of the difference in terms of payment from accounts receivable, should be shown separately and not included with the customers' accounts. Employees' accounts that are subject to the same terms of payment as those of regular customers need not be presented separately. If the employees' accounts are substantial in amount, as is generally true in retail department stores, it is a good plan to mention the amount thereof parenthetically, or to show them in a schedule.

Customers' credit balances, whether due to the return of merchandise or to remittances received in advance for future purchases, should be shown on the liability side of the balance sheet. The credit balances, if insignificant, are usually included in the total of the accounts payable. On the financial statement of a stock broker, the customers' free credit balances are properly separated from the customers' "short" accounts.

REVIEW QUESTIONS

1. What significance would you attach to a lack of agreement between the accounts receivable trial balance and the general ledger Accounts Receivable controlling account?
2. Mention the points that should be kept in mind when examining the accounts receivable agings.
3. Describe the method that ought to be followed in the selection of customers to be circularized for the purpose of confirming their accounts.
4. What procedure should be employed if customers' accounts, selected for confirmation, are ascertained to be "confidential"?
5. Should an auditor accede to a client's request not to circularize customers who had paid their balances, due at the balance sheet date, subsequently thereto?
6. Is it permissible for an independent accountant to accept the offer of the accounts receivable confirmations obtained by the client's own internal auditing staff?
7. Is it regarded as the proper auditing procedure to accept, without confirmation, a written guarantee by customer A of customer B's account?
8. What procedure ought to be followed with respect to exceptions reported by customers?
9. Should the independent accountant take cognizance of the trend in the average collection period?
10. Describe the procedure that should be followed in verifying assigned accounts receivable.
11. What course ought to be followed in the audit of customers' credit balances?
12. What procedure should be followed when accounts receivable include charges for goods billed but not shipped?
13. What action, if any, would you take upon ascertaining that the Accounts Receivable account contains notes receivable from purchasers of the company's capital stock?

CHAPTER 10

INVENTORIES

The taking of inventories by the company's personnel is observed by the independent accountants. Quantities are test-checked. Consigned goods are confirmed by correspondence. Inquiry is made as to the existence of obsolete items in the inventory. The basis of pricing is investigated. Mathematical computations of the inventory are verified to the extent deemed necessary. Rate of current inventory turnover is compared with those of several preceding years, and the trend is noted. The gross profit percentage test is applied. Inventories are classified. Intercompany profits in inventories are eliminated in consolidated statements. An inventory certificate is obtained, signed by an officer or partner.

The general practice of business undertakings is to make a complete count of the stock of materials on hand at least once a year, usually at the annual balance sheet date. Taking of interim inventories depends upon the requirements of the particular business, value of the stock, effectiveness of the system of internal control, and policy of the company's management. Factories, a little before inventory-taking time, usually taper off production so as to have as little work in process of manufacture as possible. Assembling plants often spread the inventorying of parts, and the checking of the book records thereof, throughout the year; the perpetual inventories of the stock on hand are then employed as the basis for the end-of-the-year record of materials.

Articles in some inventories are deemed of sufficient value to make it worth while to maintain a subsidiary stores ledger, showing money values, and an Inventory controlling account in the general ledger. An internal check, under this system, is obtained by comparing the total of physical inventory with the book control. Valuable articles of merchandise, such as jewelry, are often assigned individual stock numbers in order to facilitate locating any inventory discrepancies that may develop.

Program of Audit. A general program for the verification of inventories, subject to such modifications as may be found necessary in order to meet the requirements of the particular auditing engagement, is presented herewith.

PROGRAM OF AUDIT

1. Read the company's instruction to its employees for taking and valuing the inventory.
2. Observe the taking of the inventory.
3. Verify, by means of selective tests, the inventory quantities.
 - a. Make independent counts of selected items during the progress of the inventory taking, or secure duplicate copies of original inventory sheets which were prepared under the observation of the independent accountant. (See Form 45, Inventory Quantities Test Schedule.)
 - b. Check items independently counted, or check selected items on the company's original inventory sheets which were prepared under the outside auditor's observation, to the company's final inventory summary.
 - c. Check selected items on the company's original inventory sheets, not prepared under the auditor's observation, to the final inventory summary.
 - d. Verify, by means of selective store-room counts, the accuracy of perpetual inventory records.
 - e. Verify, by means of selective tests, the accuracy with which quantities shown on perpetual inventories have been transcribed to final inventory summaries.
 - f. List numbers, or other identification symbols, of selected unopened cases of goods.
 - g. Check items of unopened cases, independently listed, to company's records and original purchase invoices and to final inventory summary. (See Form 46, Inventory of Goods in Unopened Cases.)
4. Ascertain what goods are being held on consignment.
5. Check, by means of selective tests, the inventories of goods held at outside locations.
 6. Ascertain whether any goods included in the inventory were pledged.
 7. Examine invoices covering goods included in the "in-transit" inventory.
 8. Ascertain the basis employed in valuing the inventory and whether the basis used is consistent with that followed the preceding year.
 9. Verify, by means of selective tests, the prices used in valuing the inventory. (See Form 47, Inventory Prices Tests Schedule—Purchased Materials; Form 48, Inventory Prices Tests Schedule—Manufactured Goods; Form 49, Retail Inventory Test Schedule.)
10. Inquire into the existence of obsolete goods and the basis used in their valuation.
11. Ascertain whether receiving department and shipping department books were properly closed.
12. Ascertain, if inventory controlling accounts are maintained, the amount of the adjustment required in order to bring the books into agreement with the physical inventory.
13. Ascertain, for consolidated balance sheets, whether intercompany profits have been eliminated from inventories.
14. Compare the current year's inventory turnover rate with that of each of several preceding years.
15. Test check the accuracy of the inventory by means of the "gross profit percentage" method.
16. Check, by means of selective tests, the extensions of the inventory.

17. Verify all additions of a selected number of inventory sheets.
18. Verify all additions, of the dollar columns only, of the remaining inventory sheets.
19. Check the totals of all detail inventory sheets to the final recapitulation inventory sheet.
20. Verify the addition of the inventory recapitulation sheet.
21. Secure inventory certificate. (See illustrative inventory certificate.)
22. Prepare a brief statement, showing the extent of the tests made, of inventory quantities and prices.
23. Write a summary of the company's system of inventory control.
24. Inventory questionnaire—large audit engagements.
 - a. Are perpetual inventory records maintained?
 - b. Is an adequate production cost system in use?
 - c. Does the company follow the practice of costing sales?
 - d. Are sales and shipments synchronized?
 - e. Are physical inventories taken by others than those who have custody of the goods?
 - f. Are inventories adequately safeguarded physically?

Inventory Instructions. The instructions issued by the company as a guide to its employees for taking the inventory should be studied by the independent accountant to see whether they are sufficiently comprehensive with respect to the needs of local conditions, character of materials, location of goods, use of printed forms for listing, and the general procedure to be followed. Examination of the company's inventory procedure should enable the independent accountant to form an opinion as to whether adherence, by the company's personnel, to the instructions will give satisfactory results. It may be found advantageous to place a copy of the company's inventory instructions in the audit working papers.

Observance of the Inventory Taking. Observance, by independent accountants, of the taking of inventories is regarded as normal auditing procedure. The independent accountant should ascertain whether the company's inventory instructions are carried out in making the stock count, summarizing the quantities, and valuing the items. Frequently it is found practicable to arrange with the company to have duplicate copies of the original inventory sheets furnished the independent auditors. Prenumbered inventory tags, if employed for listing the stock, should be controlled by the outside accountants.

Methods employed in the measurement and counting of goods and materials are usually in accordance with established trade practices. Raw materials are generally fairly easy to describe and are not extremely varied except as to sizes. Component parts used in the production of assembled articles, such as motor vehicles, are ordinarily

designated by means of numbers or symbols. The reason for this practice is the difficulty usually experienced in describing manufactured parts, the specifications of which generally entail the necessity for giving dimensions. It is necessary, when inventorying goods in process of manufacture, that their location in the plant be recorded and also the name of the last process through which they have passed. This information is needed in order that the costs of production of goods in process at the balance sheet date may be correctly verified or computed. Manufactured articles, in industrial establishments, are usually identified by their respective catalogue numbers or designations.

It is essential that all original inventory tickets and sheets be preserved by the company, until after completion of the final inventory figures and the termination of the annual audit, in order to permit the independent accountant to make such tests as he may find necessary and investigate any discrepancies that may develop in connection therewith.

Making Selective Test Checks. If the company's procedure does not lend itself to the writing of duplicate inventories, it is the general practice for independent accountants to count and list selected articles for checking later to the company's inventory sheets. Special attention is generally paid to items of relatively large value, inasmuch as any effort to inflate inventories is likely to be confined to the larger items from both a quantity and price point of view. These tests of quantities by the independent accountant ought to be checked to the company's final inventory sheets in order to ascertain whether any changes in the items tested had been made. Should changes be discovered that cannot be satisfactorily explained, the auditor will naturally be alert to the implications involved.

The independent accountant, in addition to making comparisons between his test counts and the company's figures, ought to compare quantities as originally listed by the company with the corresponding items which appear on the inventory summary sheets. It is necessary that sufficient tests be made by the independent accountant to satisfy himself that the original count of quantities was correctly made and summarized. When the company maintains quantity controls, such as the yardage inventory controls which are sometimes found in textile piece-goods jobbing houses, it is easy to check the total units in the final inventory against the related quantity control.

The Inventory Quantities Test Schedule, Form 45, shows a comparison between the company's and the outside auditor's counts of quantities, together with explanations of any discrepancies encountered.

INVENTORY QUANTITIES TEST SCHEDULE

DATE **December 31 (Year)**
THE BLANK COMPANY

PREPARED BY *J. White, Jr.*
 REVIEWED BY *G. Jones, Jr.*

ARTICLE DESCRIPTION	UNIT	COMPANY'S INVENTORY		AUDITOR'S COUNT		REMARKS	
		REF.	QUANTITY	COUNT	OVER UNDER		
Part 2,010	Ca	Sheet 101	14,000	14,000			
Do 2,020	Ca.	Do 102	75,000	65,000	10,000	Auditor's count accepted	
Do 2,040	Ca.	Do 103	60,000	60,000			
Do 2,060	Ca.	Do 104	90,000	90,000			
Do 2,070	Ca.	Do 105	200,000	200,000			
Do 2,080	Ca.	Do 106	70,000	70,000			
<i>Total</i>			509,000	499,000	10,000		
<i>Inventory value of parts tested</i>			\$303,700				
<i>Total inventory value of parts</i>			\$1,214,800				
<i>Percent tested to total</i>			25%				
		<i>James White, February 15 (Year)</i>					

THE BLANK COMPANY
 YEAR ENDED DECEMBER 31, (YEAR)

PREP BY *J.M.L. 7/7*
 REV'D BY *B.G. 2/7*

INVENTORY OF GOODS IN UNOPENED CASES

CASE NUMBER	SUPPLIER	DESCRIPTION	COST
1,652 [†]	<i>Baltic Mills</i>	* <i>Blue worsteds</i>	† 900 [‡]
1,653 [†]	<i>Do</i>	* <i>Do</i>	† 900 [‡]
1,654 [†]	<i>Do</i>	* <i>Do</i>	† 900 [‡]
7,700 [†]	<i>Lowell Company</i>	* <i>Olive, chat worsteds</i>	† 1,100 [‡]
7,701 [†]	<i>Do</i>	* <i>Do</i>	† 1,100 [‡]
7,702 [†]	<i>Do</i>	* <i>Do</i>	† 1,100 [‡]
7,703 [†]	<i>Do</i>	* <i>Do</i>	† 1,100 [‡]
4,820 [†]	<i>Plymouth, Inc</i>	* <i>Grey wools</i>	† 850 [‡]
4,821 [†]	<i>Do</i>	* <i>Do</i>	† 850 [‡]
4,822 [†]	<i>Do</i>	* <i>Do</i>	† 850 [‡]
1,910 [†]	<i>Cranston Mills</i>	* <i>Green wools</i>	† 1,200 [‡]
1,911 [†]	<i>Do</i>	* <i>Do</i>	† 1,200 [‡]
		<i>Total</i>	12,050

[‡] *Checked to purchase invoice*

* *Checked to inventory summary sheet*

† *Cost checked to market quotations*

† *Case physically examined*

James White
December 31 (Year)

Should differences be regarded as excessive in number and amount, it may be necessary to arrange to have a recount made of the entire stock.

The Inventory of Goods in Unopened Cases Schedule, Form 46, illustrates the procedure followed where it is impracticable to open scaled cases and containers in order to examine their contents. Reference is made to creditors' invoices which cover the purchase of the respective goods. Descriptions ought to tally with the marks on the containers. Should there be any doubt regarding the contents of original packages, some of them ought to be opened at random and the materials inspected. The independent accountant should verify that cases and containers are not empty by tipping them up, or handling them. The examination should be sufficiently comprehensive to satisfy the outside auditor of the correctness of the inventory of goods in unopened cases.

Goods Held on Consignment. The goods which are being held by the company on consignment, at the balance sheet date, ought to be confirmed by circularizing the consignors. Unless this procedure is followed, there is the possibility that goods held on consignment or on "memorandum" may have been erroneously included with the company's own goods. Invoices from consignors, covering goods held on consignment, should ordinarily be found on file and marked to indicate that title to the goods which are covered thereby has not passed to the consignee.

Goods on Consignment Outside. Goods, at the time an inventory is taken, are often out on consignment. It is essential that these goods be verified by correspondence with the consignees. Usually companies that make a practice of consigning goods maintain perpetual inventories to which the goods out on consignment can be checked. Comparisons between reports received from consignees and the company's book records should establish the accuracy of the quantities of consigned goods included in the inventory.

Goods in Transit. Goods in transit, at the date of the balance sheet, are usually inventoried from the purchase invoices covering them. This procedure applies to purchases with respect to which title to the goods passed to the buyer at the time of shipment, the f.o.b. point being the shipper's place of business. Invoices for goods in transit should be found, by the independent accountant, to bear dates prior to that of the balance sheet.

Inventory Prices. The term "cost," as used in connection with inventory valuation, refers to the price paid, including incoming transportation charges, duties paid on imports, and insurance on goods while in transit, when paid for by the purchaser. Cost of articles, if on hand

at the close of the previous year, generally refers to the inventory price then used. Articles which have previously been marked down, from cost to market, are not ordinarily restored to cost. The reason for this procedure is that goods which have not moved within a year are quite likely to be suffering from obsolescence. Deduction of cash discounts from suppliers' invoice prices is permissible when computing cost prices, provided that this practice is consistently followed by the company. Retail department stores usually treat cash discounts as a reduction of cost.

There are several methods in use for calculating the cost of materials, as follows:

- Specific article cost.
- Average cost.
- First-in, first-out cost.
- Last-in, first-out cost.
- Base stock cost.

The first of the above-mentioned methods refers, as its name indicates, to situations where individual articles can be identified with the respective prices paid for them. This system is likely to be found in use where articles are quite valuable. Dealers in silk and woollen piece goods generally assign stock numbers to the goods which practice permits the respective prices paid to be recorded on inventory records. The exact cost prices of goods, under this plan of procedure, are readily ascertainable.

Average costs are much used particularly in connection with raw-material calculations, notably in continuous-process plants. Every time that a purchase of material is made at a price which differs from the then existing average, a new average cost price must be computed. This plan is often regarded as too burdensome where the variety of materials is considerable.

The first-in, first-out method (frequently referred to as the "fi-fo" method) of cost finding is used primarily in the interests of simplicity. It follows the chronological order of the purchases, the first lot being exhausted at the price paid for the material before applying the price paid for the second lot received, and so on. Goods on hand are regarded as belonging to the most recent purchases. Whenever there is a great variety of articles in an inventory, as is true in most assembling plants, it is quite likely that the first-in, first-out system of costing materials will be found in operation.

The last-in, first-out method (frequently referred to as the "li-fo" method) of figuring costs of materials is employed where it is deemed

important that costs of materials used (both in production and in goods sold) be based, so far as possible, upon current prices. This plan has the effect of valuing materials taken out of stores at approximately replacement prices. Many enterprises which are engaged in the production of crude oil, textile fabrics, and some retail stores employ the last-in, first-out system of costing with good results.

The base stock method of inventory valuation is found in certain industries, notably in the metallurgical field, where the required stock needed to permit of maintaining manufacturing operations is carried either at original cost or at some arbitrarily established amount. The theory behind this plan is that price fluctuations in materials, included in the company's basic inventory, should not be permitted to affect the periodic income statements.

Tests made of inventory prices of purchased materials should be recorded somewhat in the manner illustrated in the Inventory Prices Tests Schedule—Purchased Materials, Form 47. References are given to the company's inventory sheets where the cost prices may be found and also to the source of the "market price" information. The price tests are limited to a selected list of representative articles.

The cost of manufactured articles consists of the sum of the elements of material, labor, and factory overhead computed in accordance with the generally accepted principles of cost accounting. Overhead rates employed in calculating manufacturing costs ought to be based upon normal operating conditions. Inquiry should be made into the method of cost finding employed and into the effectiveness of the company's cost system. The three general types of cost finding in use are as follows:

Job costs, sometimes referred to as specific order costs, such as those found in use in job printing plants where work is performed in accordance with customers' specifications.

Process costs, as employed in plants where materials flow through various operations until completed, as in a breakfast-food factory, a cotton yarn mill, or an oil refinery.

Standard costs, usually found in assembling plants, where parts are put together according to specifications, in order to make the finished article, such as a watch or a typewriter.

The Inventory Prices Tests Schedule—Manufactured Goods, Form 48, is intended for use in verifying the prices of a selected list of manufactured goods in the inventory. It will be noticed that the form provides for making an analysis of the costs according to their several basic elements: material, labor, and overhead. Explanations ought to

DATE **December 31 (year)** **THE BLANK COMPANY**
INVENTORY PRICES TESTS SCHEDULE - PURCHASED MATERIALS

PREPARED BY *J. White, Jr.*
 REVIEWED BY *S. B. Smith, Jr.*

ARTICLE		INVENTORY PRICE		MARKET PRICE		REMARKS	
QUANTITY IN INVENTORY	DESCRIPTION	UNIT	REFERENCE	AMOUNT	SOURCE		AMOUNT
40,000	Red Paint	Gal.	Sheet 10	2.50	Vendor	225	Change inventory
20,000	Orange Paint	D.	D. 10	3.00	D.	275	
16,000	Yellow Paint	D.	D. 11	4.00	D.	350	D.
90,000	Blue Paint	D.	D. 11	3.50	D.	315	D.
15,000	Indigo Paint	D.	D. 12	6.00	D.	450	D.
20,000	Violet Paint	D.	D. 12	4.50	D.	475	
150,000	White Paint	D.	D. 13	1.25	D.	130	
30,000	Black Paint	D.	D. 13	2.50	D.	300	
381,000	Total Tested	D.					
1,524,000	Total Inventory	D.					
2.5%	Percent tested to total						
	↓ Checked to confirmation						
	James White, February 15 (year)						

INVENTORY PRICES TESTS SCHEDULE - MANUFACTURED GOODS
 DATE *December 31 (Year)* THE **BLANK COMPANY**
 PREPARED BY *J. W. H. 1/10*
 REVIEWED BY *R. G. M. 1/10*

QUANTITY IN INVENTORY	ARTICLE		INVENTORY PRICE			MARKET PRICE			REMARKS	
	DESCRIPTION	UNIT	TOTAL	MATERIAL	LABOR	OVER-HEAD	TOTAL	MATERIAL		LABOR
14,000	Part 2010	Ca.	3 00	2 00	50	50	3 10	2 10	50	* 50
75,000	Do 2020	Ca.	5 50	4 00	75	75	5 70	4 20	75	* 75
60,000	Do 2040	Ca.	11 20	10 00	60	60	11 70	10 50	60	* 60
90,000	Do 2060	Ca.	14 20	12 00	110	110	14 70	12 50	110	* 110
200,000	Do 2070	Ca.	1 80	1 00	40	40	1 85	1 05	40	* 40
70,000	Do 2080	Ca.	3 90	2 50	70	70	3 90	2 50	70	* 70
500,000	<i>Total</i>									
2,307,000	<i>Inventory value of parts tested</i>									
12,148,000	<i>Total inventory value of parts</i>									
25%	<i>Percent tested to total</i>									
	1 Checked to confirmation									
	2 Checked to purchase order schedule									
	* Checked to current factory reports									
	<i>James Whit, February 15, (Year)</i>									

PREPARED BY *J. White, Jr.*
 REVIEWED BY *G. Reed, Jr.*

THE BLANK COMPANY
 YEAR ENDED DECEMBER 31 (YEAR)
 RETAIL INVENTORY TEST SCHEDULE

LOCATION	ARTICLE	UNIT	COMPANY'S COUNT		AUDITOR'S COUNT	REMARKS
			REFERENCE	QUANTITY		
<i>Drug Dept</i>	<i>Analgesic balm</i>	<i>Ea.</i>	<i>Shed 47</i>	<i>275</i>	<i>275</i>	
<i>"</i>	<i>Zinc oxide ointment</i>	<i>"</i>	<i>"</i>	<i>1010</i>	<i>1010</i>	
<i>"</i>	<i>Eucalyptic salve</i>	<i>"</i>	<i>"</i>	<i>655</i>	<i>655</i>	
<i>"</i>	<i>Doan's pills</i>	<i>"</i>	<i>"</i>	<i>325</i>	<i>325</i>	
<i>"</i>	<i>Lithia tablets</i>	<i>"</i>	<i>"</i>	<i>1200</i>	<i>1200</i>	
<i>"</i>	<i>Witch hazel</i>	<i>"</i>	<i>"</i>	<i>375</i>	<i>375</i>	
<i>"</i>	<i>Absorbine</i>	<i>"</i>	<i>"</i>	<i>121</i>	<i>121</i>	
<i>"</i>	<i>Mentholatum</i>	<i>"</i>	<i>"</i>	<i>67</i>	<i>67</i>	
<i>"</i>	<i>Mustole</i>	<i>"</i>	<i>"</i>	<i>475</i>	<i>475</i>	
<i>"</i>	<i>Cocoa butter</i>	<i>"</i>	<i>"</i>	<i>66</i>	<i>66</i>	
<i>"</i>	<i>Anguentine</i>	<i>"</i>	<i>"</i>	<i>144</i>	<i>144</i>	
			<i>James White</i>			
			<i>December 31</i>			<i>(Year)</i>

FORM 49

be made in the "Remarks" column of any price variations that violate the principles of cost accounting.

The term "market price" as employed in inventory valuation ordinarily refers to replacement cost; market quotations can be secured for a considerable number of commodities from the daily newspapers and trade publications. Prices prevailing for materials near the balance sheet date can frequently be secured from suppliers' invoices in the company's files. Market prices, with respect to a manufacturing company's own products, are the respective sales prices reduced by the selling overhead. The reason for this procedure is that there is no market for a company's products other than its own customers. The highest value at which goods should be taken into the inventory is a price which will allow sufficient margin to cover the cost of selling.

Large retail stores quite generally employ the "retail inventory system" for the purpose of controlling inventories and detecting the existence of stock shortages. The retail value of goods on hand is reduced, by the initial markup percentage, in order to ascertain the balance sheet valuation of the inventory. The result obtained by this method is believed to correspond closely to that which would be secured by pricing the goods on hand at the lower of cost or market price. Markup percentages are bound to vary, and so the inventory of each department, under the retail system, is separately computed.

The Retail Inventory Test Schedule, Form 49, is intended for use in making a limited check of the count of goods in a retail store. Space is arranged for use in recording the auditor's independent count of the articles listed. The outside accountant should indicate the results of his investigations of any discrepancies that may have been discovered.

Use of sales prices less cost of marketing is prevalent in the farming industry for inventory valuation because production costs are not readily ascertainable. It is impracticable, for example, to compute crop costs on a wheat ranch, including depletion of the land, labor of the rancher and members of his family, and so on. This method, frequently referred to as the "farm-price" system, applies to both crop and live-stock inventory prices.

Market Price Quotations. It is often necessary, in order to ascertain market prices prevailing as of the balance sheet date, to communicate with the company's suppliers, or at least some of them. Letters requesting that market prices of specified articles be furnished should be signed by the company and mailed by the outside auditor in envelopes bearing the accounting firm's corner card. An illustrative letter, requesting that prices be furnished to the independent accountant, is presented herewith.

THE BLANK COMPANY
100 BROAD STREET
NEW YORK, N. Y.

December 31 (year)

Messrs. Grey & Brown
Boston, Massachusetts

DEAR SIRs:

In connection with an audit of our books, which is being made by George White & Co., 1000 Broadway, New York, N. Y., Certified Public Accountants, will you please furnish them with the market prices, as of December 31 (year), of the following fabrics which we regularly purchase from you:

Alpha worsted suiting.
Beta worsted suiting.
Gamma woolen dress goods.
Delta woolen dress goods.

A self-addressed envelope is enclosed for use in mailing your reply.

Very truly yours,
(Signed) A. BLANK, PRESIDENT
The Blank Company

Obsolete Goods. Independent accountants, while observing the taking of inventories, are generally afforded an opportunity of inquiring into the existence of slow-moving articles. Perpetual inventory records, when available, can be advantageously inspected to ascertain whether there are any relatively important items that have not moved during the past year. Some articles of merchandise, such as style wearing apparel, are particularly susceptible to obsolescence.

There are two methods in use for pricing obsolete or slow-moving goods.

Value the articles which are expected to be sold within a reasonable period of time at the lower of cost or replacement prices; assign only salvage values to the remainder of the stock on hand of the respective articles.

Value the articles on hand at a sufficiently low unit cost so that they will not show a loss when sold.

Either of these two methods should arrive at approximately the same result.

Some retail department stores make a practice of aging their inventories in order to furnish an indication as to the accumulation of slow-moving articles in their stocks. Goods in each department are separately aged, and comparisons of results are made with those of preceding years, in order to ascertain any significant trends.

Supplies Inventories. When supplies on hand at the balance sheet date are treated as a current asset, in accordance with the established

practice of the particular trade, the same principles of inventory valuation should be employed as those observed in the valuation of the regular inventory. Cartons for making deliveries of goods to customers are often treated as a part of the regular inventory.

Principles of Inventory Valuation. Consistency in inventory valuation, from year to year, is of primary importance. The most generally accepted basis of inventory valuation is the "lower of cost or market"; ordinarily, departures from this basis are only made in accordance with established trade practices. In a rising commodity market, it is quite likely that the cost of all, or nearly all, articles in the inventory will be less than their replacement, or market, value. However, in a declining market it is not unlikely that some, and perhaps all, of the goods and materials in the inventory can be replaced below cost. The basis employed for pricing materials should be uniform throughout the inventory.

Enterprisers frequently take the attitude that interest (lost on investments sold to secure funds to enable them to embark upon a business venture) constitutes an element of cost. Such a situation is presented in Form 50, where the inventory includes an interest charge, the Profit and Loss account having been credited. The auditor observed, "Inclusion of an interest carrying charge in the inventory is looked upon as being an anticipation of profits and thus violates generally accepted accounting conventions."

Receiving Book. Tests should be made for the purpose of ascertaining whether the receiving book was properly closed at the balance sheet date. All goods received up to this date ought to be included in the inventory. Early closing of the receiving book and the exclusion of "new-season" goods from the inventory is a practice that ought not to be countenanced by the outside auditor.

Inventory Turnover Rate. Causes underlying any significant change in the rate of inventory turnover, from that of the preceding year or two, ought to be looked into and a satisfactory explanation obtained. An accumulation of large quantities of materials in anticipation of rising market prices causes a decrease in the turnover rate, all other things remaining the same. A substantial reduction in sales without curtailing purchases will slow up the turnover rate. For comparative purposes, either the cost, or sales, basis of computing the inventory turnover rate gives good results as long as the system adopted is consistently followed.

Gross Profit Percentage Test. Consistency in the gross profit percentage, from year to year, is usually regarded as an indication of the correctness of the inventory. A substantial change in the relationship

VIOLATION OF GENERALLY ACCEPTED ACCOUNTING CONVENTIONS - ILLUSTRATED

THE BLANK COMPANY

ACCOUNT *Inventory*

DATE		✓	CHARGE	DATE	✓	CREDIT
(YEAR) Dec. 31	Balance		4175.220 00	(YEAR) Dec 31		4,342.220 00
" 31	Profit and Loss (Interest) J-66		167,000 00			
(YEAR) Jan. 1	Balance		4342.220 00			4342.220 00
			4342.220 00			

THE BLANK COMPANY

ACCOUNT *Profit and Loss*

DATE		✓	CHARGE	DATE	✓	CREDIT
(YEAR) Dec. 31	Surplus J-67		294,500 00	(YEAR) Dec 31		127,500 00
				" 31		167,000 00
			294,500 00			294,500 00

Conclusion - Inclusion of an interest carrying charge in the inventory is looked upon as being an anticipation of profits and thus violates generally accepted accounting conventions. James White Jan. 2 (year)

FORM 50

between the gross profit and the sales may, of course, be brought about by some unusual situation. An inquiry might reveal that the basis of inventory valuation had been changed. The "gross profit percentage test" has sometimes indicated the desirability of making an investigation that revealed the existence of stock shortages.

Inventory Certificates. The usual practice of independent accountants is to obtain an inventory certificate from the company under audit; this should generally be signed by an officer and also by the employee who was in direct charge of the inventory. Certificates, covering inventories, contain pertinent information which is subscribed to by those signing them. Unless satisfactory answers are obtained to the questions on the certificate, it is unlikely that the company's inventory figures can be unqualifiedly accepted by the independent accountant. The company, in the illustrative certificate presented herewith, affirms that it has title to all goods included in the inventory. The certificate contains a statement regarding the basis employed in pricing and the adequacy of the provision made for obsolete goods. Amounts shown in the inventory certificate ought to be checked to the corresponding figures in the audit working papers. An illustrative inventory certificate is presented herewith.

ILLUSTRATIVE INVENTORY CERTIFICATE

Messrs. George White & Co.
Certified Public Accountants
1000 Broadway, New York, N. Y.

DEAR SIRS:

The following is a summary of the inventory of The Bay Company, Inc., as of December 31 (year).

Finished goods	\$ 4,750,000
Work in process	6,200,000
Raw materials	2,500,000
	<hr/>
Total	\$13,450,000
Supplies	325,000
	<hr/>
Total	<u><u>\$13,775,000</u></u>

The inventory is classified as follows:

Physical inventory	\$ 9,200,000
Book inventory	4,575,000
	<hr/>
Total	<u><u>\$13,775,000</u></u>

With respect to said inventory, I hereby certify that to the best of my knowledge and belief:

1. Physical inventory. All quantities were determined by actual count, weight, or measurement.
2. Book inventory. All quantities are based upon perpetual inventory records which are checked periodically against physical inventories.
3. All goods included in the inventory are the property of this company and are unencumbered; no goods are held on consignment from others.
4. The inventory includes all goods of any value which are the property of this company, wherever located.
5. The inventory does not include goods purchased for which invoices have not been entered, nor goods returned by customers for which credits have not been given.
6. Adequate provision has been made in the valuation of the inventory to provide for obsolete and slow-moving goods.
7. Goods have uniformly been valued at the lower of cost or market prices.
8. There is no overlapping of items or values as between that portion of the inventory designated as physical inventory and that designated as book inventory.

Very truly yours,

(Signed) ALFRED BAY, PRESIDENT

(Signed) GEORGE BAY, TREASURER

(Signed) JOHN SMALL, STOREKEEPER

The Bay Company, Inc.

January 10 (year)

Balance Sheet Treatment. Inventories appearing in the current assets section of balance sheets generally comprise finished goods, work in process of manufacture, and raw materials. Financial statements of merchandising enterprises usually contain only the first inventory classification, while those of industrial enterprises ordinarily include all three classifications.

The basis of valuation is generally stated, as there are several different methods for pricing inventories. Supplies on hand, chargeable to expense accounts when used, are ordinarily treated as a prepaid expense. Interest on investments is not properly included in inventories, as this procedure is looked upon as being an anticipation of profits. Intercompany profits, in consolidated balance sheets, are properly eliminated; the principle involved is that articles should not be inventoried above their cost to the consolidation. Prices of goods on hand which were purchased in other than local currencies should be converted at the rates of exchange prevailing at the balance sheet date. The employment of inventory valuation reserves is not a general practice. Mention is often made (unless the item has been included in the accounts), in a footnote to the balance sheet, of the amount of goods held on consignment or "on memorandum," in order to indicate clearly to what extent such goods are held.

The independent accountant cannot be expected to take cognizance of declines in inventory values which may have occurred between the balance sheet date and the time when he renders his report. It is common knowledge that goods and materials included in inventories are subject to market fluctuations.

REVIEW QUESTIONS

1. Why should the taking of inventories be observed by a company's independent accountants?
2. Outline the program that should be followed in the verification of quantities in a company's finished-goods (merchandise) inventory.
3. How should the contents of unopened cases of goods be verified?
4. Explain the procedure which should be followed in the verification of consigned goods at outside locations.
5. What program should be followed in verifying pledged inventories?
6. How should inventories of goods in transit be verified?
7. On what basis are inventories generally valued? Explain fully.
8. What procedure ought to be followed with respect to the treatment of cash discounts received on purchases when valuing the inventory?
9. Are incoming transportation charges regarded as a part of the cost of materials?
10. Should recognition be given to preparatory costs when valuing material inventories?
11. Should factory overhead rates used in the valuation of work in process, manufactured products, and factory-made finished goods be based upon the rates for the current year or for a longer period?
12. On what basis should materials obtained from natural resources, such as a coal property, be valued?
13. What does the term "cost" mean for materials that were marked down below cost at the date of the previous balance sheet?
14. What procedure should be followed in ascertaining market prices of materials purchased from outside sources?
15. What is understood to be the meaning of "market prices" with respect to a company's own products?
16. Explain the "retail system" of inventory valuation used by retail department stores.
17. What method of costing inventories is adapted to the needs of companies in the metallurgical industry?
18. Explain the following methods of costing inventories.
 - a. Specific cost.
 - b. Average cost.
 - c. First in, first out.
 - d. Last in, first out.

19. How can the existence of slow-moving items in the inventory be ascertained?

20. What purpose is served, where an inventory controlling account is maintained, in ascertaining the amount of the adjustment required to bring the books into agreement with the physical inventory?

21. To what extent should the mathematical calculations of inventories be verified?

22. Mention some of the reasons for obtaining an inventory certificate.

23. Is it regarded as acceptable accounting practice to employ book inventories as the basis for the final inventory?

24. In an initial auditing engagement, is it necessary to examine the inventory at the beginning of the accounting period in addition to the examination made of the inventory as of the current balance sheet date?

25. Is it permissible to employ inventory reserves for valuation purposes?

26. Is it the general practice to indicate the basis of inventory valuation on a balance sheet?

CHAPTER 11

LAND

By correspondence with the company's attorneys and examination of the most recent real estate tax bills, the fact is verified that title to land is held by the company. Existence of any liens on the real estate owned and also the amount of any unpaid tax bills is ascertained by circularizing the local tax collector. Real estate closing papers are examined in support of prices paid. Treatment of carrying charges on unimproved property comes in for review. Depletion of natural resources is investigated. Comparisons are made between book values and recent assessed valuations. Correctness of credits for sales of land is investigated. Land not in use is separately stated on the balance sheet.

Companies which either utilize, or deal in, land generally carry it on the books at cost. Although one might regard the lots owned by a developer of suburban property as his stock in trade, nevertheless the general principle of inventory valuation, whereby the inventory is usually valued at the lower of cost or market, is not applicable.

When the number of lots owned by a company is considerable, as is often true in suburban developments, a "number-of-lots" control is frequently maintained. Furthermore, property maps are generally marked to show the lots that have been sold; a list of unsold lots can be made at any time from the maps.

Production records, in order to permit depletion to be computed, are generally maintained by companies which derive their revenues from the exhaustion of natural resource properties. The cost of raw materials which are removed from a natural resource is represented by the depletion which is applicable to them.

Commercial enterprises generally record the cost of land owned at each location in the land accounts. There may be, as in a chain-store organization, a considerable number of parcels of land owned by the enterprise.

Program of Audit. The program for the verification of land accounts presented below is subject to such modifications as are found necessary to meet the requirements of the particular audit engagement.

PROGRAM OF AUDIT

1. Secure a schedule of real estate properties owned by the company. (See Form 51, Land Schedule.)

2. Examine vouchers, including closing papers, in support of changes which took place in the land accounts during the period covered by the audit.

3. Examine the minutes of the board of directors for authorizations covering purchases and sales of land.

4. Verify title to real estate owned by the company.

5. Examine most recent tax bills on the company's real estate.

6. Make a record of the assessed valuations of the parcels of land owned.

7. Investigate the method of treating carrying charges on unimproved property.

8. Ascertain basis employed in allocating cost of subdivision property, including improvements, to the respective lots in the development.

9. Ascertain method of treating lots sold under sales contracts which provide that title is to pass when the last payment is received from the buyer.

10. Investigate basis for computing the depletion of land from which materials have been removed.

11. Examine reports of experts with respect to the estimated number of recoverable units of material in natural resource properties.

12. Investigate procedure followed in treatment of expenditures incurred in the reforestation of timber lands.

13. Land questionnaire—large audit engagements.

a. Does the company follow the practice of holding title to real estate in its own name?

b. Does the company, under audit, deal in land?

c. Does a comparison between book and assessed valuations indicate either excessive undervaluation or overvaluation?

Cost of Land. Land is ordinarily stated on the books at cost. This cost is not necessarily the same amount as the cash paid at the time of purchase. The seller may have taken back a second mortgage on the property, or a mortgage, already on the property, may have been assumed by the buyer when the land was acquired. Then, again, there may have been accrued real estate taxes on the land that, when the purchase was made, were assumed by the buyer. The usual practice, at the time of the sale of real estate, is for the seller, or the real estate agent who handles the transaction for the seller, to prepare a "closing statement" that shows the various amounts for which the seller is to be credited and charged and the net amount to be paid by the buyer when the transfer of title takes place. Assumption of unpaid real estate taxes by the buyer is quite frequent. Quite likely it will be found that the transfer of title was handled by a title guarantee company.

Expenditures incurred in perfecting title, making a preliminary survey, and in improving land, as well as the price originally paid therefor, are properly included in the cost of land. Assessments levied by a municipality for public improvements, such as paving and curbing streets, constitute additional costs. When land is condemned and taken for public purposes, such as a highway or park system, the proceeds

from condemnation proceedings are generally treated as a reduction of the land cost.

Improvements to suburban development properties often consist of laying streets, planting shrubbery, erecting ornamental entrance posts, and installing gas mains and electric wiring conduits. Carrying charges incurred during the development period, such as property taxes and interest, are generally regarded as an addition to cost. However, in this connection, it should be mentioned that interest on the development company's own capital is not properly added to the cost of land.

A purchase of land which was paid for by the issue of the company's capital stock will most likely be found to have been authorized in the minutes of the company's board of directors.

Verification of Land Accounts. The Land Schedule, Form 51, is for use in connection with making an examination of land accounts. Provision is made on the schedule for recording locations of the various properties owned by the company. The addresses of properties should correspond to those which appear on supporting documents. Examination, by the independent accountant, of deeds, insurance policies, and tax bills ought to be indicated in the manner shown in Form 51. It is informative, in connection with the examination of the most recent real estate tax bills, to enter, on the Land Schedule, the properties covered by the respective bills, together with the assessed valuations of the various parcels of land. Supplementary columns can be added to the Land Schedule, in the case of natural resource properties, for the purpose of recording information regarding depletion.

When making an initial audit of a company which owns land, the company's attorneys should be requested to certify to the outside auditor that title to the parcels of land, shown by the company's books to be owned, vests in the company, or to furnish the names of the corporations which hold the titles. Deeds should show evidence of having been recorded and should have the requisite amounts of tax stamps attached. Title insurance policies, if titles were insured by title companies, ought to be examined. Papers on the basis of which the purchase of property was made, at the time title passed, should be examined by the independent accountant, and the amounts appearing thereon should be checked to the company's books.

In addition to the examination of the most recent real estate tax bills, the independent accountant should request local tax authorities to report, as of the balance sheet date, any unpaid taxes, assessments for improvements, and other liens on the company's real estate. The letters which request this information should be signed by an officer

THE BLANK COMPANY
Year Ended December 31 (Year)
LAND SCHEDULE

PREPARED BY White 1/5 or
REVIEWED BY Bond 1/5 or

REF	LOCATION OF LAND	DATE ACQUIRED	COST	DEED EXAMINED	TITLE POLICY EXAMINED	PERIOD COVERED BY LAST TAX BILL	AMOUNT OF LAST TAX BILL	ASSESSED VALUATION
20	100 Maple St.	6/30 (Year)	100,000 ^N	A. Fry	A. B. W.	(Year)	1,200 [*]	60,000 [†]
" 21	400 Park Ave.	7/15 (Year)	400,000 ^N	A. B.	A. B.	(Year)	5,000 [*]	250,000 [†]
" 23	1,000 Chester Bld.	10/20 (Year)	600,000 ^N	A. B.	A. B.	(Year)	8,000 [*]	400,000 [†]
	Total		1,100,000					
	Information furnished by Company							
	↓ Checked to general ledger account							
	⊗ Checked to confirmation of title from Company's attorney							
	* Checked to confirmation from tax collector							
	† Checked to real estate tax bill							
	‡ Checked to deed							
	⊙ No entries during year in account							
	James White, February 15 (Year)							

By Company

of the company under audit and mailed by the outside auditor in envelopes bearing the accounting firm's corner card.

Although not necessarily representing the actual land values, the assessed valuations of the parcels of land owned by a company are often significant. Real estate owned by a company may have been acquired at an excessively high valuation from the promotor of the enterprise. Assessed valuations sometimes indicate that realty is carried on the books at greatly inflated values.

Suburban Development Properties. The cost of a suburban development property, upon completion of the improvements, is usually allocated to the respective lots in the subdivision in proportion to their relative sales values. The theory behind this practice is that, when the schedule of sales prices is established, the advantages possessed by each lot, such as size, location, and improvements, are taken into consideration. Thus, a lot which is priced to sell for \$5,000 would have allocated to it a cost twice as much as that allocated to a lot priced to sell for \$2,500. Each time that a sale of a lot takes place, the cost thereof is generally credited to the Land account.

Contracts with buyers of lots in subdivision properties, during the predevelopment period, sometimes contain an agreement whereby the real estate company covenants to make certain specified improvements within a stated future period of time. The ordinary procedure is to provide reserves for the estimated cost of making these contractual improvements. Expenditures, when made, are charged to the respective Reserve for Improvements accounts.

Lots which are repossessed, when purchasers thereof fail to meet their obligations, are generally recorded by the company at the original cost to it. Cash receipts from lot buyers who forfeit their payments constitute a "contract cancelations" profit. Land repurchased at an auction, at which there is competitive bidding, should be recorded at the price paid.

It is within the scope of an independent accountant's duties to examine the contracts with lot buyers and the manner in which sales have been costed and repossessions handled.

Natural Resource Properties. The depletion of natural resource properties is generally based upon the cost of the properties and the estimated number of recoverable units of material. Inquiry ought to be made, by the independent accountant, into the source of the company's information regarding the recoverable units of material; any reports on file from experts, such as geologists, should be examined. Natural resource industries which derive their income from the depletion of land ordinarily reduce the land values by the cost of the

OVERSTATEMENT OF DEPLETION COST - ILLUSTRATED

THE BLANK COMPANY

Account *Mining Property*

DATE		CHARGE	DATE		CREDIT
(YEAR) Jan. 2			(YEAR) Dec. 31		
Nov. 10	Cost CD-4	2,000,000.00		Depletion Cost J 77	1,000,000.00
	Appreciation J-5	8,000,000.00	" 31	Balance	9,000,000.00
		10,000,000.00			10,000,000.00
(YEAR) Jan 1	Balance	9,000,000.00			

THE BLANK COMPANY

Account *Depletion Cost*

DATE		CHARGE	DATE		CREDIT
(YEAR) Dec. 31					
	Mining Property J 77	1,000,000.00			

Conclusion - Computation of depletion cost of material mined should have been based on the cost of the mining property, and not upon the appreciated value James White February 2 (Year).

FORM 52

materials which are removed therefrom. Such records as the company maintains with respect to the depletion of its properties ought to be examined by the outside auditor.

Land is sometimes found to contain more valuable resources than the owner was aware of when the property was acquired. An appraisal may indicate that the value is several times as much as the amount at which the property is carried on the books. If appreciated values are employed in computing depletion costs a situation such as the one illustrated in Form 52 results. The accountant's conclusion was that the method used by the company resulted in an overstatement of depletion cost. The accepted accounting procedure is to compute depletion on the basis of cost. Amortization of appreciation is properly chargeable to the Surplus from Revaluation of Property account.

Expenditures incurred in reforestation of timberlands are a charge against the new crop, even though a half century may be required for the full growth of the trees. The maintenance expenses incurred in connection with growing trees and the carrying charges on timberlands may properly be capitalized. Timberlands suffer from depletion when the standing trees are cut down.

Balance Sheet Treatment. Land values, on balance sheets, are ordinarily stated at cost. Any unutilized sites which are being held for future needs of the business ought to be presented separately on a financial statement. The properties held for sale should be distinguished from those occupied by the company. Natural resource properties are generally stated at cost, less provisions made for depletion. Sites used for buildings are not ordinarily regarded as suffering from obsolescence but are presumed to be worth cost to a going concern, regardless of changes that may have occurred in the local real estate market. Should it be found that the book value of land represents an appraisal, this situation ought to be set forth in the company's financial statement. Mention may be made parenthetically, if it is deemed desirable to do so, of the assessed value of the company's land. When the available information regarding land values indicates either gross understatement, or overstatement, the situation should be commented upon in the audit report.

REVIEW QUESTIONS

1. What information regarding purchases and sales of land can be found in the "closing papers" used at the time that title passed?
2. Where should authorizations for a company's transactions in land be found?

3. Describe the procedure that should be followed in the verification of title to land.
4. What purpose is served, if any, in comparing assessed values of parcels of land with the book values thereof?
5. Explain the procedure for the verification of the cost of unsold lots in a suburban development property.
6. What method ought to be employed in checking the value of natural resource properties that are subject to depletion?
7. Are expenses of planting fruit-bearing trees regarded as a capital, or as an operating, expenditure?

CHAPTER 12

DEPRECIABLE AND INTANGIBLE ASSETS

Detail records of depreciable assets are compared with related control accounts. Additions made to the depreciable assets accounts, since the preceding audit, are vouched to the extent regarded as necessary in view of the company's system of internal control. The method of costing articles of equipment made in the company's own shops is checked. Entries which pertain to the transactions covering the abandonment of depreciable assets are examined. The classifications which are assigned to charges to the depreciable asset accounts are scrutinized. Current provisions for depreciation and the adequacy of the reserves for depreciation are looked into.

Documents in support of intangible assets are examined. Charges to the patents, copyrights, and any other intangible asset accounts since the previous audit are vouched. Cognizance is taken between the stated values and the earning power of the respective intangibles. Any item which has become obsolete and valueless is written off.

The distinction between capital and revenue is pretty generally observed when making charges to the depreciable and intangible asset accounts. Expenditures which enlarge the capacity or extend the life of depreciable assets are regarded as capital outlays. The cost of an article of equipment, unless it has a life expectancy in excess of a year, should not be capitalized.

Manufacturing enterprises frequently clear all new equipment through an Equipment in Process account. Expenditures for new articles of equipment, incoming transportation charges which are applicable thereto, and equipment installation labor costs are charged to the respective equipment orders which are issued therefor. Costs of completed equipment orders, including the cost of producing articles and machines in the company's shop, are transferred from the Equipment in Process account to the proper depreciable asset accounts.

The practice is often followed, by business enterprises, of identifying individual articles of equipment and machinery either by means of numbers or symbols. Detailed records are generally maintained, where this plan of identification is employed, in a depreciable assets

ledger which is subsidiary to a controlling account in the general ledger. Under this system, information can be readily ascertained regarding any piece of equipment or machinery, by referring to the card record which bears the symbol appearing on the identification tag of the respective asset. Ordinarily the detail records of depreciable assets are arranged by departments in order to permit the cost of the machinery and the equipment in each department to be summarized.

Sometimes it is impracticable to identify each article of depreciable assets by a tag bearing the number or symbol of the particular item. The procedure then followed is usually to maintain general ledger accounts only, without detail records, for the various classes of depreciable assets.

Some companies, notably in the industrial field, have a system of equipment orders in operation for authorizing the removal of articles of equipment that are to be sold or abandoned. Deductions from the respective depreciable asset accounts are then made in accordance with entries contained in the register of equipment orders.

Expenditures in connection with the purchase or development of patents are ordinarily charged to the Patents account. Under the United States patent laws, owners of patents are afforded protection for a period of seventeen years.

Payments for full publication rights to manuscripts are usually charged to the Copyrights account. Owners of copyrights are protected, under the United States copyright laws, for a period of twenty-eight years and may obtain a renewal. However, it is unusual for a book to continue to sell for as long a period as twenty-eight years.

Prices sometimes paid by companies for formulas employed in their operations indicate the high values which are frequently attached to this intangible asset.

The purchaser of a going business often pays a large price for its good will because of the concern's record for high earnings in the past.

Managers of business enterprises generally recognize that the useful life of depreciable and intangible assets is limited. Good will is an exception. The customary procedure is to employ reserves for the purpose of valuation. As provisions for depreciation of fixed assets and amortization of intangibles are largely a matter of estimates, based upon practices in the particular trade and experience in the individual undertaking, the discussion thereof will be deferred until a subsequent chapter. (See Chapter 16.)

Program of Audit. There is presented herewith a general program for the audit of depreciable and intangible asset accounts.

PROGRAM OF AUDIT

1. Secure a schedule of the depreciable fixed asset accounts. (See Form 53, Depreciable Fixed Assets Schedule.)
2. Secure a schedule of the intangible asset accounts. (See Form 55, Intangible Assets Schedule.)
3. Verify, by means of selective tests, whether the trial balances from subsidiary depreciable and intangible asset ledgers are in agreement with the detail accounts and whether the trial balance totals are in agreement with the respective controlling accounts.
4. Ascertain whether depreciable and intangible assets are carried at cost, subject to valuation reserves. Ascertain the basis for valuation of good will, brands, formulas, and trademarks.
5. Examine vouchers in support of additions, during the period covered by the audit, to depreciable and intangible asset accounts. (See Form 56, Additions to Depreciable Fixed Assets Schedule.)
6. Inquire into the company's practice with respect to the treatment of incoming transportation charges, installation costs, cash discounts received, and sales or use taxes on purchases of depreciable assets.
7. Ascertain method employed in calculating costs of depreciable assets made in the company's own plant.
8. Ascertain the company's policy in valuing depreciable assets that are paid for in part, or wholly, by the trade-in of used equipment.
9. Investigate the manner of treating interest on bonds issued to secure funds for construction purposes.
10. Inquire into the company's practice with respect to charging expenses, incurred in developing its products, to the Patents account.
11. Ascertain whether the accounts have been properly credited for depreciable and intangible assets disposed of, or abandoned, and for patents and copyrights which expired during the period covered by the audit.
12. Examine the minutes of the board of directors for authorizations for expenditures for depreciable and intangible assets.
13. Review, with an officer of the company, expenditures made in excess of the respective authorizations.
14. Inquire into the adequacy of the depreciation and amortization reserves.
15. Depreciable and intangible asset accounts questionnaire—large audit engagements.
 - a. Is a detail ledger of depreciable and intangible assets maintained?
 - b. Are trial balances prepared periodically from the depreciable and intangible assets ledgers?
 - c. Are disposals and abandonments of depreciable and intangible assets currently recorded?

Changes in Depreciable Asset Accounts. Opening balances in depreciable asset accounts should be checked to whatever supporting records are available. Additions to these accounts consist, for the most part, of the cost of new acquisitions to the company's property, such as a warehouse building or a metal-working lathe. Many expenditures which are charged to this class of asset accounts cover improvements

THE BLANK COMPANY
Year Ended December 31 (Year)
DEPRECIABLE FIXED ASSETS SCHEDULE

PREPARED BY J. White & Co.
REVIEWED BY B. Jones & Co.

REF.	CLASSIFICATION	BEGINNING BALANCE	ADDITIONS		DEDUCTIONS		FINAL BALANCE	SUB-ANALYSIS NUMBER
			PURCHASES	TRANSFERS	RETIREMENTS	TRANSFERS		
41 30	Buildings	† 4,000,000					4,000,000	
" 40	Machinery	† 3,100,000	* 200,000 †	94,000 †	140,000 *		3,254,000	
" 50	Tools	† 800,000	* 75,000 †	6,000 †	60,000 *		821,000	
" 60	Office Furniture	† 180,000	* 15,000 †		10,000 *		185,000	
" 70	Leasehold Improvements	† 200,000					200,000	
" 80	Machinery in Process	† 14,000	* 110,000 †			100,000 *	24,000	
	Total	† 8,294,000	400,000	100,000	210,000	100,000	8,484,000	
	Information furnished by Company							
	† Additions reached 75%							
	* Deductions reached 100%							
	* Checked to authorization by Finance Committee							
	† Checked to final trial balance for preceding year.							
	James & White, February 15 (Year)							

MISUNDERSTANDING OF PRINCIPLE OF ACCOUNTING - ILLUSTRATED

THE BLANK COMPANY

Name Maintenance and Repair

NAME	DATE	(YEAR)	CHARGE	DA
	Dec. 31		2,715,250.00	

THE BLANK COMPANY

Name Provision for Depreciation

NAME	DATE	(YEAR)	CHARGE	DA

THE BLANK COMPANY YEAR ENDED DECEMBER 31 (YEAR) ADJUSTMENT JOURNAL ENTRIES		DEBIT	CREDIT
<i>Provision for Depreciation</i>			
<i>of Machinery and Equipment</i>		8872.5000	
<i>Balance for Depreciation</i>			8872.5000
<i>of Machinery and Equipment</i>			
<i>Entry to record de-</i>			
<i>preciation of machinery</i>			
<i>and equipment.</i>			
<i>James White</i>			
<i>January 22 (Ym)</i>			

Conclusion:

Failure on the part of the company to provide for depreciation of machinery and equipment, on the ground that generous expenditures for maintenance and repairs compensate for depreciation, indicates a lack of understanding of an accepted principle of accounting. James White, March 1 (Ym)

and extraordinary maintenance costs, such as the rebuilding of a motor truck in order to extend its useful life. Deductions which are made from depreciable asset accounts are mostly due to the sale or salvaging of either structures or depreciable articles which have outlived their usefulness.

The Depreciable Fixed Assets Schedule, Form 53, illustrates the method of summarizing the transactions which took place, during the period covered by the audit, in the accounts which are indicated by the title of the schedule. The transactions can be itemized in as much detail as desired. Quite frequently the independent accountant will find authorizations for new buildings, machinery, and pieces of equipment either in the minutes of the company's board of directors or in those of the finance committee. Inquiry should be made, where the system of formal authorizations is in vogue, into any substantial increases in expenditures over those authorized. The schedule presented in Form 53 shows the general audit program followed by the independent accountant.

Sometimes business men are under the impression that generous expenditures for maintenance and repairs do away with the necessity for making a provision for depreciation of depreciable property. Such a situation is illustrated in Form 54, where the independent accountant was of the opinion that failure on the part of the company to provide for depreciation indicated a lack of understanding of an accepted principle of accounting.

Changes in the Intangible Asset Accounts. An analysis of the intangible asset accounts can usually be made without much difficulty for the reason that the transactions which are recorded in these accounts are not ordinarily very numerous. Whatever records are available for analytical purposes should be utilized by the independent accountant. Any authorizations for the acquisition of intangibles that are contained in the minutes of the company's board of directors or of the finance committee, for the period covered by the audit, should be checked against the charges to the intangible asset accounts.

The Intangible Assets Schedule, Form 55, illustrates an analysis of a Book Copyrights account. Descriptions of the respective book titles are given, together with dates of acquisition and the estimated lives. The manner employed in making an analysis of any particular intangible asset account must necessarily be adapted to the needs of the situation. The audit program followed is set forth in the lower portion of the schedule for convenience in making reference thereto.

Vouching Additions. Vouchers covering all, or a substantial portion, of the additions to a depreciable or intangible asset account ought

THE BLANK COMPANY
Year Ended December 31 (Year)
INTANGIBLE ASSETS SCHEDULE

PREPARED BY J. White, 1/14
REVIEWED BY B. G. M., 1/14

REF	DESCRIPTION	DATE ACQUIRED	COST	ESTIMATED LIFE	DOCUMENTS EXAMINED
	<i>Copyrights:</i>				
R 10	Walt's Trigonometry	6/10 Year	4,000 *	28 yrs	Bill of sale - Copyright ⊕
R 11	Brown's Arithmetic	7/5 Year	3,000 *	28 "	D. ⊗
R 12	Coan's Calculus	3/6 Year	6,000 *	28 "	D. ⊗
R 13	Deal's Telegraphy	5/8 Year	2,000 *	28 "	D. ⊗
R 14	Ensign's Botany	6/1 Year	3,000 *	28 "	D. ⊗
R 15	Frank's Algebra	8/4 Year	5,000 *	28 "	D. ⊗
	<i>Total</i>		23,000		
	↓ Bill of sale examined				
	⊕ Copyright examined				
	* Cancelled bank check examined				
	James White, February 15 (Year)				

to be examined by the independent accountant, in connection with the program for vouching expenditures, and particular attention should be paid to the approvals which appear thereon. Care should be exercised to see whether the distinction between capital and revenue was properly observed with respect to the purchase invoices or other vouchers, which are examined, for the period covered by the audit.

Cash discounts received on purchases of capital assets are rightfully treated as a reduction of the costs thereof. The practice is quite generally followed of treating sales and use taxes, included in vendors' invoice prices of depreciable assets, as a part of the cost. However, there is no objection to the treatment of these taxes as current expenses; consistency in the procedure followed is essential.

If the cost of a piece of equipment is excessively high because of the experimental and development expenses incurred in connection with its production, these should be allocated to an appropriately named account and not treated as part of the cost. Articles bought on the installment plan ought to be recorded at the full amount of the contract price at the time of purchase.

The Additions to Depreciable Fixed Assets Schedule, Form 56, illustrates the manner in which the items vouched, when significant in amount, may be recorded by the independent accountant. Even in a fairly large enterprise the number of additions of a substantial amount made during the audit period may not be very numerous. The program followed by the outside auditor is shown on the schedule.

Writing off large amounts of depreciable or intangible assets against capital surplus, when such surplus is available for the purpose, has the effect of reducing future depreciation provisions. Making liberal charge-offs of assets, a company's officers sometimes explain, is due to the adoption of a policy of extreme conservatism. Such a procedure is not in accordance with accepted accounting practice.

A transaction which was improperly treated is illustrated in Form 57, where the independent accountant came to the conclusion that "The company failed to observe the accounting principle that repairs to a newly acquired old building constitute an additional cost thereof." When an old building is acquired, the purchaser naturally takes into account its condition and the cost of making the repairs which are necessary in order to make the structure usable. The adjustment journal entry which is required to correct the situation is presented.

Balance Sheet Treatment. Depreciable and intangible assets are generally presented, under major classifications, on a balance sheet. Use of a separate schedule for them permits the presentation of a

THE BLANK COMPANY
 Year Ended December 31 (year)

ADDITIONS TO DEPRECIABLE FIXED ASSETS SCHEDULE

PREPARED BY *White* 2/15/49
 REVIEWED BY *White* 2/15/49

REF.	VENDOR	DESCRIPTION	AUTHORIZATION	AMOUNT	REMARKS
V-105	Will & Co.	Engine lathe	* Finance Committee	1,200	
V-110	Bates Bros	Milling machine	* Dr	2,700	
V-120	Crates & Son	Automatic screw machine	* Dr	4,000	
P-750	Home made	Special planer	* Dr	10,800	Machine inspected
V-140	Will & Co.	Punch press	* Dr	3,500	
V-141	Dr	Shop	* Dr	2,800	
		Total		25,000	
		↓ Checked to purchase invoice			
		⊙ Checked to cost of production sheet			
		* Checked to minutes of Finance Committee			
		James White, February 15 (year)			

MISUNDERSTANDING OF PRINCIPLE OF ACCOUNTING - ILLUSTRATED

THE BLANK COMPANY

NAME *Factory Building*

DATE (YEAR)		CHARGE
<i>May 5</i>	<i>Purchase PJ-167</i>	<i>400,000.00</i>

NAME *Repairs to Factory Building*

DATE (YEAR)		CHARGE
<i>May 31</i>	<i>New roof PJ-175</i>	<i>560,000.00</i>

THE BLANK COMPANY YEAR ENDED DECEMBER 31 (YEAR) ADJUSTMENT JOURNAL ENTRY		
	DEBIT	CREDIT
<i>Factory Building</i>	<i>560,000.00</i>	
<i>Repairs to Factory Building</i>		<i>560,000.00</i>
<i>Entry to transfer repairs to newly-acquired factory building to Factory Building - account.</i>		
<i>James White Invd. 1 (year)</i>		

Conclusion:

The company failed to observe the accounting principle that repairs to a newly-acquired old building constitute additional cost thereof.

*James White
April 10 (year)*

FORM 57

large number of accounts. On a balance sheet, the depreciable and intangible assets are ordinarily shown at cost, and then reduced by the depreciation and amortization reserves which are applicable thereto. By this means the reader can readily see the relation between the cost and the net values of the respective assets.

Companies frequently follow the policy of stating the intangible assets at a nominal amount. It is not uncommon to see good will valued at one dollar on a balance sheet. This procedure is followed in order to emphasize the company's policy of conservatism.

If the book values of depreciable or intangible assets are the result of appraisals, this situation should be set forth on the balance sheet. When it is ascertained that sound values of depreciable assets are considerably in excess of book values, probably owing to the use of high depreciation rates, this condition of affairs can be set forth parenthetically on the balance sheet. Property which is not in use, if substantial in amount, should be stated separately.

Conversions of the fixed asset accounts of foreign subsidiaries, in consolidated balance sheets, should ordinarily be made at the rates of exchange prevailing at the various dates when the respective assets were acquired.

REVIEW QUESTIONS

1. Is it within an auditor's province to compare the total of the trial balance of the subsidiary depreciable assets ledger with the balance to the related general ledger controlling account?
2. Are repairs to a newly acquired old building regarded as an addition to its cost?
3. How should proceeds from salvaging an old building, on newly acquired property, be treated?
4. Would you approve of the capitalization of a \$500 expenditure for reconditioning a motor truck?
5. Is it permissible to show only the installment payments made to date on purchases of articles of equipment?
6. Is it regarded as acceptable procedure to revalue depreciable assets in accordance with an appraisal?
7. Do changes in market prices of articles of equipment affect the values at which they are carried?
8. Describe the steps to be taken in auditing a Good Will account.
9. Outline the procedure applicable to the audit of Formulas, Brands, and Trademarks accounts.
10. What procedure should be followed in verifying returnable containers on hand and in the possession of customers?

11. What steps ought to be taken in the verification of the cost of machinery and equipment made in a company's own plant?

12. Is the capitalization of interest on bonds sold to obtain funds for construction work regarded as being in accordance with generally accepted accounting principles?

13. What procedure should be followed with respect to the verification of retirements of depreciable assets?

CHAPTER 13

MISCELLANEOUS ASSETS

The various loans and advances receivable are verified, for the most part, by correspondence with the debtors. Advances to company employees who render periodic expense reports are checked thereto. Prepaid expenses and deferred charges, as at the balance sheet date, are vouched. These items should be found to be currently absorbed in the company's operations. Prepayment of expenses that cover definite periods of time are readily verified. Items which are arbitrarily deferred are reviewed with an executive and explanations are obtained. Supplies inventories are checked. Deposits with utility companies are confirmed by correspondence. Worthless items among the miscellaneous asset accounts are written off.

Most companies have miscellaneous assets, some of which may be classified as "current" and some as "noncurrent." The program followed in the audit of a miscellaneous asset account must, of course, be adapted to the needs of the particular account. Procedures are presented in this chapter with respect to several miscellaneous asset accounts which are frequently encountered. The material presented should be helpful in the preparation of audit programs for other accounts than those mentioned.

Minor loans and advances to employees are often evidenced by I.O.U.'s in the company's petty cash box. Usually these items of indebtedness are repaid out of future payrolls. Wages due to employees who quit before pay day are frequently advanced from the petty cash fund which is reimbursed when the next payroll is made up. This procedure simplifies the handling of advance payments and payrolls. Traveling salesmen are generally supplied with funds which are replenished, from time to time, on the basis of their periodic expense reports.

Sufficient importance is attached to the supplies used by some companies to make it worth their while to maintain perpetual inventories thereof. These records furnish an internal check on physical inventories of supplies and give the purchasing agent valuable information regarding the rates at which various items of supplies are consumed.

Many business undertakings make a practice of insuring the lives of one or more of their executives. Funds can be borrowed from the

issuing companies, in times of financial stress, up to the cash surrender values of the life insurance policies owned. Business enterprises quite generally maintain a register which shows all of the fire insurance and miscellaneous policies in force, the monthly expirations of premiums, and the unexpired values of premiums.

In order to facilitate the keeping of their accounts on an accrual basis, particularly where monthly financial reports are desired, companies frequently follow the practice of maintaining a columnar record which shows the monthly expirations of such prepaid expenses as membership fees in trade associations, annual subscription fees for credit service, privilege taxes, motor vehicle licenses, business licenses, and debt discount. Such prepayments cover definite periods of time. Various expenses are often more or less arbitrarily deferred until future accounting periods: selling overhead applicable to unfilled customers' orders, costs of designs for the new season's goods, and organization expenses. The conservative practice is to spread the expenses incurred in the organization of a corporation over a period of from three to five years.

General Procedures. Credence is accorded the amount of a prepaid expense account when the related expense for the period covered by the audit compares favorably with the corresponding expense item for the preceding period. If the Insurance Expense account appears normal, then, in all probability, the Unexpired Insurance Premiums account balance is correct. An inquiry should be made into situations where prepaid expense accounts do not appear, from a brief scrutiny, to be properly stated.

Transactions pertaining to a miscellaneous asset account, both before and after the balance sheet date, should be scrutinized. For example, if the postage metering machine had been replenished a short time before the balance sheet date with \$2,000 worth of postage and the reported reading was \$1,500 at the balance sheet date, the auditor should, by means of a little mental arithmetic be able to decide whether the amount of the respective item shown on the balance sheet is probably correct. Ordinarily the items included under the headings of "prepaid expenses" and "deferred charges" are absorbed rapidly in the company's operations.

The misstatement of a miscellaneous asset on a company's balance sheet has just as much effect on the profit showing of the company under audit as the over- or understatement of cash in bank. For the purposes of this chapter, the term "miscellaneous assets" is used to cover asset accounts which have not been dealt with previously. It is not intended to convey the impression that miscellaneous asset

accounts cover only those with relatively minor balances. Sometimes the prepaid expenses and deferred charges amount to a considerable sum of money.

Naturally an auditor must consider the relative importance of an asset account when verifying it. An asset account which represents a fraction of 1 per cent of a company's total assets does not merit the time spent upon its verification that an account merits which approximates 10, or more, per cent of the total assets.

Program of Audit. A comprehensive audit program should be followed in the verification of miscellaneous asset accounts. The procedures ought to be adapted to the needs of the particular engagement.

PROGRAM OF AUDIT

1. Secure a schedule of the miscellaneous asset accounts.
2. Confirm, by correspondence, loans and advances receivable. (See Form 58, Loans and Advances Receivable Schedule.)
3. Examine entries made subsequent to the balance sheet date in order to ascertain whether any renewals of substantial advances were made to borrowers who had paid their loans just before the closing date.
4. Verify, by means of selective tests, the inventories of supplies: (a) quantities, (b) prices, and (c) mathematical computations.
5. Examine insurance policies.
6. Check the company's schedule of unexpired insurance premiums, and investigate adequacy of insurance coverages. (See Form 59, Unexpired Insurance Premiums and Risks Insured Schedule.)
7. Confirm, by correspondence, pertinent information regarding insurance policies, including cash surrender values of life insurance policies and any loans thereon.
8. Confirm, by correspondence, the deposits of funds with landlords and public utility companies.
9. Inspect vouchers in support of the major items of deferred charges and prepaid expenses. (See Form 60, Prepaid Expenses Schedule.)
10. Verify, by means of appropriate audit procedures, the major items of miscellaneous assets not mentioned above.
11. Ascertain whether deferred charges and prepaid expense accounts will be cleared of items contained therein at a reasonably early date.
12. Scrutinize Exchange accounts thoroughly, even if they do not contain any open items at the balance sheet date.
13. Miscellaneous asset accounts questionnaire—large audit engagements.
 - a. Is an insurance register maintained?
 - b. Is a register maintained that shows amounts of deferred charges and prepaid expenses to be written off monthly?
 - c. Does the company advance funds, according to the "imprest" system, to traveling salesmen?

Vouching Significant Charges to Miscellaneous Asset Accounts. Significant charges to the miscellaneous asset accounts should be

vouched. Ordinarily, these are covered in connection with the verification of cash disbursements and examination of purchase invoices. Deposits with landlords and utility companies are usually evidenced by receipts which should be examined. Business and motor vehicle licenses ought to be presented, if available, for inspection. Copies of returns covering privilege taxes, such as franchise taxes, are generally scrutinized with respect to significant items of information appearing thereon. The company should be requested to furnish the auditor with a copy of its report to the insurance company, covering any blanket fire insurance policy, for the last month of the period covered by the audit. Information contained in the report ought to be checked to the company's records.

Verification of Loans and Advances Receivable. Inquiry ought to be made into the manner in which loans and advances are to be repaid and the interest, if any, chargeable thereon. Advances to traveling salesmen are generally used by them for the payment of railroad fares, hotel accommodations, transfers of baggage, meals, and so on. Shortages in cash receipts turned in by driver-salesmen are ordinarily treated as advances and deducted from their earnings. Advances to authors by book publishers are usually liquidated through royalty accruals after publication of the authors' books.

The Loans and Advances Receivable Schedule, Form 58, illustrates the procedure adapted to the verification of the accounts mentioned in the title of the schedule. In view of the lack of formality which often accompanies the making of loans and advances it is especially desirable that they be confirmed. Loans and advances, whether to employees or outsiders, should be reviewed with an officer of the company and his opinion secured as to the collectibility of the respective amounts. If substantial loans receivable were paid off just before the balance sheet date and then renewed immediately thereafter, the situation ought to be inquired into. It may be found that such loans were not in reality paid off and should be reinstated as of the balance sheet date. Comments, by the independent accountant, regarding his investigation of loans and advances should be made in the manner shown in schedule 58.

Checking Allocations of Expenses to Accounting Periods. Allocations of expenses to accounting periods, where the time basis is applicable, should be test-checked. Numerous benefits and privileges which are paid for by business enterprises run for specified periods of time so that the accounting periods to which they apply are readily ascertainable. Portions of such expenses as are applicable to periods

THE BLANK COMPANY
 Year Ended December 31 (Year)
 LOANS AND ADVANCES RECEIVABLE SCHEDULE

PREPARED BY J. W. L. G. Co.
 REVIEWED BY G. B. Smith

REF.	NAME AND ADDRESS	AMOUNT	NOT CONFIRMED	CONFIRMED		REMARKS
				No EXCEPTION	WITH EXCEPTION	
	M. Allen, 100 Home St.	500		500		Salesman
	W. B. Black, 160 Pine Ave.	500		500		D.
	O. Brown, 300 Grand Ave.	750			750*	D.
	P. Coanuit, 440 Bar St.	1,000		1,000		D.
	J. Dickson, 66 Cedar St.	500		500		D.
	F. James, 144 Day St.	100		100		Employee
	A. Frankel, 3308 End Ave.	250	250			Former employee
	W. Hand, 6010 Front Bldg.	2,000			2,000†	Assistant treasurer
	Total	5,600‡	250	2,600	2,750	
		100%	4%	47%	49%	
	† Checked to general ledger					
	⊗ Loan appears doubtful of collection					
	* Doctor states "My account should have been credited for \$250.00 returned 12/15/24" Received 1/2 Year					
	† Doctor expects his name to pay loan					
						James White, February 15 (Year)

subsequent to the balance sheet date are properly treated as prepaid expenses.

The Unexpired Insurance Premiums and Risks Insured Schedule, Form 59, illustrates the procedure followed in making a computation of unexpired insurance premiums. The schedule illustrated provides for showing the fire risks insured. Any indications of under- or over-insurance should be brought to the attention of an officer of the company under audit. In the lower portion of the schedule is indicated the procedure followed in the verification of unexpired insurance premiums. Special features of the insurance policies examined ought to be mentioned in the "Remarks" section of the schedule, such as the provisions of a coinsurance clause, or exceptions with respect to the name of the insured as recorded on the policies should be mentioned. When an insurance register shows amounts of unexpired insurance premiums as of the balance sheet date, all that is then necessary for the auditor to do, in order to verify the prepaid insurance, is to add the amounts of the unexpired insurance policies in the register and to compare the total, thus obtained, with the related control account.

Cash surrender values of life insurance policies for audit and statement purposes are generally ascertained from the companies which issued the respective policies. This procedure makes it unnecessary for the independent accountant to compute values, for the balance sheet, from the tables which are printed on the policies.

The Prepaid Expenses Schedule, Form 60, illustrates the method of procedure followed in calculating sundry prepaid expenses such as those listed. If time is not the basis for the determination of the prepaid expenses, other bases must be used as, for example, the inventorying of supplies on hand. Debt discount and expense are generally apportioned over the period covered by the bond issue to which they are applicable. Provision is made on the schedule for entering references to supporting analyses. The program followed is set forth in the lower portion of the schedule.

The company's inventories of supplies should be test-checked to supporting records and arithmetical computations should be verified. Usable supplies are generally priced at cost. Included in the inventory of supplies may be catalogues and circulars, relating to the company's product, for future distribution to customers. Postage stamps and postal cards, if significant in amount, are generally inventoried at the balance sheet date.

Confirmation of Miscellaneous Assets. Normal auditing procedure requires that rental deposits with landlords, security deposits with utility companies, insurance premium deposits, cash surrender values

PREPARED BY *J. White*
 REVIEWED BY *J. White*

THE BLANK COMPANY
 Year Ended December 31 (Year)
UNEXPIRED INSURANCE PREMIUMS AND RISKS INSURED SCHEDULE

LOCATION OF PROPERTY	RISK COVERED	PERIOD COVERED BY POLICY	AMOUNT OF PREMIUM	UNEXPIRED INSURANCE PREMIUMS	AMOUNT OF RISK INSURED	VALUE OF RISK INSURED	REMARKS
100 Chain Street	Fire	1/1 Year 12/31/24	1,200		200,000	175,000	Aetna 400,150
110 Do	Do	7/1 Year 6/30/24	2,400	1,200	400,000	350,000	Do 600,205
120 Do	Do	7/1 Year 6/30/24	3,000	1,500	500,000	400,000	Do 777,444
100 Do	Spindle, Sledge	1/1 Year 12/31/24	120		20,000		Aetna 125,007
110 Do	Do	7/1 Year 6/30/24	240	120	40,000		Do 140,666
120 Do	Do	7/1 Year 6/30/24	300	150	50,000		Do 222,040
Total				2,970			
		Information furnished by Company					
↑		Insurance policy examined					
⊗		Checked to cash book					
*		Checked to confirmation from insurance agent					
⊕		Checked to property records					
⊕		Checked to general ledger					
		James White, February 15 (Year)					

All of above policies contain an 80% co-insurance clause

PREPARED BY *J White 1/5/59*
 REVIEWED BY *B Grand 1/5/59*

THE BLANK COMPANY
(Year ended December 31 (year))
PREPAID EXPENSES SCHEDULE

REF	DESCRIPTION	LAST INVOICE		PREPAID PORTION		SUB-ANALYSIS NUMBER
		PERIOD	AMOUNT	PERIOD	AMOUNT	
	New York State franchise tax	<i>11/1 year - 10/1 year</i>	<i>24,000</i>	<i>1/1 year - 10/31 year</i>	<i>20,000</i>	0
	New York City gross receipts tax	<i>7/1 year - 6/30 year</i>	<i>6,000</i>	<i>1/1 year - 6/30 year</i>	<i>3,000</i>	0
	Motor vehicle license	<i>1/1 year - 12/31 year</i>	<i>1,800</i>	<i>1/1 year - 12/31 year</i>	<i>1,800</i>	0
	Discount on note payable	<i>12/1 year - 3/1 year</i>	<i>800</i>	<i>1/1 year - 1/1 year</i>	<i>400</i>	0
	Expenses for annual transport	<i>12/1 year</i>	<i>1,500</i>	<i>1/1 year</i>	<i>1,500</i>	0
	Inventory of office supplies	<i>11/31 year</i>	<i>3,900</i>		<i>3,900</i>	0
	Total				<i>30,600</i>	†
	Information furnished by Company					
	↓ Checked to tax return			0	Checked Company's calculations	
	⊗ Checked to licenses			†	Checked to general ledger	
	* Checked to cash book					
	+ Checked to purchase invoices					
	⊕ Checked to inventory certificate					
	<i>James White, February 15 (year)</i>					

FORM 60

of life insurance policies, and memberships in trade associations be confirmed, if significant in amount. It is possible, unless this procedure is followed, that applications of deposits to the payment of overdue bills may not be detected.

A confirmation letter for verification of significant information regarding life insurance policies, including any policy loans thereon, is presented herewith.

ILLUSTRATIVE LIFE INSURANCE CONFIRMATION LETTER

THE BLANK COMPANY
100 BROAD STREET
NEW YORK, N. Y.

December 31 (year)

The Safe Insurance Company
Hartford, Connecticut

DEAR SIRs:

In connection with an examination of our accounts which is being made by Messrs. James White & Co., One Wall Street, New York, N. Y., Certified Public Accountants, will you please furnish them with the following information regarding each of our life insurance policies as at the close of business on December 31 (year):

- (a) Number and face amount of policy.
- (b) Name of beneficiary.
- (c) Date to which premiums have been paid.
- (d) Cash surrender value.
- (e) Amount of policy loan, if any.

A self-addressed envelope is enclosed for use in mailing your reply.

Yours truly,

(Signed) JOHN BLANK, PRESIDENT
The Blank Company

Businessmen sometimes appear, from the manner in which they keep their books, to be influenced by income tax regulations. As life insurance premiums are not deductible when computing taxable income, some companies exclude life insurance premiums from the Profit and Loss account. The effect of this procedure is that the Life Insurance Premiums account balance amounts to more than the cash surrender value of the respective policies, as set forth in Form 61. The conclusion reached by the independent accountant was that the Insurance Premiums asset account, here, was overstated by \$13,095. This is a violation of the accounting principle that all assets should be properly valued.

OVERSTATEMENT OF AN ASSET - ILLUSTRATED

THE BLANK COMPANY BALANCE SHEET DECEMBER 31 (YEAR) ASSETS	
CURRENT ASSETS	\$175210.00
CASH	
LIFE INSURANCE PREMIUMS	\$35600.00
CAPITAL: CAPITAL STOCK \$1000000.00 SURPLUS 2150250.00 TOTAL CAPITAL 3150250.00 TOTAL 5500000.00	

WORLD INSURANCE COMPANY
 ONE BROADWAY, NEW YORK

January 10 (Year)

Messrs White & White
 New York

Dear Sirs:

As requested by The Blank Company we herewith furnish you with the following information regarding the \$100,000.00 life insurance policy No. 47555 issued by us on the life of Henry Blank. The Blank Company is the beneficiary. The premiums have been paid to June 30 (Year). No loans have been made on the policy. The cash surrender value of the policy at December 31 (Year) was \$22,505.00

World Insurance Company

Conclusion - The Life Insurance Premiums account is overstated by \$13,095.00 (the difference, between the book value of \$35,600.00, and the cash surrender value of \$22,505.00) which is a violation of the accounting principle that all assets should be properly valued.

*James White
 February 20 (year)*

FORM 61

Some companies make a practice of treating the unexpired portion of privilege taxes as a deferred charge, although recoveries cannot be obtained in the event business is discontinued. Others follow the practice of ignoring any values attached to prepaid privilege taxes, arguing that payments for one year's privilege taxes are shown in the company's annual income statements and that is all that is necessary. Whatever method is adopted by a company regarding the treatment of minor prepaid expense items should be followed consistently.

Balance Sheet Treatment. The selling overhead which is deemed to be applicable to unshipped customers' orders, as of the balance sheet date, is sometimes presented as a deferred charge. This procedure is likely to be found in companies where a considerable period of time elapses between the receipt of an order and the shipping date. Expenditures made for designs for the new season's goods, in some lines of business, are often deferred. Organization expenses which had not been absorbed in the company's operations, as of the balance sheet date, should be treated as a deferred charge.

Prepaid expenses, such as unexpired insurance premiums, unused portions of business and motor vehicle licenses, unabsorbed debt discount and expenses, and unabsorbed privilege taxes are usually grouped together on a balance sheet. Deposits with landlords and security deposits with utility companies are often included under the head of prepaid expenses. If it is deemed desirable to do so, a supporting schedule of the prepaid expenses can be furnished.

As life insurance policies are not ordinarily borrowed upon, in the normal course of business, to meet financial obligations, the procedure followed is usually to present them as a noncurrent asset. Should there be loans outstanding against life insurance policies it is the acceptable procedure to show the loans deducted from the cash surrender values, in the short column, and to extend the net amount into the long column. Since the loans on insurance policies are secured, there is no need on the part of issuing companies to induce owners of policies to pay their obligations.

Miscellaneous securities, often received from debtors after reorganization of their financial structures, are frequently presented at a nominal value. This procedure focuses the reader's attention on the fact that the company follows a conservative policy with respect to the unmarketable stocks and bonds which it holds.

The term "deferred charges" appears to have a somewhat wider scope than that of "prepaid expenses" so that deferred charges is quite frequently looked upon as including prepaid expenses. Consistency in the treatment of deferred charges and other miscellaneous assets is

of importance to the end that the accounts shall be presented, in a company's financial statements, on a comparable basis.

REVIEW QUESTIONS

1. With respect to which prepaid expenses is the inventory method of valuation employed?
2. What procedure should be followed in verifying unexpired insurance premiums?
3. How should the cash surrender value of a company's life insurance policies be verified?
4. Outline the procedure to be followed in the verification of workmen's compensation insurance premium deposits.
5. How should deposits with mutual insurance companies be verified?
6. What procedure should be followed in verifying rental deposits with landlords or utility companies?
7. How should drawings by salesmen, against future commissions, be audited?
8. What procedure should be followed in the verification of prepaid discounts on unmatured notes payable that had been discounted?
9. What steps should be taken in order to verify unamortized bond discount?
10. What purpose is served by comparing the prepaid expenses and deferred charges at the balance sheet date with the corresponding items at the beginning of the period covered by the audit?
11. Mention some taxes that might be presented as deferred charges.
12. Is organization expense properly treated as a deferred charge to future operations?

CHAPTER 14

CURRENT LIABILITIES

Details of notes payable are confirmed by circularizing the note creditors. Any collateral held as security by note creditors is also confirmed. Amortization and interest payments made to note creditors, during the current accounting period, are test-checked. Transactions between the balance sheet date and the time of the audit are examined for the purpose of ascertaining whether any liabilities were omitted from the accounts payable at the balance sheet date. The larger creditors are circularized in order to verify their accounts. All debit balances in creditors' accounts are investigated. Security deposits are checked to the company's records thereof and also confirmed by correspondence. Accrued liabilities which are not payable until subsequent to the balance sheet date are checked and compared with those of the preceding year. Minutes of the company's board of directors are read in order to ascertain whether there are any dividends which had been declared prior to the balance sheet date, but which were not payable until after the balance sheet date. A liability certificate is obtained.

Financial obligations are frequently classified as liabilities which are payable within a year after the balance sheet date and liabilities which are payable more than a year after the balance sheet date. Obligations of the short term class are usually described as "current," while those of the long term class are generally called "other," or "noncurrent."

Several Current Liabilities Described. Notes payable are generally issued for relatively short periods of time as compared with bonds and mortgages payable. Some notes payable are secured by pledging marketable securities, chattels, or accounts receivable. Borrowings by stock brokers are usually made on notes, payable "on call," which are secured by stocks and bonds having a market quotation value equal to at least 125 per cent of the loans. Business houses generally borrow funds, when required for short periods of time, by discounting their unsecured notes. Loans payable to commercial factors are usually secured by pledging trade accounts receivable and, in the event that the accounts receivable are inadequate for security, by also pledging merchandise. Details of notes payable are ordinarily kept in a columnar register which shows amounts and maturity dates of the notes so that payments received from creditors when due will not be overlooked.

Purchase invoices are usually recorded either in a subsidiary accounts payable ledger or in a columnar voucher register, a list of the unpaid creditors' invoices at the end of any given period of time being obtainable from one or the other of these records. Bills received from creditors are recorded generally without any reduction for cash discounts that may be deductible therefrom for prompt payment. However, the practice is sometimes followed of recording all purchases net. Usually consignees' accounts payable to consignors are credited, as of statement dates, when account sales reports are rendered to the respective consignors. Goods which were purchased f.o.b. (free on board) shipping point and which were in transit at the balance sheet date give rise to "in-transit" accounts payable.

There are quite likely to be some liabilities at the balance sheet date which have accrued but which will not become payable until subsequently. The payroll covering the last few days of an accounting period is often not paid until the following month. Interest on notes payable, bonds payable, and mortgages payable, unless paid to date on the last day of an accounting period, constitute accrued liabilities as of the balance sheet date. Taxes which are payable after the close of the year or fiscal period, on which the tax is based, are properly treated at the end of the period as an accrued liability. Authors' royalties not paid at the balance sheet date often constitute a book publisher's largest liability. Companies which make a practice of preparing monthly financial statements generally record liabilities currently.

Security deposits are frequently required of customers, consumers of service, tenants, driver-salesmen, and others. Beverage companies usually demand deposits from customers on returnable bottles and cases. The security deposits, upon the return of empty containers, are either refunded or credited to the respective customers' accounts.

Dividend declarations, particularly for large corporations, often specify that stockholders of record as of a given date are to be paid a dividend at a subsequent date. The company's stock ledger is kept by its agent if a corporation has a fiscal agent who attends to stock transfers and to the payment of dividends with funds furnished by the company. The dividend, in corporations where the stock is closely held, is often payable simultaneously with its declaration. If not, it should be treated as a current liability until it is paid.

Some businessmen are under the impression that only such financial obligations as are immediately payable represent liabilities. Frequently, installments payable on the basis of this mistaken theory of accounting are not recorded until paid. An examination by an inde-

UNDERSTATEMENT OF LIABILITIES - ILLUSTRATED

THE BLANK COMPANY CASH DISBURSEMENTS

DATE	NAME	CK	NET CASH	ACCOUNTS PAYABLE	GENERAL LEDGER ACCOUNT	AMOUNT
(Year) July 1	Baker & Co.	75	450.00	450.00		
" 1	Ohio Machinery Co.	76	2,500.00		Machinery	2,500.00
" 1	Ray Brothers, Inc.	77	1,275.00	1,275.00		
" 1	The Realty Co.	78	500.00	500.00		

AGREEMENT

The Ohio Machinery Co. agrees to sell The Blank Company 25 Ohio Knitting Machines for a total of \$100,000.00, payable \$2,500.00 the first of each month, beginning July 1 (Year); 4% interest to be charged on the unpaid balance.

The Ohio Company
George Brown President
The Blank Company
C. A. Blank President

Conclusion:
At the time title passed, July 1 (Year), the \$100,000.00 cost of the machinery purchased from The Ohio Machinery Co., should have been charged to Machinery account, and not just the \$2,500.00 initial payment. Not to record the total contract price, at time of purchase, results in an understatement of liabilities which is a violation of accounting principles.

James White July 10 (Year)



pendent accountant of a company's books of account might reveal a situation such as that illustrated in Form 62 where the conclusion was reached that, at the time title passed to the machinery purchased, the total cost thereof should have been recorded and not just the initial installment payment.

Program of Audit. The list of current liability accounts which is covered by the audit program presented herewith is not, by any means, intended to be exhaustive. The general program outlined is subject to such modifications as are found necessary in order to meet the requirements of the particular audit engagement.

PROGRAM OF AUDIT

1. Secure a schedule of notes payable.
2. Check the items in the notes payable schedule to the company's notes payable register.
3. Confirm, by means of circularization, the notes payable, together with the company's collateral held by note creditors as security.
4. Ascertain whether provisions of the minutes of the board of directors regarding note issues have been complied with.
5. Examine any note extension agreements and ascertain how payments made to note holders, in consideration for their agreeing to extensions, are being amortized.
6. Obtain a trial balance from the accounts payable ledger and check amounts to the ledger.
7. Ascertain whether the purchase journal was properly closed. (See Form 63, Last Goods Received Schedule.)
8. Verify that the total of the accounts payable trial balance is in agreement with the Accounts Payable controlling account.
9. Examine copies of account sales statements rendered consignors as of the balance sheet date.
10. To detect the omission of accounts payable, examine all entries covering expenditures made, for as long a period as possible, after the balance sheet date. (See Form 64, Unentered Liabilities Schedule.)
11. Investigate debit balances to accounts payable accounts. Follow the same procedure in confirming accounts payable debit balances as that employed in connection with the verification, by circularization, of accounts receivable.
12. Circularize creditors, whenever the lack of internal control indicates the desirability of doing so, for the purpose of securing statements of balances due them.
13. Secure an analysis of the accrued liability accounts. (See Form 65, Accruals Payable Schedule.)
14. Examine journal entries from which postings were made to the accruals payable accounts, and inspect documents in support of the respective entries.
15. While examining expenditures made, subsequent to the date of the balance sheet, look for expenses which should have been accrued.
16. Examine the minutes of the board of directors with a view towards the detection of the omission of any accruals payable.

17. Examine the first payroll paid subsequent to the end of the period covered by the audit, in order to ascertain whether any portion thereof was omitted from the accruals payable as of the balance sheet date.

18. Examine contracts and agreements on file for payments of salaries, bonuses, commissions, rents, and royalties, in order to verify whether accruals of these items have been properly made.

19. Examine the terms of interest-bearing obligations for the purpose of determining whether interest had been properly accrued.

20. Examine the last tax returns made by the company for the period covered by the audit, and examine the tax bills received during that period, in order to ascertain whether taxes have been accrued correctly.

21. Secure a schedule of deposits payable and confirm a selected list of the deposits by circularization.

22. Examine securities held in lieu of cash for depositors.

23. Read minutes of the board of directors authorizing payments of dividends and ascertain whether the dividend accounts are in agreement therewith. (See Form 66, Dividends Paid and Payable Schedule.)

24. Verify that dividends which were declared prior to the date of the balance sheet, and which were not payable until a later date, were properly accrued.

25. Check the company's calculation of dividends payable on its outstanding shares of capital stock as of the balance sheet date.

26. Secure a liability certificate. (See accompanying form.)

27. Current liability accounts questionnaire—large audit engagements.

a. Are notes payable recorded, according to maturities, in a register?

b. Are records maintained that show the collateral pledged as security for notes payable?

c. Is an accounts payable ledger, or the voucher system, employed?

d. Are monthly trial balances of accounts payable, regularly prepared?

e. Are purchase invoices checked as to arithmetical calculations and approved as to prices, terms, quantities, and quality before being entered?

f. Is the practice followed of setting up accruals monthly?

g. Is a subsidiary ledger maintained of deposits payable?

h. Are lists of stockholders, to whom dividends are payable, prepared by a transfer agent?

i. Are dividend payments to stockholders made by a transfer agent?

Examination of Subsequent Transactions. Considerable dependence is placed upon the examination of transactions, subsequent to the balance sheet date, in order to detect omissions of accounts payable and accruals payable. If the audit is not made until after the lapse of a month from the date of the balance sheet, a scrutiny of the cash disbursements book should indicate whether any payments applicable to the preceding year had been made for which either accounts payable or accruals payable were omitted. A payment made in January, following the balance sheet date, on account of legal services performed the preceding December, may have been omitted from the liabilities at the balance sheet date.

Accruals Payable Accounts. When making an examination of a company's various accrued liability accounts, the auditor should make a comparison between the related expense accounts for the period covered by the audit and those for the corresponding preceding period. If it is found that a particular privilege-tax expense account for the current accounting period is about the same in amount as that for the preceding period, it is quite probable that the amount of the accrual for this particular privilege-tax is correct. The situation, if the comparison is unfavorable, merits investigation.

There is another matter to be considered in connection with accruals payable and that is the probability that items of expense which are covered by accruals one year are quite likely to reappear the following year. Hence it is regarded as a desirable procedure to compare the accruals at the close of the current year with those at the end of the preceding year. By this method, omissions of accruals payable may sometimes be brought to light.

Some accruals payable can be checked readily as for example the accrual of a privilege tax that was paid subsequent to the balance sheet date and before completion of the audit. A gap, between the date to which an expense has been paid and the date of the balance sheet, necessitates an accrual.

Miscellaneous Liability Accounts. Outstanding gift certificates which entitle holders to purchase merchandise and which are open on the books of a company, such as a retail department store, should be found to correspond with the related controlling account.

Lack of agreement between the number of lessees in an apartment house, or business property, and the number of items in the list of security rental deposits is a matter that should be investigated. Any discrepancy between the number of a company's driver-salesmen who are required to furnish security deposits and the number of the driver-salesmen's deposit accounts ought to be inquired into. Perhaps it will be found that the requirement regarding security deposits has been waived in certain instances.

Reserves which appear on the liabilities side of the balance sheet usually comprise "true reserves," an illustration of which is a Reserve for Contingencies account. The company ought to be asked to furnish a full explanation of such a reserve. If the necessity for a reserve for contingencies account no longer exists, the account should not be carried.

Circularization of Creditors. Requests sent to banks for confirmation of balances generally include a provision for reporting upon any loans and collateral held. Other note creditors are usually asked to

confirm their obligations as to amount, interest rate, maturity, and collateral held. Care must be exercised, by the outside auditor, to confirm the company's liabilities to commercial factors together with the accounts receivable and merchandise pledged as security for loans payable. It may be deemed necessary, where an effective control over purchase invoices is not maintained, to request suppliers with whom the company has been doing business to furnish statements of their accounts with the company, as of the balance sheet date, directly to the company's independent accountants. It is regarded as a desirable practice to circularize a selected list of depositors, with particular reference to those having the larger balances, for the purpose of confirming the amounts of money or securities held by the company on deposit.

Whatever procedure is followed with respect to the circularization of the company's customers, the same one should ordinarily be extended to include accounts payable debit balances. By this means the authenticity of the balances, whether resulting from returns of merchandise or advances of funds on account of future purchases, can be substantiated.

Confirmations which are received directly by the independent accountant, from the creditors of the company under audit, should be checked to the company's records. Amounts of accounts payable, for which confirmations are not obtained should be compared with the creditors' statements in the company's files.

Sundry Audit Schedules. The Last Goods Received Schedule, Form 63, illustrates the procedure followed in making a test of the manner in which the purchase journal was closed. Information appearing on the schedule is usually obtained from the company's receiving book. Tests of relatively important items of receipts of materials, just before the balance sheet date should indicate whether the purchase journal is being kept properly. Closing the purchase journal sometime in advance of the balance sheet date is a practice that should not be permitted.

The Unentered Liabilities Schedule, Form 64, shows the procedure followed in making an investigation into omitted accounts payable and accruals payable. Clues to the omission of liabilities may be found in the company's minute book. Agreements may have been entered into by the board of directors for the performance of services for which bills have not been received or accruals payable provided. It should be apparent from the schedule whether the examination by the independent accountant included disbursements made since the balance sheet date.

THE BLANK COMPANY
YEAR ENDED DECEMBER 31 (YEAR)
LAST GOODS RECEIVED SCHEDULE

PREPARED BY *W. L. H.*
 REVIEWED BY *G. W. H.*

RECEIVING NUMBER	DATE RECEIVED	SUPPLIER'S NAME AND ADDRESS	AMOUNT
4075	Dec 31 W.	Henry Smith & Co., 100 Main St., Boston	\$ 1,075.00
4076	D.	Brown Bros., 47 South St., Boston	\$ 400.00
4077	D.	Grey & Black, 60 Center St., Boston	\$ 3,000.00
4078	D.	Alford's Sons, 400 Atlantic Ave., Boston	\$ 500.00
4079	D.	Strong & Land, Inc., 50 Pacific St., Boston	\$ 2,000.00
		Total	\$ 5,175.00
		↓ Checked to purchase invoice and purchase journal	
		* Checked to creditor's account	
		⊕ Last item received during year ended December 31 (Year)	
		James White	
		February 10, (Year)	

FORM 63

THE BLANK COMPANY
 YEAR ENDED DECEMBER 31 (YEAR)
 UNENTERED LIABILITIES SCHEDULE

PREPARED BY J. H. Co. 3/64
 REVIEWED BY C. A. H. 4/64

REFERENCE	CREDITOR	EXPLANATION	AMOUNT	ACCOUNT TO BE CHARGED	ADJUST- MENT NO.
Cash 75	Amos Byron	Engineering services ↘	15,000	Power plant A-14	J-6
Dr	Bee Candy Shop	Candy for Christmas party ↘	1,200	Administrative Exp X-10	J-7
Dr	Tails Mills, Inc.	New season goods ↘	27,000	Purchases X-12	J-8
Dr	Brown & Brown	Legal services ↘	5,000	Administrative Exp X-10	J-9
		Above adjustments reviewed with Wm. Blain, treasurer.			
	↘ Invoice examined	James White			
		January 15 (year)			

THE BLANK COMPANY
 Year Ended December 31 (year)
DIVIDENDS PAID AND PAYABLE SCHEDULE

PREPARED BY J. White 1/15/19
 REVIEWED BY B. Bond 1/15/19

REF	DESCRIPTION OF DIVIDEND	DATE DECLARED	DATE PAYABLE	DIVIDEND RATE	SHARES OUTSTANDING	DIVIDEND PAID	DIVIDEND UNPAID AT END	DECLARATION CHECKED TO MINUTES
	7% Preferred Stock:							
		12/10 Year	1/10 Year	* 3.50	100,000*	350,000*		J. White
		6/10 Year	7/10 Year	* 3.50	100,000*	350,000*		J. W.
		12/10 Year	1/10 Year	* 3.50	100,000*		350,000	J. W.
	Common Stock:							
		3/10 Year	4/10 Year	* 1.50	200,000*	300,000*		J. W.
		9/10 Year	10/10 Year	* 1.50	200,000*	300,000*		J. W.
	Total					1,300,000	350,000	
	Information furnished by Company							
	Checked to minutes of Board of Directors							
	Checked to confirmations from registrar and transfer agent							
	Checked to cancelled bank check							
	Checked to general ledger.							
	James White, February 15 (year)							

The Accruals Payable Schedule, Form 65, indicates the manner of procedure employed in the verification of the accounts comprehended in the title. Scrutiny of the last tax returns filed by the company under audit should be helpful in ascertaining whether accruals of tax liabilities were properly made. Examination of the first payroll paid after the balance sheet date ought to enable the independent accountant to ascertain whether there was any accrued payroll at that time. Information needed for the purpose of checking the accrued interest payable on notes payable should ordinarily be found on the independent accountant's notes payable schedule.

The Dividends Paid and Payable Schedule, Form 66, illustrates the manner of analyzing and verifying the transactions in the dividend accounts for the period covered by the audit. It will be seen that dates are shown as of which stockholders of record are entitled to dividends and payments are due. Bank checks in payment of dividends payable at the balance sheet date can be usually examined before the completion of an audit. Funds for dividend payments, if a company has a transfer agent, are sent to the agent who makes the distribution. Any dividend checks that are returned by the post office department to the transfer agent are generally held until the stockholders' claims become outlawed. After that, the cash should be returned to the company by the agent and the unclaimed dividends should be transferred to the Surplus account. Any doubt as to whether a company discharged its dividend obligations by supplying the necessary funds to its fiscal agent with which to pay declared dividends can be cleared up by obtaining an opinion from the company's attorneys. The omission, if it is found there are no minutes covering the declaration of a dividend which has been paid, should be recorded in the working papers and brought to the client's notice.

The showing of all a company's current liabilities, in one section of a financial statement, is particularly desirable in view of the importance which is attached to the ratio of current assets to current liabilities. An examination of a company's balance sheet and records may reveal that, as illustrated in Form 67, a mortgage is shown as a noncurrent liability whereas the installment that is due the year following the balance sheet date should be shown as a current liability and the remainder only as noncurrent.

A Mixed Control Account Situation. It sometimes happens that a control account will be found to contain several varieties of accounts, in which case it is necessary to analyze the respective control into its constituent elements. Such a situation with respect to an Accounts Payable account is illustrated in Form 68. In addition to trade ac-

UNDERSTATEMENT OF CURRENT LIABILITIES-ILLUSTRATED

THE BLANK COMPANY BALANCE SHEET DECEMBER 31 (YEAR)	
Assets	
CURRENT ASSETS	\$ 270,500.00
CASH	1,000,000.00
INVESTMENTS	<u>1,270,500.00</u>
TOTAL CURRENT ASSETS	\$ 1,270,500.00
REAL ESTATE (SUBJECT TO MORTGAGE - per contra)	10,747,000.00
TOTAL	<u>12,017,500.00</u>
LIABILITIES	
CURRENT LIABILITIES	\$ 145,000.00
ACCOUNTS PAYABLE	22,500.00
ACCURALS PAYABLE	<u>22,500.00</u>
TOTAL CURRENT LIABILITIES	\$ 167,500.00
MORTGAGE PAYABLE	4,000,000.00
CAPITAL:	
CAPITAL STOCK	\$ 7,500,000.00
SURPLUS	<u>350,000.00</u>
TOTAL CAPITAL	7,850,000.00
TOTAL	<u>12,017,500.00</u>

INDENTURE

The Blank Company hereby mortgages its real estate in Colville, Ind., as security for a 4% \$4,000,000.00 loan from Falls, Inc., payable \$250,000.00 every July 1 (with interest) until payment has been made in full.

The Blank Company
John Blank President
 Falls, Inc.
Lony Falls President

December 31 (Year)

Conclusion - The \$250,000.00 mortgage payment which will become due on July 1 (Year), following December 31 (Year), should be shown as a current liability on the balance sheet and the remainder of the mortgage payable shown as a non-current liability on the balance sheet.

James White Grant 3 (Year)



ANALYSIS OF AN ACCOUNT - ILLUSTRATED

ACCOUNT <i>Accounts Payable</i>			
DATE	CHARGE	DATE	CREDIT
	✓	YEAR Dec. 31	74,675 00
<i>Balance</i>			

Conclusion:
The Accounts Payable account is a mixed account and should be broken up into its constituent elements.
James White
January 10 (Year)

THE BLANK COMPANY ANALYSIS OF ACCOUNTS PAYABLE DECEMBER 31 (YEAR)		
ACCOUNT	DEBIT BALANCE	CREDIT BALANCE
TRADE ACCOUNTS PAYABLE		175,250 00
DUE TO OFFICER		100,000 00
DUE FROM BLUE CO. (WHOLLY OWNED SUBSIDIARY)	200,575 00	
BALANCE	74,675 00	
TOTAL	275,250 00	275,250 00

counts payable there is an amount due to an officer and an amount due from a wholly owned subsidiary company. The conclusion reached by the independent accountant, in the case cited, was that the Accounts Payable account is a mixed account. It should be separated into its various classifications.

Liability Certificate. The usual procedure followed by independent accountants is to request an executive of the company under audit to sign a liability certificate, such as the one presented herewith. Provision is made, in the liability certificate, for recording amounts of

LIABILITY CERTIFICATE

MESSRS WHITE & WHITE

CERTIFIED PUBLIC ACCOUNTANTS

For the purpose of enabling you to determine the financial condition of _____ as of _____ 194 ____.

I hereby certify that, to the best of my knowledge and belief:

1. There are no direct liabilities not shown on the books, except \$ ___ for _____
2. There are no contingent liabilities not shown on the books, except \$ ___ for _____

Remarks: _____

Signed _____ Title _____
Date _____

(Use other side for explanations if necessary)

direct liabilities and contingent liabilities which are not shown on the company's books. There may be invoices covering goods and services which have been held out, for one reason or another, and not furnished to the accounting department for entry. Contingent liabilities include such items as discounted notes, drafts, and acceptances; assignments of debts with a guaranty of collection or under a repurchase agreement; endorsements or guarantees of obligations of others; open balances on letters of credit, judgments, and pending litigation. Sometimes it is necessary that the amount of a contingent liability be estimated. Information regarding a company's liabilities which are not carried on its books is necessary in order that steps may be taken to set up the liabilities, or else to comment upon them in a balance sheet footnote. A properly signed certificate, addressed to the independent accountant, shows that he made an inquiry regarding the liabilities of the company under audit.

Balance Sheet Treatment. It is a generally accepted principle of accounting that all of a company's liabilities should be shown on its

balance sheet. Security deposits from customers on returnable containers are generally regarded as a current liability. However, in some trades the practice is followed of showing container deposits made by customers as noncurrent, the idea behind this practice being that when an empty container is returned a full one is usually delivered.

If the date of the balance sheet falls between the date of a dividend declaration and the payment date, a dividend payable liability results. Mere mention of the dividend declaration and the amount of the unpaid dividends, in a footnote to a balance sheet, is not regarded as acceptable practice. Dividends payable to stockholders who cannot be located are usually presented on a balance sheet as "Unclaimed dividends payable."

Creditors holding past-due notes payable are likely to take legal action to compel payment or to obtain title to their collateral which is held as security. In view of the possibility of such a situation arising, the past-due notes payable, whether secured or unsecured, should be set forth as such on the balance sheet.

Accounts payable debit balances are properly shown as an asset, generally in the current section, on a balance sheet. If they are relatively insignificant in amount, the accounts payable debit balances are usually included with the accounts receivable.

REVIEW QUESTIONS

1. Write a program for the verification of notes payable.
2. Mention some transactions that might indicate the omission of notes payable.
3. How may authorizations for incurring notes payable obligations generally be ascertained?
4. What attitude would you take to the omission of notes payable covering purchases of equipment which had not been charged to the Equipment account?
5. What purpose is served by making a list of the last few receipts of goods just before the balance sheet date?
6. How may the omission of accounts payable be detected?
7. What action would you take if a client omitted, from the accounts payable, invoices for "new season" goods on the ground that the goods had not been included in the inventory?
8. What procedure should be followed in order to ascertain whether there are any unpaid assessments for taxes on income?
9. Distinguish between accounts payable and accruals payable.
10. Mention several accruals payable that are frequently encountered, on a properly kept set of books, at the balance sheet date.

11. Is it likely that omitted accruals payable may be brought to light when examining the expense accounts?
12. Describe a practical method of checking accrued interest payable.
13. What is the purpose and what are the contents of a liability certificate?
14. Explain the procedure which should be followed in the audit of notes receivable discounted.

CHAPTER 15

NONCURRENT LIABILITIES AND DEFERRED CREDITS

Information shown by the company's records regarding the mortgages payable is verified by correspondence with the respective mortgagees. Payments of principal and interest during the current accounting period, under examination, are checked. Transactions during the current year in the funded debt and sinking fund accounts are examined. Deferred credits and unearned income are verified to see whether the accounts meet the requirements of accrual accounting. Unrealized Profits accounts on the books of installment sellers of lots in suburban development properties, of furniture dealers, and of others are checked to ascertain whether the accounts conform to the installment method.

Mortgages payable are described according to the property which is pledged as security therefor, such as "real estate," or "chattel," mortgages. The lender can institute foreclosure proceedings if the mortgagor does not meet his obligations under the terms of the agreement. Chattel mortgages payable are generally secured by pledging articles of equipment. Mortgages payable covering suburban development properties sometimes provide that a portion of the mortgage, covering any particular parcel of property, may be released upon making payment of the amount of the mortgage which is applicable thereto. Such a provision permits the seller of a lot in a development property to convey it, free of any mortgage encumbrance, to the purchaser.

A debt which is incurred to obtain funds, usually a long term obligation, is frequently referred to as a funded debt. Most of the railroads, many of the public utility enterprises, and numerous large industrial concerns have debts of this nature. These are represented generally by bonds issued under the terms and provisions of a trust agreement. The pledge of property given as security for the bond issue is held by the trustee, under the indenture, for the bondholders. Real properties, such as the right of way, terminals, and stations of a railroad company, are frequently pledged as security for long term bonds. Rights and privileges of bondholders, interest dates, interest rate, redemption value if called, maturity, and conversion privileges are all set forth in the indenture and the bonds. Usually bonds run for periods of time in excess of five years.

Some bonds contain sinking fund provisions which require that a sufficient amount of money be deposited periodically with the trustee so that these contributions, together with interest accretions, will be sufficient to redeem the bonds, for which the fund was established, at maturity. Trustees frequently invest funds in bonds of the same issue as the one for which the sinking fund was established, so that by the time the issue matures a considerable portion of the bonds will have been acquired. In order to make them attractive to investors, bonds are often given conversion privileges which enable holders to exchange their bonds for shares of stock. Issuance of serial bonds does away with the necessity of investing sinking fund monies.

The issuing company, or the company's fiscal agent, keeps a record of registered bondholders and pays them the interest with funds provided for the purpose. Bond redemptions are made by the company or its agent. When a fiscal agent, usually a trust company, redeems bonds at maturity, it generally cremates the bonds and furnishes cremation certificates to the issuer.

Payments by customers, in advance, for services are treated properly as deferred credits to future operations. Receipts, in advance, by a correspondence school for courses of instruction, purchased by students, are looked upon as a deferred credit to future periods; the income is not considered as having been earned until the instruction has been given. Most subscriptions for periodicals are received, in advance, from readers, and are recorded in the books of account as "unearned subscriptions" until such time as the periodicals are mailed. Then a transfer from unearned to earned subscriptions income is made. The receipt of an advance payment from an advertiser is treated as unearned advertising income until the advertisement has been published; then the revenue from the advertising space becomes earned income.

Proceeds received by a corporation from the sales of its bonds above par constitute a deferred credit which is apportioned over the life of the bond issue, thereby reducing the interest expense on the issue.

The special feature of sales on the "deferred payment plan" is the relatively long period of time, as compared with other classes of sales, allowed purchasers in which to complete their payments. Developers of suburban properties frequently permit lot buyers to spread their payments over a four-year period. It is deemed a conservative practice, on account of the long period of time that elapses from the date of purchase by an installment buyer to the date of final payment, to spread the profit on an installment sales transaction over the period of the payments. The plan followed, when a sales contract is signed,

is to credit the gross profit thereon to the Unrealized Profits on the Installment Sales account. Then, upon receipt of an installment payment, the unrealized amount of profit applicable to the payment is transferred to the current Realized Profits on Installment Sales account.

Program of Audit. A general program, subject to modification in order to meet the requirements of the particular audit engagement, for the verification of noncurrent liability and deferred credit accounts is presented herewith.

PROGRAM OF AUDIT

1. Secure a schedule of the mortgages payable. (See Form 69, Mortgages Payable Schedule.)
2. Confirm, by means of circularization, pertinent information regarding each mortgage payable.
3. Classify mortgage payments which will be due within the year following the balance sheet date as current, including amounts of past due mortgages payable.
4. Examine canceled mortgages which were paid during the period covered by the audit.
5. Ascertain whether mortgage payments made during the period covered by the audit were recorded in the public records.
6. Examine interest payments, made near the balance sheet date, for the purpose of detecting the omission of any mortgages payable.
7. Secure a schedule showing the bonds payable of each issue.
8. Read bond indentures and any supplementary agreements thereto.
9. Confirm, by communicating with trustees, pertinent facts regarding the company's bond issues.
10. Examine reacquired bonds on hand.
11. Examine bonds canceled, and certificates received from trustees covering bonds cremated, during the period covered by the audit.
12. Ascertain whether sinking fund provisions have been complied with.
13. Ascertain whether sufficient shares of the company's capital stock are available if bondholders should exercise their conversion privileges.
14. Ascertain whether provisions of the minutes of the board of directors relating to mortgages and bonds payable transactions have been complied with.
15. Secure a schedule of deferred credits to income.
16. Investigate system employed by company in transferring amounts from the Deferred Credits to Income account to the current operations.
17. Ascertain the procedure followed by company in making transfers from the Unrealized Profits on Installment Sales account to current income.
18. Check, by means of selective tests, the items that comprise the balances to the Deferred Credits to Income account and the Unrealized Profits on Installment Sales account.
19. Noncurrent liabilities and deferred credits accounts questionnaire—large audit engagements.
 - a. Have copies of bond indentures been secured?
 - b. Is a register maintained that shows the amounts of deferred credits that are to be transferred to income periodically?

- c. Are profits on deferred payment sales apportioned to accounting periods on the basis of collections?
- d. What procedure is followed when property sold on the installment plan is repossessed?

Changes in Mortgages and Bonds Payable Accounts. It is within the province of the independent accountant's duties to examine the transactions which took place, during the period covered by the audit, in the Mortgages and Bonds Payable accounts. This is not ordinarily very burdensome because the transactions are usually relatively few in number. Payments made to mortgage and bond creditors on account of principal ought to be supported by proper vouchers. Canceled mortgages payable, when paid in full during the period covered by the audit, should be presented for inspection by the independent accountant. Credits to Mortgages and Bonds Payable accounts ordinarily correspond to the receipt of cash or the acquisition of property. The principal amount of a real estate mortgage payable, taken back by the seller of property, should be checked to the papers on the basis of which title to the property was closed.

The Mortgages Payable Schedule, Form 69, illustrates the manner in which the independent accountant should tabulate pertinent information regarding the mortgages payable by the company under audit. It will be noted that provision is made for recording the accrued interest payable as of the balance sheet date. The audit program, followed by the independent accountant, appears in the lower portion of the schedule for convenience in making reference thereto.

Cognizance should be taken of past-due mortgages payable, frequently referred to as "open" mortgages. The danger to the mortgagor when this situation arises is that a mortgagee may press the borrower for payment at a time of stringency in financial markets.

Funded Debts. All pertinent financial matters covered in the company's bond indentures should be tabulated and checked to the books of account. Examination of sinking fund assets is comprehended in the audit of funded debts where the bond issues contain sinking fund provisions. It is necessary, in connection with the verification of sinking fund assets, to examine the agreement between the corporation, the bondholders, and the trustees of the sinking fund and to ascertain whether the terms of the indenture have been lived up to. Redemptions of funded debts should be evidenced by the canceled bonds or the trustee's cremation certificates.

Confirmations of Mortgages and Bonds Payable Accounts. It is normal auditing procedure to confirm significant facts pertaining to mortgages and bonds payable. The request for information regarding

THE **Blank**
Year *Ended*
MORTGAGES PAYABLE

LOCATION OF PROPERTY	MORTGAGEE	INTEREST		AMORTIZATION		MATURITY
		RATE	DATES	AMOUNT	DATES	
100 Grand Ave.	Mutual Savings Bank	5%	J. J.	2,500	J. J.	(Year)

COMPANY
December 31 (year)
SCHEDULE

PREPARED BY JWL:ky
REVIEWED BY B. B. m/f

BEGINNING BALANCE	ADDITIONS	DEDUCTIONS	FINAL BALANCE	INTEREST ACCRUED BEGINNING	INTEREST ACCRUED END	INTEREST PAID FOR PERIOD	INTEREST PAYEE
100,000		5,000	95,000	2,500	2,375	4937	Mutual Savings Bank
200,000		10,000	190,000	5,000	4,750	9875	D. J.
300,000		15,000	285,000	7,500	7,125	14,812	
↓	Checked to final balance in preceding year's working paper						
⊗	Checked to confirmation						
*	Checked to cancelled bank check						
†	Checked to Company's computation. James White February 15 (year)						

FORM 69

212 NONCURRENT LIABILITIES AND DEFERRED CREDITS

a bond issue is generally sent to the company's fiscal agent, usually a trust company, which attends to the making of transfers of registered bonds and payments to bondholders. Unless this procedure is followed, it may be that an irregularity which is concealed in entries to the Mortgages or Bonds Payable accounts will go undiscovered.

Mortgagees should be requested to furnish the following information regarding the mortgages which they hold.

- a. Principal amount of mortgage at the balance sheet date.
- b. Interest rate and dates.
- c. Amortization requirements.
- d. Maturity.
- e. Description of property mortgaged.
- f. Date to which interest has been paid.
- g. Amortization payments in arrears, if any.

The trustees for the bondholders should be requested to supply the following information.

- a. Principal amount authorized and outstanding of each issue at the balance sheet date.
- b. Interest rate and dates.
- c. Amortization requirements.
- d. Maturity.
- e. Sinking fund provisions.
- f. Conversion privileges.
- g. Property held as security.
- h. Amounts of cash and investment securities held in sinking fund.
- i. Amounts of bonds canceled and cremated during period covered by the audit.
- j. Amount of cash on hand for payments of bond coupons and principal amounts of matured bonds.

Deferred Credit and Unrealized Profit Accounts. The Unearned Discount account of a bank at the statement date should be found to be in agreement with the supporting records, the accuracy of which should be test-checked. In the case of a magazine publisher, the undelivered periodicals at a given date, shown by the company's subscription expiration records, multiplied by the average per copy subscription rate ought to give an amount that corresponds closely with the balance to the Unearned Circulation account. The outstanding service coupons, in the case of a commercial laboratory, times the average price per coupon should result in a product that corresponds closely with the balance to the Deferred Coupon Sales account.

A deferred foreign exchange credit, sometimes referred to as a reserve for fluctuation of foreign exchange, should equal the net amount, or the balance remaining, after the reduction of accounts

payable in foreign currencies to quoted exchange rates as of the balance sheet date.

The balance to an Unrealized Profits account, such as carried on the books of a developer of suburban property, should be found to be in agreement with the company's detail records. The following illustration shows how an Unrealized Profits account might appear in a subsidiary ledger.

UNREALIZED PROFITS ACCOUNT, LOT 1, BLOCK 4

Realized profits:		Unrealized profit:	
On down payment	500	On sale	2,500
On first installment	500		
Balance	1,500		
	<hr style="width: 100%;"/>		
Total	2,500	Total	2,500
	<hr style="width: 100%;"/>		
	<hr style="width: 100%;"/>	Balance	1,500

The \$1,500 balance to the Unrealized Profits account will be transferred to income from time to time when the last three installment payments have been made by the debtor.

Balance Sheet Treatment. Mortgages payable amortization payments which fall due, as well as mortgages which mature within a year after the balance sheet date, together with past-due mortgages payable, are properly treated as current liabilities on a balance sheet. An analysis of mortgages payable, according to maturities, is sometimes presented in a supporting schedule. The practice, if mortgages are sold at a discount, is to present them on a balance sheet at face value and show the unamortized portion of the discount as a deferred charge to income. The unamortized premium on a mortgage which is sold above par is treated as a deferred credit to future operations.

The balance sheet treatment accorded bonds payable is analogous to that explained in connection with mortgages payable. Sufficient details should be given to enable the reader to identify the respective bond issues. When the issues are very numerous, as is frequently the case in consolidations of parent and subsidiary companies, it is frequently desirable to append to the balance sheet a supporting mortgages payable schedule.

The nature of an agreement covering the company's guarantee of the payment of a mortgage, or bond issue, is generally stated in a footnote to a balance sheet. Some parent companies guarantee the

mortgage and bond indebtedness of one or more of their subsidiaries as to both principal and interest.

Sinking fund assets are generally presented on the asset side of a balance sheet under a major classification.

Deferred credits to income, on the balance sheet, are shown usually grouped together in one amount. The unearned income items do not ordinarily represent a liability that must be paid in the usual manner. Frequently they represent obligations to render services. Amounts of uncompleted construction contracts should be mentioned by means of appropriate footnotes, on building contractors' balance sheets, rather than shown as a deferred credit to future operations.

On the balance sheet of a company which sells goods on the deferred payment plan and which employs the "installment basis" of accounting, the Unrealized Profits from Installment Sales account is usually presented after the liability accounts. Employment of the installment basis of accounting does away with the necessity of reserves for bad debts and collection expenses. The balance to the Unrealized Profits on Installment Sales account ordinarily exceeds the balance to any reserve account that would be carried if the reserve method of accounting had been employed.

REVIEW QUESTIONS

1. Describe the procedure that should be followed in checking the Unearned Circulation account of a periodical publishing business.
2. What is your understanding of the "installment method" of accounting for profits on deferred payment sales?
3. How should the Unearned Advertising Revenue account, in a periodical publishing business, be audited?
4. Indicate the procedure to be followed when auditing the Unearned Tuition account in a school which sells correspondence courses of instruction.
5. Outline the general procedure applicable to the verification of the Unearned Income account in a commercial laboratory which sells coupons, entitling holders to have analyses of materials made.
6. What procedure should be followed in auditing the Gift Certificates Outstanding account in a retail department store?
7. How may the verification of accrued interest and unamortized discount on notes payable be readily verified?
8. How may guarantees of obligations, by a parent company, become a liability?
9. Explain the procedure which should be followed in auditing unclaimed wages.
10. Distinguish between an account payable and a deferred credit.

CHAPTER 16

RESERVES

Valuation reserves are looked into at the time the asset accounts are audited. A securities valuation reserve is established when valuations of investment securities are below book values. A reserve for bad debts is set up to cover losses on the accounts and notes receivable, based on an analysis of the accounts and the company's experience. Reserves for depreciation of depreciable assets are provided in accordance with established trade practices. All assets which appear on the balance sheet are valued. The adequacy of the true reserves which are presented under the liabilities classification on a balance sheet is verified. Surplus reserves are investigated and their authorizations checked.

Reserve accounts are classified frequently as "valuation," "true," and "surplus" reserves. It is an accepted accounting principle that the assets should be valued as of the balance sheet date, and so valuation reserves are employed in many instances for the purpose. The procedure is illustrated in the case of a Reserve for Depreciation of Machinery account which is shown as a deduction on the asset side of a balance sheet. It is also recognized as an established principle that all liabilities should be presented, and so true reserve accounts are often found to be necessary. A Reserve for Injuries to Workmen account, when the company does not have a workmen's compensation insurance policy and carries the risk itself, illustrates this type of reserve. Use of a surplus reserve is a method of earmarking a portion of the surplus so that it cannot be paid out in the form of dividends. A Sinking Fund Reserve account is sometimes set up for this purpose. Charges to reserve accounts are made ordinarily for the items for which the respective reserves were provided. Any manipulation of reserves for the purpose of distorting the profit showing should not be countenanced by the independent accountant.

Depreciation Reserves. Valuation reserves are normally provided for depreciable property of all classes, such as buildings, machinery, fixtures, equipment, and furniture. The most common methods in use for computing periodic provisions for depreciation which are added to the depreciation reserves are as follows:

1. Fixed proportion of cost method.
2. Fixed percentage of diminishing value method.

3. Sinking fund method.
4. Number of units of production, or service, method.

The experience of the company and the practices of the trade are relied upon, to a considerable extent, when estimating the useful life of depreciable properties. Some kinds of equipment, such as motor vehicles, are subject to considerable wear and tear. Articles of equipment which necessitate the making of ever increasing expenditures for repairs, as time goes on, finally reach a state where it is no longer deemed economical to maintain them in serviceable condition.

Advancement in the arts and sciences has the effect of rendering a good deal of property obsolete. Certain industries are particularly susceptible to obsolescence because of the rapidity with which changes take place, as in the airplane industry. The shifting of trading centers in cities has often caused business buildings to become obsolete before wearing out. The useful life of depreciable property, on the whole, is more likely to be determined by obsolescence than by wear and tear.

The "fixed proportion of cost method" is widely used for calculating periodic provisions for depreciation. This plan seems to be employed extensively, for computing depreciation provisions, where the element of obsolescence is the predominant factor in determining the useful life of the property. This method is referred to frequently as the "straight line system" because when depreciated values are plotted on coordinate paper, and the points joined, a straight line is obtained.

The "fixed percentage of diminishing value method" has the effect of providing gradually lessening periodical amounts of depreciation during the useful life of the property. Under this plan, the sum of the periodic expenditures for repairs and of depreciation provisions are more uniform throughout the life of the property than they are when the straight-line system is used. Tables are available which facilitate obtaining the percentages required for use in making calculations.

The "sinking fund method" provides gradually increasing periodic provisions for depreciation during the life of the property. This situation is due to basing the periodic depreciation provisions on the increments that would take place if a sinking fund should be established, each increment being equal to the current sinking fund contribution plus the interest accretion. The increments increase, as the result of the growth of the fund which earns interest. Advocates of the sinking fund method argue that the depreciated value of the property follows the efficiency curve which decreases at a more and more rapid rate as time goes on. Although the periodic depreciation provisions are based upon a sinking fund table, a sinking fund does not necessarily have to be established.

The "number of units of production method" provides for spreading the cost of depreciable property on the basis of the number of units of output, or service, rendered. Application of this plan can be seen in the case of a taxicab which cost \$2,000 and which is estimated to be serviceable for 100,000 miles; the rate of depreciation is thus seen to be two cents per mile.

The depreciation of a group of assets without regard to the individual articles, such as a company's furniture and fixtures, is referred to as the "composite life" method. If depreciation is provided for individual items of depreciable property, as is frequently the case in industrial enterprises, the plan is described as the "specific article" method.

There is no further need for periodic depreciation provisions after a reserve has been provided that equals the original cost of the property. Fully depreciated buildings and equipment which are still in use are quite frequently encountered. This situation ordinarily indicates that a conservative depreciation policy has been followed by the company and that the time may not be far distant when replacements of depreciable assets will be required.

When depreciable assets are sold, or otherwise disposed of, it is the proper procedure to remove the cost thereof from the respective asset accounts where they are recorded and to remove the reserves for depreciation, applicable thereto, from the related reserves for depreciation accounts.

Salvage values are not ordinarily taken into consideration, inasmuch as the proceeds received from sales of abandoned depreciable properties may be no more than the cost of breaking up the articles for sale to junk dealers.

Departures from conventional depreciation procedures should not be countenanced by independent accountants. A violation of generally accepted depreciation methods is illustrated in Form 70, which reveals the discovery by the independent accountant that proceeds from sales of fully depreciated machinery and equipment had been credited erroneously to the Reserve for Depreciation of Machinery and Equipment account. The credit should have been to an appropriately named income account, such as Sales of Fixed Assets account.

The Reserve for Depreciation Schedule, Form 71, contains an analysis of the changes which took place in several depreciation reserve accounts during a given period. It will be noted that additions to reserves are classified between provisions which are regularly made and other credits, such as adjustments. Charges to the reserves are analyzed as to retirements and other items. Reference can frequently be made to property records in order to ascertain the cost of

VIOLATION OF GENERALLY ACCEPTED DEPRECIATION METHODS - ILLUSTRATED

THE BLANK COMPANY
CASH RECEIPTS PAGE 175

DATE	ITEM	ACCOUNTS RECEIVABLE	DISCOUNT ALLOWED	CASH SALES	GENERAL LEDGER ACCOUNT	AMOUNT	NET CASH
Nov 30	Brought forward	175,100 00	2,250 00	1400 00			174,250 00
4 30	J. H. Blank Co. (sale of fully depreciated machinery)				Reserve for Depreciation of Machinery	12,000 00	12,000 00
	TOTAL	175,100 00	2,250 00	1400 00		12,000 00	186,250 00

THE BLANK COMPANY

Account Reserve for Depreciation of Machinery and Equipment

DATE	CHARGE	DATE	CREDIT
	✓	Nov 30	210,500 00
		6 30	12,000 00
		Balance	
		CR 175	
		223,500 00	

Conclusion - Crediting of proceeds of sales of fully depreciated machinery and equipment to the Reserve for Depreciation of Machinery and Equipment account is not in accordance with generally accepted depreciation methods.

James White January 10 (Year)

PREPARED BY J. White, Jr.
 REVIEWED BY B. B. White, Jr.

THE BLANK COMPANY
Year Ended December 31 (year)
RESERVE FOR DEPRECIATION SCHEDULE

DESCRIPTION OF PROPERTY	BEGINNING BALANCE	ADDITIONS		DEDUCTIONS		FINAL BALANCE
		PROVISIONS	OTHER	RETIREMENTS	OTHER	
Machinery	1080,000 ↓	54,000 ⊗		12,000 *		1122,000
Furniture and fixtures	50,000 ↓	5,000 ⊗		1,000 *		54,000
Patterns	40,000 ↓	8,000 ⊗				48,000
Tools	30,000 ↓	6,000 ⊗				36,000
Dies	120,000 ↓	24,000 ⊗		6,000 *		138,000
Jigs and fixtures	80,000 ↓	16,000 ⊗		1,000 *		95,000
Total	1400,000	113,000		20,000 *		1493,000
Information furnished by Company.						
↓ Checked to preceding year's final balance						
⊗ Checked Company's calculations and verified rates						
* Checked to register of retirement						
James White, February 15 (year)						

FORM 71

any particular item and the reserve which is applicable thereto. The program followed by the independent accountant is shown, for convenience in referring thereto, in the lower portion of the schedule.

The effect on the company's operations of any change in the basis of computing depreciation provisions, from that used the preceding year, should be investigated. Any changes made in the company's depreciation policy that are actuated by a desire to manipulate the income result ought not to be assented to by the independent accountant. The argument sometimes advanced that maintenance expenditures more than offset depreciation is not tenable. Any failure by the company under audit to make adequate depreciation provisions should be commented upon in the audit report.

The practice is usually followed of calculating amortization provisions for leasehold improvements on the basis of the life of the lease. An exception arises when the estimated useful life of the improvements is less than that of the lease. Ordinarily no consideration is given to renewal provisions in leases, when computing amortization, unless the leases run for very short periods of time. Leasehold improvements sometimes comprise the erection of building on leased land. However, in most cases, leasehold improvements cover alterations to and installations in leased buildings.

Amortization Reserves. Inasmuch as patents and copyrights have limited lives, by the provisions of the laws governing their issue, it is the custom to amortize them over periods not in excess of their legal existence. The proper procedure, should a patent or copyright be sold or abandoned, is to remove its cost from the respective asset account and the reserve for amortization which is applicable thereto from the related reserve account.

The Sundry Reserve Accounts Schedule, Form 72, shows the changes that took place during the period covered by the audit in several reserve accounts. It will be seen that additions to the reserve accounts which are illustrated consisted of provisions for losses. Ordinarily, these provisions are made in accordance with the company's established practice. The deductions from the reserves consist of charges covering losses for which the respective reserves were provided. Special care should be exercised by the independent accountant to ascertain whether all charges to reserve accounts consisted of items for which the respective reserve accounts were established. If it is ascertained that a particular reserve is no longer required it should be closed out.

Reserves for Maintenance. A reserve for maintenance generally indicates that expenditures for repairs and upkeep have not been up to

PREPARED BY *J.M.H. 1/4*
 REVIEWED BY *J.B.M. 1/4*

THE BLANK COMPANY
 Year Ended December 31 (year)
SUNDRY RESERVE ACCOUNTS SCHEDULE

REF.	DESCRIPTION	BALANCE AT BEGINNING	ADDITIONS		DEDUCTIONS			BALANCE AT END
			PROVISION	TRANSFERS	OTHER	CHARGE OFFS	TRANSFERS	
	<i>Reserve for bad debts</i>	25,000	6,000*			5,000*		26,000
	<i>Reserve for workman's compensation insurance</i>	70,000	40,000*			35,000†		75,000
	<i>Reserve for loss on purchase commitments</i>		100,000*					100,000
	<i>Total</i>	95,000	146,000			40,000		201,000
	↓ Checked to find balance in preceding year's working papers							
	⊙ Checked to journal voucher signed by treasurer							
	* Checked to journal voucher signed by credit manager							
	† Checked to accounting for payment of claims							
	<i>James White, February 15 (year)</i>							

FORM 72

normal requirements on the basis of the company's past experience. The deficiency in maintenance expenditures is provided for by means of a true reserve. Accounting periods, by this means, bear the maintenance expenses which are applicable thereto, although actual expenditures have not been made. When conditions are favorable to the making of delayed repairs, the maintenance work can be done and charged to the Reserve for Maintenance account.

Reserves for Contingencies. Numerous contingencies arise in the course of business for which reserves are found necessary. Companies which carry their own workmen's compensation insurance often have to pay injured employees' claims that would otherwise be paid by the insurer, if insurance policies were carried with an insurance company. In view of this situation, a Reserve for Workmen's Compensation claims is often necessary. Companies which guarantee their products against defective workmanship frequently have to pay customers' claims and so a Reserve for Product Guarantee is not uncommon. Unfavorable market prices of commodities at the balance sheet date may necessitate the establishment of a Reserve for Losses on Purchase Commitments or a Reserve for Losses on Sales Contracts for Future Delivery. Notice of a proposed tax assessment, due to the disallowance of some tax deduction for a previous year, may have been received from the Bureau of Internal Revenue, and a Reserve for Contingencies may have been established.

It sometimes happens that, during the course of an examination of accounts, the auditor discovers an omission by the company from its balance sheet of a reserve for contingencies. From information which he obtains, the independent accountant may be led, as illustrated in Form 73, to the conclusion that a reserve for contingencies should be set up on the company's balance sheet.

Reserves are not usually provided for losses that may occur in the future on account of contingent liabilities, the amounts of which are not ascertainable. Under this category may be mentioned notes receivable discounted, unless sold "without recourse," unused commercial letters of credit, and guarantees of obligations of affiliated companies. The practice may be followed of keeping individual reserve accounts or the amounts may be included in one Reserve for Contingencies account. See Form 74, Contingent Liabilities Schedule for the method of procedure followed in making an investigation of a company's contingent liabilities.

Detection of Existence of a Secret Reserve. Some companies indulge in accounting practices which result in understating the value of one or more of their assets. An examination of a company's investment ac-

COMMISSION OF A RESERVE FOR

Liability Certificate

Messrs White & White,
75 West 42nd Street
New York City
Dear Sirs:

This is to certify that at the close of business on December 31 (Year). The Blank Company had no liabilities which were not on the books, other than a \$10,000.00 claim for back commissions by Peter Brown, a former salesman. It is the opinion of our attorneys that this claim can be settled for not more than \$5,000.00.

Very truly yours,

The Blank Company
Blank President
January 10 (Year)

CONTINGENCIES - ILLUSTRATED

THE BLANK COMPANY BALANCE SHEET DECEMBER 31 (YEAR)	
ASSETS	LIABILITIES
CURRENT ASSETS	CURRENT LIABILITIES
CASH \$ 27,250.00	ACCOUNTS PAYABLE \$ 55,275.00
ACCOUNTS RECEIVABLE NET 460,500.00	ACCRUED EXPENSES 20,500.00
INVENTORY 810,250.00	ACCRUED TAXES 12,100.00
TOTAL \$ 1,298,000.00	TOTAL \$ 878,750.00
FURNITURE, NET 66,200.00	CAPITAL STOCK 1,000,000.00
PREPAID EXPENSES 4,100.00	SURPLUS 280,425.00
TOTAL \$ 1,368,300.00	TOTAL \$ 1,368,300.00

Conclusion:

Provision of a \$5,000.00 Reserve for Contingencies should be made for the liability which may arise out of Peter Brown's claim against the company for back commissions. James White February 1 (Year)

FORM 73

THE BLANK COMPANY
 YEAR ENDED DECEMBER 31 (YEAR)
 CONTINGENT LIABILITIES SCHEDULE

PREPARED BY J. White Jan
 REVIEWED BY G. Smith 2/1/24

First National Bank:	
Contingent liabilities	None ↓
Unused letters of credit	\$ 10,000 ↓
Notes receivable discounted	\$ 75,000 ↓
Federal corporation income and -excess profits taxes	Tax returns last examined for year ended December 31 (Year) ↓ *
New York State franchise taxes	Tax returns last examined for year ended December 31 (Year) ↓ *
Pending litigation	Unsettled claims, estimated by the company's attorney's not to exceed \$5,000 ↓ †
Other contingent liabilities	None per liability certificate signed by two officers
	↓ Checked to confirmation, attached to bank reconciliation statement
	* Checked to correspondence files
	† Confirmation attached
	James W. White March 2 (Year)

DETECTION OF EXISTANCE OF A SECRET RESERVE - ILLUSTRATED

THE BLANK COMPANY

NAME *Investment Securities - Stocks*

DATE	CHARGE	DATE	CREDIT
(YEAR) <i>Dec. 1</i>		(YEAR) <i>Dec. 31</i>	
<i>B. balance</i>	980,000.00	<i>Dividends</i>	10,000.00
" <i>31</i>		" <i>31</i>	985,000.00
<i>Purchases PJ 55</i>	15,000.00	<i>Balance</i>	995,000.00
	995,000.00		
(YEAR) <i>Jan. 1</i>	985,000.00		
<i>Balance</i>			

Conclusion:
The company's practice of crediting dividends received to the Investment Securities-Stocks account has resulted in a secret reserve of \$115,000.00.

James White
February 1 (Year)

THE BLANK COMPANY INVESTMENT SECURITIES DECEMBER 31 (YEAR)			
SHARES	NAME	COST	VALUE
1,000	A.M. CORP.	100,000.00	90,000.00
5,000	C.O. CORP.	450,000.00	420,000.00
4,000	F.P. CORP. PFD.	460,000.00	390,000.00
1,000	K.N. CORP.	90,000.00	85,000.00
	TOTAL	1,100,000.00	985,000.00
	EXCESS OF COST OVER		
	BOOK VALUE	115,000.00	

FORM 75

counts may reveal that the practice has been employed of crediting dividends received directly to the respective asset account, instead of to the Dividends Income account, thereby building up a secret reserve. Such a situation is illustrated in Form 75 where the independent accountant concluded, as a result of his examination, that a secret reserve of \$115,000 existed in the Investment Securities Stocks account. Removal of the secret reserve, in the instant case, was necessary before the company's balance sheet could be certified without qualification.

Program of Audit. A program of audit is presented herewith for the verification of reserve accounts, including contingent liabilities, subject to such modifications as may be needed in order to meet the requirements of the particular audit engagement.

PROGRAM OF AUDIT

1. Secure a schedule of the reserve accounts. (See Form 71, Reserve for Depreciation Schedule; Form 72, Sundry Reserve Accounts Schedule.)

2. Ascertain the bases employed by the company in determining credits to the respective reserve accounts.

3. Ascertain whether the charges made, during the period covered by the audit, to the various reserve accounts covered items for which the respective reserves were provided.

4. Ascertain whether the policy maintained by the company, with respect to its reserves, throughout the period covered by the audit was consistent with that of the preceding year.

5. Reserve for valuation of marketable securities. Check the company's calculation of quotation values, of marketable securities, by referring to published quotations as at the close of business on the balance sheet date. (This work is generally done in connection with the audit of the investment securities accounts.)

6. Reserve for doubtful notes and accounts receivable; investigate the adequacy of the reserve for doubtful notes and accounts receivable after giving due consideration to the verification of notes receivable, agings of the accounts receivable, and the company's bad debts experience for the current and several preceding years. (This work is usually performed in connection with the verification of the notes and accounts receivable accounts.)

7. Reserve for depreciation: Inquire into the adequacy of the depreciation reserve, after giving due regard to trade practices and local conditions. Indicate the method of depreciation that is employed. (This work is ordinarily done in connection with the audit of the depreciable asset accounts.)

8. Reserve for amortization: Ascertain the period of time employed in connection with the amortization of intangible assets or whether some other basis than time is used. (This work is generally performed at the time that the intangible asset accounts are verified.)

9. Reserve for depletion: Ascertain whether the depletion of natural resource properties is based upon the estimated quantity of recoverable units of material contained therein. (This work is usually performed at the time the land accounts, including natural resource properties, are audited.)

10. Reserve for workmen's compensation claims not covered by insurance: Check the balance of this reserve to supporting documents, including those covering awards already made and unpaid, and estimates of awards to be made later for injuries that have been reported.

11. Reserve for loss in fluctuation of foreign exchange rates: Check the company's calculation of this reserve.

12. Reserve for losses on purchases and sales contracts for future deliveries of materials to and by the company: Check the company's computations and verify the quantities, contract prices, and market prices employed in calculations.

13. Reserve for contingencies: Ascertain the nature of the contingencies and whether those for which this reserve was established still exist. (See Form 74, Contingent Liabilities Schedule.)

14. Request an executive of the company, under audit, to prepare a list of pending claims against the company and an estimate of the probable payments that will have to be made on account of such claims.

15. Request the company's depositories of funds to report, as of the balance sheet date, on the following matters:

a. All direct and indirect obligations of the company.

b. Notes receivable held under discount.

c. Unused letters of credit. (Provision is generally made on the bank confirmation request form for obtaining the above information.)

16. Ascertain for what years the company's tax returns have not been examined by Federal and state tax agencies.

17. Read the company's files of correspondence, with the various tax agencies, and make excerpts from any letters which indicate the existence of tax deficiencies that may be later assessed.

18. Inquire whether the company is contingently liable on any guarantees.

19. Secure a list of contracts for future purchases or sales, as of the balance sheet date, and ascertain whether any contingent liabilities attach thereto.

20. Secure a liability certificate signed by an officer of the company, under audit, stating that all known liabilities as of the balance sheet date were recorded on the books with the exceptions noted.

21. Prepare a statement of the conclusions reached, after examining transactions subsequent to the date of the balance sheet, as to the probable amount of the company's contingent liabilities.

22. Reserve accounts questionnaire—large audit engagements.

a. Are standard journal entry forms employed by the company for making monthly entries to all reserve accounts?

b. Has a statement been prepared covering your conclusions regarding the adequacy of all valuation and true reserves?

c. Have drafts been made of balance sheet footnotes covering those contingent liabilities for which reserves have not been provided?

Balance Sheet Treatment. Reserves play an important part in the presentation of a company's financial position. Valuation reserves, such as the reserve for depreciation, are ordinarily deducted (in the short column) from the respective asset accounts to which they relate, and the net amounts are extended into the long column on a balance sheet. By following this procedure, the reader can readily see the re-

lation between the gross amount of an asset and the related valuation reserve.

A distinction is observed between accruals payable, such as accrued taxes under the provisions of the Social Security Act, the amounts of which are readily determinable, and true reserves which are frequently a matter of estimate. The president's letter to the company's stockholders which is embodied in the company's annual report sometimes contains an explanation that, "A reserve for contingencies has been provided in anticipation of such liabilities as may arise in the future, the existence of which was not known at the balance sheet date."

A restriction on the distribution of surplus, in the form of dividends, is often effected by the establishment of a surplus reserve. The requirements of a preferred stock sinking fund agreement might not have been met, with respect to the transfer of a specified amount of cash to the trustees, and so a Sinking Fund Surplus Reserve is in order. This procedure is a preventive against the payment of dividends out of the surplus which had been reserved until such time as the necessary sinking fund contribution shall have been made. Then the restriction can be lifted. A Working Capital Surplus Reserve account indicates that surplus has been appropriated for the company's working capital requirements and will not be available for dividend purposes.

REVIEW QUESTIONS

1. Distinguish between valuation, true, and surplus reserves.
2. What attitude would you take if you found a reserve charged with losses of a different character from those for which the reserve was provided?
3. Should an auditor inquire into a company's past experience in collecting its notes receivable?
4. Suggest a method of reviewing a company's bad debt experience.
5. What errors of commission might be detected by the circularization of customers whose accounts had been written off as bad debts during the period covered by the audit?
6. Explain the difference between depreciation and depletion reserves.
7. Distinguish between the "composite life" and the "specific article" methods of depreciating machinery.
8. What disposition should be made of depreciation reserves applicable to depreciable property which has been disposed of?
9. What procedure should be followed in the examination of the Reserve for Workmen's Compensation Insurance where a company carries its own compensation insurance?
10. Describe the manner of keeping a Reserve for Losses on Foreign Exchange account.

11. Explain the purpose of a Reserve for Losses on Purchase Commitments account.

12. Explain the meaning of a Reserve for Losses on Sales for Future Delivery account.

13. Should a company which guarantees its product and which has to spend considerable sums of money to meet its obligations, under the guarantees, carry a reserve?

14. For what kind of losses would you expect to find a reserve for contingencies provided?

15. If a company had not complied with the provisions of a "sinking fund" agreement with its preferred stockholders, would a surplus reserve be in order?

CHAPTER 17

CAPITAL

Provisions of the certificate of incorporation with respect to the company's capital stock are read. Minutes of the corporation's board of directors are examined in order to ascertain whether any resolutions were made during the current year that affect the capital stock accounts. Treasury stock certificates are inspected at the time the company's investment securities are examined. The partnership agreement is read and its provisions checked to the company's accounts, with particular reference to partners' capital contributions, drawings, and profit-sharing ratios. Cognizance is taken of any mention made of interest on partners' accounts and salaries of partners. Surplus accounts are examined to ascertain whether they meet approved accounting standards. All charges and credits, made during the current accounting period, to the surplus accounts are verified.

Financial statements of business enterprises are ordinarily prepared in conformity with generally accepted accounting conventions. Capital, or net worth, of a business as set forth in its balance sheet equals the excess of assets over liabilities. Net worth of a corporation is represented by its capital stock and surplus accounts, while that of a partnership is comprised of the individual partners' accounts. The special feature of the corporate form of organization is the limited liability of the stockholders in contrast to the unlimited liability of the general partners in a partnership. A corporation's certificate of incorporation is the foundation for its capital structure, whereas the articles of co-partnership constitute the basis for the organization of a partnership. Changes in a corporation's capital structure require the stockholders' consent. Dividend distributions by a corporation are ordinarily authorized by its board of directors. Fewer formalities are required in connection with the affairs of partnerships than of corporations.

Capital Stock. A company's certificate of incorporation contains the authorization for the issue of its capital stock and is granted by the state of incorporation, such as New York State. Large corporations which have their shares listed on a stock exchange usually have registrars whose duty it is to see that shares are not issued in excess of those authorized. Shares of ownership in a corporation are generally evidenced by capital stock certificates. Some issues of capital stock have preference over others in the distribution of dividends and, if the

corporation goes out of business, in the proceeds of liquidation. Preferred capital stock is described as "cumulative" when dividends in arrears thereon must be paid before dividends are paid on the company's common stock. A liquidating, or callable, value for preferred shares above the par value thereof, is quite common. Capital stock has either a par or no-par value; the shares of stocks with a no-par value are frequently assigned a "stated value." The stock ledger which is kept by a corporation, or its transfer agent, shows the stockholders' names, addresses, and holdings, so that dividend checks and official notices can be sent.

The laws bearing on a company's capital stock transactions must be given due consideration. Perhaps the corporation laws of the state of incorporation provide that a company's outstanding capital stock is automatically reduced when shares are reacquired. Stock which has been reacquired by a corporation is generally referred to as treasury stock.

A split up of a corporation's par value shares, into lower denominations, increases the number of outstanding shares but does not affect the surplus or the total amount of the Capital Stock account. An exchange by a company, with its stockholders, of new shares of \$50 par value stock for a corresponding number of old shares having a \$100 par value does not change the total number of outstanding shares but does decrease the balance of the Capital Stock account and increase the capital surplus of the corporation.

Watered stock refers to a situation where the assets received in exchange for capital stock were overvalued. The promoter of a company may have paid for \$1,000,000 par, or stated value, of the company's capital stock with a piece of property which cost him only a fraction of that amount.

Original-issue tax stamps, when a company keeps its own capital stock records, will usually be found affixed to the stubs of the stock certificate book. Transfer tax stamps are generally attached either to the stubs of the stock certificate book or to the old certificates which were surrendered when the new ones were issued.

Corporate Surplus. The surplus of a corporation may arise from earnings, donations, revaluations of property, payments by stockholders for their shares in excess of par or stated values, reduction in the par value of the shares, and so on. The net income of a corporation is usually transferred to its general surplus account, frequently referred to as "earned Surplus." This is the account to which ordinary dividend payments are charged. Donation by a stockholder of capital stock to the treasury of a corporation, usually for the purpose of enabling the

company to obtain working capital from the sale of the stock, results in a "donated surplus." Revaluation of land, as for example where valuable mineral deposits have been discovered, frequently gives rise to a "surplus from revaluation of assets." Sales by a company of its capital stock above par results in an addition to "capital surplus," or "paid in surplus" as it is sometimes called. Reduction in the par value of a corporation's shares of stock is accompanied by a credit to the Capital Surplus account.

Restrictions are sometimes placed on a corporation's surplus. Presentation of treasury stock as an asset on a balance sheet is accompanied, sometimes, with a restriction being placed against the company's surplus or net worth. This procedure shows that payments have been made for the treasury stock and to that extent funds are not available for dividend purposes.

Violation of Generally Accepted Practice. Sometimes the treatment accorded a company's accounts indicates an ultra conservative accounting policy on the part of the management. Such a situation is presented in Form 76 where the Machinery and Equipment account had been reduced to one dollar, the write-down having been charged to Capital Surplus account. The company's independent accountant observed that the effect of this action in writing down the value of machinery and equipment by a charge to Capital Surplus was to exclude depreciation in the amount of \$4,749,999 from the company's future operations. Such a procedure results in the overstatement of future profits and constitutes a violation of generally accepted principles of accounting.

Program of Audit. The following program of audit is furnished as a guide to be followed in making a verification of a company's capital accounts, subject to modifications which are required in order to meet the needs of the particular auditing engagement.

PROGRAM OF AUDIT

1. Examine the company's certificate of incorporation and make excerpts of important items of information contained therein.
2. Examine the company's by-laws with respect to any provisions contained therein that are applicable to its capital stock and make excerpts thereof.
3. Examine the minutes of the company's board of directors for the purpose of ascertaining whether any resolutions have been passed that pertain to the company's capital stock.
4. Examine any agreements which provide for a change in the par value, or a reduction in the shares, of the company's outstanding capital stock.
5. Examine the company's capital stock certificate book and ledger for the purpose of ascertaining the number of shares of capital stock issued and out-

VIOLATION OF GENERALLY ACCEPTED ACCOUNTING PRACTICE-ILLUSTRATED

THE BLANK COMPANY

Machinery and Equipment

ACCOUNT	DATE	✓	CHARGE	DATE	✓	CREDIT
(YEAR) Dec. 31	Balance		4750,000 00	YEAR) Dec. 31	Capital Surplus J-97	4749999 00
				" 31	Balance	1 00
YEAR Jan. 1	Balance		4750,000 00			4750,000 00
			1 00			

THE BLANK COMPANY

Capital Surplus

ACCOUNT	DATE	✓	CHARGE	DATE	✓	CREDIT
(YEAR) Dec. 31	Machinery and Equipment J-97		4,749,999 00	YEAR) Dec. 31	Capital Stock (reduction in capital stock)	10,000,000 00
" 31	Balance		5250,001 00			10,000,000 00
			10,000,000 00			

Conclusion - The effect of this write down of machinery and equipment, by a charge to Capital Surplus, is to exclude depreciation in the amount of \$4749999.00 from the company's future operations with the result that profits will be overstated which procedure is a violation of generally accepted accounting principles. James White March 1 (year)

standing of each class; or secure a confirmation thereof from the company's registrar and transfer agent. (See Form 77, Capital Stock Schedule.)

6. Examine treasury stock certificates and authorizations for the certificates purchased during the period covered by the audit.

7. Verify canceled shares of capital stock by inspection, or secure a confirmation thereof from the company's transfer agent.

8. Ascertain whether a certificate of reduction of capital stock was filed if the authorized shares of stock were reduced during the period covered by the audit.

9. Ascertain whether sufficient shares of treasury, or unissued, stock have been reserved to meet conversion options.

10. Check, to supporting records, the amounts due from subscribers to a company's stock.

11. Ascertain the sources of a company's surplus.

12. Ascertain whether gains and losses on transactions in the company's own capital stock have been treated as capital surplus transactions.

13. Examine the minutes of the board of directors for authorizations of charges made to surplus accounts.

14. If the revalued assets are subject to depreciation or depletion, ascertain the procedure followed in making periodical reductions in the Surplus from Revaluation of Assets account.

15. Verify dividend payments made during the period covered by the audit.

16. Ascertain the amount of preferred stock dividends in arrears, if any, at the balance sheet date.

17. Capital stock accounts questionnaire—large audit engagements.

a. Are the company's corporate stock ledgers kept by a transfer agent?

b. Is a list of stockholders, together with their respective holdings, received periodically from the company's transfer agent?

c. Are the company's stocks listed on any stock exchange?

18. Read, when making an audit of a partnership, the copartnership agreement and ascertain whether the provisions of the articles contained therein are reflected in the accounts.

19. If there is no copartnership agreement, ascertain whether the profits have been apportioned in accordance with the principles of partnership law.

20. Make an analysis of the partners' capital accounts. (See Form 80, Partners' Capital Accounts Schedule.)

Changes in Capital Accounts. The Capital Stock Schedule, Form 77, shows the procedure followed in analyzing the changes which took place in the company's capital stock accounts during the period covered by the audit. Capital stock authorized should be ascertained to be in agreement with the company's certificate of incorporation. Issued shares should agree with the corporation's capital stock records. Shares shown by the stock record to be issued in the company's name ought to be inspected. This is usually done in connection with the examination of the corporation's securities.

If a trust company acts in the capacity of registrar, it should be asked to confirm the shares authorized and outstanding as of the bal-

THE BLANK COMPANY
 Year Ended December 31 (Year)
CAPITAL STOCK SCHEDULE

PREPARED BY J. White
 REVIEWED BY G. Brown

REF.	DESCRIPTION	AUTHORIZED		ISSUED		AUTHORIZED AND ISSUED CONFIRMED		TREASURY STOCK		RESERVED		
		SHARES	AMOUNT	SHARES	AMOUNT	TRANSFER AGENT	REGISTRAR	SHARES	AMOUNT	CERTIFICATES EXAMINED	SHARES	AMOUNT
	7% Cumulative Prc											
	Amort \$100 Prc	10,000	100,000	6,000	60,000	J. White	J. White	1,000	100,000	J. White	2,000	200,000
	Common Stock											
	\$100 Prc	20,000	2,000,000	20,000	2,000,000	J. W.	J. W.					
	Total	30,000	3,000,000	26,000	2,600,000			1,000	100,000		2,000	200,000
	↓ Checked to certificate of incorporation											
	⊗ Checked to agreement with holders of Company's 6% debenture bonds											

ance sheet date. The company's transfer agent, if it has one, should be requested to confirm the number of shares outstanding.

A sufficient number of shares ought to be found to be unissued to meet any existing option agreements, as for example where bondholders have been given the privilege of converting their holdings into shares of the company's stock. An "employees stock purchase plan" necessitates that sufficient shares of capital stock be available for sale to participating employees. Companies sometimes fail to show, as illustrated in Form 78, appropriated shares of capital stock. Such shares should be set forth in the capital section of the company's balance sheet.

All transactions in the company's stock accounts during the period covered by the audit should be vouched. Minutes of the board of directors that pertain to capital stock transactions, amendments to the company's certificate of incorporation, and dividend lists ought to be examined. Authorization by a company's board of directors of an unlawful dividend is regarded as an "ultra vires" act. When a company's books show a surplus with a debit balance, after payment of dividends, the accountant is naturally led to the conclusion, as illustrated in Form 79, that an ultra vires act has been committed.

The Partners' Capital Accounts Schedule, Form 80, illustrates the procedure followed in presenting an analysis of the changes which took place in partners' accounts during the period covered by the audit. Examination of partners' capital accounts and the firm's articles of copartnership should enable the independent accountant to ascertain whether entries in the accounts were made in accordance with the provisions of the articles of copartnership. An agreement between partners usually covers the apportionment of profits, compensation of partners, treatment of drawings by partners, and interest on partners' accounts. The liability of a "special partner" is generally limited to his capital contribution.

If difficulty is experienced in understanding the copartnership agreement, an interpretation by someone who is familiar with the articles should be obtained. When a firm conducts its affairs on the basis of verbal understandings among the partners, it is highly desirable that the partners reduce their agreement to writing and furnish a copy of it to their independent accountants. The practice of having each partner sign the firm's annual financial statement is a preventive against future disputes.

Balance Sheet Treatment. On the balance sheet of a corporation are shown the shares and amount of the company's authorized capital stock, as set forth in the corporation's certificate of incorporation, in

A CAPITAL STOCK SITUATION - ILLUSTRATED

THE BLANK COMPANY BALANCE SHEET DECEMBER 31 (YEAR)	
ASSETS	
CURRENT ASSETS	
CASH	\$ 475,050.00
ACCOUNTS RECEIVABLE	2150,160.00
INVENTORY	3750,000.00
CAPITAL	
PREFERRED 7% STOCK \$100 PAR	
AUTHORIZED 10,000 SHARES	\$1,000,000.00
LESS UNISSUED 5,000 "	500,000.00
ISSUED 5,000 "	\$ 500,000.00
COMMON STOCK \$100 PAR-AUTHORIZED AND ISSUED 10,000 SHARES	1,000,000.00
TOTAL CAPITAL STOCK	\$ 1,500,000.00
SURPLUS	2,750,000.00
TOTAL CAPITAL	\$ 4,250,000.00

THE BLANK COMPANY
YEAR ENDED DECEMBER 31(YR)

EXCERPTS FROM MINUTES
March 1 (Year) meeting of Board of Directors
Present: A. Blank, B. Blank and C. Blank.
"Resolved that 2,000 shares of the company's 7% preferred stock be set aside for purchase at par value within five years by the employees of the company
(Signed) Charles Blank Secy

Conclusion
Appropriation of 2,000 shares, out of The Blank Company's 5,000 shares of unissued 7% preferred stock, should be shown parenthetically in the capital section of the balance sheet.

James White
March 2 (Year)

FORM 78

AN "ULTRA VIRES" ACT - ILLUSTRATED

THE BLANK COMPANY			
NAME		No. L 250	
DATE	CHARGES	DATE	CREDITS
(YEAR) Jan. 1		(YEAR) Dec. 31	
	Balance		Profit J-192
Dec. 15	Dividends Payable \$180 \$25,000.00		1,050,000.00

THE BLANK COMPANY	
YEAR ENDED DECEMBER 31 (YEAR)	
AUDIT PROGRAM	
ITEM	AUDITOR DATE
Dividends:	
Check dividend declarations to minutes of Board of Directors.	White 3/10 (year)
Examine paid dividend checks.	

THE BLANK COMP		
Dividends Payable		
DATE	CHARGES	DATE
(YEAR) Dec. 20		
	Cash C 712	
	1,000,000.00	

Conclusion:
 Payment of the December (Year) dividend, when the surplus was insufficient for the purpose, constituted an "Ultra vires" act
 James White, March 1 (Year)

FORM 79

PREPARED BY *W. H. G. & Co.*
REVIEWED BY *W. H. G. & Co.*

THE BLANK COMPANY
(Year Ended December 31 (Year))
PARTNERS' CAPITAL ACCOUNTS SCHEDULE

REF.	PARTNER	PROFIT SHARING PERCENTAGE	BALANCE AT BEGINNING	ADDITIONS		DEDUCTIONS		BALANCE AT END
				SHARE OF PROFITS	CAPITAL CONTRIBUTIONS	SHARE OF LOSSES	CAPITAL WITHDRAWALS	
1010	H. Jones	25%	500,000 [⊗]	25,000 [∧]				525,000
1011	J. Barton	25%	400,000 [⊗]	25,000 [∧]				425,000
1012	T. Cannon	20%	150,000 [⊗]	20,000 [∧]				170,000
1013	E. Davis	20%	600,000 [⊗]	20,000 [∧]				620,000 [⊕]
1014	D. Easton	10%	350,000 [⊗]	10,000 [∧]			50,000 [*]	310,000
	Total	100	2,000,000	100,000			50,000	2,050,000
	<i>Information furnished by Company</i>							
	<i>∧ Checked to partnership agreement</i>							
	<i>⊗ Checked to final trial balance for preceding year</i>							
	<i>* Checked to confirmation</i>							
	<i>⊕ Guarantees account of customer J. Stone</i>							
	<i>James White, February 15 (Year)</i>							

FORM 80

addition to the shares and amount of issued stock; this procedure applies to each stock classification. In addition the par or, in the case of no-par-value stocks, the assigned value per share is stated. Mention of the callable, or liquidating, value of preferred shares of stock is informative. Shares which are set aside to meet requirements of conversion privileges that have been given bondholders are usually mentioned parenthetically on a balance sheet, inasmuch as such shares cannot be issued for any other purpose than that of conversion until such time as the option expires. Treasury stock is preferably presented as a deduction from the total issued stock; the remainder represents the shares of the company's stock outstanding in the hands of the public. The number and amount of shares of a company's stock which have been subscribed, but which have not been fully paid for, should be shown in the capital section of the balance sheet. Examination of a corporation's financial statements often reveals that reacquired shares of its capital stock are presented on the asset side of the balance sheet. An investigation of this situation may lead the auditor to the conclusion that the company employed this method in order to show as large an amount of capital as possible. Such a case is illustrated in Form 81 where the revision of the capital section of the balance sheet resulted in a reduction of capital, as originally stated, by \$6,500. The general procedure is to show the treasury stock in the net worth section of the balance sheet. The book value per share of capital stock can then be more readily calculated than when the treasury stock is shown as an asset.

The source of the corporation's surplus is generally of interest to readers of financial statements. Any appropriation of surplus, such as for working capital, should be mentioned in the company's balance sheet. Changes in surplus accounts are generally presented in balance sheets or accompanying exhibits; otherwise, a reduction in surplus might be construed as having resulted from the payment of a dividend, whereas the decrease may have been brought about by operating losses. The date as of which a deficit was eliminated from earned surplus, by a transfer to capital surplus, should be stated parenthetically on a balance sheet. The amounts, on a consolidated balance sheet, of the minority stockholders' interest in the capital stock and the surplus of subsidiary corporations should be shown. Sufficient information ought to be contained on a corporation's balance sheet to enable one to compute the book value per share of the company's stock, or stocks.

During the past few years there has been a definite tendency away from using the surplus account as a place in which to dispose of trans-

OVERSTATEMENT OF CAPITAL - ILLUSTRATED

THE BLANK COMPANY BALANCE SHEET DECEMBER 31 (YEAR) ASSETS	
TREASURY STOCK	\$ 6,500.00
CAPITAL CAPITAL STOCK \$10.00 PAR AUTHORIZED 10,000 SHARES, LESS UNISSUED 4,000 SHARES; ISSUED 6,000 SHARES	
	\$ 60,000.00
SURPLUS	<u>240,000.00</u>
TOTAL CAPITAL	<u>\$ 300,000.00</u>

Conclusion:
 A purchase by a company of its own capital stock, which but for exceptions, is generally regarded as a reduction in the outstanding stock and should be so shown in the capital section of the balance sheet somewhat as follows:

Capital:	
Capital Stock \$10.00 Par:	
Authorized 10,000 Shares	\$ 100,000.00
Less Unissued 4,000 "	<u>40,000.00</u>
Issued 6,000 "	\$ 60,000.00
Less Treasury Stock 100 "	<u>1,000.00</u>
Outstanding 5,900 "	\$ 59,000.00
Surplus (after deduction of \$5500.00 loss on capital stock)	
	<u>234,500.00</u>
Total Capital	<u>\$ 293,500.00</u>

actions variously described as "prior period," "nonrecurring," "extraneous," and so on. At the close of the preceding accounting period a certain tax accrual may have been understated on a company's books. The tax finally paid in excess of the accrual, inasmuch as this is something which may be expected to occur at any time, should be treated as an income deduction rather than a surplus charge. Unusual losses sustained through the abandonment of properties, uninsured casualties, and so on are to be expected from time to time in business enterprises and are properly shown in the income section of a profit and loss statement.

Heavy write-downs of properties should be charged to income unless the original write-ups, still retained in earned or capital surplus, are sufficient to absorb the charges. Deficits in earned surplus, frequently brought about by the write-down of fixed assets, are often transferred to capital surplus if such is available for the purpose.

It should not be necessary to revamp a company's income statements, on account of entries in the surplus account, in order to ascertain the correct amount of income for a period of several years.

REVIEW QUESTIONS

1. Should changes in a corporation's capital structure be authorized in the stockholders' minutes?
2. Should the uses of the proceeds received from sales of its capital stock by a company be authorized by the board of directors of the company?
3. What is the effect on a company's Capital Stock account of the conversion of its old \$100 par value shares into new \$50 par value shares?
4. Should confirmations of shares issued and outstanding be obtained from the company's registrar and transfer agent?
5. Should an auditor verify that stubs in stock certificate books contain the requisite amounts of Federal and state transfer tax stamps?
6. Mention the characteristics of treasury stock.
7. What procedure should be followed in verifying unpaid stock subscriptions?
8. How should the gift to a company, by a municipality, of a piece of land, for use as a factory site, be recorded on the donee's books?
9. What support would you expect to find for an entry crediting the Revaluation Surplus account for an amount described as being, "Due to the increased value of land in which oil had been discovered"?
10. Is it customary to treat gains and losses on a corporation's own stock as affecting earned surplus or capital surplus?
11. What effect does a reduction in the par value of the capital stock of a corporation have on its Surplus account?

12. Should the total shares appearing on a corporation's dividend list be compared with those shown to be issued and outstanding by the company's capital stock records?

13. What purpose is served by making an examination of paid dividend checks?

14. What is meant by the statement that the declaration of dividends from capital constitutes an "ultra vires" act?

CHAPTER 18

SALES AND RETURNED SALES

Consideration is given to the company's method of exercising control over sales and returned sales. Cash sales are traced into bank deposits. Charge sales are checked to the accounts receivable controlling account. Entries in the shipping register for the last few days of the current accounting period are compared with the sales book. The receiving book records for several days at the end of the period under review are checked against the returned sales. Account sales statements covering outgoing shipments from consigned goods stocks on hand are examined. Unusually large returns shortly after the balance sheet date are investigated. Authorizations for returned sales, allowances, and discounts are verified.

Ordinarily, sales are accompanied by the delivery of goods to the buyer. Sales are generally recorded as such in the event that materials are sold "free on board" the supplier's place of business, when delivery is made to the transportation company. Customers sometimes request that goods, which they have purchased, be held for shipping instructions. It is the general custom to book installment sales at the time made although title may not pass to buyers until later. Sales memoranda are usually marked "on consignment" when goods are consigned. Upon receipt, by the consignor, of an account sales statement the sales are entered. "Cash on delivery" sales by retail stores are usually recorded without waiting for delivery. Sales made by driver-salesmen who deliver such items as bakery products or beverages are determined generally by taking an inventory at the start and finish of each trip. After the checkup of deliveries has been completed, the driver-salesmen's sales are entered. In general, title to property passes when the sale is made.

Internal Control. The routine followed in the accounting department of most companies provides for the maintenance of a check on sales records so that any errors of omission will be discovered. Sales and shipping records are generally synchronized. All computations on sales invoices are usually checked by someone among the company's personnel. The function of the sales audit department in a retail department store is to verify the correctness of the sales and to prepare various sales statistics. This work is facilitated by the use of cash registers and prenumbered sales sheets. Many large enterprises make

a detailed analysis of sales, primarily for the information of the company's executives, by means of the "punch card system" which necessitates the use of special punches, sorting machines, and tabulators. Sales analysis sheets are frequently prepared to furnish information as to sales by departments and various classifications, such as cash, C.O.D., and charge. Daily sales figures are recapitulated frequently in order to ascertain the monthly totals which are usually journalized.

Independent accountants, in the case of large audit engagements, should include in the working papers a description of the procedure employed by the company under audit in exercising control over sales. The routine followed by the company's internal auditors, if there are such, should be described. Information regarding the company's sales routine and system of internal check is helpful to the supervising partner of the accounting firm when reviewing the working papers.

Examination of Sales Records. The sales and returned sales sheets for the period covered by the audit should be scrutinized by the independent accountant as to their apparent regularity, particularly with respect to the consecutive numbers thereof and to the approvals which appear on them. Sales sheets often bear the names of the company's salesmen who are entitled to receive credit for commissions. Sheets are generally marked "House" when no commissions are to be paid. The practice is quite general, on the part of bookkeepers, of checking sales sheets in a distinctive manner if they are entered in a sales book. Particular attention should be paid to the authenticity of the approvals which appear on returned sales sheets. Any unusually large amounts of returned sales during the first month following the balance sheet date should merit the independent accountant's attention.

Entries in sales summary books should be checked to the supporting sales sheets from which they were made. Distributions made of sales ought to be included in the checking of the entries in sales books. Returned sales ought also to be checked to the books in which recorded. The extent of the examination of sales and returned sales sheets, and of the checking of entries in sales and returned sales books, must be determined upon after giving due consideration to the effectiveness of the company's internal control and check systems.

In the case of retail stores selling for cash, where the practice is followed of depositing cash receipts intact, it may be found that sales correspond to bank deposits. Some chain-store systems follow the procedure of having stores make deposits in local banks upon which only the home office executives can draw checks. The comparison of sales with cash receipt books and bank statements for selected periods should

enable the independent accountant to satisfy himself as to the correctness of the recorded cash sales figures.

General building contractors do not ordinarily record sales until architects' certificates, covering work done, have been received. It is quite a general practice in the case of "cost-plus-a-fee" contracts for contractors to submit monthly bills to property owners. These statements, after approval by the owner's architect, are payable by the respective debtors in accordance with the terms of the construction contracts. The procedure usually followed by independent accountants is to check all applications, made to property owners by building contractors for payments, to the books of original entry in which entered.

A perpetual inventory record furnishes an effective check on sales as well as on the stock of goods on hand. Inventory control systems are most likely to be found in use by companies which handle relatively high-priced goods. Should it be found that physical inventories, when last taken, were in agreement with the book records, there would be good reason to believe that sales quantities have been correctly recorded.

Gasoline service stations ordinarily follow the practice of taking physical inventories as a means of checking sales of gasoline, oil, tires, tubes, and accessories. Agreement of book inventories, after taking into account the normal shrinkages from evaporation, with physical inventories should enable one to satisfy himself as to the reliability of gasoline service station sales figures.

Many business enterprises maintain records which show the packages shipped. Frequently, the shipments are numbered consecutively. Dates when shipments were made can be ascertained from the records. Returned sales will usually be found entered in the receiving book. Entries in sales and returned sales books for a period of a few days just before, and just after, the balance sheet date ought to be checked to the records of goods shipped and received, respectively.

A summary of the sales to family laundry customers by a route delivery man gives the total sales for the route. A recapitulation of the sales of all routes gives the total family laundry sales. Daily sales are recapitulated in order to obtain monthly sales figures. The laundry sales records should be test-checked back to the individual customers' charge tickets.

Prices on sales invoices are usually accepted by independent accountants as shown, inasmuch as the company's office routine generally provides for a check thereon. Sales invoices, when it is ascertained that the company's personnel regularly checks the calculations thereof, are usually accepted by outside auditors as being correctly computed.

The Last Shipments Made Schedule, Form 82, illustrates the manner followed in conducting a test to ascertain whether the last shipments made at the end of the accounting period were properly entered on the sales record. It will be noted that the test was extended to cover the checking of the charges to the respective customers' accounts. It may be found, when making such a test, that some goods in process of being packed at the balance sheet date were not shipped and billed until subsequent to that date. In cases such as this, it is regarded as a desirable practice to include the accounts of the purchasers of the goods in the list of accounts receivable selected for confirmation.

Reference to the Test of Sales Schedule, Form 83, shows the procedure followed in making a test of the postings of charge sales to customers' accounts. It will be seen that care was exercised, by the independent accountant, in verifying that shipping dates agree with those of corresponding charges made to the accounts of the respective debtors. This procedure can be reversed to good advantage, and selected charges to the customers' accounts can be checked back to the sales book. Consideration ought to be given, should any irregularities develop, to the matter of extending the tests.

A fraud-conscious auditor should be alert to the implications involved where there are charges for shipments in customers' accounts without any supporting entries in the sales record. Irregularities in customers' accounts have sometimes been covered up by the simple expedient of omitting shipments from the sales book and entering the charges directly in the respective debtors' accounts. The effect of this procedure is to increase the total amount of the accounts receivable without affecting the related controlling account.

When selective tests, in place of some of the detailed checking, are relied upon for the verification of sales, it is desirable that an analytical review of the sales account be made. Such a review must, of course, be adapted to meet the needs of local conditions. There are seasonal variations in the sales of most business enterprises to be studied. A comparison of the monthly sales with those of the preceding year is frequently enlightening. The causes of any undue seasonal, or monthly, variations as compared with those of the preceding year ought to be inquired into. An alert auditor should be quick to grasp the significance of a substantial increase in the sales for the last month of the accounting period over the amount that would normally be expected in view of the current year's sales trend. One can readily understand how the sales account might be overstated by the erroneous transfer to it of the balance of a reserve for contingencies that is no longer required, or by the inclusion of fictitious sales.

THE BLANK COMPANY
YEAR ENDED DECEMBER 31 (YEAR)
LAST SHIPMENTS MADE SCHEDULE

PREPARED BY *J. H. Smith*
 REVIEWED BY *C. Brown*

SHIPPING NUMBER	DATE SHIPPED	CUSTOMER'S NAME AND ADDRESS	AMOUNT
6675	Dec. 31 Year	Johnson Brothers, Seattle Wash.	* ↓ 725.00
6676	Do	Bliss & Sons, Boston, Mass.	* ↓ 1,510.00
6677	Do	Ayres & Block, Chicago, Ill.	* ↓ 495.00
6678	Do	Earl, Conant & Co. Brooklyn, N. Y.	* ↓ 4,250.00
6679	Do	Wright and Flint, New York City	* ↓ 685.00
6680	Do	Holmes, Inc. Albany, N. Y. †	920.00
		↓ Checked to sales book	
		* Checked to customer's account	
		† Last shipment	
		James White	
		December 31 (year)	

THE BLANK COMPANY
 Year Ended December 31 (Year)
 TEST OF SALES SCHEDULE

PREPARED BY J. White
 REVIEWED BY B. Jones

DATE OF SHIPMENT	CUSTOMER	AMOUNT OF CHARGE		DATE POSTED TO CUSTOMER'S ACCOUNT	REMARKS
		REFERENCE	AMOUNT		
12/31 Year	P. Acker	S 600	4.00	12/31 Year	
	A. Bonds	D.	1,200	D.	Hold for shipping instructions
	Mr. Cheal	D.	5.00	D.	Do
12/31 Year	L. Daly	D.	2,000	D.	
D.	K. Ellen	D.	6.00	D.	
D.	J. F. Leach	D.	1,000	D.	
D.	J. Grey	S 601	3.00	D.	
D.	H. G. Wallen	D.	2.00	D.	
D.	G. H. Gray	D.	8.00	D.	
	F. French	D.	7,100	D.	Hold for shipping instructions
	C. H. Kane	D.	6.00	D.	Do
12/31 Year	D. Lander	D.	5.00	D.	
	Total		15,200		
	↓ Checked to	confirmation from customer			
		James White, February 15 (Year)			

FORM 83

The Analytical Review of Sales Schedule, Form 84, illustrates the procedure that may be employed to good advantage in making a review of the sales account where the sales are regularly costed, as is the practice in numerous companies. Ordinarily, the percentage of the cost of sales to sales does not vary appreciably from month to month, regardless of the variations in sales volume. On account of this state of affairs, it is quite probable that a substantial inflation of the sales account will noticeably affect one or more of the percentages of cost of sales to sales. Any important variation in the monthly percentages of cost of sales to sales should be inquired into, and the causes should be ascertained. Often the end-of-the-year adjustment to the inventory controlling account will explain the variation. This situation frequently comes about through the practice of stating final inventories at the "lower of cost or market." Where sales and cost of sales are recorded departmentally, the examination of monthly sales figures and cost percentages can frequently be extended advantageously to include departmental operations.

Mistakes in recording sales and returned sales in enterprises using the "retail system" of inventory control are bound to cause variations between book and physical inventories. This situation necessitates that substantial discrepancies in inventories of retail department stores and chain stores, using the retail system of inventory control, be inquired into in connection with the verification of their sales accounts. An auditor will naturally be alert to the possibility that an inventory shortage may be the result of unrecorded sales.

Exceptions reported by customers as a result of circularization may bring to light irregularities in the Sales account. Until the customers' major exceptions have been investigated, the independent accountant cannot be sure of the correctness of the sales figures.

The procedure for making a general review of a company's operating accounts is presented in Chapter 22, "Analytical Review of Accounts."

Income Statement Procedure. Returned sales, and allowances made to customers, are a proper deduction from gross sales on a statement of income. The cost of sales and the expense of doing business are computed as a percentage of net sales, for statistical purposes. The published financial statements of retail department stores ordinarily include sales made by the leased departments in the total sales figures, the cost of sales being included in the cost amount. The difference between the sales and cost of sales of leased departments represents the store's income from leased departments. All intercompany sales, on a correctly prepared consolidated statement of income, are eliminated.

THE BLANK COMPANY
YEAR ENDED DECEMBER 31 (YEAR)
ANALYTICAL REVIEW OF SALES SCHEDULE

PREPARED BY *J. Williams*
 REVIEWED BY *R. Clark*

MONTH	CURRENT YEAR		PRECEDING YEAR		REMARKS
	SALES	COST	SALES	COST	
<i>January</i>	238,100	120,000	221,770	110,000	496
<i>February</i>	228,630	115,000	227,180	112,000	493
<i>March</i>	261,570	130,000	249,280	122,000	489
<i>April</i>	250,520	125,000	241,450	120,000	497
<i>May</i>	230,000	115,000	215,140	118,000	502
<i>June</i>	235,300	120,000	237,520	119,000	501
<i>July</i>	279,280	140,000	278,790	135,000	495
<i>August</i>	356,420	175,000	322,580	160,000	496
<i>September</i>	384,610	190,000	355,290	178,000	501
<i>October</i>	495,050	250,000	478,080	240,000	502
<i>November</i>	423,400	210,000	389,220	195,000	501
<i>December</i>	362,170	180,000	318,090	160,000	503
<i>Total</i>	3745,050	1870,000	3534,390	1769,000	500

FORM 84

The relative importance of the various departments of a business enterprise, as indicated by their sales, is a matter of general interest that can be presented to good advantage in the comments which accompany a statement of income. It is a worth-while procedure, if the information is available, to show the amount of the gross profit on the sales of each department.

REVIEW QUESTIONS

1. Describe some of the methods that are in general use for controlling sales.
2. What scrutiny should be made, by the independent accountant, of the sales book in connection with the verification of the sales account?
3. Should the outside auditor take steps to ascertain whether the company's shipping and sales records are properly synchronized?
4. What selective tests ought to be made, when verifying the Sales account, where a perpetual inventory system is in operation?
5. What procedure should be employed in the verification of sales made from goods held on consignment?
6. Is there any direct relation between the sales and the bank deposits in a chain cash-sales stores system?
7. Describe the procedure that ought to be followed in auditing the Sales account of a family laundry.
8. What records would you examine, in support of the Sales account, when auditing the books of a building contractor?

CHAPTER 19

SUNDRY REVENUES

Miscellaneous income items, such as those from pledges, dues, and appeals, are audited to the extent regarded as necessary. Sales of salvage to material dealers are verified by circularization. Contracts between landlords and tenants are examined and checked to the former's books of account. A comparison is made between the rental income on a 100 per cent occupancy basis and the rental received. Income reports of internal auditors are examined and checked to the company's accounting records. Income earned on the company's investment securities is checked at the time the stock and bond investment accounts are audited. Attention is directed to the practice employed in amortizing premiums and accumulating discounts. Dividends on stocks owned are checked to a dividends service publication.

The independent accountant should familiarize himself with the sources of the revenues of the company under audit, particularly those which do not result from the regular sales of goods and services. A description ought to be included in the accountants' working papers of any significant revenue accounts, the names of which are not sufficiently explanatory. Memoranda regarding the rates of dues and fees payable by members of a benefit, or social, organization are useful in the conduct of the audit of such organizations. A brief outline of the company's system of accounting for its revenues, such as the use of prenumbered receipts by a charitable agency, is informative. In auditing some types of business the names of purchasers of scrap materials from the company, if the sale of salvaged materials constitutes a significant source of revenue, are needed for circularization purposes.

Whatever internal checks are maintained in connection with sundry revenue accounts should be examined, and their effectiveness should be ascertained. It may be found that the company's internal auditors regularly make a detailed verification of the revenue accounts. The "night auditors" in a hotel enterprise usually check revenues from room rentals, food and beverage sales, and other items. Independent accountants can, after making limited tests, generally accept the revenue figures which have been checked by a regularly constituted staff of internal auditors.

An examination should be made, by the independent accountant, of any agreements pertaining to the company's revenues. The leases, or at least a selected number of them, with tenants of rented premises should be inspected as to their apparent regularity. Agreements with customers for rendering them services, such as the supplying of hotels and restaurants with table linen, ought to be scrutinized. The independent accountants should check, by means of selective tests, the basic records and documents which underlie the revenue accounts that are chosen for verification.

Rental Revenues. The practice is often followed, in connection with the audit of building rental projects, of making a reconciliation, by taking vacancies into account, between the monthly rental income and the rentals which would be received on a 100 per cent occupancy basis. The making of an inquiry regarding vacancies, shown in such a reconciliation statement, is properly included in the program for auditing rental income. Cash received from tenants covers payments of rentals in arrears, current rentals, prepayments of rentals, and security deposits. These items are ordinarily verified in connection with the examination of cash receipts. Test-checking of entries of rent collections, in the tenants' rent register, to the cash receipts book should establish the accuracy with which postings have been made to the former record. Excessive arrearages in a rental property suggest that some of the rental payments received from tenants may not have been recorded. Circularization of a selected list of tenants is generally relied upon to bring to light irregularities in the tenants' current rental accounts, including rental prepayments and securities deposits.

Membership Dues and Fees. Societies generally maintain a register of members that is used as a basis for making charges for dues. Changes in the roster are usually authorized by the society's membership committee. Each organization has its own method of making charges for fees. It is within the scope of the independent accountant's duties to test the accuracy of the membership register of the society under audit and to test the revenue derived from dues and fees during the period covered by the audit.

It will be found frequently that the revenue from dues and fees in benefit and social organizations is obtained by taking a transcript of the charges to the respective members' accounts. Columns are generally provided on the transcript for use in making an analysis of the organization's revenue. An overall check by an independent accountant can usually be made on the dues revenue by multiplying the average number of dues-paying members of each class (full members, associate members, junior members, etc.) by the respective rates of dues

payable. The association's record of the revenue from fees should be test-checked.

Contributions. Appeal agencies generally follow the custom of issuing prenumbered receipts to contributors, the duplicate copies of which constitute a permanent record of donations. The recorded contributions should be found, by the independent accountant, to be in agreement with the footings of the cash book, or register, in which the contributions are entered. It is not the general practice of outside auditors to confirm the contributions received, during the period covered by the audit, by circularization. The verification of revenues entered directly in the cash book, such as donations and contributions received by charitable organizations, is generally made in connection with the audit of the cash records.

Admissions Sales. An internal check on the revenue from admissions sales is usually obtained by means of prenumbered tickets and cash registers. Cashiers of amusement enterprises are required to account for the proceeds from sales of admissions and for unsold tickets. Whatever data are available should be utilized by the independent accountant for checking the revenue from admissions sales. An inventory of unsold tickets, in an amusement enterprise, is generally depended upon as a check upon unsold admissions on the one hand and also upon the proceeds from sales of admissions on the other hand. The method of internal control should be checked carefully.

Securities Sales. Advices from stockbrokers covering sales of securities, made during the period covered by the audit, should be checked to the company's records of the respective transactions. The method of treating the commissions paid on sales of securities, transfer taxes, and any accrued interest receivable sold should be looked into for the purpose of ascertaining whether the accepted principles of accounting were followed. The basis employed in costing sales of securities ought to be investigated, inasmuch as there are several methods in use. Consistency in the method employed in costing sales of securities is important, whether it be the specific certificate cost, the average cost, or the first-in, first-out method. Verification of gains and losses from security sales is usually made at the time that the investment accounts are audited.

Interest Income. Some companies follow the practice of recording accrued interest receivable at the close of each accounting period. Collections of interest are then credited to the Accrued Interest Receivable account. Interest purchased, when interest-bearing investment securities are bought between interest dates, is properly treated as a receivable which will be collected from the next interest receipts.

Under the "investment basis" of accounting, the premiums on bonds and mortgages purchased above face value are amortized and discounts on those bought below face value are accumulated periodically so that at maturity each interest-bearing investment security will stand on the books at its face value. The amortization of bond premiums reduces the income from investments, and the accumulation of discount increases the income thereon. Whatever plan is followed by a company for recording interest income should be consistently adhered to so that the income from period to period will be stated on a comparable basis.

Income on interest-bearing investments can readily be checked, inasmuch as the principal, rate, and dates of payment are definite. However, it should be borne in mind that issuing companies may be in default in making interest payments. It is not the practice to accrue the interest income on bonds which are in default. Usually the examination of the Interest Income on Investment Securities account is made at the same time that the investment accounts, including the Accrued Interest Receivable account, are verified.

Dividends Income. Dividend rates are fixed, with respect to most preferred stocks. During periods of prosperity, corporations often pay "extra" dividends on their common stock issues. In order to allow sufficient time for the preparation of dividend lists of stockholders, for corporations which have their stocks listed on stock exchanges, a period of several days generally elapses between the date when a dividend is declared and the date when it is paid. Dividend checks which are received on investments in corporations that obtain their income from the exhaustion of natural resource properties, such as oil lands, are generally accompanied with a letter of information as to what portion of the dividend represents income and what part a return of capital from depletion.

Some companies having large investments in stocks follow the practice of recording dividends for control purposes at the time declared. Receipts of dividends are then credited to the Dividends Declared Receivable account. This plan of procedure provides a check on the collection of dividends.

The established auditing procedure followed by independent accountants is to check the dividends received on investment stocks, during the period covered by the audit, to a standard dividends service publication. Verification of the Dividends Income account is generally made at the time the investment accounts are examined.

Sales of Salvage. Scraps of material which have been salvaged from manufacturing operations are frequently returned for credit to the

vendors from whom purchases of material are regularly made. Ordinarily these vendors issue "credit memos" for the value of the salvage. The independent accountant should check a reasonable percentage of credit memos, received by the company during the audit period, to the Income from Scrap Material Sales account.

Disposals of Depreciable Assets. The procedure generally followed, upon the sale of a depreciable asset, is to remove the cost thereof from the asset accounts and the provision for depreciation applicable thereto from the reserve accounts and to transfer these amounts to the Profit and Loss on Disposals of Depreciable Assets account. It often happens that, on account of the conservative depreciation rates in use, considerable gains are realized from disposals of machinery and other items of depreciable property.

Gains and losses from sales and trade-ins of depreciable assets ought to be checked to whatever supporting records are available. Some large companies maintain a special register for the purpose of recording information regarding disposals of fixed assets. The maintenance of such a register requires that each article of depreciable property be identified with the record thereof at the time of its disposal.

Difficulty is often experienced, if detail records of depreciable property are not maintained, in ascertaining the cost and reserve for depreciation of each piece of machinery, or article of equipment, disposed of. It is often necessary, where there is considerable doubt regarding the date of acquisition of a depreciable asset, to regard the article as being fully depreciated and treat the proceeds from its disposal as a credit to income.

The allowances received from trade-ins of used pieces of machinery, or other articles of depreciable property, quite generally appear on the invoices received for the new articles purchased to replace those disposed of. At the completion of a large building project, many major articles of equipment are often disposed of to dealers in used machinery. An inquiry should ordinarily be made into the situation, if the records do not show that trade-ins were made at the time new pieces of machinery and articles of equipment were purchased.

Confirmation of Sundry Revenue Receipts. It is regarded as normal auditing procedure to confirm casual revenue receipts, such as proceeds from sales of salvaged materials. The Miscellaneous Income Schedule, Form 85, illustrates the procedure followed in verifying the proceeds from scrap metal sales. Confirmation of the receipts, although the items were checked to the credit memos on file, is regarded as necessary. One can understand readily how easily credit memos can be tampered with on account of the informal manner in which they frequently are

THE BLANK COMPANY
YEAR ENDED DECEMBER 31 (YEAR)
MISCELLANEOUS INCOME SCHEDULE

PREPARED BY *J.M.L.*
 REVIEWED BY *G.M.*

DATE	REFERENCE	DESCRIPTION	ALPHA METAL Co.	BETA METAL Co.	GAMMA METAL Co.	TOTAL
Jan. (year)	d 10	Scrap metal sales	1* 175	1* 210	1* 65	450
Mar. "	d 40	Do	1* 210	1* 340	1* 70	620
Apr. "	d 65	Do	1* 87	1* 375	1* 80	542
June "	d 71	Do	1* 250	1* 400	1* 85	735
Aug. "	d 85	Do	1* 310	1* 280	1* 50	640
Sept. "	d 97	Do	1* 215	1* 200	1* 55	470
Nov. "	d 105	Do	1* 170	1* 180	1* 60	410
Dec. "	d 112	Do	1* 160	1* 175	1* 55	390
		<i>Total</i>	1,577	2,160	520	4,257
		↓ Checked to credit memor.				
		* Checked to confirmation Newark				
		<i>James H. Aute</i>				
		<i>February 5 (year)</i>				

prepared. Another matter to be considered, in connection with the verification of sundry revenue receipts, is the lack of control that is often maintained over casual sales. There is quite likely to be a considerable amount of income from the sale, without adequate control, of salvaged materials during the construction period and after the completion of a large building.

Income Statement Treatment. The customary procedure is to show, on an income statement, the major revenues of a company. Miscellaneous revenues of businesses engaged primarily in selling goods are ordinarily presented, after the "income from sales," as income credits.

REVIEW QUESTIONS

1. What information should be secured from the examination of leases with tenants?
2. Why might a reconciliation between rental income and vacancies with the rentals that would be earned on a 100 per cent occupancy basis be worth while?
3. To what extent should royalty agreements with licensees be checked to the books of account?
4. Should summaries of detail records of revenues that are the basis for journal entries be verified?
5. Of what interest to an independent accountant is the roster of members in a benefit organization which is being audited?
6. What procedure should be followed in verifying the revenue from sales of admissions?
7. Why is it necessary to examine brokers' advices covering sales of investment securities?
8. Why is the verification of interest income usually made at the time that interest bearing investments are audited?
9. What is the purpose of checking dividends received to a standard dividends service?
10. What purpose is served by the circularization of purchasers of scrap metals and salvaged materials?

CHAPTER 20

PURCHASES AND RETURNED PURCHASES

Authorization for the approvals which appear on purchase invoices is verified. Returned purchases are checked to credit memoranda on file from suppliers. Entries in the receiving book for a few days just before the end of the accounting period are checked against entries in the purchase journal. Copies of account sales statements, sent to consignors, are examined. The treatment accorded rebates and discounts received is investigated. Goods in transit at the balance sheet date, where title passes to the buyer at the shipping point, are checked to the suppliers' invoices. Inquiry is made as to the company's procedure in checking the prices, terms, quality, and quantities of purchases.

Ordinarily purchase transactions are consummated by the receipt of the articles bought, but this is not always so. Buyers often request suppliers to hold goods for shipment at a later date. When a business serving as consignee wishes to buy goods from a consignment for which it is accountable, it really makes a purchase from itself as agent for the consignor. In such a case the consignee makes two complete entries, one as consignee recording a sale on behalf of the consignor, and the other on its own behalf recording the purchase. Incoming transportation charges and duties on imports, when paid by the buyers, are properly added to the cost of the goods.

Cash discounts received from creditors for prompt payment are frequently regarded as additional income. Some enterprises, notably retail department stores, make a practice of recording purchases net. Either method of treating cash discounts received is usually acceptable as long as it is consistently followed and is in line with the customary practice of the particular trade.

Use of prenumbered order forms for making purchases is quite a general practice. Copies of purchase orders are usually furnished to receiving clerks as an aid in checking incoming deliveries of goods. Original copies of receiving records are frequently attached to the respective purchase invoices to which they relate.

Companies sometimes maintain a register covering all purchase invoices received. Open items in the register of unaudited purchase invoices show which bills have been received but not yet approved and entered in the purchase journal. This procedure furnishes a means for

following up purchase invoices which have been distributed to various department heads for their signatures. Columnar purchase journals, in order to provide distribution columns for use in classifying invoices, are extensively employed. When the account classifications required are too numerous to permit using a columnar book, the practice is often followed of making distributions on card forms which are designed for the purpose. Very large enterprises frequently employ the "punch card" system for classifying purchases. This plan necessitates the use of special punch, sorting, and tabulating machines by means of which the totals of the purchase invoices to be distributed to general and expense ledger accounts are readily obtained.

The practice which is frequently employed of clearing materials through a perpetual inventory record furnishes a good internal check on purchases. Should a duplicate purchase invoice, for example, be received and posted on the inventory record, a shortage in the physical count as compared with the book inventory would develop. This should cause an investigation to be made. In retail department stores the purchase invoices are generally marked, by the respective buyers, with the selling prices which are extended in order to ascertain, for purposes of accounting control, the retail value of goods bought. Mistakes in entering purchases where adequate controls are maintained ought to come to light when physical inventories are taken.

Internal Control. Inquiry should be made by the outside auditor regarding the safeguards adopted by the company in order to insure that all purchase invoices are recorded before the books of account are closed. Sometimes the practice is followed of marking invoices received towards the end, and just after the close, of the year with a rubber stamp which indicates whether or not the goods covered by the respective invoices were includible in the inventory. The receiving record is usually relied upon to control the record of purchases. Classifications of purchases are generally made in accordance with a chart of general ledger and expense accounts. It is desirable that, inasmuch as independent accountants rely, to a considerable extent, upon a company's system of internal control and check, a brief description of the routine followed by the company in handling purchases be included in the working papers. Consideration should be given to the company's internal control system when determining upon the scope of the audit program for purchases and returned purchases.

Examination of Purchase Invoices. Purchase invoices ought to be examined for the purpose of establishing their authenticity, particular attention being paid to the approvals which appear thereon. Ordinarily these approvals cover the receipt of the goods, the quality of the

materials, the prices, the terms, and the computations. The company's classification code of general ledger and expense accounts should be found to have been adhered to in the distribution of purchases; otherwise, the accounts will not be stated in a manner that is consistent with the classifications followed the previous year. Quite likely it will be found that violations of accounting principles in classifying purchases can be attributed to a misunderstanding on the part of the voucher clerk regarding the true distinction between revenue and capital expenditures. Treatment of a substantial leasehold improvement as a repair expense would be a violation of this basic accounting principle.

All purchase invoices which are examined should be checked to the purchase journal as to the amount and distribution thereof. Recapitulations of purchases that have been made by means of the punch card system, previously referred to, ought to be checked to the journal vouchers on which the amounts are entered. Care should be exercised in the examination of credit memos from vendors, in order to ascertain whether they were properly approved and recorded.

It is necessary to obtain a satisfactory explanation for the absence of any purchase invoices from the company's files. Canceled bank checks in payment of debts represented by the missing bills should be examined and, if the missing invoices are for relatively large amounts, the company ought to be asked to secure duplicates.

The months selected for the examination of purchase invoices and the minimum amounts of the purchase invoices to be examined ought to be determined upon in the light of the company's system of internal control and check. The situation must be exceedingly good in a company's office in order that the examination and checking of purchase invoices may be restricted to one month, not necessarily the last month of the year, and to amounts in excess of \$25. The accuracy of the verified quantities appearing on purchase invoices can generally be relied upon when the receiver of goods is responsible for checking quantities. Prices on purchase invoices are generally accepted as shown, inasmuch as the company's office routine usually provides for a regular check thereof. Purchase invoices, when it is ascertained that the company's personnel regularly checks the computations, are usually accepted by independent accountants as being correctly calculated. The account classifications indicated on purchase invoices by the company's personnel, subject to the scrutiny of those on relatively large purchase invoices, can usually be accepted as correct.

Independent accountants generally follow the practice of comparing entries in the receiving record, for the last day or two of the accounting period under review, with those in the purchase journal. All goods

PREPARED BY J. White
REVIEWED BY C. Bond

THE BLANK COMPANY
Year Ended December 31 (Year)
TEST OF PURCHASES SCHEDULE

DATE RECEIVED	SUPPLIER AND DESCRIPTION	AMOUNT OF INVOICE	DATE ENTERED IN PURCHASE JOURNAL	REMARKS
12/31 Year	W. Alt & Co. Wool	5,000	12/31 Year	
Dr	W. Bond & Co. Linen	4,000		
Dr	J. Bates & Co. Cotton	2,000	12/31 Year	Returned to vendor 1/4 Year
Dr	K. Doe & Son. Lard	3,000	Dr	
Dr	J. Eaton & Bro. Jute	1,000	Dr	
Dr	J. Fawc. Inc. Silk	500	Dr	
Dr	H. Green & Co. Wool	2,000		
Dr	G. H. H. & Co. Silk	1,500	12/31 Year	Returned to vendor 1/3 Year
Dr	W. Jan & Son. Jute	5,000	Dr	
Dr	C. Jones & Co. Cotton	1,000	Dr	
Dr	D. Kyle, Inc. Linen	6,000	Dr	
Dr	C. Leeds & Co. Wool	5,000	Dr	
	Total	36,000		
	Returned to credit invoice from vendor			
				James White
				February 5 (Year)

FORM 86

THE BLANK COMPANY
 Year Ended December 31 (Year)
 PURCHASE COMMITMENTS SCHEDULE

PREPARED BY *JKL*
 REVIEWED BY *EDM*

SUPPLIER	GOODS	CONTRACT		MARKET PRICE	CONTRACT OVER (UNDER) MARKET		REMARKS
		QUANTITY	PRICE		PRICE	AMOUNT	
B. Cressk Co	"Half Moon" Silk	100 Bales	↓ 2.00	⊙ 2.30	(30)	3900	Gain
Do	"Pyramid" Silk	100 Do	↓ 2.40	⊙ 2.30	10	1330	Loss
Do	"Star" Silk	100 Do	↓ 2.30	⊙ 2.30			
Do	"Sun" Silk	100 Do	↓ 2.40	⊙ 2.30	10	1330	Loss
E. Babcock	"Triangle" Silk	100 Do	↓ 2.40	⊙ 2.30	10	1330	Loss
Do	"Wedding" Silk	100 Do	↓ 2.50	⊙ 2.30	20	2660	Loss
	Total	600 Bales				2660*	Loss
			↓ Checked to confirmation from supplier				
			⊙ Checked to market quotation				
			* Checked to general ledger account, "Return for Loss on Purchase Commitments"				
			James White, February 15 (year)				
			One bale weighs 153 lbs				

FORM 87

which have been received and to which title has passed to the company should be found recorded in the purchase journal. The Test of Purchases Schedule, Form 86, illustrates the manner of making a test of a list of the goods received on the last day of the accounting period. It will be seen, with respect to the goods which had been received and which had not been entered in the purchase journal, that the goods had been returned to the respective vendors.

Purchase Commitments. It is within the scope of the auditor's duties to inquire into the purchase commitments of the company under audit in the manner illustrated in Form 87. It will be noted that the Purchase Commitments Schedule contains a tabulation of the contract prices and the current market prices. Suppliers should be asked to furnish such market prices as are not procurable from published quotations or from current invoices. Tests may indicate that the general price level of the commodities that the company purchases is approximately the same as it has been for a considerable period of time so that a reserve for loss on purchase commitments is unnecessary.

Income Statement Treatment. Returned purchases and allowances received from suppliers are properly deducted from the gross purchases and the remainder shown as the "purchases" on the statement of income. All intercompany purchases on a properly prepared consolidated income statement are ordinarily eliminated. The comments which accompany an income statement can often include, to good advantage, an analysis of purchases according to major classifications. Closing the purchase journal in advance of the end of the accounting period is a vicious practice which should, if encountered, be condemned.

REVIEW QUESTIONS

1. To what extent should an independent accountant make an investigation of the method of control exercised over purchases by the company under audit?

2. Why is it generally recognized as the duty of outside auditors to ascertain which employees are authorized to approve purchase invoices for payment?

3. To what extent ought the arithmetical computations on purchase invoices be checked by independent accountants?

4. Should the distribution, in the purchase journal, of creditors' invoices be checked?

5. Where perpetual inventory records are maintained, is it deemed necessary to investigate the manner in which purchase invoices for materials are entered thereon?

6. Would you take any exception to the classification of an invoice, covering the purchase of a new machine, as a charge against the Reserve for Depreciation account?

7. What action would you take if purchase invoices are missing from the company's files?

CHAPTER 21

PAYROLLS, EXPENSES, AND INTEREST

Disbursements made on account of payrolls are checked to underlying records. Bank checks drawn to the order of individual employees are examined, particular attention being paid to endorsements. Employees' signatures on payroll receipts are verified to the extent regarded as necessary. Minutes of the company's board of directors authorizing bonuses are examined. The independent accountant conducts an unannounced pay off of employees of the company from time to time. The individual ledger expense accounts are examined to see whether they appear regular in every respect. An analysis is made of any large general expense account.

Payrolls are frequently prepared monthly or semimonthly for salaried employees and weekly or biweekly for wage workers. A record of the time of arrival and departure of employees is usually maintained. Reports are made of the number of pieces turned out by piece workers. Payroll records covering bonuses for high factory production and commissions on sales must, of necessity, be adapted to meet the requirements of local conditions. The Social Security and Revenue Acts make it necessary that certain payroll deductions be recorded in connection with the earnings of employees.

Provision of the facilities required to carry on a business enterprise entails a considerable amount of expense, particularly in an industrial undertaking. The cost of furnishing the production plant and equipment for the use of factory operatives often amounts to as much as the direct labor payroll. Distinctions between so-called fixed and variable expenses are generally recognized; the fixed expenses include such items as real estate taxes that do not fluctuate with the volume of production or sales, while the variable expenses cover such items as supplies, the consumption of which usually varies directly with the activity of a business.

Interest expense, when books are kept on the accrual basis, is computed periodically and includes charges covering the amortization of prepaid discounts, premiums (on premium bond investments), and credits resulting from the accumulation of discounts (on discount-bond investments). Making the interest expense and related entries is usually a part of the routine bookkeeping work.

Internal Routine. Additions to a company's personnel are generally authorized by an executive, or the employment manager, or the company. Special bonuses and profit sharing distributions are usually acted upon by the company's board of directors. Payrolls are ordinarily provided with columns for use in making deductions from the compensation of employees and are generally approved by an executive of the company. The currency for a payroll is usually obtained by drawing a bank check for the exact amount thereof. Advances from petty cash, made to employees who leave the company's employ before payday, are ordinarily reimbursed on the next regular payday from the pay envelopes of the respective employees. The practice of requiring employees to sign the payroll is quite common, particularly where payments are made in currency. Endorsements of employees' pay checks furnish evidence of payments having been received by the respective payees. It is regarded as desirable that the person who distributes the payroll envelopes, or bank checks, be different from the one who prepares them or approves the payroll.

All vouchers, including petty cash tickets, and journal entries which cover charges to expense accounts are generally approved by persons who are authorized by the company's management to do so. The classification of expenses is ordinarily controlled by means of a chart of standard account classifications which is adapted to meet the company's needs.

Examination of Payrolls. Careful consideration should be given by the independent accountant to the company's system of internal control and check, when determining upon the scope of the program of audit for the verification of payrolls. The company's internal control system ought to be found to be exceedingly effective if the verification of payrolls is to be limited to those for one month.

The outside auditor should check the payrolls, selected for verification, to the supporting data used in their preparation. It is essential that the total amounts of the payrolls examined, when paid in currency, be checked to the related cash book entries. Approvals on payrolls ought to be examined. Employees' payroll checks should be compared with the entries, corresponding thereto, on the payrolls in addition to making a reconciliation of the payroll bank account in the usual manner. Attendance records, usually consisting of time recording clock cards, should be test-checked to the payrolls. Piece workers' earnings ought to be found to be in agreement with shop production records and established rates.

It is quite a general practice for independent accountants to analyze changes which took place in the company's personnel during the period

covered by the audit. Changes in employees are not relatively numerous in a good many organizations, particularly in those which consist largely of clerical workers. The net increase, or decrease, in the number of employees in any one occupation should be discussed with one of the company's major executives in order to obtain the benefit of his comments regarding the situation.

It is within the province of the independent accountant to ascertain what member of the company's organization is charged with responsibility for seeing that the company complies with all wage regulations. The accountant should ascertain whether wage increases for the period covered by the audit have been made in accordance with provisions of the laws regarding approvals by governmental agencies and whether employees hired during the period under review are being paid at prescribed rates, if there are such. Furthermore, the outside auditor ought to ascertain if there are any violations of wage stabilization regulations.

Reference to the company's Social Security record of employees' earnings can usually be made for the purpose of ascertaining the personnel changes which took place during the period covered by the audit. The Changes in Personnel Schedule, Form 88, illustrates the manner followed in tabulating the additions to, and deductions from, the company's personnel. The program followed by the independent accountant in connection with the analysis of the changes in the company's personnel is shown in the lower portion of the schedule. It will be noticed that the new employees added to the company's organization were checked to the authorizations on file in the personnel department.

The Analytical Review of Payrolls, Form 89, illustrates the manner in which a statistical study of a company's payrolls may be made; departmental payrolls of the current year are compared with those of the preceding year. Means for observing the trend in rates of compensation are furnished by the departmental yearly average earnings of employees. It will be noted, in the illustrative case, that on the whole there was an increase in personnel and an upward trend in rates of pay. Mention ought to be made on the analytical review working sheet of any significant items which were investigated, such as a general revision of rates of pay for the members of the company's organization.

Supervising Pay-Offs. Payroll records, on account of their confidential nature, are usually kept in the custody of the company's paymaster. This condition of affairs is conducive to the concealment of irregularities in payrolls. Unannounced visits, by independent accountants, are often made on paydays so that the paying off of employees

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THE BLANK COMPANY
YEAR ENDED DECEMBER 31 (YEAR)

PREP BY J White
REV'D BY C Lane

CHANGES IN PERSONNEL SCHEDULE

DATE	NAME	OCCUPATION	RATE	
			AMOUNT	PERIOD
<i>Additions</i>				
<i>(1922) Feb 7</i>	<i>B. Cole</i>	<i>Bookkeeper *</i>	<i>60.00</i>	<i>Week</i>
<i>Mar 8</i>	<i>E. Ray</i>	<i>Typist * †</i>	<i>30.00</i>	<i>Dr</i>
<i>June 12</i>	<i>D. Mills</i>	<i>Elevator operator *</i>	<i>25.00</i>	<i>Do</i>
<i>July 10</i>	<i>E. Gray</i>	<i>Telephone operator *</i>	<i>25.00</i>	<i>Do</i>
<i>Nov 15</i>	<i>F. Land</i>	<i>Mail clerk * †</i>	<i>15.00</i>	<i>Dr</i>
<i>Deductions</i>				
<i>Feb 1</i>	<i>H. Kane</i>	<i>Bookkeeper †</i>	<i>60.00</i>	<i>Week</i>
<i>June 12</i>	<i>F. Hill</i>	<i>Elevator operator *</i>	<i>22.00</i>	<i>Do</i>
<i>July 9</i>	<i>P. Hart</i>	<i>Telephone operator *</i>	<i>25.00</i>	<i>Do</i>
<i>July 1</i>	<i>H. Fowler</i>	<i>Gardener † ‡</i>	<i>20.00</i>	<i>Do</i>
<i>Dr</i>	<i>H. Amos</i>	<i>Do † ‡</i>	<i>20.00</i>	<i>Do</i>
<i>Dr</i>	<i>E. Brewster</i>	<i>Do † ‡</i>	<i>20.00</i>	<i>Do</i>
<p>‡ Grant Contracting Co. employed to replace gardeners</p> <p>* Checked to authorizations on file in personnel department</p> <p>† Checked to personnel records</p> <p>‡ Additions to regular staff</p>				
<p><i>James White</i> <i>February 2, (year)</i></p>				

THE BLANK COMPANY
 YEAR ENDED DECEMBER 31 (YEAR)
 ANALYTICAL REVIEW OF PAYROLLS SCHEDULE

PREPARED BY *J. White, Jr.*
 REVIEWED BY *C. Reed, Jr.*

DEPARTMENT	CURRENT YEAR			PRECEDING YEAR		
	AMOUNT	AVERAGE NUMBER OF EMPLOYEES	AVERAGE PER EMPLOYEE	AMOUNT	AVERAGE NUMBER OF EMPLOYEES	AVERAGE PER EMPLOYEE
<i>Administrative</i>	4,750	1	4,750	4,750	1	4,750
<i>Manufacturing</i>	10,800	3	3,600	10,650	3	3,550
<i>Editorial</i>	16,000	4	4,000	11,475	3	3,825
<i>Advertising</i>	19,800	6	3,300	16,250	5	3,250
<i>Sales</i>	28,500	10	2,850	24,300	9	2,700
<i>Accounting</i>	10,625	5	2,125	7,940	4	1,985
<i>Bookkeeping</i>	20,625	11	1,875	17,500	10	1,750
<i>Circulation</i>	17,640	14	1,260	13,800	12	1,150
<i>Filing</i>	6,750	5	1,350	5,100	4	1,275
<i>Order</i>	6,460	6	1,410	6,950	5	1,390
<i>Shipping</i>	15,200	10	1,520	13,320	9	1,480
<i>Total</i>	157,150	75	2,095	132,035	65	2,031
<p><i>Reviewed with Mr. C. Gray, company treasurer, who stated that there had been an increase in the personnel of approximately 10 persons and some increases in compensation rates.</i></p> <p><i>James White, February 10 (Year)</i></p>						

can be supervised for the purpose of ascertaining whether the practice of padding payrolls is being indulged in.

After completing the pay-off, there are quite likely to be some pay envelopes, or bank checks, remaining unclaimed. Inquiry ought to be made by the independent accountant regarding the whereabouts of the absentee employees. One of the explanations frequently given for the absence of employees on payday is that they work on the night shift. It is sometimes practicable for the outside auditor to retain control of unclaimed pay envelopes and checks until called for by the respective payees. It frequently is desirable for the independent accountant to mail the unclaimed payroll checks to the absentees. The outside auditor must satisfy himself that the payroll, when he observed the paying off, did not contain the names of any fictitious persons.

Examination of Expense Accounts. It is a good plan to make comparisons with the preceding year, of the monthly amounts in the current year's expense accounts, for the purpose of ascertaining significant variations. There are certain expense accounts which are ordinarily charged monthly for the same or somewhat similar amounts, such as rent or telephone service. Quite likely it will be discovered that trends in the monthly charges to expense accounts for the current year will follow closely those of the preceding year.

The principal charges to some expense accounts will be found to occur quarterly, as in the case of some tax expense accounts for which tax accruals are not provided. The regularity with which the quarterly charges appear and their similarity to those of the preceding year ought to be observed. Any unusual charge, such as the payment of an assessment of a prior year's tax, should be apparent from the examination made.

An inspection of expense accounts ought to bring to light any change in the company's procedure, such as the discontinuance of the practice of treating unexpired insurance premiums as a prepaid expense. An unusual charge to the Insurance Expense account may be found to be due to the payment of an initial premium on the insurance policy on the life of an officer of the company. Any particularly large, or extraordinary, debit to an expense account should be inquired into.

The independent accountant, as a result of the examination of the expense accounts of a company, should be able to detect significant omissions of charges. Lack of a monthly charge to an account that is ordinarily debited regularly for expenses should be looked into. It will probably be found that the voucher covering the omitted expense has been misplaced. The action taken by the independent accountant, as a result of the conclusion reached, after an investigation of an account is

shown in Form 90. Omission of the Federal Old Age Benefit Tax expense for the third month of the first quarter of the year under review is taken care of by the adjustment journal entry. Inasmuch as taxes, for the most part, are applicable to definite periods of time it is usually an easy task to make a comprehensive examination of tax expense accounts.

In the Expense Accounts Schedule, Form 91, an illustrative study of several relatively important expense accounts is presented. Amounts for the current and preceding years are shown in comparative form, together with increases and decreases. As an aid to the examination of the accounts it will be seen that the sales figures for two years are given. By making a review of large expense accounts, in the manner illustrated, any significant variations during the current year as compared with the preceding year will surely be noticed so that an inquiry can be made into the causes thereof.

The Directors' Fees Schedule, Form 92, shows the manner of procedure that may be followed in the verification of fees paid to directors during the period covered by the audit. Attendance at meetings is checked to the minutes of the company's board of directors which contain the names of the directors who were present at the meetings. Amounts which are paid to directors who attended meetings are checked to supporting vouchers. Sometimes payments to directors who reside away from the meeting place cover traveling expenses. The rates of fees paid directors are frequently authorized in the minutes of the board. Ordinarily the directors who draw salaries from the corporation are not entitled to receive fees for attendance at board meetings. In view of the practice frequently followed of charging directors' fees to some general expense account, it is often necessary to tabulate those paid in order to ascertain the total amount thereof.

The Large Expense Accounts Schedule, Form 93, illustrates the manner of procedure that can be followed in making a statistical study of important expenses. It will be noted that monthly percentages have been introduced for the purpose of showing the percentages which the current year's expenses bear to those of the preceding year. Any significant changes in monthly expenses of the current year as compared with those of the preceding year will be evident by scanning the columns of percentages. The sales figures for the current and preceding years are given in order to indicate the change in the volume of business done. Such an analysis as that contained in Form 93 is designed to reveal unusual charges that might otherwise escape one's notice. Often a few expense accounts make up a large portion of a company's total expenses.

INVESTIGATION OF EXPENSE ACCOUNT - ILLUSTRATED

THE BLANK COMPANY
 NAME *Federal Old Age Benefit Tax Expense*

DATE	CHARGE	DATE	CREDIT
Jan. 31 (YEAR)	✓	Jan. 1 (YEAR)	6.100 00
Feb. 28	Quarter ended 14 (yr) C-75 (a)		
Mar. 31	January (year) tax J-10		
	February (year) tax J-35		
			6.100 00

Conclusion:

The Federal Old Age Benefit Tax Expense account should be adjusted by the addition of the March (year) tax, in order that the account may show the correct amount of tax for the first quarter of (year) James White March 10 (year)

THE BLANK COMPANY
 QUARTER ENDED DECEMBER 31 (YEAR)
 ADJUSTMENT JOURNAL ENTRIES

	DEBIT	CREDIT
<i>Federal Old Age Benefit Tax Expense</i>	2,175 00	
<i>Accrued Federal Old Age Benefit Tax</i>		2,175 00
<i>Entry to record F.O.A.B. tax for March (year) James White</i>		
<i>April 10 (year)</i>		

PREPARED BY *J. H. White* 12/31/24
 REVIEWED BY *E. C. Brown* 1/1/25

THE BLANK COMPANY
 YEAR ENDED DECEMBER 31 (YEAR)
 EXPENSE ACCOUNTS SCHEDULE

ACCOUNT	CURRENT YEAR	PRECEDING YEAR	INCREASE OR DECREASE		EXPLANATION
			AMOUNT	%	
<i>Association dues</i>	22,606	21,615	991	4.6	(1) This covered the
<i>Motor vehicle expense</i>	7,707	7,730	(23)	(.3)	cost of a sales pro
<i>Packing supplies</i>	106,291	119,610	(13,319)	(11.1)	motional campaign
<i>Power house expense</i>	35,839	33,214	2,625	7.6	the results of which
<i>Purchased power and light</i>	24,075	27,831	(3,756)	(13.5)	were unsatisfactory for
<i>Purchasing expenses</i>	9,567	9,514	53	3.7	In Black sales manager
<i>Repairs</i>	14,342	11,170	3,172	28.2	
<i>Special contest expense (1)</i>	26,630		26,630		
<i>Stationery</i>	22,970	22,465	505	2.2	
<i>Telephone service</i>	21,637	20,685	952	4.6	
<i>Uniforms expense</i>	7,200	7,150	50	7	
<i>Sales</i>	326,025	310,500	155,525	50	

THE BLANK COMPANY
 YEAR ENDED DECEMBER 31 (YEAR)
 DIRECTORS' FEES SCHEDULE

PREPARED BY *J.M. 2/2/24*
 REVIEWED BY *C. 2/2/24*

DATE MEETING OF BOARD OF DIRECTORS	VOUCHER		Amos Allen	Clayton Blaine	Henry Tomah	Philip Dwyer	George Eagle	Bruce Train	Bird & Gray
	DATE	REF AMOUNT							
Feb 3 Op.	2/3 Op.	* 60.00	F 20.00	F 20.00	F 20.00	F	F	F	F
Apr 5 Op.	4/5 Op.	* 60.00	F 20.00	F 20.00	F 20.00	F	F	F	F
June 7 Op.	6/7 Op.	* 60.00	F 20.00	F 20.00	F 20.00	F	F	F	F
Aug 9 Op.	8/9 Op.	* 60.00	F 20.00	F 20.00	F 20.00	F	F	F	F
Oct 12 Op.	10/12 Op.	* 60.00	F 20.00	F 20.00	F 20.00	F	F	F	F
Dec 15 Op.	12/15 Op.	* 60.00	F 20.00	F 20.00	F 20.00	F	F	F	F
	Total	360.00	120.00	120.00	120.00				
* Checked to minutes of meeting of the board of directors P Present per minutes of board of directors * Checked to petty cash voucher James White February 10 (Year)									

THE BLANK COMPANY
 YEAR ENDED DECEMBER 31 (YEAR)
 LARGE EXPENSE ACCOUNTS SCHEDULE

PREPARED BY J. K. [unclear]
 REVIEWED BY [unclear]

MONTH	Editorial Expense		Advertising Expense		Circulation Expense		%
	CURRENT YEAR	PRECEDING YEAR	CURRENT YEAR	PRECEDING YEAR	CURRENT YEAR	PRECEDING YEAR	
January	16,720	15,200	15,000	12,500	12,250	9,800	125
February	15,850	15,100	14,300	13,000	12,120	10,100	120
March	18,600	15,500	15,060	13,100	13,325	10,250	130
April	17,700	15,400	14,350	13,050	12,560	10,050	125
May	17,100	15,550	14,500	12,950	12,000	10,000	120
June	16,800	16,000	12,500	12,500	13,750	11,000	125
July	16,800	15,850	13,260	13,000	13,380	11,150	120
August	17,600	16,000	13,900	13,250	14,400	12,000	120
September	19,800	16,500	14,410	13,100	15,125	12,100	125
October	20,560	16,450	16,440	13,700	16,900	13,000	130
November	21,450	16,500	18,500	14,800	18,225	13,500	135
December	23,800	17,000	19,500	15,000	20,300	14,500	140
Total	222,780	191,050	181,720	159,950	174,335	137,450	127
Averages	2730.975	2100.750					

FORM 93

BAD DEBTS OVER \$100 WRITTEN OFF SCHEDULE

THE BLANK COMPANY
Year Ended December 31 (Year)

PREPARED BY J. White, P. G.
REVIEWED BY C. G. G. G.

CUSTOMER	WRITTEN OFF		DATE OF LAST CHARGE	AUTHORITY FOR WRITE OFF	LAST DATE COMMENCED WITH DEBTOR	REMARKS ON EXAMINATION OF CREDIT DEPT'S FILES
	DATE	AMOUNT				
F. Allen	Dec 31 Year	1,025 ⁰⁰	6/6 Year	Credit Manager	3/1 Year	Confirmation returned by Post Office
E. Bates	Do	610 ⁰⁰	3/10 Year	Do	2/1 Year	Do
D. Coates	Do	1,400 ⁰⁰	2/1 Year	Do	4/6 Year	Customer claims to never receive goods
E. Davis	Do	7125 ⁰⁰	4/1 Year	Do	10/2 Year	Confirmation returned by Post Office
B. Eaton	Do	375 ⁰⁰	5/10 Year	Do	12/1 Year	Do
A. Flint	Do	125 ⁰⁰	6/1 Year	Do	1/4 Year	Do
Ch. Gault	Do	2,000 ⁰⁰	4/7 Year	Do	6/5 Year	Customer claims to never receive to date
Total		12,660 ⁰⁰				of \$2,000.00
← Information furnished by Company →						
	✓	Checked to	general journal			
	⊙	Checked to	customer's account			
	*	Checked to	authorizing			
			James White, February 15 (Year)			

AN ERRONEOUS ACCOUNTING STATEMENT - ILLUSTRATED

ICE, INC.	
STATEMENT OF INCOME AND SURPLUS FOR YEAR ENDED DECEMBER 31 (YEAR)	
SALES	\$ 10,655,725.00
Less: RETURNS AND ALLOWANCES	\$ 725,250.00
DISCOUNTS ALLOWED	1,000,000.00
* NET SALES	\$ 8,930,475.00
COST OF SALES	
INVENTORY EXPENSES	12,000.00
MISCELLANEOUS TAXES	2,410.00
PROFIT BEFORE INCOME TAXES	\$ 9,950,220.00
PROVISION FOR INCOME TAXES	1,200,000.00
REMAINDER	\$ 2,750,220.00
LESS PRESIDENT'S 10% BONUS	275,022.00
NET PROFIT FOR (YEAR)	\$ 2,475,198.00
SURPLUS, JANUARY 1 (YEAR)	4,150,150.00
TOTAL	\$ 6,625,348.00
MISCELLANEOUS TAXES APPLICABLE TO PRIOR YEAR (IN EXCESS OF RESERVES THEREFOR)	27,105.00
SURPLUS DECEMBER 31 (YEAR)	\$ 6,598,243.00

ICE
INCORPORATED

To the Stockholders of ICE, INC.

Your company earned a net profit, for the year ended December 31 (Year), of \$2,475,198.00 which amounted to \$405 per share of the outstanding capital stock.

Very truly yours,
Louis Land President

New York
January 10 (Year)

Conclusion:
Prior period expenses paid during the current year are usually regarded as properly chargeable to current operations, and not to Surplus - account.

James White
March 5 (Year)

Inasmuch as irregularities are sometimes concealed in the Bad Debts Expense account, it is desirable that this account be investigated. Sometimes the bulk of the bad debts arise from a relatively few items. It will be seen by referring to Form 94 that bad debts over \$100 were investigated, including the circularization of the respective debtors. Particular care should be exercised in the examination of any replies received from debtors whose accounts were written off during the period covered by the examination. Any objection on the company's part to the circularization of customers whose accounts had been charged off as bad debts should be regarded with suspicion.

Income Statement Treatment. Details of selling, administrative, and general expenses are usually presented in the form of a supporting schedule, which is usually omitted from published income statements. Major classifications of payrolls, expenses, and interest generally correspond to those which appear on tax returns, statements which are filed with the Securities and Exchange Commission, and other reports required by governmental agencies. This procedure saves the time that would otherwise be required in analyzing accounts. Examination of a company's financial statements and reports often leads an independent accountant to the conclusion that he cannot certify that they have been prepared in accordance with generally accepted accounting conventions. This situation is illustrated in the case which is presented in Form 95, where the net profit for the year is stated before giving effect to the payment of miscellaneous taxes which were applicable to a prior year. (During the following year payments of taxes applicable to the current year may also be made.) Ice, Incorporated, should consent to have its statement of income and surplus recast in such a manner that the statement conforms to accepted accounting conventions.

REVIEW QUESTIONS

1. What purpose is served by comparing payroll amounts with cash book entries covering payroll disbursements?
2. Why is it regarded as desirable that the changes which took place in the company's payroll and personnel for the period covered by the audit be ascertained?
3. What authorizations should the independent accountant find for changes in the personnel of the company under audit?
4. Is it regarded as being within the scope of an auditor's duties to examine the approvals on payrolls?
5. What purpose is served, by an independent accountant, in conducting an unannounced paying off of the company's employees?

6. Outline the procedure that should be followed in verifying employees' bonuses.
7. Indicate the steps that ought to be employed in the audit of employees' sales commission accounts.
8. Should amounts in the trial balance of a subsidiary expense ledger be checked by the independent accountant to the ledger accounts?
9. Is the scrutiny of expense accounts a desirable procedure?
10. Is any useful purpose served in comparing the expenses of the current period with the budgeted expenses for the respective period?
11. Should significant differences, say 20 per cent or more, between relatively important expenses of the current as compared with the preceding period be investigated?

CHAPTER 22

ANALYTICAL REVIEW OF ACCOUNTS

Through the medium of a study of comparative figures, trends, and ratios, an analytical review is made of a company's accounts. All significant variations and unusual situations are investigated. Reasons for relatively important changes as between the current and preceding accounting periods are ascertained. The extent of an analytical review depends upon the nature and scope of the business of the company under audit.

The substitution by independent accountants of tests for some of the detailed checking, except in the case of "detailed audits," is quite general. A convenient means of testing accounts, particularly the operating accounts, is the making of an analytical review. Such a review comprehends a study of important relationships and trends. Any significant changes that may have occurred during the period covered by the audit, as compared with one or more previous periods, require investigation. A comprehensive analytical review of a company's accounts should indicate the probable accuracy of the results from operations.

An analytical review should cover selected transactions for the current and at least the two preceding years. In many instances it is desirable that the study of the operating accounts be extended to cover a five-year period. The analytical review sheets should be accompanied with such explanations as are offered by the client's personnel regarding causes of unusual variations and changes in significant relationships.

Work Program. Mention is made here of some of the relationships that may be profitably studied when making a general review of a company's operations.

1. Sales and accounts receivable.
2. Sales and inventories.
3. Sales and cost of sales.
4. Sales and selling expenses.
5. Sales and income from operations.
6. Sales and net income.
7. Sales and discounts and allowances.
8. Purchases and discounts received.
9. Provision for depreciation and cost of depreciable assets.
10. Net income and number of shares of capital stock.

The foregoing list is merely intended to be suggestive, and can be readily amended to meet the needs of the particular audit engagement.

Sundry Relationships Discussed. The relationship between sales on credit and accounts receivable trends, for a period of from three to five years, is worthy of consideration by the outside auditor. The analyst would ordinarily expect that a doubling of the sales volume would be accompanied with a comparable increase in the accounts receivable. A slowing up of the collection period would undoubtedly be evidenced by a greater percentage of increase in the accounts receivable than in the sales. An inquiry into the company's collection experience ought to enable the independent accountant to ascertain whether his suppositions regarding the company's accounts receivable are correct. It is the general practice to compute the average collection period at the time the accounts receivable are audited.

There is a close relation between the sales and the inventory. Substantial increases in sales over a period of several years are usually accompanied by considerable increases in inventories. One cannot expect the volume of business done to increase substantially without an additional investment in the inventory. Should sales remain at approximately the same level while inventories go up by leaps and bounds, it suggests that the company may be accumulating an undue quantity of slow-moving goods. Many of the mistakes of management have been concealed in inventories. The usual procedure is to calculate the average rate of inventory turnover at the time the inventory is verified and to make comparisons with the turnover rates of several preceding years.

Ordinarily the relation of the percentage of gross profit to sales remains fairly constant from period to period. This situation quite generally prevails although a considerable variation may take place in the sales volume. Any significant variation in the gross profit percentage figure requires looking into. An investigation will sometimes bring to light items in the cost of sales account that are, to say the least, of an extraordinary character. Not infrequently the Cost of Sales account is improperly used as a resting place for items that ought to be treated as a charge to some expense account. The study of the gross profit percentage figures, if the necessary data are available, ought to be extended to cover the departmental operations of the company. Any significant distortions in the gross profit percentages during the period covered by the review should be explained in the accountant's working papers. A study is generally made of a company's gross profit percentage figures in connection with the examination of the inventory.

The trend in selling expenses as compared with that of the sales is worthy of study. Percentages of increase in selling overhead are not ordinarily expected to be as great as those of sales. The reason is that the so-called fixed charges, such as rent of the show room, do not ordinarily increase proportionately with an expansion in the volume of business done. However, a reduction in sales is not usually accompanied with a comparable decrease in selling overhead.

Relatively important items of expense can be compared with the sales to good advantage. Royalties, paid authors by book publishers, generally bear a close relation to sales from year to year. One reason is that the royalty agreements between book publishers and their authors usually provide for the payment of royalties on the basis of sales. There are numerous other relationships that do not ordinarily change much from year to year.

An examination of the relation between annual provisions for depreciation and cost of depreciable assets should be informative. If there is a drop in the annual provision for depreciation, without a corresponding decrease in the depreciable assets, the indication is that some of the assets have become fully depreciated. It ought to be an easy task to ascertain whether this is so. The auditor may find that there has been a change in the depreciation rates used.

The net annual income from operations for several years ending with the period under review, as compared with sales that showed increases throughout the same period, ought to show a favorable trend. However, when the trend in net income after all taxes is compared with the sales trend, the result is quite likely to be entirely changed, owing primarily to the inability of the company to pass along to customers all taxes, particularly income taxes.

Financial reports which cover the company's foreign branches and which are audited by local accountants should be reviewed analytically before the figures are incorporated in consolidated statements.

The Schedule of Significant Relationships, Form 96, illustrates the manner in which a working sheet may be prepared for the purpose of making an analytical review of accounts. It is intended that the sheet shall be moved forward in the accountant's working papers from year to year so that new figures can be added and comparisons can readily be made with the figures for preceding years. The accounts which are to be studied analytically should be selected after giving due consideration to the requirements of the particular audit engagement. Naturally, the accounts studied for a book publishing business would differ from those for a mining enterprise.

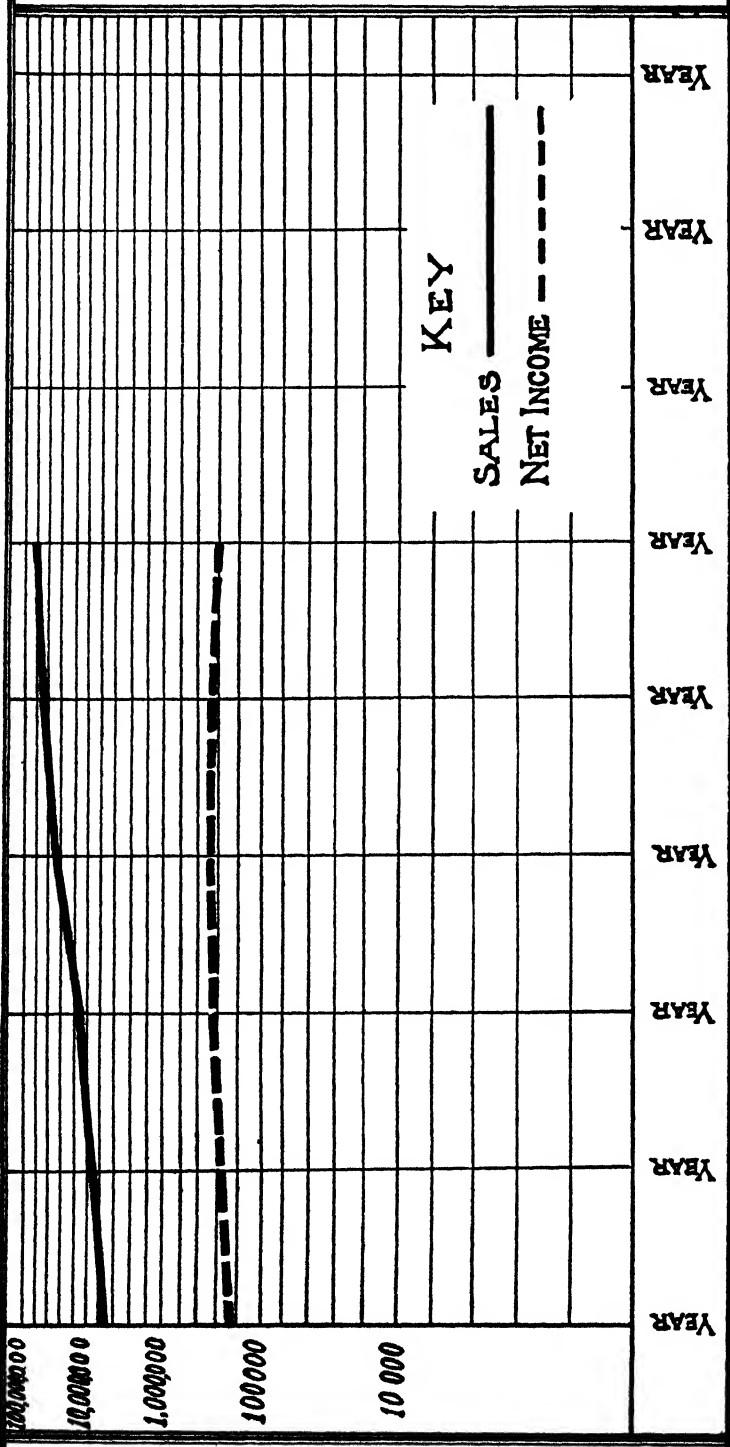
THE BLANK COMPANY
 YEAR ENDED DECEMBER 31 (YEAR)
 SIGNIFICANT RELATIONSHIPS

PREPARED BY J. H. ...
 REVIEWED BY C. ...

DESCRIPTION	YEAR	YEAR	YEAR	YEAR	YEAR	YEAR
<i>Sales</i>	3165,725	3210,250	3534,390	3745,050		
<i>Cost of sales</i>	1,510,050	1,553,761	1,767,190	1,870,000		
<i>Percentage of cost to sales</i>	47.7 %	48.4 %	50.0 %	49.9 %		
<i>Selling expense</i>	1,111,170	1,165,320	1,357,200	1,505,510		
<i>Percentage of selling expense to sales</i>	351 %	36.3 %	38.4 %	40.2 %		
<i>Income from sales</i>	544,505	491,169	410,000	369,540		
<i>Percentage of income to sales</i>	17.2 %	15.3 %	11.6 %	9.9 %		
<i>Average accounts receivable</i>	664,650	663,400	718,580	748,800		
<i>Change - daily - sales</i>	10,550	10,700	11,780	12,480		
<i>Ratio of average accounts receivable to daily sales</i>	63 to 1	62 to 1	61 to 1	60 to 1		
<i>Average Inventory</i>	274,545	295,950	353,438	340,000		
<i>Annual rate of inventory turnover</i>	5 1/2	5 1/4	5	5 1/2		
<i>Capital at beginning of year</i>	842,000	1,052,500	1,305,100	1,592,222		
<i>Net profit</i>	210,500	252,600	287,122	318,444		
<i>Percentage of net profit to capital</i>	25 %	24 %	22 %	20 %		

FORM 96

THE BLANK COMPANY
RATIO CHART SHOWING SALES COMPARED WITH NET INCOME



FORM 97

Graphic Charts. Historical comparisons can often be made advantageously by means of graphic charts. Relationships are frequently studied by plotting data on a "ratio chart" in the manner illustrated by the Ratio Chart Showing Sales Compared with Net Income, Form 97. It is quite clear from a glance at this chart that, although sales have had an upward trend, there has been a lag in income. The chart has sufficient vacant space to permit extending the lines to cover several future years' operations.

Paper for preparing ratio charts can be obtained already ruled so that the drawing of the lines is a simple task. It will be noticed that the spaces between the horizontal lines correspond to those on the slide in a logarithmic slide rule. Use of this paper for showing historical data graphically permits of presenting information in such a manner that ratios rather than magnitudes are apparent. Significant relationships that are developed by means of ratio charts are more easily grasped than when presented by means of statistical tables of figures. However, ratio charts are used to good advantage as supplementary to statistical tabulations. Graphic charts are helpful at conferences with a company's executives when reviewing operations, trends, and important ratios.

Explanations of all items which are inquired into in connection with the analytical review of accounts should be contained in the working papers. The action taken with respect to the items which are investigated, such as the making of adjustment journal entries, should be stated.

REVIEW QUESTIONS

1. What is the main object in making an analytical review of the operating accounts of a company?
2. Why is a five-year period more desirable than a three-year one, when making a study of relationships in a company's operating accounts?
3. What relation is there between a company's sales and its accounts receivable?
4. What relation is there between sales and inventories?
5. What relation is to be found between sales and operating income?
6. What relation is looked for between the provision for depreciation and the cost of depreciable assets?
7. What is the significance of the net income earned per share on capital stock?

CHAPTER 23

INDEPENDENT ACCOUNTANTS' REPORTS

Upon the completion of an audit the independent accountant makes his report thereon. The requirements of the client are given due consideration. Reports which accompany interim examinations of accounts are quite likely to be brief. Those which are prepared at the completion of an annual audit contain the certificate of the independent accountant, and often include quite extensive comments. The certificate is presented on the independent accountant's letterhead and is suited for publication in the company's annual report. Comments in an audit report contain information which is regarded as being of interest to the reader of the company's financial statements. Graphic charts are frequently introduced for the purpose of simplifying the presentation of statistical data.

It is the usual practice, at the conclusion of the examination of a company's accounts, for an independent accountant to prepare a report covering his findings. This report ordinarily contains a statement of the period of time covered by the examination and a reference to accompanying financial exhibits and schedules. Information regarding the company's operations is often summarized and statistical data is introduced. The body of an audit report is frequently given over to comments regarding the main accounts which appear in the company's financial statements. Mention is generally made of any restrictions which have been placed upon the scope of the examination and any exceptions regarding the company's financial statements. Usually the last paragraph of the report is devoted to a statement of the opinion which the accountant has formed, on the basis of the examination made, of the accompanying statements and the manner of keeping the accounts on which the statements are based.

Short Form of Report. A short form of audit report, usually described as an "accountant's certificate" (such as the ones presented in Chapter 1 and in Appendix A), together with financial statements, is furnished to companies which desire to publish the certificate with their balance sheets and statements of income and surplus. Any qualifications which are contained in the long form previously described, should be stated in the short form of report. Sometimes, especially where

companies have internal auditing staffs which regularly prepare detailed financial reports, only the accountant's certificate is furnished. The contents of the usual form of accountant's certificate were discussed in Chapter 1. Certificates are preferably reproduced, when published, on the independent accountant's letterhead.

Interim Reports. Independent accountant's reports which are furnished after the completion of an interim examination of accounts are usually somewhat abbreviated. Generally, it is not feasible, owing to the incompleteness of interim audits which are usually made monthly or quarterly, to render an opinion covering the company's financial statements. Some clients find that frequent financial reports containing a limited amount of explanatory matter meet their requirements. Naturally the needs of each accounting engagement, when planning end-of-year or interim audit reports, must be given careful consideration.

Outline of Typical Audit Report. The following outline is presented for the purpose of indicating the scope of a general purpose report, sometimes referred to as the "long form," which is prepared after the annual examination of a company's accounts has been completed.

Report to be typewritten on independent accountant's letterhead:

1. Date.
2. Name and address of addressee.
3. Statement of period covered by the examination and name of company, together with a reference to the company's accompanying financial statements, and a general description of the audit procedure followed in making the examination.
4. Summary of the results of the company's operations, together with significant percentages.
5. Pertinent comments regarding the accounts which appear in the company's financial statements and any relevant matters. Comments of a general nature and any recommendations.
6. Qualifications which are pertinent to the examination made of the company's accounts, or exceptions taken to the company's financial statements which accompany the audit report.
7. Opinion reached by the independent accountant regarding the company's financial statements, after completion of the audit, and a statement of the basis employed by the company in keeping its accounts.
8. Accountant's signature.

The procedure is often followed of making an index of exhibits and schedules when they are numerous and of referring in the introductory paragraph of the audit report to the accompanying index.

Financial Statements. Titles employed for financial statements should conform to those in general use. Exhibits which accompany

audit reports generally consist of balance sheets and statements of income and surplus. Frequently the surplus account, instead of being combined with the statement of income, is shown separately. Current assets and current liabilities are usually presented in the upper portion of the balance sheet so that the relation between them, frequently spoken of as the "current ratio," can be seen readily. Excess of current assets over current liabilities is called the working capital. Current assets are those which, in the normal course of business, will become available for paying liabilities during the year following the date of the balance sheet. Inasmuch as inventories are generally priced at the "lower of cost or market" they are included among the current assets, although experience may show that some goods will in all probability not be sold for over a year. Liabilities which are not payable until after the lapse of a year from the balance sheet date are referred to as "long term" and are shown below the current section. All assets in a properly prepared balance sheet are valued, and all liabilities are stated. Extensive use is made of valuation and true reserves. A balance sheet usually shows the composition of the company's capital and also carries a description of each class of stock. The balance sheet of a partnership shows the individual partner's accounts.

The report form of income and surplus statement is generally employed, as it provides a convenient means for showing relationships between the major items in the statement. Introduction of vertical percentage columns in statements of income is helpful to readers. As many schedules are supplied in support of financial statements as are deemed necessary, such as a "Schedule of Selling and Administrative Expenses." Exhibits are ordinarily lettered and arranged alphabetically, the letter "A" being assigned to the balance sheet; schedules are quite often numbered and arranged numerically after the exhibits.

Financial statements are prepared, preferably, in comparative form, with increases and decreases shown, so as to indicate short period trends. Illustrative financial statements are not presented here, inasmuch as the published annual reports of large corporations, containing balance sheets and statements of income and surplus in approved forms, are readily available for study.

Footnotes which appear on financial statements are regarded as an integral part thereof and supplement the information which is contained in the balance sheets and income and surplus statements. The notes contain information that cannot be presented conveniently in the bodies of exhibits and schedules. Amount of dividends in arrears, if any, on the company's preferred stock is a suitable item of information

NECESSITY FOR A BALANCE SHEET FOOTNOTE - ILLUSTRATED

Conclusion - The balance sheet of The Blank Company is incomplete without the addition of a footnote, stating that the surplus shown by the consolidated balance sheet of The Blank Company and subsidiary, Green, Inc., shows (SEE BELOW)

THE BLANK COMPANY AND SUBSIDIARY CONSOLIDATED BALANCE SHEET	
ASSETS	LIABILITIES
CURRENT ASSETS	CURRENT LIABILITIES
CASH \$ 1310,150.00	ACCOUNTS PAYABLE \$ 165,050.00
INVENTORY 3500,275.00	NOTES PAYABLE 200,000.00
TOTAL \$ 4810,425.00	DIVIDENDS PAYABLE 100,000.00
NET WORTH	TOTAL \$ 465,050.00
ORGANIZATION EXPENSE 179,700.00	NET WORTH:
GOODWILL 100,000.00	CAPITAL STOCK \$ 2,000,000.00
TOTAL \$ 5965,125.00	SURPLUS 3,500,075.00
	TOTAL \$ 5,965,125.00

THE BLANK COMPANY BALANCE SHEET DECEMBER 31 (YEAR)	
ASSETS	LIABILITIES
CURRENT ASSETS	CURRENT LIABILITIES
CASH \$ 30,100.00	ACCOUNTS PAYABLE \$ 40,025.00
INVENTORY 999,925.00	NOTES PAYABLE 150,000.00
TOTAL \$ 1,300,250.00	DIVIDENDS PAYABLE 75,000.00
INVESTMENT IN GREEN, INC. 2,650,075.00	TOTAL \$ 265,025.00
FURNITURE, NET 825,000.00	NET WORTH:
ORGANIZATION EXPENSE 110,000.00	CAPITAL STOCK \$ 2,000,000.00
GOODWILL 100,000.00	SURPLUS 1,750,075.00
TOTAL \$ 4,015,100.00	TOTAL \$ 4,015,100.00

Conclusion continued - a net worth of \$ 1,750,000.00 (\$ 3,500,075.00 - \$ 1,750,075.00) in excess of that of the parent company.
James White March 1 (year).

FAILURE TO DISCLOSE INFORMATION - ILLUSTRATED

THE BLANK COMPANY BALANCE SHEET DECEMBER 31 (YEAR)		LIABILITIES	
ASSETS			
CURRENT ASSETS		CURRENT LIABILITIES	
CASH	\$ 45,210.00	ACCOUNTS PAYABLE	\$ 175,250.00
ACCOUNTS RECEIVABLE NET	180,050.00	OTHER LIABILITIES	260,125.00
INVENTORY	210,025.00	TOTAL	\$ 435,375.00
TOTAL	\$ 435,285.00	CAPITAL:	
LAND AND BUILDINGS NET	294,005.00	PREFERRED STOCK	100,000.00
DEFERRED CHARGES	16,210.00	COMMON STOCK	250,000.00
GOODWILL	100,000.00	SURPLUS	60,125.00
TOTAL	\$ 845,500.00	TOTAL	\$ 845,500.00

Conclusion:

Mention should be made in a footnote, on the balance sheet of The Blank Company, of the agreement whereby the company is to buy \$100,000.00 quarterly of its preferred stock issue. James White, February 2, (year).

AGREEMENT

Whereas, Henry Blank is desirous of selling his Main Street, York, factory for \$100,000.00 and

Whereas, The Blank Company is desirous of acquiring said factory.

It is hereby agreed between the above mentioned parties that the company shall issue \$100,000.00 of its preferred stock in payment for the factory and furthermore it is agreed that the company shall buy back \$100,000.00 of said stock semi-annually until all preferred stock has been acquired.

John Doe
Witness
Dated December 31 (Year)

Henry Blank
The Blank Company
Henry Blank President

FORM 99

for a footnote to a balance sheet. Guarantees by the company of obligations of others that may possibly become real liabilities are properly mentioned in a footnote. Proposed Federal income tax assessments which the company has not agreed to, and which are going to be contested, constitute a suitable subject for footnoting. Details of agreements with employees for the purchase of the company's capital stock are pertinent. Reasons for excluding certain subsidiary companies from a consolidated financial statement are sometimes set forth in a footnote.

A situation, where information is of such a character that it can be best presented in the form of a footnote is illustrated in Form 98. It will be seen that the surplus of The Blank Company is considerably less than that shown on the consolidated balance sheet of The Blank Company and its subsidiary, which is a matter that should be set forth on the balance sheet of the parent company as indicated by the conclusions reached by the independent accountant. An examination of the accounts and financial records of a company sometimes brings to light information of such a character that the independent accountant cannot certify, without appropriate qualifications, to the company's balance sheet as originally submitted. Such a state of affairs is illustrated in Form 99 where the auditor came to the conclusion, after reading the agreement relating to the purchase in installments by the company of its preferred stock, that an appropriate footnote covering the agreement is required on the balance sheet.

Excessive use of footnotes, or the inclusion therein of lengthy statements, is generally guarded against. Absence of footnotes indicates that the financial statements are complete without them. It is considered unnecessary, where footnotes are presented, for the independent accountant to again refer to the subject matter thereof in his report.

Summary of Operations. A comparative summary of the company's operations for the current year and the preceding year gives readers a quick view of the trend in income. A generous use of percentages is helpful towards an understanding of the significance of the various figures. The following tabulation is presented for the purpose of illustrating the procedure followed in summarizing a company's operations with comparisons.

Sometimes a statement of application of funds is introduced for the purpose of showing sources of funds and their disposition during the year under review. An analysis of the changes which took place, during the current year, in the company's working capital is often informative.

	CURRENT YEAR		PRECEDING YEAR		INCREASE
	<i>Amount</i>	<i>%</i>	<i>Amount</i>	<i>%</i>	
Sales	\$475,200	100	\$420,750	100	\$54,450
Cost of Sales	285,120	60	256,657	61	28,463
Gross Profit	\$190,080	40	\$164,093	39	\$25,987
Selling Expenses	104,544	22	84,150	20	20,394
Income from Sales	\$ 85,536	18	\$ 79,943	19	\$ 5,593
Income Charges	9,504	2	16,830	4	7,326 *
Net Profit	\$ 76,032	16	\$ 63,113	15	\$12,919

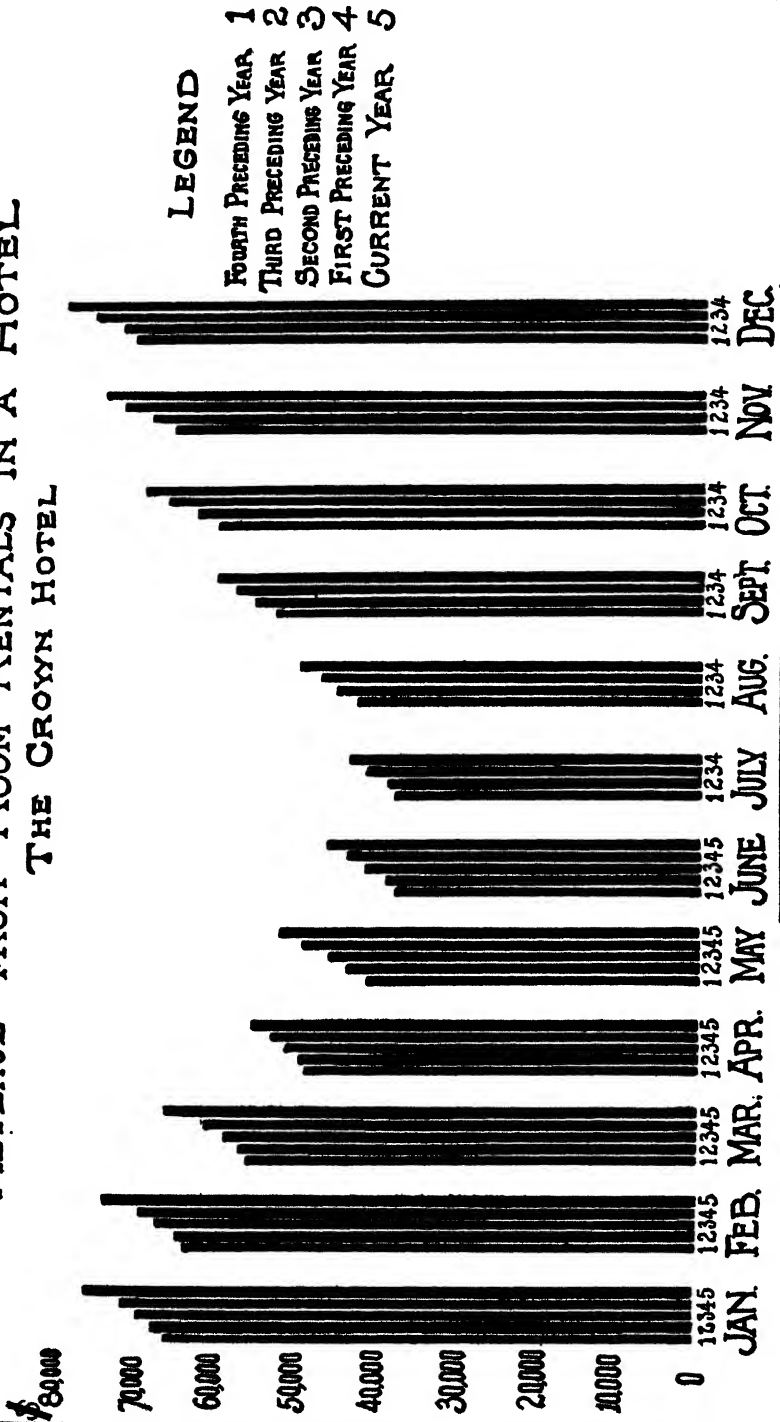
* Decrease.

Statistical Data. Audit reports frequently contain significant percentages, ratios, and trends that will assist readers to a ready comprehension of the company's financial position and operations. Statistics which are pertinent to the current year's statements are frequently compared with corresponding figures for two or more preceding years. A judicious use of index numbers is helpful towards understanding trends in a series of amounts for several successive years. The following list of statistics is offered merely as a suggestion of the trends and comparisons that may be found in an audit report.

1. Ratio of current assets to current liabilities.
2. Analysis of changes in working capital.
3. Percentage of net worth to noncurrent assets.
4. Percentage of current assets to total assets.
5. Percentage of net income for year to net worth at beginning of year.
6. Trend in inventory compared with trend in sales.
7. Trend in cost of sales compared with trend in sales.
8. Trend in selling and administrative expenses compared with trend in sales.
9. Trend in operating income compared with trend in sales.
10. Trend in Federal income and excess profits taxes compared with trend in sales.
11. Trend in net income compared with trend in sales.

Credit grantors are generally interested in the ratio of current assets to current liabilities and also in changes which took place in the company's working capital during the year under review. Any explanations regarding significant changes in the working capital position should be found valuable. The percentages of net worth to the non-

CHART SHOWING FIVE YEAR COMPARISON OF MONTHLY REVENUE FROM ROOM RENTALS IN A HOTEL
THE CROWN HOTEL



FORM 100

current assets and of the current assets to the total assets are often significant. Some readers may find a statement of the percentage of the year's income to the net worth at the beginning of the year of use.

The employment of graphic charts is often helpful to an understanding of a company's operations. Such charts enable the reader to visualize trends and relationships more readily than can be done from figures in comparative exhibits and schedules. Justification for graphic charts is found in the fact that the meanings of figures can be more readily grasped than without their aid. Quite a number of the published reports of corporations contain graphic charts which condense operational data for the information of stockholders. A barograph chart is presented in Form 100. The current year's monthly revenues from room rentals in a hotel are shown compared with those of several preceding years. The vertical arrangement of the bars facilitates visualizing both the annual and monthly trends. Historical data is often presented on semilogarithmically ruled paper, in order to show rates of increase and decrease. Comparisons can readily be made between different units, such as payrolls and yards produced, inasmuch as it is ratios rather than magnitudes that are of interest. Graphic charts frequently permit a good deal of information to be condensed into a comparatively small space.

Comments Section. Information which is contained in the auditor's working papers at the close of an examination of a company's accounts, and which is deemed to be of interest to readers, is made available to them in the comments section of the independent accountant's report. Sometimes, where there are absentee holders of large blocks of stock in a corporation or absentee partners in a partnership, it may be deemed desirable to furnish information regarding nearly all of the balance sheet accounts and the important income accounts. Auditors' comments should serve a useful purpose in giving readers a better understanding of the company's accounts, and should not be burdened with analyses of expenses which can be presented best in the form of supporting schedules. Accounts in the working capital section of the company's balance sheet, because of their importance, generally receive the most attention.

CASH. The company's depositaries and the amount of cash in each are frequently set forth in the comments section of an audit report. Credit grantors, in particular, are likely to be interested in the names of the banks with which the company does business. It is quite likely that, if the company has adopted a "natural business year," the cash on deposit is somewhere near the peak point at the annual balance sheet date. Mention is frequently made of the receipt of confirmations of

bank balances from the company's depositaries, although the securing of bank confirmations is regarded as normal auditing procedure when the independent accountant's certificate is to accompany the balance sheet.

INVESTMENT SECURITIES. The company's investment securities are frequently shown, in the comments section, by major classifications, together with the income and average rate of return upon each class of investments. This information is likely to be of interest to anyone who wishes to make an analysis of the company's finances. A comparison with rates of return earned the previous accounting period is helpful in showing significant trends. It seems to be a good plan to list, as is sometimes done, the investments on which no income was received during the period under review. Comments regarding investments often state that stock certificates and bonds owned by the company were examined and found to be in order, or that a certificate covering the company's stock and bond investment securities has been received from the custodian thereof.

NOTES RECEIVABLE. In the comments section of an audit report, the notes receivable are frequently shown by classes and mention is made of the value of collateral held and of the maturities of time notes. Installment notes receivable are often classified according to the number of months that have elapsed since the last payments were made by the respective debtors. Undoubtedly credit grantors are interested in knowing whether notes receivable were accepted from customers whose accounts were in arrears and whether the company's reserve for losses that may be sustained in the collection of notes receivable is regarded by the independent accountant as adequate.

ACCOUNTS RECEIVABLE. The comments section of an audit report frequently contains a statement of the average collection period, a summary of the agings of the accounts receivable, and a tabulation of the results obtained from the circularization of customers. A comparison of the current year's average collection period with that for the preceding year indicates the collection trend, which information is likely to be of general interest. Data obtained from the circularization of customers and the agings should be of interest to the client and credit grantors. Statistics regarding results obtained from the circularization of debtors, on notes and open accounts, indicate that the respective debtors were circularized for the purpose of confirming their balances.

INVENTORY. An analysis of the inventory by major classifications and a statement of the average rate of turnover of the inventory are frequently included in the comments. By comparing the rate of inventory turnover during the current period with those of several pre-

ceding periods, the trend in the movement of the stock can be seen. The relative importance of inventories is such that, although it is recognized as the proper procedure for the independent accountant to be present and observe the inventory taking, the comments often include a statement to the effect that the taking of the inventory by the company's employees was observed, that test-checks were made, and that the mathematical computations of the inventory were verified. A statement that an inventory certificate has been received is pertinent, particularly when reliance is placed upon the certificate for information as to the valuation of the inventory.

DEPRECIABLE ASSETS. The average lives of depreciable assets, together with the percentages of depreciated values to costs by major classifications, are frequently presented in the comments section of an audit report. Information with respect to the average lives and depreciated values of the main classes of depreciable property should be of interest to the company's management. Low depreciated values indicate that replacements of depreciable assets may be required before long.

MISCELLANEOUS ASSETS. Explanatory remarks regarding the miscellaneous assets, since there is usually less interest in them than in the current assets, are usually restricted to special features which are deemed to be of particular interest. Omissions from the asset accounts constitute an appropriate subject for report. Claims which have been made for refunds of Federal income taxes are not ordinarily recorded on the books, but may nevertheless be significant in amount and worthy of comment.

CURRENT LIABILITY ACCOUNTS. Any special features of the current liability accounts should be explained in the comments. A change may have taken place in the tax laws that necessitates an unusually large accrual as compared with the preceding year. An explanation of a reserve for contingencies is pertinent. A full disclosure should be made regarding any contingent liabilities for which a reserve has not been provided. The average number of days' purchases represented by the trade accounts payable shows how fast the company's creditors are being paid. The maturities of notes payable, together with the value of collateral pledged as security therefor, are often mentioned in the comments. A comparison of the average rate of interest paid on borrowed capital with the rate of return earned by the company on its capital is often significant. It may be deemed appropriate to state that a liability certificate has been received from the company, stating that all liabilities, including contingent ones, had been recorded on the books or disclosed in the certificate. Any unusual features re-

garding the company's accounts payable, or accruals payable, that may be of interest come within the scope of the audit comments.

BONDS AND MORTGAGES PAYABLE. Interest on long term obligations is regarded as a fixed charge and so the practice is frequently followed of stating, in the comments, the number of times that the interest on the company's long term, or funded, debt was earned during the current period. This information should be of interest to investors in the long term securities of the company under audit.

CAPITAL STOCK. The number of times that the preferred stock dividends were earned during the current period is mentioned frequently in the comments section of an audit report. This information ought to be of interest to holders of, and prospective investors in, the company's preferred stock. Details regarding any preferred stock dividends in arrears, in addition to those furnished in a footnote to the balance sheet, are often presented.

The practice is frequently followed of stating the book value per share of the company's common stock. The portion of the surplus which is applicable to dividends in arrears on preferred stock is deducted from the total surplus in order to arrive at the amount of surplus which is to be allocated to the company's common stock. Excess of callable value over the par value of preferred stock is also deducted from the surplus, in order to ascertain the remainder applicable to common stock. Earnings per share of common stock are generally mentioned in the comments section and should be of interest to the management and investors alike.

OPERATING ACCOUNTS. Explanations of any particular features of the operating accounts, as for example the use of the "installment method" of accounting for profits on deferred payment sales, are illuminating. Mention is sometimes made of trade practices, followed in recording financial results, which differ from usual procedures. Use of the "percentage of completion basis" for computing profits on long term construction contracts is an illustration of a trade practice. Distortion of the current year's statement of income may be due to some nonrecurring transaction, which may not be readily apparent from the income statement, and so an explanation of the situation is in order.

Miscellaneous Comments. The examination of the company's insurance policies is frequently referred to in the audit report. The adequacy of fire and sprinkler leakage coverages is a pertinent subject for comment. A digest of any discussion of the company's insurance policies, including the miscellaneous ones, with an executive of the company is sometimes reported upon. Mention in audit reports that "An examination of the insurance policies did not disclose the existence of a

fidelity bond" has frequently resulted in the taking out of fidelity insurance policies by the clients concerned.

In the report upon the initial audit of a company's accounts, a brief review of the history of the organization is appropriate. A corporation may be the successor to a partnership or the company might have grown out of a consolidation of several enterprises. Such information is likely to be of interest to the reader.

The audit report offers an opportunity for the independent accountant to make constructive suggestions regarding the company's business. Perhaps a change in the form of organization would result in tax economies that the client has overlooked. Introduction of certain types of bookkeeping machines might increase the efficiency of the office staff. Improved office routines, such as internal check systems, which the independent accountant desires to direct to the company's consideration can be outlined. Many clients think that the experience of their independent accountants, while making numerous visits to various business houses, should enable the accountants to offer constructive suggestions.

Qualifications in Audit Reports. Qualifications regarding the scope of the examination made by the independent accountant, or exceptions taken to any of the accounts presented in the company's financial statements, may be stated in connection with each account commented upon or be summarized in a separate section of the audit report. Judgment has to be exercised as to which procedure is to be followed. One of the advantages in summarizing the qualifications regarding the audit which has been made and the company's financial statements is that when a short form of report is issued, in addition to the long one, the qualifications contained in the long form can be readily reproduced in the short form.

The accounts of the company's foreign branches may have been audited by local accountants, in which case such a qualification as the following one is applicable to the situation.

Financial statements of the Corporation's branches in South America were examined by local accountants and are included in the consolidation. The net worths of the foreign branches amounted to 10 per cent of the total net worth at December 31 (year), and their net incomes amounted to 20 per cent of the total net income of the consolidation for the year ended that date.

A shift in the basis employed for depreciation of machinery may have been made, in order to conform to rates which are acceptable to the Bureau of Internal Revenue, so that the net income differs from that which would have been shown if the depreciation provisions had

been computed on a basis comparable with that employed the preceding year. The following qualification is applicable to this condition of affairs.

During the current year a change in depreciation rates was made in order to conform to those which are acceptable to the Bureau of Internal Revenue, with the result that the net income shown for the year ended December 31 (year) is \$20,000 more than it would have been if the former rates had been used.

Qualifications in an audit report cover omissions of any normal auditing procedures as, for instance, where a client objects to the circularization of customers for the purpose of confirming the accounts receivable.

Independent Accountant's Opinion. The concluding paragraph of the accountant's report generally contains a statement of the opinion which he has formed on the basis of the examination made, "subject to the foregoing comments and qualifications," of the company's financial statements. It appears that the phraseology of the accountant's opinion is substantially the same in the long form of report as in the "accountant's certificate" form, inasmuch as both forms of reports contain any qualifications which are applicable to the examination or the company's financial statements.

Review of Report Draft. It is generally recognized as highly desirable that, after the draft of the audit report has been written, the report be reviewed with one or more executives of the company. This is often done, in a large accounting firm, by the partner supervising the particular engagement. An opportunity is afforded, during the review, for a discussion of the various topics mentioned in the report. Often any exceptions that are taken to the report by the client can be overcome by a change in phraseology that does not affect the thought behind the comments.

During the discussion regarding the audit report and the company's financial statements, the independent accountant is generally able to obtain a better understanding of the company's problems and establish a closer relationship with the client. The discussion may develop ways whereby the independent accountant can be of greater service to the client.

Format of Audit Reports. Audit reports are generally typewritten on the accountant's letterhead which contains the designation "Certified Public Accountant." Where this is true, it is unnecessary to repeat the Certified Public Accountant designation after the accountant's signature. Audit reports are usually bound in covers which are provided for the purpose and which contain the independent accountant's card printed thereon.

REVIEW QUESTIONS

1. What is the distinction between the "long" and "short" forms of independent accountants' reports?
2. Mention some of the advantages in presenting financial statements in comparative form.
3. What is the relation between the independent accountants' examination of a company's system of internal control and the audit procedures employed in the examination of the company's accounts?
4. What is the necessity for disclosing, in an audit report, the omission of any standard audit procedure?
5. Would the failure to confirm accounts receivable due from the United States government merit a qualification in the independent accountants' report?
6. Should failure by the company to prepare its financial statements, in accordance with generally accepted accounting conventions, be commented upon by independent accountants?
7. May the limitations which are placed upon the examination of a company's accounts and records be so extensive as to preclude an unqualified certificate?
8. Mention some items that may be presented to good advantage in the comments section of an independent accountants' audit report.
9. What are some of the relationships that can be set forth with good results in an audit report?

CHAPTER 24

ILLUSTRATIVE REPORT AND WORKING PAPERS—BOOK-PUBLISHING BUSINESS

For the purpose of rounding out the discussion of auditing procedure, a report and a set of working papers on a book-publishing business will be presented in this chapter. A few comments will help to make clear some of the important features in auditing book-publishers' accounts.

In this country, publications are protected by copyrights which run for twenty-eight years and which may be renewed once for another, similar period.

The special feature of the inventory of a book publisher is the limitation placed on the number of books, bound and unbound, of any title which may be included in the inventory. It is a well-recognized principle that the number of books of any title which are included in the inventory should not exceed the probable future sales of books of that title. Thus, considering educational books, it may be assumed that copies in excess of four years' probable sales should not be inventoried. It is not unusual to find on the shelves of a book publisher more than a thousand titles from which a sale has not been made in two years. The accumulation of unsalable books has frequently been the cause of publishers' financial difficulties.

It will usually be found that print paper is for books which are about to be published. This is a matter which can easily be determined.

The initial expenditure for the metal plates from which books are printed represents a relatively large portion of the cost of publication. Various practices are followed in valuing the book plates which are on hand at the close of an accounting period. One plan is to appraise each set of plates, after taking into account the probable future sales of the books for the printing of which the plates were made. A method which is favored because of its simplicity is to depreciate book plates on a "straight line" basis. Plates for nonfiction books are frequently estimated to have a life of five years. It is highly desirable that a conservative valuation be placed on the book plates.

Agreements with authors generally provide for the payment of royalties, which are based on books sold, at stated rates. Records which show the sales of books of each title are usually kept, in order to facilitate the preparation of royalty statements. Amounts due authors, as shown by the royalty statements, are usually recorded in a book provided for the purpose. This book is a posting medium for making entries to the credit side of the authors' accounts in the royalty ledger.

Reference to the royalty accounts will usually show that many charges have been made covering advances to authors and books which have been sent according to authors' instructions. These charges should be carefully investigated by the auditor. It has frequently happened that authors never completed the manuscripts on which the advances were made. Advances to authors in anticipation of the completion of manuscripts should be inquired into by the auditor with the greatest care.

If the audit is made after royalty checks have been mailed to authors it is a comparatively easy matter to verify that the amounts due authors at the date of the balance sheet have been liquidated.

Book publishers usually employ a perpetual inventory system which furnishes a good check on the accuracy of the sales records. A record of the books sold, as shown by the sales book, is made currently in the perpetual inventory book. It is thus seen that if the number of books shown by the record to be on hand at the date of the inventory agrees with the tally made by the stock-takers, a good check on the accuracy of the sales is obtained. It is evident that, should an error be made in entering sales on the stock record, there would be a discrepancy between the book and the physical inventories. Special attention should be paid by the auditor to the reconciliation of the perpetual inventory with the stock-takers' tally sheets.

When an auditor completes his work he should have his report prepared, ready for typing, and his working papers properly indexed. There is presented herewith an auditor's illustrative report, together with the working papers that accompany it. The index symbols are shown that enable one to trace figures from the working papers to the financial statements, and vice versa. Typists in an auditor's office are instructed not to type the index symbols, which are usually in red pencil and circled. For the purpose of this presentation, the index symbols have been shown on the printed financial statements in the same manner as they appeared on the auditor's original pencil drafts.

The general plan of indexing the working papers will be self-evident from an examination of the financial statements and accompanying papers.

BROWN & WHITE
500 MADISON AVENUE
NEW YORK

CERTIFIED PUBLIC ACCOUNTANTS

New York, N. Y.
(Date)

The Worth Publishing Co., Inc.,
100 Broadway
New York, N. Y.

GENTLEMEN :

Pursuant to your instructions we have made an audit of your books for (year), and present herewith our report thereon, including a Balance Sheet as of December 31 (year) and an Income and Profit and Loss Statement for (year). The following comments are pertinent to the statements submitted.

Certificates confirming the cash on deposit were received from banks.

Wholesale customers accounts receivable (amounting to 69 per cent of the total amount due from trade debtors) were confirmed by correspondence. Balances due from retail customers were so numerous that they were not confirmed. The accounts receivable were all examined, and those which were ascertained to be past due were discussed with your treasurer and proper disposition was made of balances which were deemed uncollectible.

Your president has certified to us that the inventory was taken by physical count under his supervision and that cost prices (which were in close agreement with the market) were used in figuring the inventory. Books on hand of any title in excess of four years' probable sales were not included in the inventory. Through the medium of a stock record system, an internal check is obtained on the inventory. We made sufficient tests to satisfy ourselves that the tally made by the stock-takers was in substantial agreement with the perpetual inventory record. Arithmetical calculations on the inventory summary sheets were checked by us.

An appraisal of the book plates, furniture, and leasehold improvements was furnished us by your treasurer. It should be noted that the depreciated value of the book plates on a five-year life basis exceeds the book value (resulting from the appraisal) by \$129,294.85. This indicates that the valuation placed on book plates was conservative. Vouchers in support of additions to the plant accounts were examined. Provision made for depreciation is adequate.

Charges to authors for books shipped at their request before royalties have accrued are included under the head of "Royalty Advances." These are in agreement with the records and were not confirmed by correspondence.

Balances due to trade creditors and loans payable were confirmed by correspondence. Royalties payable were found to be in agreement with the author's subsidiary ledger. Reference to the cash book, subsequent to the date of the balance sheet, showed that the royalties due December 31 (year) have been paid. The necessary reserve for Federal Income Taxes has been set up. Your treasurer

has certified to us that all liabilities of the corporation as of the date of the balance sheet were recorded on the books, and that there were no contingent liabilities as of that date.

A comparative balance sheet, showing increases and decreases, which took place during the year, is presented below. The following changes may be mentioned as being favorable: increase in cash \$3,193.78; increase in net accounts receivable \$10,111.55; increase in inventory \$14,915.46; and decrease in accounts and loans payable \$7,110.44. In analyzing the comparative balance sheet it should be noted that a reserve for federal income taxes was not set up at the beginning of the year. The increase in the surplus for the year as shown by the books was \$13,354.92, whereas the increase shown would have been \$21,056.76 if a reserve for federal income taxes had been set up at the close of the preceding year.

COMPARATIVE BALANCE SHEET

	December 31 current year	December 31 preceding year	Increase or decrease
ASSETS			
Cash	\$ 70,669.07	\$ 67,475.29	\$ 3,193.78
Accounts Receivable, less reserve for bad debts	141,029.42	130,917.87	10,111.55
Inventory	236,992.80	222,077.34	14,915.46
Total Current Assets	\$448,691.29	\$420,470.50	\$28,220.79
Book plates, furniture and leasehold improvements, less reserve for depreciation	230,908.78	231,911.99	1,003.21
Royalty Advances	16,517.23	16,647.23	130.00
Due from Officers and Employees	892.37	1,892.37	1,000.00
Total Assets	\$697,009.67	\$670,922.09	\$26,087.58
LIABILITIES AND CAPITAL			
Accounts and Loans Payable	\$ 52,996.04	\$ 60,106.48	\$ 7,110.44
Royalties Payable	149,749.43	135,749.43	14,000.00
Reserve for Federal Income Taxes	5,843.10		5,843.10
Total Current Liabilities	\$208,588.57	\$195,855.91	\$12,732.66
Capital	200,000.00	200,000.00	
Surplus	288,421.10	275,066.18	13,354.92
Total Liabilities and Capital	\$697,009.67	\$670,922.09	\$26,087.58

A comparison of the current assets with the current liabilities shows that the ratio is somewhat better than 2 to 1. The credit position, as indicated by this relationship, was about the same at the close as at the beginning of the year.

The ratio of current assets to total assets increased from 62.7 per cent at the beginning of the year to 64.4 per cent at the end of the year. This trend is in the right direction.

Reference to the foregoing comparative balance sheet shows that the capital at the end of the year was 70 per cent of the gross assets. This is a very good showing for a book-publishing house.

During the year there was an increase in the capital (after providing a reserve for federal income taxes) of 4.5 per cent.

The ratio of dividends paid for the year to capital (after making provision for federal income taxes) at the beginning of the year was 3.4 per cent. Book value of the corporation's capital stock at the close of the year was \$244. Profit earned per share for year was \$21.

After deducting federal income taxes, the profit per share for the year was \$18.47. Dividends paid per share for year were \$8.

Below is a summary of the Income and Profit and Loss Statement for the year ended December 31 (year).

		Per cent
Net Sales	\$861,923.17	100.0
Cost of paper, printing, binding, plates, and royalties	557,906.09	64.7
	<hr/>	<hr/>
	\$304,017.08	35.3
 SELLING AND GENERAL EXPENSES		
Officers' Salaries	\$56,188.31	6.5
Office Salaries	88,662.52	10.3
Advertising	53,615.63	6.2
Other Expenses	66,088.90	7.7
	<hr/>	<hr/>
	264,555.36	30.7
 Profit from Selling	 \$ 39,461.72	 4.6
Additions to Income, Net	3,331.04	.4
	<hr/>	<hr/>
Net Profit	\$ 42,792.76 *	5.0
	<hr/> <hr/>	<hr/> <hr/>

* Exclusive of income taxes.

There are several items which deserve commenting upon in connection with the Income and Profit and Loss Statement. For the year, royalties amounted to 24.2 per cent of the net sales. Cost of paper, printing, binding, plates, and royalties were 64.7 per cent, or nearly two-thirds, of the net sales as shown.

Bad debts expense equaled 1.3 per cent of the sales.

For the year, the net profit (before any deduction for federal income tax) equals 5 per cent of the net sales.

We have reviewed the systems of internal control and the accounting procedures of the company and, without making a detailed audit of the transactions, have examined or tested accounting records of the company and other supporting evidence, by methods, and to the extent, we deemed appropriate. Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and included all procedures which we considered necessary,

In our opinion, the accompanying balance sheet and related Income and Profit and Loss Statement present fairly the position of The Worth Publishing Co., Inc., at December 31 (year) and the result 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.

Respectfully submitted,
 BROWN & WHITE
 Certified Public Accountants

AUDITOR'S DRAFTS OF FINANCIAL STATEMENTS

THE WORTH PUBLISHING CO., INC.

EXHIBIT A

BALANCE SHEET

December 31 (Year)

Assets

CURRENT ASSETS

<i>A</i>	Cash		\$ 70,669.07
<i>B</i>	Accounts Receivable	\$ 140,103.86	
<i>FF</i>	Less Reserve for Bad Debts	5,715.94	134,387.92
		<hr/>	
<i>C</i>	Accounts Payable, Debit Balances		2,173.50
<i>D</i>	Loans and Notes Receivable		4,375.00
<i>E</i>	Inventory		236,992.80
<i>F</i>	Interest Accrued Receivable		93.00
			<hr/>
	Total Current Assets		\$448,691.29

OTHER ASSETS

<i>G</i>	Book Plates and Plate Boxes	\$1,366,398.43	
<i>GG</i>	Less Reserve for Depreciation	1,152,539.27	213,859.16
		<hr/>	
<i>H</i>	Furniture, Fixtures, and Leasehold Improvements	\$ 34,044.15	
<i>HH</i>	Less Reserve for Depreciation	16,994.53	17,049.62
		<hr/>	
<i>J</i>	Royalty Advances		16,517.23
<i>K</i>	Due from Officers and Employees		892.37
			<hr/>
	Total Assets		\$697,009.67

Liabilities and Capital

CURRENT LIABILITIES

<i>AA</i>	Accounts Payable			\$ 32,417.89
<i>BB</i>	Accounts Receivable, Credit Balances		578.15	
<i>CC</i>	Royalties Payable		149,749.43	
<i>DD</i>	Loan Payable		20,000.00	
<i>EE</i>	Reserve for Federal Income Taxes		5,843.10	
	Total Current Liabilities			<u>\$208,588.57</u>

CAPITAL

<i>JJ</i>	Capital Stock Authorized and Issued 2,000 shares, \$100 par		\$200,000.00	
<i>KK</i>	Surplus Jan. 1 (year)		275,066.18	
<i>LL</i>	Net Addition (year) per Exhibit B		42,792.76	
<i>MM</i>	Federal Income Tax Refund		107.10	
			<u>\$517,966.04</u>	
<i>NN</i>	Less: (year) Federal Income Tax	\$ 7,701.84		
<i>PP</i>	(year) Federal Income Tax	5,843.10		
<i>QQ</i>	Dividends	16,000.00	29,544.94	488,421.10
	Total Liabilities and Capital			<u><u>\$697,009.67</u></u>

THE WORTH PUBLISHING CO., INC.

EXHIBIT B

INCOME AND PROFIT AND LOSS STATEMENT

For the Year Ended December 31 (Year)

<i>1</i>	Sales			\$869,687.13
<i>2</i>	Less Freight and Cartage			7,763.96
	Net Sales			<u>\$861,923.17</u>
COST OF GOODS SOLD				
<i>3</i>	Inventory, January 1 (year)		\$237,027.28	
<i>4</i>	Purchases		222,439.34	
			<u>\$459,466.62</u>	
<i>5</i>	Less, Inventory, December 31 (year)		236,992.80	
			<u>\$222,473.82</u>	
<i>6</i>	Depreciation of Plates and Plate Boxes		126,662.71	
<i>7</i>	Royalties		208,769.56	557,906.09
	Gross Profit on Sales			<u><u>\$304,017.08</u></u>

SELLING AND GENERAL EXPENSES

8	Circular Advertising	\$ 45,903.52	
9	Magazine Advertising	3,660.00	
10	Advertising Expense	4,052.11	
11	Free Distribution of Publications	6,325.03	
12	Traveling Expense	9,432.55	
13	Postage	4,186.93	
14	Officers' Salaries	56,188.31	
15	Office Salaries	88,662.52	
16	Overtime	827.35	
17	Professional Opinions	1,230.00	
18	Rent	14,199.98	
19	Light	1,059.05	
20	Insurance	1,556.28	
21	N. Y. State Franchise Tax	3,242.68	
22	Bank Exchange	291.49	
23	Depreciation of Office Furniture	2,895.40	
24	Depreciation of Leasehold Equipment	1,033.33	
25	Donations, etc.	489.50	
26	General Expense	19,319.33	264,555.36
	Profit on Selling		\$ 39,461.72
27	Other Income, Net, Schedule I		3,331.04
	Net Profit, per Exhibit A to B/S		<u>\$ 42,792.76</u>

THE WORTH PUBLISHING CO., INC.

EXHIBIT B

SCHEDULE I

INCOME AND PROFIT AND LOSS STATEMENT

OTHER INCOME

ADDITIONS TO INCOME

1	Sale of Old Plate Metal	\$ 4,807.55	
2	Discount on Purchases	13,561.67	
3	Interest on Bank Balances	599.52	
4	Interest on Notes Receivable	168.15	
5	Notes Receivable Adjustment	1,315.88	
6	Loan Receivable Adjustment	375.00	
	Total Additions to Income		\$20,827.77

DEDUCTIONS FROM INCOME

7	Bad Debts	\$ 6,115.08	
8	Addition to Reserve for Bad Debts	5,000.00	
9	Interest Paid	2,936.02	
10	Royalties applicable to preceding year	3,445.63	
	Total Deductions from Income		17,496.73
	Net Addition to Income per Exhibit B		<u>\$ 3,331.04</u>

MEMORANDUM OF ENGAGEMENT

February 1 (year)

Today Mr. George Worth, President of The Worth Publishing Company, Inc., called. He engaged us to make an audit of the books and records of The Worth Publishing Company, Inc., 100 Broadway, New York, for the year ended December 31 (year) and prepare the Federal Corporation Income Tax Return for (year). Balances due from retail customers are not to be confirmed by correspondence. Our certificate is to be qualified accordingly. Charge for the service is to be on the basis of \$50.00 per diem for the senior accountant and \$25.00 per diem for the junior accountants. The audit is to be started as soon as possible and a complete report rendered not later than the end of February (year).

R. A. Brown

WORTH PUBLISHING CO.

PROGRAM OF AUDIT

CASH

- (a) Reconcile bank balances with bank statements.
- (b) Confirm by correspondence the balances shown by bank statements.
- (c) Investigate old outstanding checks.
- (d) Examine petty cash.
- (e) Investigate disbursements subsequent to date of audit to ascertain if any were applicable to period covered by review.

ACCOUNTS RECEIVABLE

- (a) Check trial balance of customers' accounts to accounts receivable ledger, and list all past-due accounts.
- (b) Take up past-due accounts with credit department manager and see that uncollectible accounts are written off.
- (c) Verify by correspondence the wholesale accounts receivable balances.
- (d) Investigate credit balances to customers' accounts.
- (e) Reconcile accounts receivable trial balance with control.
- (f) Test postings of debits and credits to accounts receivable ledger to books of original entry.
- (g) Verify that credits for returned merchandise were approved by an officer of the corporation.
- (h) Ascertain if returns by customers were excessive during period subsequent to date of balance sheet.

PAPER STOCK

- (a) Check quantities on summary of paper stock inventory to original reports received from warehouses, or binderies, where paper is stored.
- (b) Compare prices used on inventory of paper stock with (1) invoices on file and (2) market prices.
- (c) Verify extensions and additions.
- (d) Ascertain if the paper on hand was purchased for special jobs.

PRINTED SHEETS FOR BOOKS

- (a) Check or test the quantities shown on final inventory against lists of books on hand in sheet form as furnished by the binderies.
- (b) Prepare a list of books on hand in sheet form in excess of four times an average year's sales, and exclude these from the inventory unless a satisfactory reason is given for their inclusion.
- (c) Compare prices used with the cost per book for paper and printing as shown by cost records on 25 per cent of items.
- (d) Ascertain how market and cost prices compare.
- (e) Verify extensions and additions.

INVENTORY OF BOUND BOOKS

(a) Check, or test, the number of books reported bound by bindery (as per invoices submitted for binding) to perpetual inventory record of bound books.

(b) Check or test the number of books sold, and returned, from sales and returned sales books, to perpetual inventory stock record.

(c) Also reverse the process, and test books received and delivered.

(d) Check, or test, physical inventory of bound books against balances shown on perpetual inventory record.

(e) Ascertain if perpetual inventory balances have been reconciled with the physical count of bound books.

(f) Check perpetual inventory balances (or physical inventory as local conditions indicate to be necessary) to the inventory summary sheets.

(g) Check, or test, prices used against such records as are kept to show the cost of production, paper, printing, and binding.

Note. It is the usual procedure to inventory separately electro-plates used in printing books.

(h) Check extensions and verify additions of the inventory of bound books.

PLATE INVENTORY

(a) Check amounts shown on inventory sheets against record kept of electro-plates on hand.

(b) Ascertain method used in valuing electro-plates so as to provide for depreciation.

(c) Ascertain if any plates for books which are no longer in demand are included in the inventory.

(d) Examine vouchers covering additions to plate account for period under review.

(e) Verify additions to plate boxes account and adequacy of reserve for depreciation of boxes.

FURNITURE AND FIXTURES

(a) If an appraisal is not available have one made of furniture and fixtures.

(b) Vouch additions to furniture and fixtures account for period covered by examination.

(c) Verify adequacy of reserve for depreciation and note rate used.

COPYRIGHTS

(a) Ascertain what consideration was given for the copyrights included in the copyright account.

(b) Inquire into method followed in valuing copyrights so as to provide for obsolescence.

(c) Compare the value placed on each copyright with the gross profit, for the four preceding years, realized from the sale of the book.

(d) Amortize copyrights on books for which there is no demand.

ACCOUNTS PAYABLE

(a) Check trial balance of accounts payable to accounts payable ledger.

(b) Examine invoices paid during period subsequent to date of balance sheet to ascertain if any contain dates prior to the date of closing.

314 ILLUSTRATIVE REPORT—BOOK-PUBLISHING BUSINESS

- (c) Investigate debit balances to accounts payable accounts.
- (d) Reconcile accounts payable trial balance with control.
- (e) Test postings of debits and credits to accounts payable ledger to books of original entry.

ROYALTY ACCOUNTS

- (a) Check, or test, number of books sold and returned, as shown by the perpetual inventory stock record, to the authors' royalty accounts, in the royalty ledger.
- (b) Check, or test, calculation of amount due authors in accordance with royalty agreements.
- (c) Check amounts of royalties due authors for the period under review, from the royalty ledger to the summary which is made of royalties accrued.
- (d) Add summary of royalties which accrued for the period reviewed.
- (e) Examine canceled checks on file in payment of royalties to authors when the visit to the client's office is made at a sufficient interval after the date of the balance sheet to permit this to be done.

INSURANCE

- (a) Obtain from client's insurance agents the following information.
 - (1) Amount of insurance in force on each class of property.
 - (2) Amount of unexpired insurance premiums at date of balance sheet.
 - (3) Amount due for unpaid insurance premiums.
- (b) Compare policies on file with list furnished by insurance agent.
- (c) Compare valuations appearing on balance sheet with insurance coverage, and prepare comment on any case of underinsurance.

CAPITAL ACCOUNTS

- (a) Examine minute book.
- (b) Examine stock certificate book.
- (c) Verify that dividends paid were in accordance with authorizations and stock holdings.
- (d) Analyze surplus account.

PROFIT AND LOSS

- (a) Verify that all books shipped were billed and that all books billed were shipped, by making a sufficient number of tests.
- (b) Test return sales against perpetual inventory record of bound books.
- (c) Examine from 25 to 50 per cent of invoices covering paper, printing, binding, catalogues, advertising, and general expense.
- (d) Check payroll book to cash disbursements book.
- (e) Compare salaries paid officers with amounts authorized as shown in the minute book.
- (f) Analyze Profit and Loss account.

STATISTICS FOR REPORT

- (a) Number of active titles by price groups.
- (b) Number of books sold.
- (c) Average selling price.

- (d) Average expense per book.
 - (1) Selling expense.
 - (2) Manufacturing expense.
 - (3) Office expense.
 - (4) Administration expense.
- (e) Number of customers.
 - (1) Retail.
 - (2) Wholesale.
- (f) Number of new titles published.
- (g) Annual rate of turnover of inventory.
- (h) Average collection period.
- (i) Bad debts expense for year.
- (j) Ratio of bad debts to charge sales.

TRIAL BALANCE AND WORKING SHEET
The Book Publishing Co., Inc.



Dec. 31 (Year)

FOL.	ACCOUNTS	TRIAL BALANCE		ADJUSTMENTS		PROFIT AND LOSS		BALANCE SHEET	
		DEBITS	CREDITS	DEBITS	CREDITS	LOSSES	GAINS	ASSETS	LIABILITIES
1	Accounts Payable		27,051.27					(C) 2173.50	98,452.1
2	Accounts Receivable	4,336.67						(D) 43,361.67	
3	Accounts Receivable—Wholesale	102,267.92						(E) 96,742.19	578.15
4	Advertising Expense	4,082.11				4,052.11	(LL-10)		
5	Bad Debt	501.12				11,115.08	(LL-3)		
6	Bank Exchange	291.49				291.49	(LL-23)		
7	Bank Notes	357,499.46							
8	Capital Stock		200,000.00					(G) 13,162,307.01	
9	Cash	70,669.07						(A) 70,669.07	
10	Circular Advertising	45,903.52				45,903.52	(LL-8)		
11	Deposits in Banks and Sav.	2,091.54				289,546	(LL-2)		
12	Expn. of Print	125,915.07				125,915.07	(LL-5)		
13	Expn. of Plate Costs	2,105.54				747.64	(LL-9)		
14	Expn. Received		13,561.67				(LL-22)	13,561.67	
15	Dividends	16,000.00							
16	Gain on Sale of Real Estate	8,171.84							
17	Gain on Sale of Real Estate	6,325.03							
18	Gain on Sale of Real Estate	7,763.96							
19	Gain on Sale of Real Estate	33,631.65							
20	General Expense	19,532.33							
21	Insurance	1,556.28							
22	Interest on Bank Balances		599.52						
23	Interest on Loans and Notes Pay	2,936.02							
24	Interest on Notes Receivable		59.13						
25	Inventory—Year 1 (Year)	2,370,272.8							
	Totals	2,090,428.50	2,412,715.91	12,460.57	33,668.18	466,316.21	14,329.54	1,606,197.59	2,302,233.56

TRIAL BALANCE AND WORKING SHEET
The World Publishing Co., Inc.

Dec. 31, (year)



FOL	ACCOUNTS	TRIAL BALANCE		ADJUSTMENTS		PROFIT AND LOSS		BALANCE SHEET	
		DEBITS	CREDITS	DEBITS	CREDITS	LOSSES	GAINS	ASSETS	LIABILITIES
26	Light	1059.05				1059.05	(L.L. 17)		
27	Notes Payable		20000.00						20000.00
28	Magazine Advertising	3660.00				3660.00	(L.L. 3)		
29	Printing Expenses	1575.89				1575.89	(L.L. 3)		
30	Merchandise Purchases	22042.13		436.32		220863.45	(L.L. 3)		
31	Notes Receivable	2683.98		2730.85				4000.00	
32	Office Salaries	88662.52				88662.52	(L.L. 3)		
33	Office Station Advances	764.62		127.75				892.37	
34	Officers' Salaries	56316.06				56188.31	(L.L. 10)		
35	Printing	827.35				827.35	(L.L. 3)		
36	Plate Bases	4091.42						4091.42	
37	Postage	4186.93				4186.93	(L.L. 3)		
38	Professional Opinions	1230.00				1230.00	(L.L. 17)		
39	Rent	14199.98				14199.98	(L.L. 18)		
40	Reserve for Bad Debts		5715.94						5715.94
41	Reserve for Depreciation of Furniture and Fixtures		15162.34						15162.34
42	Reserve for Depreciation of Plates		1149805.81		798.86				1149805.81
43	Reserve for Depreciation of Plate Bases		2196.38						2196.38
44	Reserves	205283.80		3485.76		208769.56	(L.L. 7)		
45	Reserve applicable to preceding year	3445.63				3445.63	(L.L. 21.10)		
46	Production Payable		129746.14						129746.14
47	Salaries		889687.13						889687.13
48	General Expenses	489.50				489.50	(L.L. 3)		
49	Expenses Year 1 (year)		275066.18	1000.00					
50	Expenses Year 2 (year)	9432.55		7701.84					251471.49
	Totals	618336.41	12467380.22	27067.69	5056.55	644590.72	869687.13	898379	1578920.05

JOURNAL ENTRIES

VI

The Worth Publishing Co. Inc.

		DEBITS	CREDITS
<i>Dec. 31. (year)</i>			
	(1)		
<i>Bad Debts</i>		6103 88	
<i> Accounts Receivable-Wholesale</i>			6103 88
<i> To write off bad debts</i>	(2)		
<i>Royalties</i>		3485 76	
<i> Royalties Payable</i>			3485 76
<i> To adjust controlling account</i>	(3)		
<i>Purchases</i>		436 32	
<i> Adjustments of Accounts</i>			15 88
<i> Accounts Payable</i>			420 44
<i> To record unentered bills and adjust</i>	(4)		
<i>Plates</i>		4807 55	
<i> Sale of Old Plate Metal</i>			4807 55
<i> To correct erroneous entry</i>	(5)		
<i>Office Salaries Advances</i>		127 75	
<i> Officers' Salaries</i>			127 75
<i> To adjust treasurer's salary</i>	(6)		
<i>Notes Receivable</i>		1300	
<i> Adjustment of Accounts</i>			1300
<i> Notes of C. Brown erroneously written off</i>	(7)		
<i>Interest Receivable</i>		93	
<i> Interest on Notes Receivable</i>			93
<i> 4 percent on \$2700 6 percent on \$1300 notes</i>	(8)		
<i>Leasehold Improvements</i>		3100	
<i> Furniture and Fixtures</i>			3100
<i> To transfer: linenum \$300</i>			
<i> lighting fixtures \$300 partition \$2500</i>			

JOURNAL ENTRIES

VIa

The North Publishing Co. Inc.

		DEBITS	CREDITS
<i>Dec 31 (year)</i>			
<i>Furniture and Fixtures</i> ⁽⁹⁾		213	
<i>General Expense</i>			213
<i>Invoice of Shaw Walker erroneously entered</i> ⁽¹⁰⁾			
<i>Depreciation, Furniture and Fixtures</i>		798 86	
<i>Res. for Dep'n Furn and Fix</i>			798 86
<i>To make depreciation 10% of \$28,954</i> ⁽¹¹⁾			
<i>Depreciation, Plate Boxes</i>		537 08	
<i>Res. for Dep'n Plate Boxes</i>			537 08
<i>To make depreciation 20% of \$3,735.42</i> ⁽¹²⁾			
<i>Depreciation, Leasehold Improvements</i>		1033 33	
<i>Res. for Dep'n Lease Imp.</i>			1033 33
<i>To make depreciation 33½% of \$3,100</i> ⁽¹³⁾			
<i>New York State Franchise Tax</i>		2772 68	
<i>New York State Franch. Tax Payable</i>			2772 68
<i>To record invoice not entered</i> ⁽¹⁴⁾			
<i>Notes Receivable</i>		16 02	
<i>Interest</i>			16 02
<i>To transfer interest erroneously entered</i> ⁽¹⁵⁾			
<i>Loan Receivable</i>		375	
<i>Adjustments of Accounts</i>			375
<i>To record loan to C. White erroneously written off</i> ⁽¹⁶⁾			
<i>Surplus</i>		16000	
<i>Dividends</i> ⁽¹⁷⁾			16000
<i>Federal Income Taxes Refunded</i>		107 10	
<i>Surplus</i> ⁽¹⁸⁾			107 10
<i>Surplus</i>		7701 84	
<i>Federal and State Franchise Tax</i>			7701 84

RECONCILIATION OF SUBSIDIARY LEDGERS

(VII)

The North Publishing Co. Inc

		GENERAL LEDGER	SUBSIDIARY LEDGER	AS ADJUSTED	
<u>Accounts Rec Wholesale</u>	Dr	506721 05	102846 07	96742 19	(B)
	Cr	404453 13	57815	57815	(B)
	Bal	102267 92	102267 92	96164 04	
	J 1 Cr	6103 88			
		96164 04			
<u>Accounts Rec Retail</u>	Dr	207190 10	43361 67		(B)
	Cr	163828 43			
	Bal	43361 67	43361 67		
<u>Royalties Payable</u>	Cr	310100 12	149749 43		(C)
	Dr	180353 68	16517 23		(J)
	Bal	129746 44	133232 20		
	J 2 Cr	3485 76			
		133232 20			
<u>Accounts Payable</u>	Cr	152100 00	29661 09	29645 21	(A)
	Dr	125048 73	2609 82	2173 50	(C)
	Bal	27051 27	27051 27	27471 71	
	J 3 Cr	436 32			
			27487 59		
	J 3 Dr	15 88			
		27471 71			
<u>Book Plates</u>	Dr	1357499 46	1362307 01		(C)
	J 4 Dr	4807 55			
			1362307 01		

ANALYSIS OF ACCOUNTS

VIII

*The Wash Publishing Co. Inc*Furniture and Fixtures

Balance Jan 1 (year) \$ 32,054.01

Trans. to Leasehold Imp. J. 8 3,100.00

\$ 28,954.01

Additions (year) \$ 1,777.14

J 9 2,130.00 1,990.14 30,944.15

Res. for Dep'n. F. and F.

Balance Jan 1 (year) \$ 13,065.80

Depreciation for year \$ 2,096.54

J 10 798.86 2,895.40 15,961.20

Plate Boxes

Balance Jan 1 (year) \$ 3,735.42

Additions (year) 356.00 4,091.42

Res. for Dep'n. Plate Boxes

Balance Jan 1 (year) \$ 1,985.82

Depreciation for year \$ 210.56

J 11 537.08 747.64 2,733.46

Plates

Balance Jan 1 (year) \$ 125,722.52

Additions for year \$ 100,270.94

J 4 4,807.55 105,078.49 136,230.01

Res. for Dep'n. Plates

Balance Jan 1 (year) \$ 102,389.74

Depreciation for year 125,915.07 114,905.81

Res. for Dep'n. Leasehold Imp.Dep'n for year $33\frac{1}{3}\%$ of \$3,100 J 12 \$ 1,033.33

NOTES ON AUDIT

The Worth Publishing Co., Inc.

IX

Organized January 1, 1900 in New York State
 Capital stock, authorized 2,000 shares, \$100 par.
 Dividends paid Jan 1 (year) \$8,000, July 1 (year) \$8,000

Compensation of officers:

Name	Title	Compensation	Shares Owned
Henry Worth	Pres	\$ 30,000.00	1,000
James Worth	V. Pres and Treas	14,000.00	500
Frank Worth	Sec'y	10,000.00	100
Sam'l Worth	Asst Treas	2,188.31	
		(LL 14) \$ 56,188.31	

Notes Receivable

Maker	Date (year)	Maturity (year)	Amount	Interest Accrued
Arthur Bush	9/1	5/1	\$ 2,700	\$ 54
Philip Brown	7/1	7/1	1,300	39
		(D)	\$ 4,000	\$ 93

Insurance Coverage

Risk	Book Value	Insurance
Books	\$ 236,992.80	\$ 200,000
⊗ Plates and Boxes	213,859.16	75,000
Furniture and Fixtures	14,982.95	12,500
Leasehold Improvements	2,066.67	2,000

⊗ The Company's treasurer stated that the book plates, except those in use, were kept in a fire proof vault.

BANK RECONCILIATIONS

(A)

*The North Publishing Co. Inc*National City Bank

① Balance, as per bank statement, Dec. 31 (year) \$ 22,883.21

Less, outstanding checks

Check No	Date Paid (year)	Amount
4174	Jan. 5	\$ 100.125
4175	" 5	75.20
4180	" 7	233.33
4181	" 7	103.36
4182	" 10	<u>27.00</u>
		<u>1440.14</u>
Balance per check book		\$ <u>21,443.07</u>

Manufacturers Trust Co

② Balance, as per bank statement, Dec. 31 (year) \$ 48,500.00

Less, outstanding checks

Check No	Date Paid (year)	Amount
310	Jan. 2	\$ 415.21
311	" 2	110.05
312	" 2	71.20
313	" 3	44.45
314	" 4	<u>15.55</u>
		<u>656.46</u>
		\$ <u>47,843.54</u>

Petty Cash

1382.46

Total Cash, as per Ledger \$ 70,669.07

(to B/S)

The National City Bank
New York

Feb. 2, (year)

Messrs. Brown & White
100 Broadway
New York, N.Y.

Gentlemen:

In accordance with the request of
The Worth Publishing Company, Inc., we are pleased
to confirm to you herewith the balance of \$22,883.21
standing to their credit December 31, (year).

The Corporation was not indebted to us
either directly or contingently on the above date.

Yours very truly,

Philip Small
Secretary

The Manufacturers Trust Company
New York

Feb. 2, (year)

Messrs. Brown & White
100 Broadway
New York, N.Y.

Gentlemen:

At the request of The Worth Publishing
Company, Inc., we beg to advise that at the close
of business December 31, (year), the Company had a
credit balance of \$48,500.00 to their account, and
was not indebted to us in any way.

Very truly yours,

THE MANUFACTURERS TRUST COMPANY

Max Hertig Secy.

MEMO. IN RE. ACCOUNTS RECEIVABLE

(B)

*The Worth Publishing Co., Inc*Wholesale Accounts Receivable :-

The trial balance of the wholesale accounts receivable ledger was checked against the ledger and found to be correct. Letters containing statements for purposes of verification were sent to about 50 per cent of the wholesale customers. These statements represented about 85 per cent of the total amount of the wholesale accounts receivable. Customers who replied represented about 60 per cent of the total of the wholesale accounts receivable. The result of the circularization of customers indicates that the balances of the wholesale accounts as shown by the books are correct.

Accounts which appeared slow were discussed with the credit department manager and proper disposition made of balances, amounting to \$6103.88, which were deemed uncollectible.

The accounts were aged with the following results :-

Amounts not due	\$ 61,921.61
" 1 to 30 days past due	20,250.22
" 31 to 60 " " "	12,410.11
" 61 to 90 " " "	1,750.25
" over 90 " " "	410.00
Total wholesale accounts receivable	\$ <u>96,742.19</u>

Retail Accounts Receivable

The trial balance from the ledger containing accounts with retail customers was checked to the ledger and found to be correct. An examination of the retail accounts receivable ledger indicated that there were a good many doubtful accounts receivable. An addition of \$5,000 has been made to the Reserve for Bad Debts to cover losses for uncollectible retail accounts. It appears that this is ample. Retail customers were not asked for a confirmation of their balances.

The Worth Publishing Co., Inc.
New York

Feb. 10, (year)

Messrs. Brown & White
100 Broadway
New York, N.Y.

Gentlemen:

I hereby certify that, to the best of my knowledge and belief:-

- (1) All customers and accounts as at December 31, (year) are good and collectible with the exception of such accounts as a reserve has been set up to provide for the estimated loss.
- (2) The customer's accounts do not contain any balances due from officers, or employees.
- (3) All known assets and liabilities, including contingent liabilities of this Company, are recorded on the books as at December 31, (year).

Very truly yours,

The Worth Publishing Co., Inc.



Treasurer

MEMO IN RE. INVENTORIES

(E)

The Worth Publishing Co. Inc.

Bound Books:- All items of bound books on the inventory summary were checked to the original sheets and to the perpetual inventory records. The total quantity of all books reported on hand by the stock takers agrees approximately with the total quantity called for by the perpetual inventory record, although in many instances overages and underages were encountered but these appear to about offset each other. The bound books were priced at the cost of paper, printing and binding, and we ascertained from the production department records that the current prices were approximately the same as cost at the date of the inventory.

Printed Sheets:- All items of printed sheets (unbound books) appearing on the summary inventory sheets were checked to the original reports received from the bindery and to the perpetual inventory record. The quantities were found to be substantially correct, discrepancies which were found being of a minor nature. Printed sheets were priced at cost of paper and printing. Replacement cost at the date of the inventory was ascertained to be as much as the cost.

The maximum quantity of printed sheets and bound books of any title was limited to four years' probable sales in the final calculation.

Sheet Stock:- The sheet stock of paper which appears on the inventory summary sheets was checked against the report (of sheet stock on hand) as received from the bindery, and also against the perpetual inventory record which is kept by the production department and found to be correct.

MEMO IN RE. INVENTORIES

E
2*The Worth Publishing Co., Inc*

Sheet Stock continued: The superintendent of production stated that the sheet stock on hand at the date of the inventory was all being held for books which were about to be published. The paper in sheets was priced at cost which was found by inspection of recent invoices received from dealers in paper to be the same as the market price.

W. A. did not make an inspection of the stock.

Arithmetical calculations in the inventory were verified.

The Worth Publishing Co., Inc.
New York

Feb. 10, (year)

Messrs. Brown & White
100 Broadway
New York, N.Y.

Gentlemen:

We hereby certify that the inventory of The Worth Publishing Company, Inc., as at the close of business December 31, (year) amounted to \$236,992.80 and was made up as follows:

Bound books	\$113,473.40
Printed sheets	112,029.59
Paper	<u>11,489.81</u>
 Total	 <u>\$236,992.80</u>

The inventory of bound-books and sheet stock was taken by physical count. A report of printed sheets on hand was furnished by the bindery. A reconciliation was effected between the original inventory sheets and the perpetual inventory stock records.

Books of any title in excess of four years' probable sales have been excluded from the inventory.

Merchandise included in the inventory is priced at cost to the Company, less all trade discounts.

Nothing has been included in the inventory for which the corresponding liability has not been set up on the books.

The inventory does not include goods sent to us on consignment and not owned by us.

All goods sent others on consignment have been included in the inventory and have not been included among customer's balances due the Company.

Very truly yours,

The Worth Publishing Co., Inc.

Henry Worth
President

MEMO. IN RE. PLATES AND PLATE BOXES

G

The Worth Publishing Co., Inc.

Plates - The trial balance of the plate ledger was checked against the subsidiary plate ledger which shows the depreciated value of the book plates as appraised at the close of the period under review, and found to be in agreement therewith. It appears that the valuation assigned to the book plates is conservative. On the basis of a five year life the depreciated value would be \$341,796.05 which is \$129,294.85 more than the appraised value. Plates for books for which there is no sale are not included in the Plate account.

Plate Boxes - The valuation of the plate boxes is based on cost less 20 per cent depreciation per annum. We were informed by the production superintendent that the net valuation of \$1,357.96 was very conservative.

Vouchers in support of additions to the Plate and Plate Boxes accounts for the year under audit were examined.

**MEMO IN RE FURNITURE AND FIXTURES (H)
AND LEASEHOLD IMPROVEMENTS**

The North Publishing Co., Inc.

An appraisal by Mr. James Worch of the office furniture and fixtures and leasehold improvements as of Dec. 31 (year) was furnished us in support of the values shown in the ledgers. A casual survey of the office indicates that the articles listed in the appraisal were all there. The valuation appears reasonable.

Proper vouchers in support of the additions to the Furniture and Fixtures and Leasehold Improvements accounts were examined.

MEMO IN RE. ROYALTIES

©

The Worth Publishing Co., Inc

The trial balance of the royalty ledger was checked against the ledger and found to be correct. We ascertained that the debit balances represent charges for books which were sent at the request of authors before royalties accrued. (K)

An inspection of the cash paid book for (year) showed that the royalties which had accrued at the close of business December 31 (year) and payable subsequently, were actually paid.

A sufficient test was made of a number of royalty accounts to satisfy us of the probable correctness of the calculations. The number of books on which royalties were paid to authors for the period covered by our examination appears to be in agreement with the number of books sold as shown by the perpetual inventory record of bound books.

CHAPTER 25

ILLUSTRATIVE REPORT AND WORKING PAPERS— MANUFACTURER, INTERIM AUDIT

Interim Audit of Manufacturer's Accounts. The following comments are pertinent to the interim audit of the accounts of a manufacturer, whether engaged in the production of silk goods or other articles. It should be borne in mind that the main objects of making interim audits are to detect bookkeeping errors and irregularities and to ascertain if the accounts are being kept in accordance with approved accounting principles. As the raw silk used by a manufacturer of thrown silk (such as is sold to the hosiery and weaving mills) is quite valuable it is highly essential that the audit program provide for testing the accuracy of the stock records.

In the audit working papers which are illustrated in this set there is included a record of the test of 20/22 size raw silk. It will be noticed that the raw silk purchased was all accounted for. By following this procedure in making tests at each interim visit it is quite probable that any irregularity, such as the embezzlement of silk, would probably be discovered sooner or later. At any rate the moral effect of these tests on the client's office staff should be given consideration.

Approvals on all creditors' invoices which have been entered in the purchase journal should be carefully scrutinized at each interim visit. By following this procedure the recording of unauthorized vouchers will be detected. Care should be exercised to verify that all mill payrolls and petty cash vouchers have been approved by the persons who have been authorized to do so. In this connection it should be remembered that, where irregularities have occurred in the past, it is generally found that looseness has prevailed in the bookkeeping procedure.

It is, of course, essential to verify that the books are in balance and that each subsidiary ledger is in agreement with its corresponding controlling account. Lack of agreement between a subsidiary record and its control indicates the possibility of the existence of an irregularity which might be discovered while looking for the difference. The client's attention should be drawn to any matters which indicate a failure on the part of his bookkeeping department to keep the accounts in an accurate, up-to-date, and approved manner.

The general scope of the interim audit for a thrown silk manufacturer will be evident, from an examination of the audit program.

INDEX

CLIENT *Gates & Ellison, Inc*
 ADDRESS *500 Fourth Avenue New York*
 AUDIT *From Sept 1 (year) to June 30 (year)*
 SUPERVISING PARTNER *D. C. Eggleston*

- I *Report*
 II *Memorandum of Engagement*
 III *Program of Audit*
 IV *Trial Balance, and Working Sheet*
 V *Journal*
- A *Cash*
 F *Investments*
 BB *Letters of Credit*
 GG *Mortgages Payable*
- 1 *Raw Silk Record Tests*
 2 *Insurance Coverage*

REPORT

Gates & Ellison, Inc.

(1)

Messrs Gates & Ellison, Inc.
500 Fourth Avenue,
New York, N. Y.
Gentlemen:-

In accordance with your instructions we have made an interim audit of your books for the period from September 1 (Year) to June 30 (Year), and herewith submit our report thereon which contains a Balance Sheet inclusive of inventory and a Statement of Revenue less charges thereto, subject to adjustment for the inventory as set forth in Exhibits A and B together with three supporting schedules:
Balance Sheet

The following comments are pertinent to the balance sheet accounts:-

Cash The amount of the funds on deposit in banks was reconciled with the June 30 (Year) bank statements on file in your office and found to be correct. Cash on hand at your Norfolk, Va. plant was ascertained to be in agreement with your superintendent's weekly report which is on file. Petty cash at the New York office was examined at the date of our visit and found correct. In view of the terms on which silk is purchased and sold and the high rate of the inventory turnover it appears that you can collect from customers for silk sold as soon as payments must be made therefor. It is apparent that you can carry on your business without resorting to borrowing money, other than by discounting customers' trade acceptances.

Accounts Receivable:- An examination of the accounts receivable was made for the purpose of ascertaining overdue balances. A list of accounts that appeared slow was submitted to your Secretary who assured us that in his opinion all balances were good and collectible. Included in the accounts receivable is \$96,670.96

REPORT (Cont'd)

Gates & Ellison, Inc.

I₂

due from the Colony Knitting Co for goods sold about five years ago. This balance is secured by 720 shares (of a total of 1000 shares) of that corporation's \$50 par value common stock. This stock is made out in the name of Gates & Ellison, Inc. From the June 30 (year) statement of the Colony Knitting Co, it appears that the book value of the stock held is considerably in excess of the balance due you.

Notes Receivable:— The maturities of the notes receivable, including trade acceptances receivable are shown below:—

June	\$ 16,469.80	Paid in July
July	132,450.25	
Aug.	134,652.73	
Sept.	76,651.12	
Oct.	4,651.73	
Total	\$ 364,875.63	

Rate of Collections:— A comparison of the average balances to your customers' accounts (open accounts and notes), with the average monthly collections shows that the average collection period is approximately 56 days or 1.86 months. The length of the collection period is shortened by your practice of discounting trade acceptances.

Investments:— An analysis of the investments is presented in Exhibit A, Schedule I. The investment in the Nelson Co. Inc. of \$300,000.00 had a book value as at June 30 (year) according to that corporation's balance sheet of \$354,700.00.

Liabilities:— So far as could be ascertained all liabilities as at the close of business June 30 (year) were recorded on the books with the exception of interest accrued on the two mortgages payable and the provision for the current year's Federal Income Taxes. The mortgage payable of \$112,500.00 on the Brookfield plant matured on November 21, last year and has not been renewed. The liabilities according

REPORT (Cont'd)
Gates & Ellison, Inc.

(L₃)

to maturities, are shown below:-

Month of Maturity	Amount of Liabilities
Pass. due mortgage	\$ 112,500.00
July	916,769.73
Aug.	1,607,216.68
Sept.	987,774.19
Total	\$ 3,624,260.60

Contingent Liabilities: Reference to the note register shows that the unmatured trade acceptances discounted amounted to \$395,953.67 at the date of the statement herewith submitted.

Purchase Commitments: An examination of the record of contracts with vendors of silk showed that purchase commitments amounted to approximately \$2,858,000 and were divided up as follows:

Order (date)	Amount	Pounds	Av. Price C.I.F. N.Y.
13/15	\$ 2,064,800	379,370	\$ 5.44
20/22	743,000	141,900	5.24
18/20	29,800	5,280	5.63
24/26	15,700	2,770	5.65
14/16	4,700	1,190	3.95
Total	\$ 2,858,000	530,510	5.39

Unused Letters of Credit: So far as could be ascertained from the information available the unused letters of credit available for purchase commitments amounted to \$1,066,581 and were open at the following banks:

Equitable Bank	\$ 255,000
Guaranty Trust	259,756
Interstate Trust	60,000
Manufacturers Trust	150,000
National Park	1,825
Philadelphia Grand	340,000
Total	\$ 1,066,581

Sales for Future Delivery: A tabulation of the unfilled customers' orders as recorded

REPORT (Cont'd)
Gates & Ellison Inc.



in the contract book, shows that the sales for future delivery amount to approximately \$ 5,000,000. The average sales price of the silk, exclusive of the charge for throwing, appears to be about \$ 5.78 per pound.

Fire Insurance Coverage:- So far as we could ascertain from an examination of the insurance policies on file in your office and the insurance registers, you are protected against fire loss to the amount of \$ 3,079,920 as set forth in the following tabulation. Insurable values are presented for purposes of comparison:-

Property	Risk Covered	Insurable Value
Brookfield Plant		
Building	\$ 550,000	\$ 432,554
Merchandise, machinery	1,270,000	794,788
Norfolk Plant		
Building	134,920	136,666
Merchandise, machinery	500,000	647,390
New York Merchandise, etc.	\$ 625,000	\$ 639,676
Total	\$ 3,079,920	\$ 2,651,074

We were informed by your Secretary that merchandise at outside throwing and rearing plants is covered by insurance policies which are carried by the owners of those plants. Insurance policies were found in force as follows: sprinkler leakage, water damage, steam boiler, elevator, inland marine burglary, robbery, indemnity bond and workmen's compensation. Policies are carried covering automobile liability, fire and theft.

Sales Trends:- Sales for the period reviewed by us are shown below. The ratio of the sales of each month to the sales for September (year) are given in order to facilitate comparison:-

Year	Sales	%	Year	Sales	%
Sept.	\$ 1,809,776	100%	Sept.	\$ 1,673,431	92%
Oct.	2,100,444	116	Mar.	1,759,406	97
Nov.	1,884,892	104	Apr.	1,794,793	99
Dec.	1,657,885	92	May	2,023,666	112
Jan.	1,593,952	88	June	2,064,622	114

REPORT (Cont'd)
Gates & Ellison, Inc.

(15)

Silk Purchases:- Below is presented a tabulation of the purchases of raw silk, and approximate average prices paid, during the past six months:

Month (Year)	Bales Purchased	Avg Price Per Lt C. I. F., N. Y.
Jan	2281	\$ 5.93
Feb	2404	5.81
Mar	2190	5.94
Apr	2373	5.80
May	1774	5.71
June	2961	5.65
		Yml. Av 5.80

It will be noted from the foregoing that the average price paid for silk during the past six months was \$ 5.80 per lb. as compared with an average price of \$ 5.39 on the purchase commitments. This is an indication of the downward trend in the market price.

Cost of Throwing: Manufacturing costs at the two throwing plants for the period covered by our examination are presented below:-

	Brookfield	Norfolk
Labor	\$ 534,079	\$ 155,687
Expense	231,527	72,158
Total	\$ 765,606	\$ 227,845

Pounds thrown on basis of 70¢ class of production (tram)	1,351,228	449,310
Average cost per lb		
70¢ class (tram)	56.66¢	50.71¢
\$1.15 class (warp)	93.08¢	

If interest on the appraised value of the plant, in excess of the mortgages payable is taken into consideration the foregoing figures would be modified as follows:-

	Brookfield	Norfolk
Labor and expense per books	\$ 765,606	\$ 227,845
10% interest on appraised value in excess of mortgages	47,230	13,950
Total	\$ 812,836	\$ 241,795

REPORT (Cont'd)
Gates & Ellison, Inc.



	Brookfield	Norfolk
Pounds thrown on basis of 70¢ class of production (tram)	1,351,228	449,310
Average cost per lb. (inclusive of interest):-		
70¢ class (tram)	61.07¢	54.68¢
\$1.15 class (crepe)	100.32¢	

If throwing had been done on a commission basis, at 70¢ for tram and \$1.15 for crepe, silk respectively, the earnings as compared with the costs for the books would have been as follows:-

	Brookfield	Norfolk
Earnings		
70¢ class (tram)	\$ 456,340	\$ 314,517
\$1.15 class (crepe)	562,281	
Total earnings	\$ 1,018,621	\$ 314,517
Labor and expense, per book	765,626	227,845
Gain	\$ 253,015	\$ 86,672
Total Gain	\$ 339,687	

From the foregoing calculation it appears that the gross gain on the throwing operations was \$339,687. If interest on the appraised value of the plants is deducted from this amount the net gain on throwing would be \$278,507 for the period.

Profit on Raw Silk Sales:- The late book shows that the gross profit on the sale of 20/22 raw silk for the seven months ended June 30 (year) amounted to \$80,233.83 or an average of \$11,462 a month.

Dividends Received:- The following dividends were received on investments:-

Carolina Furniture Co	\$ 1777.78
Ilmor Knitting Co.	85.00
Haythorn Hosiery Co	366.66
Lang & Strong	656.25
United States Texting Co.	70.00
Total	\$ 2955.69

REPORT (Cont'd)
Gates & Ellison, Inc.

①

Bad Debts:- During the ten months recovered by us bad debts were written off as follows:

Alford, Clark & Co	\$ 3,544.84
Philip Chester & Son	2,736.87
Frank Deerfield & Co	2,392.34
B. Emory & Co	946.00
K. Kildersmilk	941.61
Albert Long	806.57
Poley & Poley	495.22
Total	\$ 11,863.45

Minutes:- Reference to the Corporation's minute book shows that unsigned resolutions are contained therein.

Recommendations:- We recommend that at the close of each month a comparison be made between the quantity of bales recorded in the two row silk bale books and in the voucher record. Obviously the quantity of bales entered in these two sets of records should be in agreement.

We shall be glad to furnish you with any further information that you may desire regarding your accounts.

Respectfully submitted
J. C. Eggleston & Co.
Certified Public Accountants

16

REPORT (Cont'd)
Gates & Ellison, Inc.

Exhibit A
Balance Sheet

June 30 (Year)

(Exclusive of Inventory)

<i>Assets</i>		
(A) Cash	\$ 282,931.82 (AA)	Liabilities and Capital \$ 503,323.50
(B) Accounts Receivable	\$ 3,724,427.22	(BB) Trade Accounts Payable 1,695,367.82
(NN) Less Reserve for Discounts	32,244.27	(CC) Other Trade Acceptances Payable 1,009,723.11
(C) Notes Receivable	364,875.63 (DD)	Reserve for Non-Trade Notes 25,093.11
(D) Dividend Loans and Advances	8,375.41 (EE)	Reserve for Federal Income Taxes 27,190.04
(E) Due from A. & C. Strong	54,602.89 (FF)	Summary Liabilities, and Accruals 26,042.90
(F) Investments	421,093.26 (GG)	Minorities Payable 137,500.00
(G) Land, Building, and Equipment, \$100,000.00	895,672.26	Total Liabilities \$ 3,624,260.60
(H) Due from Officers	396,721.48	Capital:
(J) Order Receivable for Subsystemic Stock	281,959.58	Capital Stock \$ 175,000.00
(K) Goodwill	450,000.00 (HH)	4% Preferred Stock 87,500.00
(L) Prepaid Expenses	1,772.14 (JJ)	Common Stock \$ 183,750.00
		Surplus (subject to adjustment)
		(KK) Balance Sheet (Year) \$ 137,169.40
		(LL) Less expenses accrued \$ 4,767.89
		\$ 132,926.31
		(MM) Charges to Reserve for Contingencies \$ 441,549.99
		888,377.22
<i>Total</i>	\$ 6,350,137.72	<i>Total</i> \$ 6,350,137.72

19

REPORT (Cont'd)
Gates & Ellison, Inc.

Schedule A
Schedule 1

G

Land, Buildings, and Equipment

	Cost	Reserve for Depreciation	Net Value	Ratio of Net Value to Cost
Brookfield Plant				
Land	① \$ 45,000.00	\$	\$ 45,000.00	100
Buildings	② 698,608.67	⑩ 166,968.55	531,638.12	76
Machinery	③ 446,736.01	⑪ 267,353.81	179,382.20	40
Furniture and Fixtures	④ 2,158.11	⑫ 1,582.53	575.58	27
Total, Brookfield Plant	\$ 1,192,500.79	\$ 435,904.89	\$ 756,595.90	64
Maple Plant				
Land (acquired)				
Buildings	⑤ \$ 115,000.00	⑬ 34,255.42	80,744.58	70
Machinery	⑥ 213,075.08	⑭ 163,079.37	49,995.71	24
Furniture and Fixtures	⑦ 2,192.94	⑮ 1,564.05	628.89	29
Total, Maple Plant	\$ 330,268.02	\$ 198,898.84	\$ 131,369.18	40
Office Furniture and Fixtures	⑧ \$ 15,002.87	⑯ 10,035.69	5,027.18	34
Laboratory Equipment	⑨ 2,630.00		2,630.00	100
Motor Vehicles	⑩ 19,032.93	⑰ 19,032.93		
Grand Total	\$ 1,559,494.61	\$ 663,872.35	\$ 895,622.26	77

REPORT (Cont'd)
Gates & Ellison, Inc.



(MM) Exhibit B
Income Statement
Subject to adjustment for closing inventory
From Sept. 1 (year) to June 30 (year)

Revenue	
① Sales	\$ 18,362,867.55
② Less: Returns and allowances	135,514.32
③ Discount received on purchases	67,578.91
④ Interest earned	18,561.80
⑤ Dividends received	2,955.69
⑥ Profit on exchange	34,179.2
⑦ Profit on joint venture	68,773.84
⑧ Adjustments of accounts for prior period	10,238.08
⑨ Profit on sale of investment	4.00
Total Revenue	\$ 18,398,883.47

Charges Against Revenue	
⑩ Inventory Sept. 1 (year)	\$ 677,736.59
⑪ Purchases	110,360,470.39
⑫ Dyeing	47,776.73
⑬ Conditioning	20,355.67
⑭ Spools	15,160.47
⑮ Brookfield plant, labor and expense (Sched. I)	765,605.59
⑯ Norfolk plant, labor and expense (Sched. I)	227,845.33
⑰ Throwing	384,560.82
⑱ Weaving	4,599.28
⑲ Administration and selling expense (Sched. II)	296,762.06
⑳ Interest, expense, and commissions on letters of credit	25,523.03
㉑ Bad debts	11,863.45
㉒ Loss on investments	2,167.25
Total Charges Against Revenue	18,840,432.66

Excess of Charges over Revenue \$ 441,549.19

Amount of inventory ?

Profit (subject to adjustment for Federal income taxes) ?

REPORT (Cont'd)
Gates & Ellison, Inc

(I)_n

Exhibit B

Schedule I

Throwing Plants, Labor and Expense

Broomfield Plant Norfolk Plant

		Broomfield Plant	Norfolk Plant	
Labor	①	\$ 534,078.81	\$ 155,687.36	⑱
Soap and oil	②	26,042.32	18,608.49	⑲
Boxes	③	14,835.89	27,893.30	⑳
Bones	④	6,689.59	3,581.98	㉑
Fuel	⑤	4,507.46	4,450.54	㉒
Light and power	⑥	43,733.67	15,507.75	㉓
Repairs	⑦	41,381.62	8,693.91	㉔
Depreciation	⑧	58,580.12	19,551.21	㉕
Insurance	⑨	4,864.51	660.18	㉖
Taxes	⑩	14,686.10	22,308.00	㉗
Interest on mortgage	⑪	6,750.00	1,500.00	㉘
Freight	⑫	5,129.08	7,255.02	㉙
Telephone	⑬	478.53	188.71	㉚
Stationery and printing	⑭	1,572.50	2,640.80	㉛
Advertising	⑮	536.64	6,340.00	㉜
Auto expense			1,853.39	㉝
Restaurant expense	⑯	1,005.17	1,361.00	㉞
General expense	⑰	733.58		
Total		\$ 765,605.59	\$ 227,845.33	

(MM-15)

(MM-16)

REPORT (Cont'd)
Gates & Ellison, Inc.



Exhibit B
Schedule II

Administrative and Selling Expense

Officers' salaries	①	\$ 100,000.00
Office salaries	②	40,533.32
Insurance	③	11,221.07
Rent	④	11,250.00
Light and power	⑤	1,051.00
New York state franchise taxes	⑥	18,410.80
Freight	⑦	11,406.03
Stationery and printing	⑧	2,806.59
Telephone and telegraph	⑨	4,589.84
Postage	⑩	1,206.32
Repairs	⑪	2,496.55
Depreciation of office furniture and fixtures	⑫	11,405.50
Legal services	⑬	1,080.29
Auto expense	⑭	2,305.94
Auto depreciation	⑮	1,691.82
Laboratory expense	⑯	508.78
General expense	⑰	17,848.71
Sub-total	\$	213,543.72
Direct Selling Expenses		
Commissions	⑱	75,745.83
Traveling	⑲	3,096.89
Entertainment	⑳	211.90
Advertising	㉑	4,169.72
		<u>83,224.34</u>
Total	\$	<u>296,768.06</u>

(MM-19)

MEMORANDUM OF ENGAGEMENT

(DATE)

GATES & ELLISON, INC.

Mr. Elmer Ellison, treasurer of Gates & Ellison, Inc., 500 Fourth Avenue, New York, called at our office today for the purpose of engaging us to make regular periodical audits of the corporation's books and submit reports thereon. Such information as is available regarding production costs is to be embodied in the reports. It will be necessary to submit interim audit reports without inventory figures. Mr. Ellison agreed to pay \$5,000 a year for the services.

GATES & ELLISON, Inc.

SUPPLEMENTARY INTERIM AUDIT PROGRAM

NOTES RECEIVABLE (INCLUDING TRADE ACCEPTANCES RECEIVABLE)

Check current entries in the notes receivable register to the accounts receivable ledger.

Check list of notes receivable (including trade acceptances) discounted to register.

Verify the amount of the credit received from the bank, as shown by the current statement, by comparison with the list of notes discounted, due regard being paid to the discount deducted by the bank.

LETTERS OF CREDIT PAYABLE BALANCES

Compare monthly balances reported by banks (about the 20th) to letter of credit accounts with corresponding accounts in the accounts payable ledger.

NOTES PAYABLE (INCLUDING TRADE ACCEPTANCES PAYABLE)

Check current entries in the notes payable register.

Check all trade acceptances payable that matured during the period as shown by the notes payable register against the paid notes returned by bank.

THROWING CHARGES

Ascertain if the books are in agreement with the monthly statements received from outside throwsters.

Compare production reports with amounts paid for throwing.

MILL PAYROLLS

Norfolk, Va., add payroll; compare with production; analyze.

Brookfield, Mass., check mill reports of expenditures with cash disbursements; compare with production reports; analyze.

RAW SILK PURCHASES CHECK

Summarize quantity of bales of silk purchased for current month:

(a) As recorded in the column provided for the purpose in the purchase journal.

(b) As recorded in the 13/15 and 20/22 bale books.

Compare the totals of the bales as obtained in (a) and (b) above.

Examine contract record and ascertain if all silk which should have been received was actually received and entered in the purchase journal.

TEST OF STOCK CONTROL

Classification: 20/22 raw silk, sold in original bales.

Select about 10 invoices covering purchases of 20/22 raw silk and record same.

Refer to the "20/22 silk bale book" and make list of customers (or weaving

350 ILLUSTRATIVE REPORT—MANUFACTURER, INTERIM AUDIT

mills), together with dates and amounts of charges, to whom the bales covered by each invoice were shipped.

Check charges to the accounts receivable ledger, or to "weaving mills memorandum" book.

Unsold bales should be located in the silk vault.

Classification: 13/15 raw silk, thrown and then sold.

Select about 10 invoices covering purchases of 13/15 raw silk and record same.

Refer to the "13/15 silk bale book" and make a list of the mills to which the respective bales were shipped and lot numbers assigned.

Refer to the "mill process stock lot book" to ascertain customers to whom shipments were made.

Check charges covering shipments to the accounts receivable ledger.

Unsold *thrown silk* should be located in the "stock on hand" file.

TRIAL BALANCE AND WORKING SHEET
Gates & Ellison, Inc.

IV

FOL	ACCOUNT	SYM	TRIAL BALANCE		ADJUSTMENTS		LOSS	GAIN	ASSET	LIABILITY			
			DEBIT	CREDIT	DEBIT	CREDIT							
1	Capital Stock			1750000.00					1750000.00				
3	Cash		280807.73					(A) 280807.73					
5	Inventory, merchandise		677736.59										
6	Supplies			132996.31					(K) 132996.31				
7	Accounts Receivable		322442.22										
11	Notes Receivable		364878.63										
13	Goodwill		450000.00										
15	Machinery, Norfolk Plant		213075.08										
17	Machinery, Broadfield Plant		446734.01										
19	Mortgage, Norfolk, Broadfield Plant			112500.00									
-21	Building, Broadfield Plant		698606.67										
23	Building, Norfolk Plant		900000.00										
27	Federal Income Tax		27360.51										
29	Profit and Loss			61855.79									
31	Merchandise Sales			18382867.55									
33	Dividends and Prof. New York		15062.87										
35	" " " Broadfield		749.50										
36	" " " " Post		1408.61										
37	" " " " Norfolk		750.10										
	Total		691590.52	2167149.65					27360.51	677736.59	1824723.34	5786494.21	3192426.31

TRIAL BALANCE AND WORKING SHEET
Jeter & E. Wilson, Inc.

IV₂

FOL.	ACCOUNT	SYM.	TRIAL BALANCE		ADJUSTMENTS		LOSS	GAIN	ASSET	LIABILITY	
			DEBIT	CREDIT	DEBIT	CREDIT					
38	Trans. and Exp. Capital Rest.		1442.84					(C) 1442.84			
39	Mortgage Payable Capital Stock			25,000.00				(C) 25,000.00			
41	Unadjustable Accounts		11,863.45		(C) 11,863.45						
43	Investments		121,093.26					(E) 421,093.26			
45	Merchandise Purchases		16,389.34		(C) 8,870.65		(M-1)				
47	Due from A. & C. Storage		354,607.89		(C) 3,000,000.00			(E) 54,607.89			
49	Dividends			2,955.69			(M-3)	2,955.69			
51	C. B. Allen			68.89				(F) 68.89			
53	M. A. Blake			348.63				(F) 348.63			
55	A. B. Cummings			3,663.18				(F) 3,663.18			
57	R. W. Drake			2,396.54				(F) 2,396.54			
59	K. L. Eastman			1,829.25				(F) 1,829.25			
61	W. P. Farmer			449.08				(F) 449.08			
63	L. B. Graham		1,772.44					(L) 1,772.44			
65	Robert Gray & Co.		465.0					(D) 6.50			
67	Milton Paul			569.03				(F) 569.03			
69	Reserve for U. S. State Bank, Inc.			25,093.11				(D) 25,093.11			
71	Storage		8.00				(M-19-2)	8.00			
73	Land Brookfield Plant		45,000.00					(E) 45,000.00			
	Total		6705,150.42	67,373.26	3,000,000.00	3,008,870.65	6,372.34	1,84	2,755,69	523,917.93	59,417.51

TRIAL BALANCE AND WORKING SHEET
Jates & Ellison, Inc.

IV₃

FOL	ACCOUNT	SYM	TRIAL BALANCE		ADJUSTMENTS		LOSS	GAIN	ASSET	LIABILITY
			DEBIT	CREDIT	DEBIT	CREDIT				
75	Allowance		3569.14							
77	Interest and Discount		696.123							
79	Freight		11466.03							
81	General Expense		1645.03							
83	Travelling		3096.89							
85	Advertising		4169.72							
87	Legal Services		1080.29							
89	Stationery and Printing		2806.59							
91	Schools		15160.47							
93	Telephone and Telegraph		4589.84							
95	Auto Expense		2305.94							
97	Conditioning		20355.67							
99	Brush and Paper		3040							
101	Commissaries		75745.83							
103	Insurance		11221.07							
105	New York Office Salaries		40533.32							
1	New York Office Rent		11250.00							
109	City of Cash		141.05						(A)	141.05
113	Light Heat and Power		1058.34							
	Total		249308.85		32244.27					281412.07

(A)

(B)

(C)

(D)

(E)

(F)

(G)

TRIAL BALANCE AND WORKING SHEET

IV₄

Gater & Ellison, Inc

FOL.	ACCOUNT	SYM	TRIAL BALANCE		ADJUSTMENTS		LOSS	GAIN	ASSET	LIABILITY
			DEBIT	CREDIT	DEBIT	CREDIT				
115	Auto		19,032.93					EP 19,032.93		
117	Interest on Mortgage		825.00			MM 15 II " 16 28	825.00			
119	Entertainment		211.90			" 18 20	211.90			
121	Postage		1208.32			" 10	1208.32			
123	Employee Welfare Ass'n			6000.00					EP 6000.00	
125	Loans		540.00					D 540.00		
127	Repairs		2496.55			" 11	2496.55			
129	Accounts Payable			247582.03				MA 108 2398711.38		
135	Notes Payable			110972.11				CC 1009723.11		
139	Oils and Grease		94.10			" 17	94.10			
141	Dyeing		4776.73			MM 12	4776.73			
143	Flouring		384560.82			MM 17	384560.82			
145	Reserve for Federal Income Tax			54550.55				EP 25000.00		EP 27190.04
149	Building for the Plant		25000.00							
151	Profit Share Accumulation		634			MM 14 32	634.00			
153	" " Cash on hand		1983.04							
157	" " Freight		7255.02			" 29	7255.02			
159	" " Oil		18608.49			" 19	18608.49			
161	" " Light & Power		1550.75			" 23	1550.75			
	Total		592006.51	347855.69	362311.6		472044.68		46555.97	344024.53

TRIAL BALANCE AND WORKING SHEET
Gates & Ellison, Inc.

IV₅

FOL	ACCOUNT	SYM	TRIAL BALANCE		ADJUSTMENTS		LOSS	GAIN	ASSET	LIABILITY
			DEBIT	CREDIT	DEBIT	CREDIT				
163	Proffitt Plant Auto Exp.		18539				18539			
165	" " Labor		14965856	⊙	239880		15204936			
167	" " Salaries		363800				363800			
169	" " Restaurant		1361				1361			
171	" " Stationary		26408				26408			
173	" " Telephone		18871				18871			
175	" " Insurance		66018				66018			
177	" " Taxes		223080				223080			
179	" " Comel		358198				358198			
183	" " Accidental Exp.		869391				869391			
185	" " Fuel		445054				445054			
187	" " Boxes		278930				278930			
201	Proffitt Plant Fuel		450746				450746			
203	" " " "		2604232				2604232			
205	" " " "		73358				73358			
207	" " " "		486451				486451			
209	" " " "		1468810				1468810			
211	" " " "		53664				53664			
213	" " " "		4373367				4373367			
	Total		27145134		239880		27385014			

(CON-1633)

(MIN 15)

TRIAL BALANCE AND WORKING SHEET

Gates & Collins Inc



FOL.	ACCOUNT	SYM		TRIAL BALANCE		ADJUSTMENTS		LOSS	GAIN	ASSET	LIABILITY
		DEBIT	CREDIT	DEBIT	CREDIT						
265	Machinery Laboratory	263000								263000	
267	Testing Laboratory Exp.	50878				(MM 19 16)		50878			
269	Wearing	459428				(MM 18)		459428			
271	Common Stock		8750000								8750000
	Depreciation, Office Tr. and Fr.			114050		(MM 19 12)		114050			
	" " Goodville Plant			5858012		(MM 15 B)		5858012			
	" " Oakfield Plant			1955121		(MM 16 25)		1955121			
	" " Motor Vehicles			169182		(MM 15 15)		169182			
	Accrued Labor				10000000	(2) 1071856					1071856
	Office Salaries					(MM 17)		10000000			
	Allowance for Discounts					(6) 3224427					3224427
	<i>Total</i>	73806	8750000	18098365	4296283			18098365		263000	13046283
		69159652	216714965		27368511			67773659	1642472334	5780499	42319242631
		440813042	6233820	30000000	30887065			637234184	295569	5239193	5941751
		2493885		3224427				2814207		14105	
		5920065	34778509	3623116				47264468		4655397	344162453
		27145134		239880				27385014			
		139336140	58296700	21139176	38396365			66517119		68450997	66387235
	<i>Total</i>	252778242827124	76315764176315764	18692822184275903	70462834748780353						

JOURNAL ENTRIES

Gates & Ellison, Inc.



Depreciation of office furniture and fixtures ⁽¹⁾	\$ 1140.50
Depreciation of Brookfield plant	58580.12
Depreciation of Norfolk plant	19551.21
Depreciation of motor vehicles	1691.82
Reserve for dep'n. furn. and fix.	\$ 1497.93
Reserve for dep'n. Brookfield machinery	36836.67
Reserve for dep'n. Brookfield building	21563.69
Reserve for dep'n. Norfolk machinery	16706.28
Reserve for dep'n. Norfolk building	2667.26
Reserve for dep'n. motor vehicles	1691.82
Entry to record depreciation for 11 months	
Payroll Brookfield plant ⁽²⁾	\$ 8319.76
Payroll Norfolk plant	2398.80
Accrued payroll	\$ 10718.56
Entry to record accrued payroll	
Reserve for Federal income taxes ⁽³⁾	\$ 27360.51
Federal income taxes paid	\$ 27360.51
Entry to trans. for	
Accounts Payable ⁽⁴⁾	\$ 8870.65
Purchases	\$ 8870.65
Entry to adjust	
Salaries officers ⁽⁵⁾	\$ 100,000.00
B. G. Gates	\$ 40,000.00
A. K. Ellison	40,000.00
C. C. North	20,000.00
Entry to record officers' salaries ⁽⁶⁾	
Discounts allowed	\$ 32244.27
Reserve for discounts	\$ 32244.27
Entry to set up 1% of accounts receivable ⁽⁷⁾	
Investments	\$ 300,000.00
Due from A. & C. Strong	\$ 300,000.00
Entry to record acquisition of 3000 shares of stock	
Due from B. G. Gates ⁽⁸⁾	\$ 70,000.00
Due from A. K. Ellison	109,000.00
Due from C. C. North	24,000.00
Officers' Notes Receivable	\$ 203,000.00
Entry to transfer	

BANK RECONCILIATIONS
Gates & Ellison, Inc.

(A)

First National Bank

Balance per bank statement June 30 (Year) \$ 279,541.13

Certified checks outstanding \$ 1035.00

6325

6340

1035.00

4050.00

5085.00

Deposit not credited by bank until July 1 (Year) \$ 270,444.00

Less outstanding checks \$ 311,670.13

6325 Paid July 2 (Year) \$ 1035.00

6340 " " 2 " 4050.00

6345 " " 3 " 1020.00

6346 " " 3 " 7.77

6347 " " 4 " 44.45

6348 " " 4 " 557.21

6349 " " 4 " 336.87

6350 " " 4 " 999.00

6351 " " 4 " 5710.00

6352 " " 4 " 8671.50

6353 " " 4 " 7320.00

6356 " " 5 " 4.50

6357 " " 5 " 1006.10

6358 " " 5 " 100.00 3086240

Balance per cash book \$ 280,807.73

INVESTMENTS
Gate & Ellison, Inc

(F)

NAME OF SECURITY	SHARES	PAR VALUE	COST		INCOME DATES	INCOME RECEIVED		CERTIFICATE NUMBERS	NAME OF OWNER	CERT'S SIGHTED
			DATE	AMOUNT		FROM	TO			
<i>Amalgamated Silk Co. 7th Aprl</i>	$36 \frac{39}{100}$	1.00	<i>June (yr)</i>	<i>4753.26</i>				<i>SP26 P28</i>	<i>J & E</i>	
<i>" " "</i>	$90 \frac{96}{100}$	1.00	<i>June (yr)</i>					<i>SE26 C27</i>	<i>J & E</i>	
<i>Calony Printing Co. 7th Aprl</i>	1000	50	<i>June (yr)</i>	<i>45000.00</i>				<i>25 P</i>	<i>J & E</i>	
<i>" " "</i>	720	50	<i>June (yr)</i>					<i>53-54</i>	<i>J & E</i>	
<i>Clare Printing Co. 8th Aprl</i>	100	100	<i>7th (yr)</i>	<i>10000.00</i>	<i>7th 7th 10th</i>			<i>9</i>	<i>J & E</i>	
<i>Rayburn Printing Co. 7th Aprl</i>	50	100	<i>June (yr)</i>	<i>50000.00</i>	<i>7th 5th 10th 7th 5th 10th</i>			<i>16</i>	<i>J & E</i>	
<i>" " "</i>	25	100	<i>June (yr)</i>					<i>6</i>	<i>J & E</i>	
<i>Lamy & Strong Co. 7th Aprl</i>	$187 \frac{1}{2}$	100	<i>June (yr)</i>	<i>18750.00</i>	<i>7th 7th</i>			<i>16</i>	<i>J & E</i>	
<i>Weston Printing Co. 6th Aprl</i>	215	100	<i>June (yr)</i>	<i>21500.00</i>				<i>10</i>	<i>J & E</i>	
<i>Wilson Co. Inc.</i>	3000	<i>See Gen</i>	<i>Aug (yr)</i>	<i>3000000.00</i>				<i>2</i>	<i>J & E</i>	
<i>Royal Bank of Canada</i>	50		<i>June (yr)</i>	<i>14250.00</i>				<i>1193</i>	<i>J & E</i>	
<i>Dental Stocks</i>				<i>419253.26</i>						
<i>U. S. Testing Co. 7th 1951 bond</i>		<i>\$2000.</i>		<i>184000</i>	<i>7th 7th</i>			<i>7000</i>	<i>J & E</i>	
<i>Caroline Furniture Co.</i>								<i>1777.78</i>		
<i>Total</i>				<i>4210932.6</i>				<i>295569</i>		



LETTERS OF CREDIT
Gates & Ellison, Inc.

PAYEE	CREDITOR	LETTER OF CREDIT NUMBER	AMOUNT	MATURITIES			AVAILABLE LETTERS OF CREDIT	CONFIRMED BY BANK
				JULY (YEAR)	AUG (YEAR)	SEPT (YEAR)		
Chase National Bank	Shimizu & Co.	11803	170,593.68	8526295	8533073			✓
Investment Trust Co.	Onomura, Imai & Co.	11827	197,065.95	17627472	2134123			✓
Manufacturers Trust Co.	Japan Cotton Trading Co.	5001	102,921.49		10292149	340000		✓
	Yokohama Specie Co.	1620	479,933.89		47993389	600000		✓
	Shimizu & Co.	1621	65,135.43	4878542	1635071			✓
	Japan Cotton Trading Co.	1640	776,326		776326		150000	✓
National Park Bank	Shimizu & Co.	10060	46,118.11	4611811				✓
	Japan Cotton Trading Co.	10025	98,174.13		9817413			✓
Philadelphia National Bank	Japan Cotton Trading Co.	1701	149,698.17		14969817	182587		✓
Chenoweth National Bank	Yokohama Specie Co.	3453	353,132.10		35313210			✓
	Shimizu & Co.	3317	84,813.14	8481314				✓
	Onomura, Imai & Co.	3469	35,099.55		1394436	2118519		✓
Wood National Bank	Shimizu & Co.		104,388.92		10438892			✓
Equitable Eastern Bank		1610				255000		✓
Guaranty Trust Co.		3255				2975634		✓
	Totally		1995,387.82	26497962	29963308	133077512	100658221	

29/22 RAW SILK RECORD TESTS
Gates & Edison, Inc.

1

DATE OF INVOICE	VENDOR	AMOUNT OF INVOICE	QUANTITY OF SALES	SALE NUMBERS	POUNDS	VOUCHER NUMBER	SALE BOOK PAGE	CHECKED TO ACCOUNTS RECEIVABLE	AMOUNT OF SALE	✓
May 31	<i>Japan Cotton Trading Co</i>	756932	10	62072-81	132795	4288	80	✓	832540	✓
May 31	" "	374120	5	62828-32	65635	4283	80	✓	411532	
June 2	" "	371954	5	64459-63	65255	4287	81	✓	409144	
June 8	" "	761578	10	65737-46	131875	4384	88	✓	837755	
June 8	" "	738478	10	61708-17	131285	4385	88	✓	812325	
June 10	" "	372239	5	60838-42	65305	4376	89	✓	409264	
June 10	" "	383724	5	17061-65	67320	4375	89	✓	422086	
June 10	" "	378908	5	62833-37	66475	4377	89	✓	416798	
	<i>Total</i>	4137933	55		725945				4551454	

INSURANCE COVERAGE

Gates & Ellison, Inc

(2)

Description of Risk	Total Risk	Location of Risk		
		New York	Brooklyn	Jersey
Fire insurance, buildings	\$ 684,920	\$ 550,000	\$ 134,920	
michy, midse	2395,000	625,000	1270,000	500,000
Sprinkler leakage	571,000	220,000	351,000	
Water damage	75,000	50,000	25,000	
Steam boiler	¹⁰ /20,000		¹⁰ /20,000	
Elevator	²⁰ /40,000		²⁰ /40,000	
Inland marine	40,000	40,000		
Stock burglary	200,000	170,000	30,000	
Indemnity bond	115,000	20,000	95,000	
Payroll robbery	1,333	1,333		
Robbery money	40,000	40,000		
Check alteration	25,000	25,000		
Public liability	50,000			
Auto liability	40,000	40,000		
Auto fire, theft	14,900	14,900		
Insurable, value of buildings as per appraisal		\$ 432,554	\$ 136,666	
Ratio of coverage to buildings		127%	98%	
Insurable, value of machinery as per appraisal	\$ 728,938	\$ 12,000	\$ 559,548	\$ 157,390
Estimated inventory, on 5% profit basis	1352,916	627,676	435,240	290,000
Total	\$ 2081,854	\$ 639,676	\$ 994,788	\$ 447,390
Ratio of coverage to machinery, und, midse		98%	128%	112%
Appraised Value net		\$ 385,054	\$ 121,666	
Real Estate, less mortgage				
Machinery		559,548	157,390	
Total		\$ 944,602	\$ 279,056	
0.7% interest on net appraised value 10 months		\$ 47,230	\$ 13,950	

CHAPTER 26

ILLUSTRATIVE REPORT—MANUFACTURING COMPANY, ANNUAL AUDIT

Comments on Contents of Report of a Manufacturing Business. Often a manufacturer not only produces, but also sells merchandise, so his operations are more involved than those of a business enterprise which restricts its activities to trading. It is not unusual in a manufacturing plant to find inventories of finished goods, work in process, and raw materials on hand. At the date when a financial statement is prepared it is necessary that all inventories be properly valued. The inventory is often the largest item among the current assets on the balance sheet of a manufacturer.

In order to convert raw materials into the finished product the manufacturer requires a plant and such equipment as is necessary. Whatever real estate, machinery, and tools are owned must be valued in accordance with sound accounting principles, at the time a financial statement is prepared. Whenever an appraisal of a manufacturing plant is available reference should be made to it in the comments which accompany the balance sheet. If the appraisal was made at a prior date it is necessary to state the amount of the present value based on the appraisal plus subsequent additions at cost, less proper provision for depreciation. On account of the various methods employed in valuing manufacturing plants, it is highly advisable that the auditor include in his comments a clear statement of the valuation basis used for the plant. If the plant was received in exchange for capital stock, mention should be made of the transaction.

In a detailed audit report, it is often the practice to state the basis employed for depreciating the plant. Thus it may be that buildings are being depreciated on a 40-year and machinery on a 10-year life basis. Such a practice would tend to indicate that the plant is valued at a conservative figure.

When a manufacturing plant carries an investment in intangible assets, such as patents, copyrights, or good will, appropriate comments regarding the valuation basis of the intangibles are in order.

Sometimes the intangibles are the most valuable assets of an industrial enterprise because of their relatively large earning power.

The effort to charge each accounting period for the expenses applicable thereto, but no others, results frequently in carrying quite large prepaid expenses. Designs for new season goods are often treated as a deferred charge to future operations. On account of the abuses that are sometimes perpetrated in connection with prepaid expenses it is a good plan to explain the nature of the items included under this head in the financial statement.

More true reserves are generally found on the balance sheets of manufacturing enterprises than upon the statements of other classes of business undertakings. Any omission of a reserve results in an overstatement of the net worth of the business. It is highly desirable that a statement be made as to the adequacy of the reserves and as to the necessity for such reserves as appear on the financial statement.

The operating statement of an industrial enterprise should be set up in such a manner as to show the cost of production separate from the expense of selling the product. One ought to be able to ascertain from the statement of a manufacturing company what it costs to sell the goods so that comparisons can readily be made with the selling expenses of trading enterprises which handle similar products.

Whenever practicable, it is a good plan to include statistics showing the quantities of the product manufactured, as for example the number of garments, either in the comments or in a supporting schedule to the report. For purposes of illustration, the auditor's annual report on The Noveltex Company is presented in this section.

The Noveltex Company
100 Dearborn Street
Chicago, Illinois

GENTLEMEN :

In accordance with your instructions, we have made a general audit of your books for the year ended December 31 (year), and present herewith a Balance Sheet as at the close of business December 31 (year), Exhibit A, and an Income and Profit and Loss Statement for the year covered by our audit, Exhibit B, together with eight supporting schedules.

FINANCIAL POSITION

The comparative balance sheets which are submitted here show the financial position of the company at the end and also at the

ILLUSTRATIVE REPORT—MANUFACTURER, ANNUAL AUDIT 367

beginning of the year. Changes which took place in the balance sheet accounts during the year are shown in the increase and decrease column.

	Assets		
	December 31 current year	December 31 preceding year	Increase or decrease
CURRENT ASSETS			
Cash	\$ 214,702.75	\$ 126,518.57	\$ 88,184.18
Accounts and Notes Receivable, Net	455,240.24	433,875.39	21,364.85
Investment Securities	108,200.00	77,450.00	30,750.00
Inventories	769,771.10	777,999.54	8,228.44
Total Current Assets	\$1,547,914.09	\$1,415,843.50	\$132,070.59
OTHER ASSETS			
Miscellaneous Loans Receivable	12,334.91	9,309.45	3,025.46
Land, Buildings and Equipment, Net	15,096.89	18,398.36	3,301.47
Investments in subsidiaries	42,283.02	44,830.22	2,547.20
Mortgages Receivable	10,000.00	10,000.00	
Officers' and Employees' Loans Receivable	25,547.65	27,718.03	2,170.38
Prepaid Expenses	21,391.82	14,479.82	6,912.00
Total Assets	\$1,674,568.38	\$1,540,579.38	\$133,989.00

Liabilities and Net Worth

CURRENT LIABILITIES			
Accounts Payable	\$ 222,055.90	\$ 180,683.18	\$ 41,372.72
Notes Payable to Banks	551,000.00	495,000.00	56,000.00
Miscellaneous Accruals	4,836.68	5,410.63	573.95
Reserve for Federal Income Taxes	4,220.97		4,220.97
Total Current Liabilities	\$ 782,113.55	\$ 681,093.81	\$101,019.74
Net Worth	892,454.83	859,485.57	32,969.26
Total Liabilities and Net Worth	\$1,674,568.38	\$1,540,579.38	\$133,989.00

STATEMENT OF APPLICATION OF FUNDS

A summary of the increases and decreases shown in the foregoing comparative balance sheets is presented below in the form of a state-

368 ILLUSTRATIVE REPORT—MANUFACTURER, ANNUAL AUDIT

ment of application of funds. Reference to this statement will show, at a glance, just how the funds were obtained and how they were expended.

SOURCES FROM WHICH FUNDS WERE OBTAINED

Net profit, after federal taxes		\$ 32,969.26
Decreases in		
Inventories	\$ 8,228.44	
Land, Buildings and Equipment	3,301.47	
Investments in Subsidiaries	2,547.20	
Loans Receivable	2,170.38	16,247.49
		<hr/>
Increases in		
Accounts Payable	\$41,372.72	
Notes Payable	56,000.00	
Reserve for Federal Taxes	4,220.97	101,593.69
		<hr/>
Total		<u>\$150,810.44</u>

OBJECTS FOR WHICH FUNDS WERE EXPENDED

Increases in		
Cash	\$88,184.18	
Accounts Receivable	21,364.85	
Investment Securities	30,750.00	
Miscellaneous Loans	3,025.46	
Prepaid Expenses	6,912.00	\$150,236.49
		<hr/>
Decrease in Miscellaneous Accruals		573.95
		<hr/>
Total		<u>\$150,810.44</u>

ANALYSIS OF SURPLUS

During the year covered by our audit, the changes in the general surplus account were as follows:

Surplus, January 1 (year)	\$259,485.57
Addition to Surplus for (year), inclusive of refund of prior year federal income taxes	32,969.26
	<hr/>
Surplus, December 31 (year)	<u>\$292,454.83</u>

The addition to the general surplus account of \$32,969.26 is equal to 3.8 per cent of the company's net worth at January 1 (year).

BALANCE SHEET RATIOS

Several ratios which show relationships between various balance sheet accounts are presented below, for December 31 of the current and preceding year.

	Current year	Preceding year
Ratio of Current Assets to Current Liabilities	1.98 to 1	2.07 to 1
Percentage of Current Assets to Total Assets	92.4%	91.9%
Percentage of Net Worth to Total Assets	53.3%	55.8%
Percentage of Net Worth Plus Borrowed Capital to Total Assets	86.2%	87.9%]

BALANCE SHEET ACCOUNTS

The following comments are pertinent to the balance sheet accounts.

CASH. The cash on deposit was confirmed by correspondence with your banks. Petty cash on hand at branches was certified to by the branch managers. Cash on hand at the main office was verified by count at the date of our audit.

Banking arrangements provide for keeping funds on deposit equal to approximately 20 per cent of the amount of money borrowed. It is therefore evident that approximately \$110,000.00 of the amount of cash on hand is unavailable for checking purposes.

ACCOUNTS RECEIVABLE. Balances due from customers were confirmed by correspondence. Replies which have been received did not indicate the existence of any irregularities. The accounts receivable have been aged, with the following results:

Not due	\$310,000.17
Past due 1 to 30 days	69,975.30
Past due 31 to 60 days	48,666.44
Past due 61 to 90 days	22,789.63
Past due over 90 days	10,210.45
	<hr/>
Total	\$461,641.99
	<hr/> <hr/>

A comparison of the average monthly collections with the average accounts receivable balances for the past year shows that the collection period was 45 days, or 1½ months, on an average. These figures compare with 48 days, or 1⅓ months for the preceding year.

Your credit manager has certified to us that in his opinion all accounts receivable are good, and all are collectible.

370 ILLUSTRATIVE REPORT—MANUFACTURER, ANNUAL AUDIT

The reserve for sales discounts which has been provided is deemed adequate, in view of your experience with regard to discounts allowed customers.

INVESTMENTS IN BANK AND FINANCIAL CORPORATION STOCKS. The investment securities included under this head were sighted by us and found to be in proper order. In Exhibit A, Schedule I, the market value is shown to be \$203,125.00, which exceeds the cost by \$99,125.00.

INVENTORY. The company's president has certified to us that the inventory was taken under his supervision by actual count or measurement, and was priced at cost or market, whichever was lower. We checked the inventory summary sheets to the original tally cards and found them to be in agreement. Approximately 20 per cent of the raw material inventory was checked back to the stock in the bins. About 25 per cent of the goods in process of manufacture was compared with the production records. Tests of approximately 25 per cent of the finished goods inventory were made by checking tally cards to the stock on hand and by checking stock on hand to the tallies. The result of these tests showed the inventory quantities to be correct.

We made comparisons between the prices employed on about 50 per cent of the raw material inventory and current quotations obtained from raw material dealers, and satisfied ourselves that the prices used in the inventory did not exceed market values. An examination of the cost records indicated that the labor and factory overhead expense on goods in process of manufacture and on finished merchandise were figured at cost, which we found to be the same as the market value.

As far as we could ascertain, no obsolete merchandise is carried in the inventory.

In Exhibit A, Schedule II, is presented an analysis of the inventory.

The rate of inventory turnover for the current year was 2.7, as compared with 2.8 for the preceding year. Below, a comparison is presented between your annual rate of inventory turnover and that of three other companies engaged in the same line of business, as ascertained from their published reports.

Conant Brothers	4.1
Hess & Bright Mfg. Co.	3.8
Pierce & Pierce	3.1
The Noveltex Co.	2.7

REAL ESTATE. The New York Title Co. has certified to us that title to the real estate which is shown on the accompanying balance sheet vests in The Noveltex Company. Real estate is shown on the books at cost, less depreciation of buildings. Rates employed for calculating depreciation are deemed to be adequate to meet the needs of the case.

EQUIPMENT. Proper vouchers were sighted covering additions to the equipment accounts during the year covered by our audit. The equipment is carried at cost, less depreciation. Adequate provision for depreciation of equipment has been made.

APPRAISED VALUE. An appraisal made July 1 (year), by the American Appraisal Company, shows that the sound value of the real estate and equipment as of the date of the appraisal, plus subsequent additions at cost, and less depreciation, was \$75,000.00 on December 31 (year). This figure is \$59,903.11 more than the book value of the real estate and equipment shown by the accompanying balance sheet.

INVESTMENTS IN AND ADVANCES TO SUBSIDIARY CORPORATIONS. The investments in and advances to the subsidiary corporations are set forth in detail in Exhibit A, Schedule III, and are in agreement with the books of the respective subsidiaries. Our audit included an examination and verification of the books of the Acorn Shirt Co. and the Stark Pajama Co., both of which are subsidiaries of your corporation. Balance sheets of the two subsidiary corporations are presented in Exhibits C and D.

LOANS AND ADVANCES. The company's president has certified to us that, in his opinion, the loans and advances to officers and employees, as shown by the books, are good and collectible.

PREPAID EXPENSES. Under this head are included the following deferred charges to future operations.

Salesmen's Commissions	\$20,163.31
Unexpired Insurance Premiums	858.61
Deposits with Service Companies	369.90
	<u>\$21,391.82</u>

We checked the arithmetical calculations of the prepaid expense items. Confirmation of the amount of the unexpired insurance premiums was obtained from your insurance agent, A. Powell & Son.

ACCOUNTS PAYABLE. The correctness of the amounts due to creditors on open account was confirmed by correspondence. A schedule which shows the accounts payable according to maturity is presented here.

372 ILLUSTRATIVE REPORT—MANUFACTURER, ANNUAL AUDIT

Due in 1 to 10 days	\$ 66,320.00
Due in 11 to 20 days	40,333.41
Due in 21 to 30 days	35,666.75
Due in 31 to 40 days	30,675.20
Due in 41 to 50 days	28,600.55
Due in 51 to 60 days	20,200.00
	<hr/>
Total	<u>\$221,795.91</u>

NOTES PAYABLE TO BANKS. The liability to banks on account of notes payable was verified by correspondence. Notes payable mature as follows:

Amount	Maturity
\$100,000.00	January 15 (year)
100,000.00	February 15 (year)
100,000.00	March 15 (year)
100,000.00	April 15 (year)
100,000.00	May 15 (year)
51,000.00	June 15 (year)
<u>\$551,000.00</u>	

ACCRUALS PAYABLE. Included under this head are the following accounts.

Payrolls Accrued	\$3,725.00
Property Taxes Accrued	1,111.68
	<hr/>
Total	<u>\$4,836.68</u>

We checked the calculations of the accruals payable.

RESERVE FOR FEDERAL INCOME TAXES. We prepared the company's federal corporation income tax return for the year ended December 31 (year), and have set up a reserve for the amount of this tax liability. The company's tax returns have all been audited by the treasury department up to the current year and no assessments for back taxes have been made to date.

CONTINGENT LIABILITIES, ETC. Your treasurer has certified to us that all of the company's liabilities at the close of business, December 31 (year), were shown by the books and that there were no contingent liabilities other than \$25,000.00 notes receivable discounted.

The company's purchase commitments on December 31 (year) amounted to \$50,000.00. A comparison of the prices on outstanding purchase orders and market quotations showed that the prices on out-

standing purchase orders were lower than the market quotations. A reserve for losses on purchase commitments is unnecessary.

Sales for future delivery at the date of the balance sheet amounted to \$35,000.00. Inasmuch as there is sufficient material on hand to manufacture the articles included in the orders for subsequent delivery, there is no necessity for a reserve to cover losses on sales for future delivery.

INSURANCE COVERAGE. A tabulation of the fire insurance policies in force, together with the risks covered, is presented below. All fire insurance policies contain the 80 per cent coinsurance clause.

	Risk covered	Amount of policy
Buildings	\$ 40,000.00	\$ 37,500.00
Equipment	59,856.28	50,000.00
Merchandise	769,771.10	775,000.00

Insurance policies covering sprinkler leakage, burglary, embezzlement, and auto damage, were found on file.

COMPARATIVE INCOME AND PROFIT AND LOSS STATEMENT

A comparison between your operations of the current year and those of the preceding year, together with percentages, is presented below.

	CURRENT YEAR		PRECEDING YEAR	
		Per cent		Per cent
Sales, Less Discounts	\$2,506,485	100.0	\$2,554,751	100.0
Cost of Sales	2,112,791	84.3	2,172,803	85.0
Gross Profit	\$ 393,694	15.7	\$ 381,948	15.0
Administrative Expenses	\$ 92,892	3.7	\$ 92,692	3.6
Selling Expenses	231,176	9.2	225,769	8.8
General Expenses	57,815	2.3	77,295	3.1
	\$ 381,883	15.2	\$ 395,756	15.5
Operating Profit or Loss	\$ 11,811	0.5	\$ 13,808	0.5
Other Income, Net	24,879	1.0	6,103	0.2
Net Profit	\$ 36,690	1.5	\$ 7,705	0.3
Provision for Federal Income Taxes	4,221	0.2		
Addition to Surplus	\$ 32,469	1.3	\$ 7,705	0.3

374 ILLUSTRATIVE REPORT—MANUFACTURER, ANNUAL AUDIT

The following table shows the sales of shirts and pajamas separately, together with the dozens sold, and the average selling price.

	Sales amount	Dozens sold	Price per dozen
Shirts	\$ 919,102.14	104,575	\$ 8.79
Pajamas	1,621,739.06	89,142	18.19
Total	\$2,540,841.20	193,717	\$13.11

A comparison between the average selling prices received during the current and during the preceding year is presented below.

	Average selling price per dozen	
	Current year	Preceding year
Shirts	\$ 8.79	\$10.60
Pajamas	18.19	17.51
Total	\$13.11	\$14.40

Sales of the leading styles of shirts and pajamas are set forth in the following table.

Style No.	SALES		COST
	Amount	Per dozen	Per dozen
Shirts			
1101	\$ 7,580	\$10.00	\$ 7.85
1107	20,110	9.75	9.00
1208	13,257	8.75	8.10
1310	19,115	7.90	7.05
Pajamas			
4210	\$42,500	\$27.00	\$20.00
4750	61,200	26.10	21.15
4910	17,155	25.50	23.80
5000	11,122	21.25	19.17

An analysis of the cost of production is presented in the following tabulation.

	SHIRTS		PAJAMAS	
	Amount	Per dozen	Amount	Per dozen
Material	\$321,152.20	\$4.46	\$ 955,470.25	\$ 6.82
Labor	120,260.17	1.70	295,100.00	2.10
Factory overhead	45,914.33	0.59	359,880.85	2.58
Total	\$487,326.70	\$6.75	\$1,610,451.10	\$11.50

ILLUSTRATIVE REPORT—MANUFACTURER, ANNUAL AUDIT 375

A comparison is presented below between the actual costs of manufacture and the standard costs of manufacture which were established at the time that the selling prices were last fixed.

Shirts	Actual cost	Standard cost	Increase
Material	\$ 321,152.20	\$ 317,200.00	\$ 3,952.20
Labor	120,260.17	100,550.00	19,710.17
Factory Overhead	45,914.33	38,200.00	7,714.33
Total	\$ 487,326.70	\$ 455,950.00	\$31,376.70

Pajamas	Actual cost	Standard cost	Increase
Material	\$ 955,470.25	\$ 950,100.00	\$ 5,370.25
Labor	295,100.00	280,000.00	15,100.00
Factory Overhead	359,880.85	341,210.00	18,670.85
Total	\$1,610,451.10	\$1,571,310.00	\$39,141.10

Operatives in the cutting, sewing, pressing, and boxing departments are paid in part on the piecework rate basis. The average hourly earnings of piece workers in all plants is compared with that of day workers in the following table.

Department	Average hourly earnings	
	Piece workers	Day workers
Cutting	\$0.75	\$0.70
Sewing	0.60	0.50
Pressing	0.80	0.60
Boxing	0.50	0.45

The percentage which the number of piecework operatives in each of the manufacturing departments bears to the total number of operatives employed is set forth below.

Department	Total operatives	Per cent on piece work
Cutting	175	75
Sewing	3,150	90
Pressing	1,610	80
Boxing	1,200	50
Total	6,135	85

The ratio of each of the main classes of expenses to sales is set forth in the following tabulation.

376 ILLUSTRATIVE REPORT—MANUFACTURER, ANNUAL AUDIT

		Per cent
Sales, Net (exclusive of piece goods)	\$2,497,461.92	100.00
Factory Costs (labor and expense)	\$ 787,410.66	31.53
Administrative Expenses	92,891.98	3.72
Selling Expenses	231,176.51	9.26
General Expenses	57,814.55	2.31
Total	\$1,169,293.70	46.82

GRAPHIC CHARTS (EXHIBITS E, F AND G). Three graphic charts are presented in Exhibits E, F and G, for the purpose of showing the five-year trend in sales, expenses, labor, and profits. These charts are as follows:

Exhibit E—Sales and profits.

Exhibit F—Sales and selling expenses.

Exhibit G—Factory labor and overhead.

We shall be glad to furnish you with any further information that you may desire regarding your accounts.

INDEPENDENT ACCOUNTANTS' CERTIFICATE

BROWN & WHITE
500 MADISON AVENUE
NEW YORK
CERTIFIED PUBLIC ACCOUNTANTS

We have examined the balance sheet of The Noveltex Company as at December 31 (year) and the income and profit and loss statement for the year ended that date. We have reviewed the system of internal control and the accounting procedures of the company and, without making a detailed audit of the transactions, have examined or tested accounting records of the company and other supporting evidence, by methods and to the extent we deemed appropriate. Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and included all procedures which we considered necessary.

In our opinion, the accompanying balance sheet and related income and profit and loss statement present fairly the position of The Noveltex Company at December 31 (year), and the results of operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Respectfully submitted,
BROWN & WHITE

THE NOVELTEX COMPANY

EXHIBIT A

BALANCE SHEET

As of December 31 (Year)

Assets

CURRENT ASSETS

Cash		\$ 214,702.75
Accounts Receivable	\$461,641.99	
Less Reserve for Sales Discount	9,236.27	452,405.72
	<hr/>	
Customers' Notes Receivable		2,834.52
Liberty Bonds, at Cost		4,200.00
Investments in Bank and Financial Corporation Stocks (Schedule I)		104,000.00
Inventories (Schedule II)		769,771.10
		<hr/>
Total Current Assets		\$1,547,914.09

OTHER ASSETS

Miscellaneous Loans Receivable		12,334.91
Land, at Cost		10,757.15
Buildings and Equipment, Cost	\$ 99,856.28	
Less Reserve for Depreciation	95,516.54	4,339.74
	<hr/>	
Investments in and Advances to Subsidiaries (Schedule III)		42,283.02
Mortgages Receivable		10,000.00
Officers' and Employees' Notes and Loans Receivable		25,547.65
Prepaid Expenses		21,391.82
		<hr/>
Total Assets		\$1,674,568.38
		<hr/> <hr/>

Liabilities and Capital

CURRENT LIABILITIES

Accounts Payable		\$ 221,795.91	
Due to Customers		259.99	
Notes Payable to Banks		551,000.00	
Miscellaneous Accruals		4,836.68	
Reserve for Federal Income Taxes		4,220.97	
			<hr/>
Total Current Liabilities			782,113.55

CAPITAL

Capital Stock Outstanding		\$600,000.00	
Surplus, January 1 (year)	\$259,485.57		
Plus Refund of Prior Year Federal Taxes	500.11		
	<hr/>		
	\$259,985.68		
Addition to Surplus, per Exhibit B	32,469.15	292,454.83	892,454.83
	<hr/>	<hr/>	
Contingent Liability on Notes Receivable Discounted	25,000.00		
	<hr/> <hr/>		
Total Liabilities and Capital			<hr/> <hr/> \$1,674,568.38

THE NOVELTEX COMPANY

EXHIBIT A

SCHEDULE I

INVESTMENTS IN BANK AND FINANCIAL CORPORATION STOCKS

Shares	Security	Cost	Market value
250	Bank of United States	\$43,250.00	\$128,000.00
1,000	Class A, City Financial Corporation	60,750.00	70,750.00
125	Class B, City Financial Corporation	Bonus	4,375.00
	Total	\$104,000.00	\$203,125.00

THE NOVELTEX COMPANY

EXHIBIT A

SCHEDULE II

INVENTORIES

	December 31 current year	December 31 preceding year
Raw Material	\$108,423.47	\$ 89,035.37
Work in Process	123,869.93	123,280.20
Supplies, Including Thread	58,929.83	70,175.80
Freight and Duty	845.62	2,792.77
	\$292,068.85	\$285,284.14
Finished Goods	477,702.25	492,715.40
Totals	\$769,771.10	\$777,999.54

THE NOVELTEX COMPANY

EXHIBIT A

SCHEDULE III

INVESTMENTS IN AND ADVANCES TO SUBSIDIARIES

ACORN SHIRT COMPANY

Stock, at Cost		\$12,000.00
Advances for Plant	\$15,467.39	
Less Depreciation	3,586.99	11,880.40
	<hr/>	
Advances for Real Estate	\$ 9,950.00	
Less Depreciation	5,496.15	4,453.85
	<hr/>	

STARK PAJAMA COMPANY

Stock, at Cost		4,900.00
Advances for Plant	\$12,282.68	
Less Depreciation	9,535.60	2,747.08
	<hr/>	
Advances for Real Estate	\$ 7,685.07	
Less Depreciation	1,383.38	6,301.69
	<hr/>	
Total		<u>\$42,283.02</u>

THE NOVELTEX COMPANY

EXHIBIT B

INCOME AND PROFIT AND LOSS STATEMENT

For the Year Ended December 31 (year)

SALES		
Shirts		\$ 919,102.14
Pajamas		1,621,739.06
Piece Goods		9,023.20
		<hr/>
		\$2,549,864.40
Less Sales Discount		43,379.28
		<hr/>
Net Sales		\$2,506,485.12
COST OF SALES		
Inventory of Raw Material and Work in Process, January 1 (year)	\$ 285,284.14	
Purchases	1,317,151.85	
Factory Costs (labor and expense) (Schedule I)	787,410.66	
	<hr/>	
	\$2,389,846.65	
Less Inventory of Raw Material and Work in Process, December 31 (year)	292,068.85	
	<hr/>	
	\$2,097,777.80	
Plus Decrease in Finished Goods Inventory	15,013.15	2,112,790.95
	<hr/>	
Gross Profit on Sales		\$ 393,694.17
Administrative Expenses (Schedule II)	\$ 92,891.98	
Selling Expenses (Schedule III)	231,176.51	
General Expenses (Schedule IV)	57,814.55	381,883.04
	<hr/>	
Operating Profit		\$ 11,811.13
Other income, net (Schedule V)		24,878.99
		<hr/>
Net Profit		\$ 36,690.12
Provision for federal income taxes		4,220.97
		<hr/>
Addition to Surplus (Exhibit A)		\$ 32,469.15
		<hr/> <hr/>

THE NOVELTEX COMPANY

EXHIBIT B

SCHEDULE I

FACTORY COSTS (LABOR AND EXPENSE)

Labor	
Department 1	\$ 25,000.10
Department 2	80,642.80
Department 3	210,610.55
Department 4	89,771.50
	<hr/>
	\$406,024.95
Salaries, Management	140,000.00
Rent	112,000.00
Light, Heat, and Power	37,100.20
Repairs	42,107.25
Supplies	13,211.02
Insurance	7,255.24
Miscellaneous	29,712.00
	<hr/>
Total	<u>\$787,410.66</u>

THE NOVELTEX COMPANY

EXHIBIT B

SCHEDULE II

ADMINISTRATIVE EXPENSES

Officers' Salaries	\$50,000.00
Office Salaries	20,000.00
Traveling Expenses	8,500.00
Legal and Professional Services	3,000.00
Office Rent	2,500.00
Miscellaneous	8,891.98
	<hr/>
Total	<u>\$92,891.98</u>

THE NOVELTEX COMPANY

EXHIBIT B

SCHEDULE III

SELLING EXPENSES

Salaries and Commissions—Salesmen	\$ 56,000.00
Traveling Expenses	19,210.00
Entertainment Expenses	4,725.25
Samples Expenses	28,271.22
Advertising	45,621.47
Rent	24,000.00
Branch Office Expenses	15,309.17
Insurance	12,221.43
Credit Information	2,750.25
Postage, Printing, and Stationery	11,821.22
Telephone and Telegraph	7,525.00
Miscellaneous	3,721.50
Total	<u><u>\$231,176.51</u></u>

THE NOVELTEX COMPANY

EXHIBIT B

SCHEDULE IV

GENERAL EXPENSES

Repairs	\$22,175.07
Depreciation	5,210.00
Advertising for Help	1,200.00
Light	2,100.50
Rent	20,000.20
Supplies	6,895.00
Miscellaneous	233.78
Total	<u><u>\$57,814.55</u></u>

THE NOVELTEX COMPANY

EXHIBIT B

SCHEDULE V

OTHER INCOME

Bad debts recovered	\$15,158.49
Interest	3,720.50
Dividends	6,000.00
	<hr/>
Total	<u>\$24,878.99</u>

THE NOVELTEX COMPANY

EXHIBIT C

ACORN SHIRT COMPANY

BALANCE SHEET

December 31 (Year)

Assets

Newark, N. J.—Real Estate	\$33,092.65
Newark, N. J.—Equipment	21,445.49
Main Office—furniture	5,129.25
Branch Office—Furniture	750.00
	<hr/>
	\$60,417.39
Less Reserve for Depreciation	9,083.14
	<hr/>
Total Assets	<u>\$51,334.25</u>

Liabilities and Capital

The Noveltex Company	\$16,334.25
First Mortgage	15,000.00
Second Mortgage	8,000.00
	<hr/>
Total Liabilities	\$39,334.25
Capital Stock	12,000.00
	<hr/>
Total Liabilities and Capital	<u>\$51,334.25</u>

THE NOVELTEX COMPANY

EXHIBIT D

STARK PAJAMA COMPANY

BALANCE SHEET

December 31 (Year)

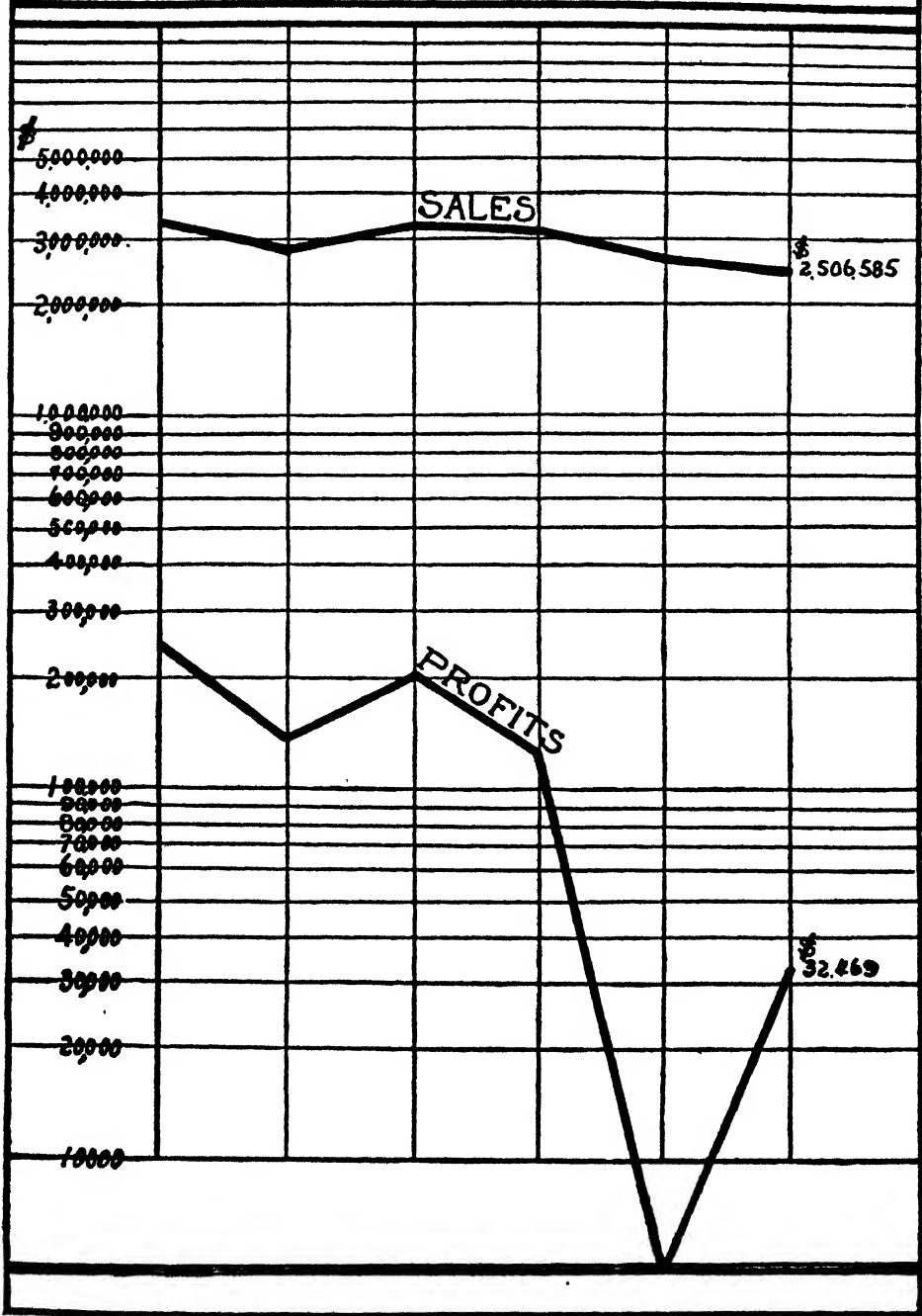
Assets

Boston, Mass.—Real Estate	\$ 7,700.18
Boston, Mass.—Buildings	5,000.00
Boston, Mass.—Machinery	9,069.38
Boston, Mass.—Furniture	1,133.32
Beverly, Mass.—Machinery	5,064.87
	<hr/>
	\$27,967.75
Less Reserve for Depreciation	10,918.98
	<hr/>
Total Assets	<u>\$17,048.77</u>

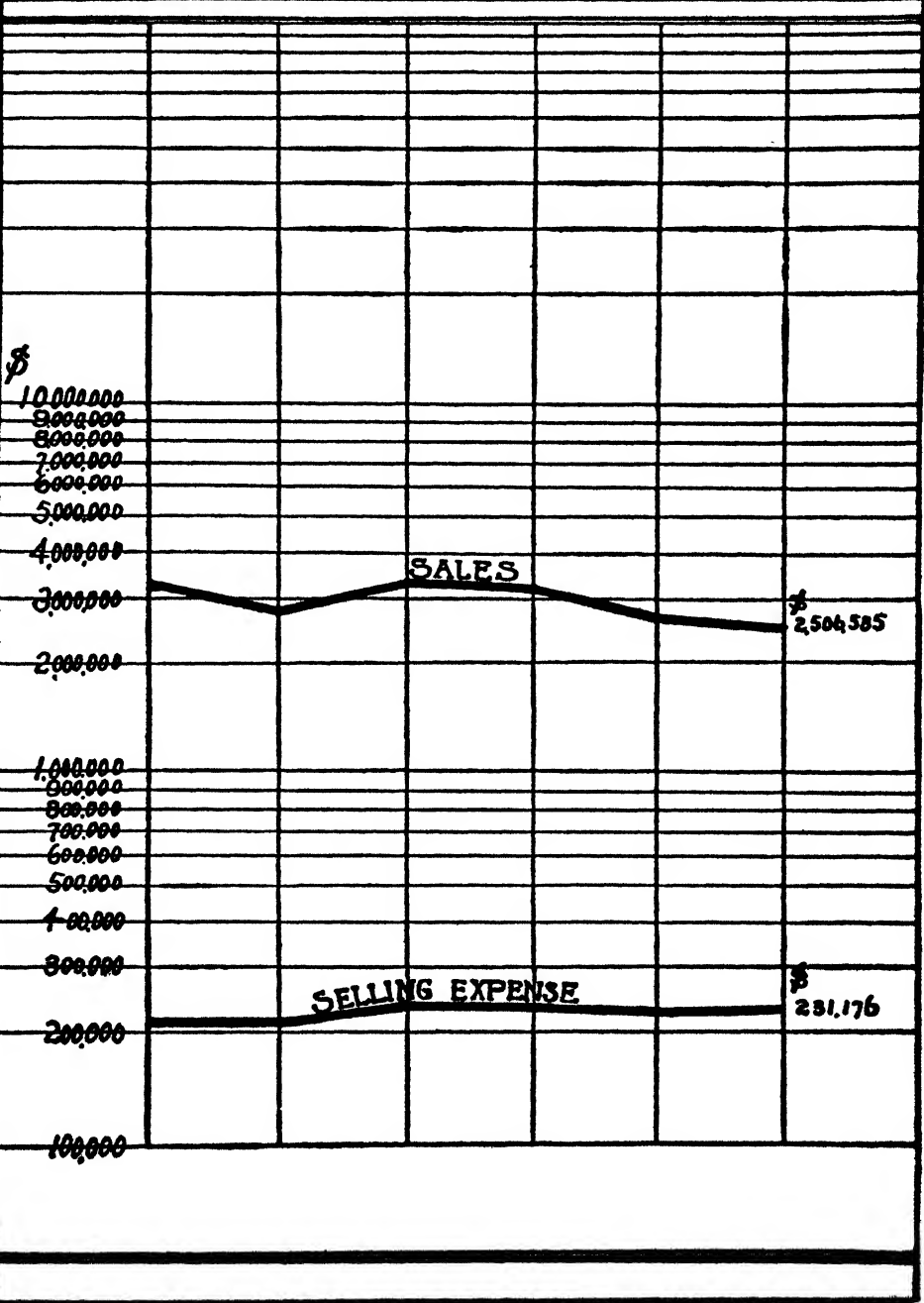
Liabilities and Capital

The Noveltex Company	\$ 9,048.77
Mortgage	3,000.00
	<hr/>
Total Liabilities	\$12,048.77
Capital Stock	5,000.00
	<hr/>
Total Liabilities and Capital	<u>\$17,048.77</u>

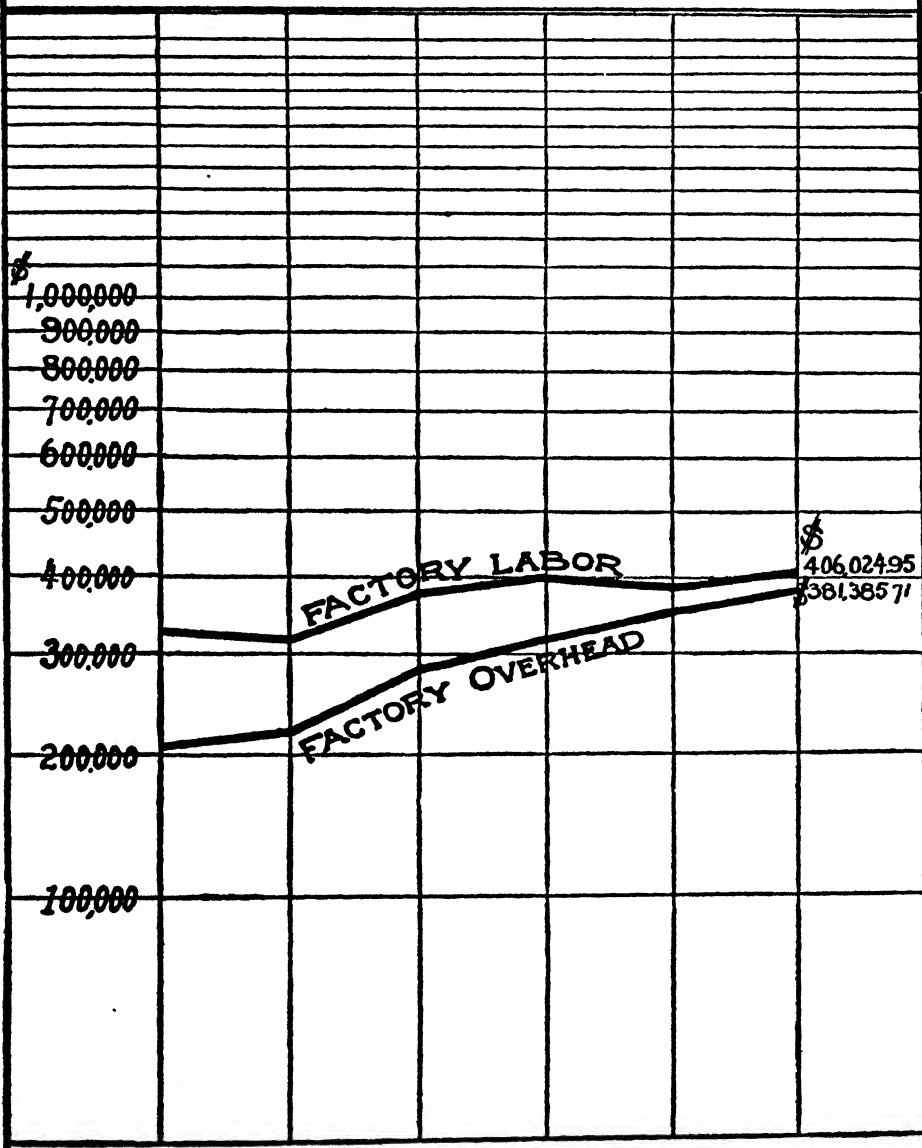
THE NOVELTEX COMPANY
EXHIBIT E
RATIO CHART SHOWING FIVE YEAR COMPARISON
BETWEEN SALES AND PROFITS



THE NOVELTEX COMPANY
EXHIBIT F
RATIO CHART SHOWING FIVE YEAR COMPARISON
BETWEEN SALES AND SELLING EXPENSE



THE NOVELTEX COMPANY
EXHIBIT G
RATIO CHART SHOWING FIVE YEAR COMPARISON
BETWEEN FACTORY LABOR AND OVERHEAD



CHAPTER 27

ILLUSTRATIVE REPORT—DEPARTMENT STORE, ANNUAL AUDIT

Comments on Contents of Department Store Reports. There are certain features that are peculiar to the financial report of a department store that should be commented upon by an auditor. Usually the condition of the inventory, its rate of turnover (number of times replaced in a year), and basis employed in pricing should be mentioned. On an average it is expected that the merchandise inventory will be replaced once each quarter. It is therefore apparent that if the closing inventory of any average department is in excess of the cost of sales for the three months' period preceding, an overstocked condition may exist.

As it is a well-known fact that from one-fourth to one-third of the net profit of a department store is generally derived from cash discounts received, it is evident that the average rate of discount is worthy of comment. The practice of the store with regard to anticipating the due date should be mentioned, as it has a bearing on the discounts where "anticipation interest" is included therein.

The average collection period for accounts receivable should be stated. If merchandise is sold on the deferred payment plan the practice should be followed of separating the regular from the installment accounts receivable. The collection period on the installment accounts is much longer than that on the regular accounts. If a Reserve for Unrealized Profits on Installment Contracts Receivable account is carried, an explanation should be made of the manner of calculating the amount thereof. Where a reserve for unrealized profits is carried, no reserve for bad debts is required.

It is a good plan to set forth a comparison between the bad debts expenses and the sales, for a period of from three to five years in order that the trend may easily be seen. Relatively large losses from bad debts indicate that the credit and collection policy require revision.

As the transactions of a department store are very numerous (individual sales in large stores running from 10,000 to 20,000 a day), it

is, of course, necessary that an adequate system of internal audit be maintained. It is certainly within the scope of an auditor's report to mention to what extent the cash and sales audit system safeguards the store. In this connection it should be remembered that in a store which does a business of \$15,000,000 a year, the daily collections average \$50,000, which must be properly controlled.

Financial and operating ratios of the store should be compared with those of other stores which publish reports. By following out this plan it is frequently an easy matter to detect the existence of an unhealthy condition that might otherwise escape one's attention.

One of the most important matters that should be commented upon is the ratio of the net profit earned to the investment at the beginning of the period. There are several representative department stores which earn 20 or more per cent per annum on the capital invested in the business.

It is a good plan to compare the operating expense ratios of a store with the average figures published annually for department stores by Harvard University. Such a comparison will quickly bring to light any expenses which are disproportionately high. It may be that the advertising expenditure is out of line with the average of other stores in which case the matter should be investigated.

Any detailed analysis of operations of a department store requires that the seasonal demands for various classes of merchandise be given careful consideration. It is therefore usual when making a detailed report to show the operations by departments and also by months. Sometimes this is done by means of graphic charts, of which there is one for each department, such as illustrated on the following page.

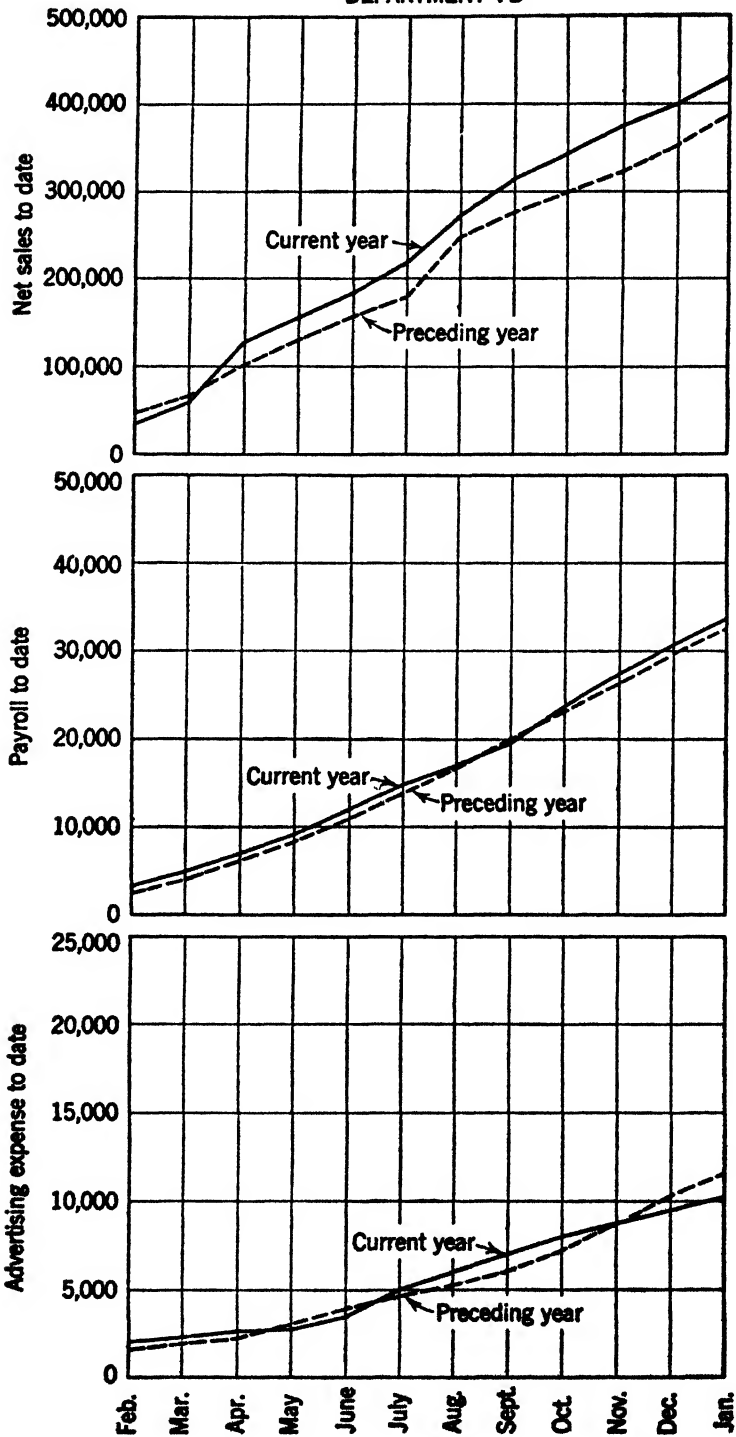
In each case local conditions must, of course, be studied and mention made of any important matters which require comment. The auditor's annual report on The Seattle Department Store is presented in the pages immediately following, for the purpose of illustrating a department store report.

*The Seattle Department Store,
200 State Street,
Seattle, Washington.*

GENTLEMEN :

Pursuant to your instructions, we have made an audit of your books for the year ended January 31 (year), and submit herewith our report, which contains a Balance Sheet as of January 31 (year), (Exhibit A), and an Income and Profit and Loss Statement for the year ended at the same date (Exhibit B), together with four supporting schedules.

DEPARTMENT FB



COMPARATIVE BALANCE SHEET. In order that changes in the financial condition of the corporation may be readily noted, a comparative balance sheet, together with increases and decreases, is presented below.

COMPARATIVE BALANCE SHEET

(Cents omitted)

Assets			
	Current year January 31	Preceding year January 31	Increase or decrease
Cash	\$ 1,619,470	\$ 749,087	\$ 870,383
Accounts Receivable	3,276,901	3,066,630	210,271
Inventories	2,029,637	1,921,695	107,942
Marketable Securities	1,600,393	743,720	856,673
Total Current Assets	\$ 8,526,401	\$ 6,481,132	\$2,045,269
Loans Receivable	1,000,000	1,200,000	200,000
Due from Officers	8,549	26,453	17,904
Fixed Assets, Net	8,196,463	8,367,045	170,582
Prepaid Expenses	16,696	226,925	210,229
Total Assets	\$17,748,109	\$16,301,555	\$1,446,554

Liabilities and Capital

Accounts Payable	\$ 903,524	\$ 1,006,789	\$ 103,265
Reserve for Federal Taxes	254,509	242,103	12,406
Unearned Income	46,464	42,076	4,388
Total Liabilities	\$ 1,204,497	\$ 1,290,968	\$ 86,471
Capital	16,543,612	15,010,587	1,533,025
Total Liabilities and Capital	\$17,748,109	\$16,301,555	\$1,446,554

The changes in your financial condition for the year ended January 31 (year), are summarized below.

(Cents omitted)

INCREASE IN NET WORTH		
Increase in Current Assets	\$2,045,269	
Decrease in Accounts Payable	103,265	\$2,148,534
DECREASE IN NET WORTH		
Increase in Reserve for Taxes, etc.	\$ 16,794	
Decrease in Noncurrent Assets	598,715	615,509
Net Increase in Capital		\$1,533,025

CREDIT POSITION. We set forth below a comparison of your credit position (ratio of current assets to current liabilities) with that of several representative stores. The figures of the other organizations were taken from published reports and are therefore public property. It goes without saying that the data obtained from your records will not, directly or indirectly, be used by us for any other purpose than confidential reports addressed to you.

	Current assets to current liabilities
The Seattle Department Store	7½ to 1
Buffalo Retail Corporation	7 to 1
The Boston-Chicago Co.	6½ to 1
Philadelphia Merchandise Co.	6¼ to 1
Tulsa Emporium	6 to 1
St. Paul Dry Goods Co.	5¾ to 1
Bell Brothers	5 to 1
Billings & Watson	3½ to 1

From the above tabulation, it is apparent that your store enjoys a better credit position than any of the other stores with which comparisons were made. Ownership of marketable securities and the absence of indebtedness to banks are the two factors which are chiefly responsible for this financial condition. Ordinarily, efforts are made to increase the credit ratio, but in your case the unusually high credit ratio indicates that all of the capital is not required in order to carry on the regular operations of the business.

CASH. The cash on deposit in banks, on January 31 (year), together with the February 1 (year) deposit, was confirmed by correspondence.

Cash on hand, including receipts of February 19 (year), was counted on the morning of February 20 (year), and found correct, with two exceptions. The basement tube room funds were over by \$25.50, and the information desk fund was short \$16.15.

The percentage which your cash bears to your current assets (exclusive of marketable securities) is shown in the following tabulation, compared with other organizations.

	Per cent of cash to cur- rent assets
Billings & Watson	28.0
Bell Brothers	25.0
The Seattle Department Store	23.5
Philadelphia Merchandise Co.	18.2
St. Paul Dry Goods Co.	16.3
The Boston-Chicago Co.	15.2
Tulsa Emporium	10.0
Buffalo Retail Corporation	8.1

ACCOUNTS RECEIVABLE. A tabulation is presented below of the results which were obtained from aging the accounts receivable.

REGULAR ACCOUNTS RECEIVABLE

Not due	\$2,875,210
Past due 1 to 30 days	282,391
Past due 31 to 60 days	27,844
Past due 61 to 90 days	15,665
Past due over 90 days	12,795
Total	\$3,213,905

INSTALLMENT ACCOUNTS RECEIVABLE

Not due	\$ 67,210
Past due 1 to 30 days	47,199
Past due 31 to 60 days	15,671
Past due 61 to 90 days	10,975
Past due over 90 days	6,020
Total	\$ 147,075

The examination which we made of the collection procedure indicates that a good follow-up system is being used.

The average collection period for your accounts receivable is as follows:

Regular Accounts	60 days
Installment Contracts	375 days

Below, a comparison is presented between the percentage which your accounts receivable (less reserve for bad debts) bears to the current assets (exclusive of marketable securities) and the corresponding percentages of other organizations.

	Per cent of accounts receivable to current assets
Buffalo Retail Corporation	55.1
St. Paul Dry Goods Co.	50.0
Bell Brothers	48.3
The Seattle Department Store	47.5
Tulsa Emporium	45.2
Billings & Watson, Inc.	40.0
Philadelphia Merchandise Co.	31.4
The Boston-Chicago Co.	26.7

The reserve for bad debts of \$84,079.64 appears to be adequate to take care of any losses which may be sustained from uncollectible accounts receivable. During the past five years, the net bad debts written off were:

	Amount	Per cent to sales
Current year	\$104,267	4.9
First preceding year	97,201	4.7
Second preceding year	90,555	4.5
Third preceding year	93,710	5.6
Fourth preceding year	87,500	5.3

INVENTORY. The inventory of each department was taken at retail price and then reduced to "cost or market, whichever is lower," by subtracting the gross profit (using percentages of record) from the retail value. We verified that the gross profit percentage figures used for inventory purposes were obtained in the proper manner. In the following table, a comparison is presented between the January 31 (year), inventory and the cost of sales (as shown by your records) for the last quarterly period of the year. The percentage figures in the right-hand column show the ratio of the last three months' cost of sales to the closing inventory. It will be noted that there are three departments in which the inventory exceeded the cost of sales for the quarter, thereby indicating the likelihood of an overstocked condition.

Department	Closing inventory	Fourth quarter cost of sales	Per cent of cost to inventory
A	\$ 100,000	\$ 100,000	100
B	37,050	33,345	90
C	25,010	35,014	140
D	10,200	11,220	110
E	110,450	112,659	102
F	250,200	132,176	88
G	95,000	71,250	75
H	37,110	46,387	125
I	244,444	317,777	130
J	78,210	78,210	100
K	125,000	137,500	110
L	137,000	137,000	100
M	422,953	888,201	210
N	42,330	59,262	140
O	58,920	80,720	137
P	160,210	205,068	128
Q	95,550	109,882	115
Total	<u>\$2,029,637</u>	<u>\$2,555,671</u>	

In the following table are presented figures which show the annual rate of turnover of the inventory (number of times that inventory is replaced in one year) in your store, together with the rates of

inventory turnover of several other representative stores. All other things being equal, a high rate of turnover is, of course, to be desired.

	Rate of turnover
Bell Brothers	8.10
The Boston-Chicago Co.	8.00
The Seattle Department Store	7.45
Philadelphia Merchandise Co.	7.05
Tulsa Emporium	6.80
Billings & Watson, Inc.	5.75
St. Paul Dry Goods Co.	4.75
Buffalo Retail Corporation	3.80

A list of the stock shortages at retail values (book inventory less physical inventory, both at retail value) is presented in the following table.

Department	Retail value of shortages	Per cent of shortages to sales
A	\$ 275	1.2
B	3,100	2.5
C	495	.7
D	875	.8
E	1,050	1.0
F	680	.2
G	3,780	2.2
H	6,410	3.0
I	180	.1
J	10	.0
K	1,200	1.2
L	800	.8
M	2,105	1.0
N	670	.4
O	800	.7
P	910	1.8
Q	47	.2
	<hr/>	<hr/>
Total	\$23,387	1.6
	<hr/> <hr/>	<hr/> <hr/>

Below, a comparison has been made between the percentage which your inventory bears to the current assets (exclusive of marketable securities) and the percentages of several other organizations.

The Seattle Department Store	29.0
Tulsa Emporium	27.5
St. Paul Dry Goods Co.	26.7
Bell Brothers	23.1
Billings & Watson	22.5

Buffalo Retail Corporation	20.0
The Boston-Chicago Co.	18.6
Philadelphia Merchandise Co.	15.2

INVESTMENT SECURITIES. All investment securities owned by the corporation were examined and found to correspond with those called for by the books. The income received on tax exempt bonds owned was at an average rate per annum of 6.2 per cent. In Exhibit A, Schedule I, is presented a list of bonds, together with the cash income received thereon, during the year. Income on bonds is not recorded on an accrual basis.

REAL ESTATE. An inspection of the county records showed that title to real estate carried on your books vests in The Seattle Dry Goods Corporation, the stock of which is all owned by The Seattle Department Store. No additions were made to the investment in real estate during the period covered by our audit. Land and buildings are carried on the books at cost, less depreciation. Provision has been made for depreciation on the basis of a 40-year life for buildings and a 10-year life for equipment. The depreciated value of the buildings at the close of the year was as follows:

	DESCRIPTION		
Buildings	Cost (A)	Depreciated value (B)	Ratio of (B) to (A) per cent
200 State Street	\$3,000,000.00	\$1,342,883.20	45
150 Main Street	820,000.00	246,000.00	30
20 Court Street	56,088.00	11,217.00	20
Totals	<u>\$3,876,088.00</u>	<u>\$1,600,100.20</u>	<u>41</u>

FURNITURE AND FIXTURES. Vouchers covering expenditures for additions to the furniture and fixtures accounts during the year ended January 31 (year) were examined and found to be in proper order. Furniture and fixtures are being depreciated on a ten-year life basis, and, at the date of the balance sheet, the depreciated value thereof was 87 per cent of the cost.

ACCOUNTS PAYABLE. The list of unpaid vouchers payable at the close of business on January 31 (year) amounted to \$601,337.10, which amount was in agreement with the general ledger Vouchers Payable controlling account. Because of the practice followed of

taking "anticipation" and paying creditors' invoices promptly, the total amount of unpaid vouchers is relatively small.

Unaudited invoices payable covering merchandise which had been received at the date of the balance sheet amounted to \$29,531.68, and are shown as a separate item among the liabilities.

BALANCE SHEET RATIOS. In the following table are set forth several balance sheet ratios for a five-year period, so that any significant trends may readily be observed.

	Current year	Preceding year	Next preceding year	Next preceding year	Next preceding year
Ratio of Current Assets to Current Liabilities	7.5 to 1	5.3 to 1	4.7 to 1	4.3 to 1	3.6 to 1
Ratio of Current Assets to Total Assets	1 to 2.1	1 to 2.5	1 to 2.5	1 to 2.2	1 to 2.6
Ratio of Net Worth to Total Assets	1 to 1.07	1 to 1.08	1 to 1.09	1 to 1.12	1 to 1.14
Ratio of Year's Profit to Capital at Beginning of Year, Per Cent	10.17	10.45	11.14	11.72	11.58
Book Value Per Share	\$207.00	\$189.00	\$168.00	\$153.00	\$130.00

INSURANCE COVERAGE. Lists showing the risks covered by insurance policies and the unexpired insurance premiums were obtained from your insurance agent, James M. Burt. We made a comparison of the list of risks covered with your insurance register and found them to be in agreement. Our examination of the policies showed that they were all on hand in the safe. All fire insurance policies contain the 90 per cent coinsurance clause.

In the following tabulation, a comparison is made between the amount of risks insured against fire (exclusive of motor vehicles) and the book value of the risks.

Risk	Coverage	Book value	Per cent of coverage to book value
Merchandise	\$1,827,000	\$2,029,637	90
Buildings	3,100,000	3,876,088	80
Furniture and fixtures	930,000	1,239,411	75

COMPARATIVE PROFIT AND LOSS STATEMENT. For the purpose of making comparisons between the operations of the current year and the preceding year, a comparative profit and loss statement, including percentages, is presented.

OPERATIONS. The operations for the year ended January 31 (year) are compared with those of the preceding year.

400 ILLUSTRATIVE REPORT—DEPT. STORE, ANNUAL AUDIT

	Year ended January 31			
	Current year	Per cent	Preceding year	Per cent
Net Income from Sales	\$20,901,219	100.00	\$20,291,055	100.00
Cost of Goods Sold	14,617,696	69.95	14,200,108	69.99
Gross Profit on Sales	\$ 6,283,523	30.05	\$ 6,090,947	30.01
Selling, Administrative and General Expenses	4,923,073	23.55	4,750,366	23.40
Operating Profit	\$ 1,360,450	6.50	\$ 1,340,581	6.61
Other Income	773,906	3.70	757,548	3.74
	\$ 2,134,356	10.20	\$ 2,098,129	10.35
Deductions from Income	373,887	1.78	456,911	2.25
Net Profit	\$ 1,760,469	8.42	\$ 1,641,218	8.10
Provision for Federal Income Taxes	233,830	1.10	221,615	1.09
Net Addition to Surplus for Year	\$ 1,526,639	7.32	\$ 1,419,603	7.01

The following table shows the amount of profit earned by each department (exclusive of leased departments) of the store and the ratio of the profit to the net sales.

Department	Profit	Per cent of profit to sales
A	\$ 36,251	5.2
B	49,721	3.5
C	138,888	6.2
D	16,210	4.7
E	136,000	7.7
F	72,050	4.2
G	118,210	10.2
H	31,500	1.1
I	17,225	2.2
J	64,529	3.7
K	197,024	8.2
L	125,077	14.7
M	66,666	6.8
N	131,222	9.2
O	67,777	10.1
P	82,100	4.3
Q	10,000	10.0
	\$1,360,450	6.5

MONTHLY VOLUME OF SALES. In the following tabulation the sales by months are shown, together with the average amount of sales per day for the number of days the store was open each month.

(Year)	Sales	Per day
February	\$ 1,110,000	\$ 44,400 *
March	3,978,225 *	159,129
April	1,671,200	66,848
May	1,720,620	68,825
June	1,325,000	53,000
July	1,041,275	65,651
August	975,840	39,033
September	1,500,075	60,003
October	1,875,000	75,000
November	1,900,665	76,026
December	2,110,170	84,406
January	1,840,270	73,610
	<hr/>	
Total	\$21,048,340	
	<hr/>	

* Anniversary sale.

OPERATING RATIOS. In order that the trend may readily be seen, several significant operating ratios, for the past five years, are presented.

	Current year	Preceding year	Next preceding year	Next preceding year	Next preceding year
Per Cent of Cost of Sales to Net Sales	69.9	70.1	70.2	70.4	70.6
Per Cent of Operating Profit (inclusive of discount on purchases) to Net Sales	9.2	9.4	9.8	10.7	10.6
Per Cent of Accounts Receivable at End of Year to Net Sales	16.1	15.5	14.8	13.2	12.2

The operating profit, inclusive of discounts on purchases, is compared with that of several other department stores.

	Per cent of operating profit (plus discounts received) to sales
The Seattle Department Store	9.21
Buffalo Retail Corporation	9.10
St. Paul Dry Goods Co.	8.75
Bell Brothers	6.30
Tulsa Emporium	5.80
Billings & Watson, Inc.	3.20
Philadelphia Merchandise Co.	2.75
The Boston-Chicago Co.	1.90

EXPENSE RATIOS. In the following table are presented the percentages which main classes of expense bear to the sales, compared

with the Harvard published expense ratios. It will be noted that the ratio of your advertising expense to sales is considerably lower than the corresponding Harvard figure. This condition of affairs leads us to the thought that consideration should be given to the advisability of increasing the budget for advertising.

	Seattle store per cent	Harvard statistics per cent
Salaries and Wages	17.89	16.20
Rentals (estimated)	2.75	3.50
Advertising	1.33	3.00
Taxes	.42	.30
Interest (estimated)	1.72	1.50
Supplies	.82	1.50
Service purchased	.29	.40
Unclassified	.60	1.20
Traveling	.09	.40
Communication	.10	.25
Repairs	.29	.40
Insurance	.09	.25
Depreciation		
Losses from Bad Debts	.36	.20
Other Depreciation	.57	.70
Professional Service	.15	.20
	<hr/>	<hr/>
Totals	27.47	30.00
	<hr/>	<hr/>

INDEPENDENT ACCOUNTANTS' CERTIFICATE

BROWN & WHITE
500 MADISON AVENUE
NEW YORK
CERTIFIED PUBLIC ACCOUNTANTS

We have examined the balance sheet of The Seattle Department Store as of January 31 (year) and the income and profit and loss statement for the fiscal year ended that date. Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances, and included such tests of the accounting records and other supporting evidence and such other procedures as we considered necessary.

In our opinion, the accompanying balance sheet and related statement of income and profit and loss fairly presents the position of The Seattle Department Store at January 31 (year) and the results of its operations for the fiscal year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Respectfully submitted,
BROWN & WHITE

APPENDIX A

STATEMENT ON AUDITING PROCEDURE ISSUED BY THE COMMITTEE ON AUDITING PROCEDURE OF AMERICAN INSTITUTE OF ACCOUNTANTS

The Revised S.E.C. Rule on "Accountants' Certificates"

The Committee states, after taking up the subject of accountants' certificates with the Securities and Exchange Commission, as follows:

The correspondence indicates that a certificate would be acceptable to the Commission in the normal case if it takes the following form:

We have examined the balance sheet of the XYZ Company as of (date), and the statements of income and surplus for the fiscal year then ended, have reviewed the system of internal control and the accounting procedures of the company and, without making a detailed audit of the transactions, have examined or tested accounting records of the company and other supporting evidence, by methods and to the extent we deemed appropriate. Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and included all procedures which we considered necessary.

In our opinion, the accompanying balance sheet and related statements of income and surplus present fairly the position of the XYZ Company at (date) and the results of its operations for the fiscal year, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

The foregoing accountants' certificate should, of course, be signed and dated.

APPENDIX B

BY-LAWS OF THE NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

Article XVIII. Rules of Professional Conduct

Membership in the Society implies that the member has assumed an obligation to be diligent in the performance of professional service, and fair and honest in relations with clients, fellow practitioners and the public, and has a proper appreciation of his duties to the community and state. In recognition thereof the Society has promulgated the following rules of professional conduct. The words "Member" or "Members of the Society" include associate members, unless otherwise indicated.

Rule 1. A member shall not render or undertake to render professional services on terms or under circumstances discreditable to the profession.

Rule 2. The designation, "Member of the New York State Society of Certified Public Accountants," may be used by an individual practicing in his own name who is a member of the Society. An associate member shall not refer to himself as a member without the definitive adjective "Associate" and shall not indicate his associate membership on letterheads or printed matter of any kind. The term "member" as used in this rule is restricted to members of the Society and does not include associate members. A firm or partnership, all of whose partners are members of the Society, may describe itself as "Members of the New York State Society of Certified Public Accountants."

Rule 3. A member shall not allow any person to practice in his name who is not in partnership with him or in his employ.

Rule 4. A member shall not submit in his name a report on an examination of financial statements, unless the examination of such statements and the related records have been made by him, a partner in, or an employee of his firm, a certified public accountant of a state or territory of the United States or the District of Columbia, or the holder of an equivalent certificate issued by the proper authorities of another country.

Rule 5. In expressing an opinion on representations in financial statements which he has examined, a member shall 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 statements; or

(c) He is grossly 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 negate 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.

Rule 6. 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.

Rule 7. A member shall not express his opinion on financial statements of an enterprise financed in whole or in part by a public distribution of securities, or on financial statements for use as a basis of credit, if he, a partner in his firm, or a member of his immediate family owns or is committed to acquire a substantial interest in the enterprise, or if he or a partner in his firm is an employee or director of the enterprise, unless he discloses such interest, employment or directorship in his report.

Rule 8. The relationship between a member and his client is confidential in character and, therefore, except as required by law he shall not disclose information acquired in the course of a professional engagement to anyone except his client without the consent of his client.

Rule 9. A member shall not directly or indirectly solicit the clients of another public accountant, but may furnish service to those who request it.

Rule 10. A member shall not advertise his professional attainments or services. The publication of what is technically known as a card is restricted to an announcement of the name, title (C.P.A., member of The New York State Society of Certified Public Accountants, or other professional affiliation or designation), class of service, and address of the person or firm, issued in connection with a change of address or personnel, and shall not exceed two columns in width and three inches in depth if appearing in a newspaper, and not exceed one-quarter of a page if appearing in a magazine or similar publication. This rule

shall not be construed to prohibit the dignified dissemination by letter, or by printed article, of impersonal information of an educational character without solicitation of professional practice.

Rule 11. A member shall not directly or indirectly pay or allow, or agree to pay or allow, to the laity a commission, brokerage, or other participation in the fees or profits of his professional services.

Rule 12. A member shall not accept directly or indirectly from the laity any commission, brokerage or other participation in professional or commercial business referred to others as an incident to his services to clients, except it be for the benefit of such clients and be credited or paid to them.

Rule 13. A member shall not be an officer, director, stockholder, representative or agent of any corporation engaged in the public practice of accountancy.

Rule 14. A member shall not engage in any other business or occupation conjointly with that of his professional practice in such a manner as would be incompatible or inconsistent therewith. A member engaged in another profession or occupation shall conduct himself in a manner creditable to his standing as a member of this Society.

Rule 15. A member shall not directly or indirectly offer employment to an employee of another accountant without first informing such accountant of his intent. This rule shall not be construed so as to prohibit negotiations with anyone who, of his own initiative or in response to public advertisement, shall apply to a member for employment.

Rule 16. A member shall not take part in any effort to secure the enactment or amendment of any State or Federal law or of any regulation of any governmental or civic body regulating the practice of the profession, without giving prior notice thereof to the Secretary of the Society.

The foregoing rules do not comprise all acts that may be considered incompatible with the obligations and responsibilities imposed by professional status and by membership in the Society or discreditable or harmful even though not specifically mentioned or described in the above rules. Under the general provisions of the By-laws any member may be censured, suspended or expelled for cause by the Board of Directors, after due opportunity of a hearing upon charges preferred against him whether or not the alleged misconduct is specifically enumerated or described in the foregoing rules.

APPENDIX C

AMERICAN INSTITUTE OF ACCOUNTANTS

Rules of Professional Conduct

(As revised January 10, 1944)

(These rules of conduct supplement the disciplinary clauses of the by-laws.)

1. A firm or partnership, all the individual members of which are members of the Institute (or in part members and in part associates, provided all the members of the firm are either members or associates), may describe itself as "Members of the American Institute of Accountants," but a firm or partnership, not all the individual members of which are members of the Institute (or in part members and in part associates), or an individual practicing under a style denoting a partnership when in fact there be no partner or partners, or a corporation, or an individual or individuals practicing under a style denoting a corporate organization shall not use the designation "Members (or Associates) of the American Institute of Accountants."

2. A member or an associate 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 or profits of professional work shall not be allowed directly or indirectly to the laity by a member or an associate.

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

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

5. In expressing an opinion on representations in financial statements which he has examined, a member or an associate shall 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 grossly 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 or an associate 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, a member or an employee of his firm, a member or an associate 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 the District of Columbia.

7. A member or an associate shall not directly or indirectly solicit the clients or encroach upon the practice of another public accountant, but it is the right of any member or associate to give proper service and advice to those asking such service or advice.

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

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 authorities 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.

10. A member or an associate shall not advertise his professional attainments or services. The publication of what is technically known as a card is restricted to an announcement of the name, title (member of American Institute of Accountants, C.P.A., or other professional affiliation or designation), class of service, and address of the person or firm, issued in connection with the announcement of change of address or personnel of firm, and shall not exceed two columns in width and three inches in depth if appearing in a newspaper, and not exceed

one-quarter of a page if appearing in a magazine, directory, or similar publication.

11. A member or an associate shall not be an officer, director, stockholder, representative or agent of any corporation engaged in the practice of public accounting in any state or territory of the United States or the District of Columbia.

12. A member or an associate 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 or associate vouches for the accuracy of the forecast.

13. A member or an associate shall not express his opinion on financial statements of any 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 to 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 or an associate shall not express his opinion on financial statements which are used as a 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 to 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.

14. A member or an associate 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 or an associate of the American Institute of Accountants engaged simultaneously in the practice of public accounting and in another occupation must in both capacities observe the by-laws and rules of professional conduct of the Institute.

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

APPENDIX D

GENERAL REVIEW QUESTIONS

At the suggestion of the editor-in-chief of the Wiley Accounting Series, Professor Hiram T. Scovill, the author has prepared a number of auditing review problems, based upon practical experience. Inasmuch as review questions were included at the end of each chapter, these supplementary problems have not been identified with the respective chapters. They will furnish an indication of the type of problem which an auditor encounters daily in connection with his work.

1. What purpose is served by making an investigation of a company's internal control situation before beginning an audit?
2. Distinguish between a general examination of accounts and a detailed audit.
3. Where would one look, in an independent accountant's office, for information regarding the scope of the audit to be made for a particular client?
4. Outline a method for filing the confirmations of accounts received by an independent accountant in connection with an audit.
5. Revise the current assets and current liabilities sections of the balance sheet presented in Form 1.
6. Draft the journal entry required to correct the situation presented in Form 2.
7. What action should the independent accountant take with respect to the accounts presented in Form 3?
8. Comment upon the state of affairs presented in Form 4.
9. Give additional illustrations, which might arise, of the general nature of the problem presented in Form 5.
10. What action would you take if you discovered that the company's cashier was the treasurer of the Employees' Athletic Fund, which fund was not carried on the company's books?
11. What action would you take if you discovered the following ledger entries, indicated by the letter "a," posted in the client's general ledger without any reference to the source from which posted?

LOANS RECEIVABLE

March 31	1,500	June 30	(a) 1,500
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RESERVE FOR BAD DEBTS

June 30	(a) 1,500	June 30 Balance	127,275
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12. What procedure should be followed by an independent accountant in order to provide for the detection of such a situation as the one illustrated in Form 6?

13. Have you any criticism to offer with respect to the cash book entry presented herewith?

Cash		12,000
Surplus		12,000
Refund of prior year's taxes	11,250	
Interest on above	950	
	<hr/>	
Total	12,200	
	<hr/> <hr/>	

14. Draft the journal entry required to correct the situation presented in Form 13. What action would you take?

15. Criticise the entry shown below.

Investment Securities	5,500	
Interest Income		5,500

Entry to record interest carrying charge on the company's investment securities for the year ended December 31 (year).

16. Draft the adjustment journal entry required to correct the entries presented in Form 14.

17. Discuss the situation illustrated in Form 15.

18. Explain what adjustments are required to correct the accounts presented in Form 16.

19. Draft the journal entry required to correct the record presented in Form 17—Parts 1 and 2.

20. Would you conclude that the cash receipts book was correctly added when the company makes a practice of depositing all cash receipts intact and, throughout the current year, the receipts per cash book corresponded exactly with those per bank statements?

21. Discuss the use of a "proof of cash statement" in the detection of errors, as disclosed in Form 19.

22. Comment upon the significance of compensating errors, such as illustrated in Form 20.

23. What procedure would you follow if you found several postdated checks in the company's petty cash imprest fund?

24. What action should an independent accountant take when a condition of affairs, such as that illustrated in Form 22, is encountered?

25. What procedure would you follow if your count of the company's \$1,500 imprest cash fund revealed a shortage of \$400?

26. What action would you take with respect to the following reconciliation statement which was prepared by yourself?

APPENDIX D

THE BLANK COMPANY
IMPREST CASH FUND COUNT

December 31 (year)

Imprest Cash Fund		\$5,000
Add: Cash received from cash sales		1,400

Total Cash, per count		\$6,400
Less: Loans to employees		
A. Brown	\$1,000	
F. Green	400	1,400
	_____	_____
Remainder		\$5,000

27. Why should auditors not countenance situations such as illustrated in Form 25?

28. What procedure would you follow if the company's cashier was absent, at the time you made the cash count, and you were unable to examine the cash fund?

29. What action should the independent accountant take with respect to the condition revealed by the following bank reconciliation?

BANK RECONCILIATION

(Year)

December 31	Balance Per Bank Confirmation	\$ 40,750
	Add: Deposits of customers' remittances entered in cash book but not credited by bank until January 7 of following year	60,100

(Year)

December 31	Balance Per Cash Book	\$100,850

30. Comment upon the following situation:

BANK RECONCILIATION

(Year)

June 30	Cash Per Bank Confirmation	\$375,000
	Less: Outstanding checks	190,000

	Remainder	\$185,000

Add: United States bonds forwarded to bank for collection

100,000

(Year)

June 30	Balance Per Cash Book	\$285,000

31. Describe the procedure which you would follow in the case presented below.

BANK RECONCILIATION

(Year)		
December 31	Balance Per Bank Confirmation	\$175,200
	Less: Outstanding checks—The Onyx Land Co. (undeposited at balance sheet date and still undeposited, two months later, by payee)	30,000

(Year)		
December 31	Balance Per Cash Book	<u>\$145,200</u>

32. What action should an auditor take upon coming across a condition such as that illustrated in Form 26?

33. Comment upon the following circumstances. Upon making a second bank reconciliation statement, as of December 31 (year), of the account with the Hudson National Bank, a check dated December 31 (year) turned up that did not appear in the list of outstanding checks in the first bank reconciliation statement.

34. What audit procedure should be followed in order to detect such a situation as the one presented in Form 28?

35. What action would you take if a bank confirmation letter mentioned the existence of a "special" bank account with a \$15,000 balance that was not carried on the company's books?

36. Draft the journal entry required to correct the records presented in Form 29—Parts 1, 2, and 3.

37. How would you present the two following accounts on a balance sheet?

Cash on deposit in Bank A	\$275,000
Cash overdraft on Bank B	\$ 16,000

38. What significance do you attribute to the situation revealed by the following account?

CASH IN BANK

		(Year)
December 31	Balance	17,505

39. You are offered a certificate by the attorney of the company under audit, to the effect that he has the custody of the company's \$100,000 of United States Treasury 2½ per cent bonds. Should you accept the attorney's certificate in lieu of making a physical examination of the company's bonds?

40. What inference would you draw from the situation presented in the following two accounts?

ACCOUNT—MORTGAGE INVESTMENTS

Date	Charge	Date	Credit

ACCOUNT—INTEREST RECEIVED ON MORTGAGES

Date	Charge	Date	Credit
		(Year)	
		January 2	45 Main St. 2,000
		July 1	45 Main St. 2,000

41. Criticise the following entry.

CASH BOOK ENTRY

Cash	1,000	
Investments—Bonds		1,000
Interest received on bonds bought "flat" at time purchased.		

42. Comment on the propriety of the following entry.

United States Bond Investments	250	
Interest Earned		250

Entry to charge former account for increase in the surrender value of the Company's U. S. Bonds.

43. Comment on the following cash book entry.

Cash	600	
Investments—Stocks		600

Entry to record receipt on April 5 (year) of first quarterly dividend on the A. B. Co., Inc., stock.

44. Comment upon the following method of presenting bond investments in a company's balance sheet.

Bonds (market value \$98,000) at cost	\$100,000
---------------------------------------	-----------

45. Does the keeping of books on the "accrual basis" necessitate that interest on bond investments, which are in default, be accrued?

46. Comment upon the propriety of the following entry which records the earnings of subsidiaries.

Investments in Subsidiaries	10,725	
Income Earned by Subsidiaries		10,725

Entry to record income earned by subsidiary corporations during the year ended December 31 (year).

47. Why is it desirable to confirm the collateral held as security for notes receivable?

48. What action should be taken by the independent accountant upon discovering a condition such as the one presented in Form 35?

49. What procedure would you follow, upon discovering that customers' notes receivable on hand at the balance sheet date had not been removed from the accounts receivable?

50. What procedure would you follow with respect to the ledger entries which are shown below and which were not posted from any medium?

Allowances	451	
Accounts Receivable		451

51. Comment upon the following entry as revealed by the cash book.

Cash	10,050	
Accounts Receivable		10,050

Entry to record remittances received from foreign customers after the balance sheet date, but bearing dates prior thereto.

52. What treatment would you accord to a company's accounts receivable when the trial balance of the customers' ledger showed the following?

Debit balances	\$17,250,110	
Credit balances		1,125,000

Remainder		\$16,125,110

53. Should an independent accountant express an opinion, in his working papers, regarding the adequacy of the reserve for bad debts?

54. What procedure should an auditor follow upon discovering a situation such as the one presented in Form 38?

55. Upon being requested by a client not to confirm the accounts receivable by circularization of customers who had paid their bills at the time of the audit, on the ground that the receipt of the cash is an acknowledgment of the debts, what procedure would you follow?

56. What adjustment entry is required to correct the account shown in Form 39?

57. What procedure should an independent accountant follow upon coming across a condition such as that revealed in Form 40?

58. What criticism have you to offer regarding the following comment in an auditor's report?

"A reserve for bad debts has not been provided, inasmuch as the company follows the practice of writing off uncollectible accounts as they occur."

59. What action would you take, upon finding the following entry on the books which you are auditing?

Accounts Receivable	105,750	
Sales		105,750

Entry to record sales to customers on orders received prior to the balance sheet date, but not shipped until after the balance sheet date.

60. What treatment would you accord the following account, upon analyzing the accounts receivable?

ACCOUNT RECEIVABLE—CUSTOMER A

<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 10%;">(Year)</td> <td style="width: 80%;"></td> <td style="width: 10%;"></td> </tr> <tr> <td>February 10</td> <td>Mdse.</td> <td style="text-align: right;">1,200</td> </tr> <tr> <td>(Year)</td> <td></td> <td></td> </tr> <tr> <td>May 20</td> <td>Returned bank check stamped, "N.S.F."</td> <td style="text-align: right;">1,200</td> </tr> </table>	(Year)			February 10	Mdse.	1,200	(Year)			May 20	Returned bank check stamped, "N.S.F."	1,200	}	<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 10%;">(Year)</td> <td style="width: 80%;"></td> <td style="width: 10%;"></td> </tr> <tr> <td>May 15</td> <td>Cash</td> <td style="text-align: right;">1,200</td> </tr> </table>	(Year)			May 15	Cash	1,200
(Year)																				
February 10	Mdse.	1,200																		
(Year)																				
May 20	Returned bank check stamped, "N.S.F."	1,200																		
(Year)																				
May 15	Cash	1,200																		

61. Comment upon the situation revealed in Form 42.

62. What action should an independent accountant take upon discovering that the Accounts Receivable account had been brought into agreement with the trial balance of the accounts receivable ledger in the manner indicated below?

RESERVE FOR BAD DEBTS ACCOUNT

<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 10%;">Current Year</td> <td style="width: 80%;"></td> <td style="width: 10%;"></td> </tr> <tr> <td>December 31</td> <td>Write-down of control to agree with detail</td> <td style="text-align: right;">62,000</td> </tr> <tr> <td>December 31</td> <td>Balance</td> <td style="text-align: right;">113,000</td> </tr> <tr> <td></td> <td></td> <td style="text-align: right; border-top: 1px solid black;">175,000</td> </tr> </table>	Current Year			December 31	Write-down of control to agree with detail	62,000	December 31	Balance	113,000			175,000	}	<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 10%;">Preceding Year</td> <td style="width: 80%;"></td> <td style="width: 10%;"></td> </tr> <tr> <td>December 31</td> <td>Balance</td> <td style="text-align: right;">175,000</td> </tr> <tr> <td></td> <td></td> <td style="text-align: right; border-top: 1px solid black; border-bottom: 3px double black;">175,000</td> </tr> </table>	Preceding Year			December 31	Balance	175,000			175,000
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		175,000																					
Preceding Year																							
December 31	Balance	175,000																					
		175,000																					

63. Give your views on the detection of lapping as illustrated in Form 44.

64. Draw up a program to be followed in observing the taking of a physical inventory by a company's employees.

65. What are some of the requisites to the acceptance of a book inventory in place of a physical inventory?

66. What action would you take upon discovering that the company's "physical inventory" was taken one month before the balance sheet date, after which purchases were added and sales (at cost) deducted up to the balance sheet date?

67. What adjustment, if any, would you make upon discovering that there were on hand \$50,000 of unentered purchase invoices which bear dates prior to the balance sheet date, the goods having been bought F. O. B. point of shipment?

68. At what prices should the following items, of the company's own product, be inventoried? The company's selling overhead is 20 per cent of its sales.

	Cost Price	Selling Price
Article A	\$1.00	\$2.00
Article B	1.50	2.00
Article C	2.00	2.00
Article D	2.25	2.00
Article E	2.25	2.75
Article F	2.75	3.50

69. Would you expect the manufacturing cost price to be higher in (a) an owned factory or (b) a rented factory?

70. Comment upon the following inventory situation in a book publishing company.

Title of Book	On Hand End of Year	Sales for Year
A	40,000	125,000
B	2,000	None
C	35,000	6,000
D	6,000	10,000
E	7,000	25

71. Comment on use in the December 31 (current year) inventory of the price of \$1.00, in view of the basis stated to be employed in inventory valuation of, "lower of cost or market."

ARTICLE BX

March 31 (preceding year)	Cost price	\$1.00 each
December 31 (preceding year)	Market price	0.80 each
December 31 (preceding year)	Inventory price	0.80 each
December 31 (current year)	Market price	1.10 each
December 31 (current year)	Inventory price	1.00 each

72. What are the main objections to including an interest carrying charge in inventories, as shown in Form 50?

73. Does the following reserve account reflect generally accepted accounting practice?

RESERVE FOR INVENTORY WRITE-DOWN

	(Year)	
	December 31	J-100 7,500

74. Comment upon the propriety of the following entry.

Raw Materials Inventory	500	
Shipping Supplies Inventory	100	
Cash		600

Cost of 100 barrels of sugar (value of barrels, for shipping out products, \$1.00 each).

75. What procedure would you follow upon finding that the company's receiving book showed the receipt of a carload of pigs of lead on December 31 (year), but that the pig lead had been omitted from the December 31 (year) inventory?

76. Where are supplies inventories generally placed upon a balance sheet?

77. Have you any criticism of the accounting practice followed where an analysis of the Land account, covering unimproved land held for future development, was as follows.

Cost	\$200,000
Property Taxes	25,000
	<hr/>
Total	<u>\$225,000</u>

78. Have you any criticism to offer when a company records lots, in a subdivision property, repossessed for nonpayment of installments due thereon, at the amounts of the unpaid balances due on the respective lots?

79. What correction should be made with respect to entry J-77 in Form 52?

80. Comment upon the following entry.

Depletion Cost of Timber	450,000	
Revaluation of Land Surplus	100,000	
Land		550,000

Removal of Timber from Land.

81. Give your views regarding the entry shown below.

Reserve for Depreciation of Motor Trucks	1,000	
Cash		1,000

Charging former account for cost of rebuilding five-ton truck.

82. What reply would you make to the manager of a company who represented that liberal expenditures for maintenance and repairs compensated for depreciation, as illustrated in Form 54?

83. Would you take any exception to the following entry?

Machinery	100	
Factory Overhead		100

Entry to charge former account with expense incurred in the installation of new flat-bed printing press, #7.

84. Under what conditions are building repairs a capital expenditure? See Form 57.

85. What action would you take where there had been no change in the Patents account, with a balance of \$500,000, for the past five years?

86. Comment upon the following cash book entry presented herewith.

Machinery	1,100	
Cash		1,100

Payment of use tax on purchase of new machine from out of state.

87. Give your views upon the situation revealed below, in view of the explanation offered that an appraisal by the company's officers showed a value of \$4,940,100, as of December 31 (year), for the company's machinery and equipment.

ACCOUNT MACHINERY AND EQUIPMENT

(Year)			(Year)		
December 31	Balance	4,775,100	December 31	Balance	4,940,100
December 31	P. & L.	165,000			
December 31	Total per appraisal	<u>4,940,100</u>	December 31	Total	<u>4,940,100</u>

88. Do you think that any adjustment is in order with respect to the following cash book entry?

Machinery	12,000	
Cash		11,880
Discount Earned		120

Record of purchase of new printing press.

89. Criticise the following entry.

Leaseholds	500,000	
Miscellaneous Income		500,000

Entry to record the appraised value of the company's real estate leases.

90. Give your views regarding the propriety of the following entry.

December 31 (current year)

Prepaid Advertising	5,000	
Cash		5,000

Entry charging former account for cost of advertisements to appear in January issues of magazines in following year.

91. What action would you take, when preparing the June 30 (year) balance sheet, in view of the state of affairs revealed by the following account with the company's president?

ACCOUNT—LOAN RECEIVABLE FROM P. HOE, PRESIDENT

(Year)		(Year)			
June 30	Balance	10,000	June 30	C.R.-70	10,000
(Following Year)					
July 1	C.D.-1	10,000			

92. Comment upon the appropriateness of the following entry.

Deferred Selling Expense	27,500	
Selling Expense		27,500

Entry to record the selling expense which is applicable to unshipped orders on hand, December 31 (year).

93. A client asks you not to confirm certain loan receivable accounts on the ground that they are "confidential." What course of action would you follow?

94. Which of the following two methods of presenting life insurance cash surrender values do you prefer?

(a)

Cash Surrender Value of Life Insurance	75,000
Less: Loan Payable to Life Insurance Company	70,000
	<u>5,000</u>

(b)

Asset		Liability
Cash Surrender Value of Life Insurance	75,000	Loan Payable to Life Insurance Company
		70,000

95. Is it ever permissible to present life insurance premiums at cost, as illustrated in the balance sheet shown in Form 61?

96. What comment have you to make on the following balance sheet footnote?

"The cash surrender value of the life insurance policy on the Corporation's president is not carried on the books and is not shown on the balance sheet."

97. What is the objection to the understatement of a company's current liabilities as set forth in Form 62?

98. What is the general accounting principle embodied in the illustration shown in Form 67?

99. Indicate the proper entry to make where the examination of cash disbursements subsequent to the balance sheet date revealed that there were \$12,500 of unentered bills, as of the balance sheet date, for Christmas presents for employees.

100. What procedure would you follow where the minutes of the company's board of directors authorized a salary of \$100,000 a year for the company's president, but where he had not drawn any salary for the year?

101. Why are notes receivable discounted at the balance sheet date generally regarded as a contingent liability?

102. Give the proper adjustment entry where the circularization of a company's creditors brought to light an unpaid balance of \$1,800 for office equipment which was being purchased on the installment plan at the rate of \$300 a month.

103. Comment upon the following entry.

Mortgage Payable	200,000	
Cash		150,000
Real Estate		50,000

Payment of matured mortgage at a 25 per cent discount, allowed on account of shrinkage in value of property.

104. What audit procedure would you follow with respect to a company's bonds that had matured during the period covered by the audit?

105. Explain the audit procedure that ought to be followed where interest payments of \$2,500 quarterly have been made on an unrecorded mortgage payable.

106. What adjustment entry is in order with respect to the following cash book entry, recording the prepayment by a subscriber of a year's subscription?

Cash	3.00	
Magazine Subscriptions Income		3.00

107. What adjustment is required, if any, to correct the situation presented in the following cash book entry?

Cash	15,000	
Reserve for Depreciation of Buildings		15,000

Proceeds from sale of a fully depreciated building.

108. Give your views regarding the following cash book entry.

Motor Trucks	24,000	
Cash		20,000
Reserve for Repairs		4,000

109. What procedure should be followed when the final Federal income tax payment amounted to \$120,000 less than the accrual which was originally provided for same, and the taxpayer had credited the amount above mentioned to the Reserve for Contingencies account?

110. Comment upon the following excerpt from the letter of the president of the A Corporation to stockholders.

"A provision has been made of a reserve of \$1,000,000 out of current earnings to take care of obligations which may have existed at the balance sheet date but which were not known to exist then."

111. What significance would you attach to the situation where the bank confirmation states that the company has outstanding \$25,000 of unused commercial letters of credit as of the balance sheet date?

112. What is the objection to mixed accounts such as the one shown in Form 68?

113. What action would you take where an appraisal showed that the company's buildings which are carried on the books at a net value of \$200,000 have an actual value of \$1,000,000?

114. Draft the adjustment journal entry to correct the records shown in Form 70.

115. Suggest several situations where a reserve for contingencies is required such as shown in Form 73.

116. What adjustment journal entry is required in order to correct the condition shown in Form 75?

117. Criticize the two following entries.

JOURNAL, JUNE 15 (YEAR)

Treasury Stock	100,000	
Capital Stock		100,000

CASH BOOK, JUNE 20 (YEAR)

Cash	50,000	
Treasury Stock		50,000

118. Criticize the following transaction.

Surplus	1,000	
Cash		1,000

Entry to record invoice for purchase of materials received prior to the balance sheet date but omitted from the previous year's purchase journal.

119. Give your views on the propriety of the transaction presented below.

Goodwill	100,000	
Surplus		100,000

Entry to record the value of the company's goodwill as per action of the Board of Directors.

120. What exception, if any, would you take in the following entry?

Cash	6,000	
Surplus		6,000

Proceeds from sale of marble statue not carried on the books.

121. Discuss the situation presented in Form 76.

122. What is the reason for mentioning, in a footnote to a balance sheet, the amount of dividends in arrears, if any, on a company's preferred stock?

123. Give your definition of "ultra vires" as used in the illustration presented in Form 79?

124. Comment upon the following entry.

Surplus	13,500	
Cash		13,500

Nonrecurring charge, as the result of fire loss.

125. Criticize the following cash book entry.

Surplus	12,500	
Cash		12,500

Prior period invoice for fuel.

126. What action would you take, upon coming across a cash book entry showing the payment of a dividend to stockholders, when the corporation's minute book did not mention the declaration of the dividend?

127. What is the objection to the inflation of its financial condition, by a company, as illustrated in Form 81?

128. Comment upon the following journal entry.

Reserve for Bad Debts	50,000	
Sales		50,000
Reduction in reserve for bad debts ascertained to be in excess of requirements.		

129. What means may be employed in order to secure an internal check on the revenue from dues in a membership organization?

130. What entry is in order where a building contractor subscribed \$5,000 towards the construction of a hospital and then allowed his subscription to be deducted by the hospital from the last payment made to him for construction work done?

131. Criticize the following cash book entry.

Cash	1,000	
Sales of Securities		1,000
Receipts from sale of 1,000 rights to subscribe, at par, for an equal number of shares of Acme Co., Inc. stock.		

132. Comment upon the propriety of the following journal entry.

Investment Securities	10,750	
Dividends Received		10,750
Entry to record market value of 1,000 shares received as a stock dividend on 10,000 shares of the Hunt Co., Inc., stock owned.		

133. What attitude would you take towards the following situation? Goods entered in the company's receiving book under date of December 30 (current year), but not entered in the company's purchase journal until January 2 (following year).

134. Discuss the following entry.

Purchases	4,475	
Installment Contracts Receivable		4,475
Entry to record the repossession, by foreclosure, of merchandise from customers who were in arrears in their payments.		

135. If a 10,000 pound lot of raw Australian wool costing \$0.50 per lb. is sorted according to the various qualities of yarn that it will make, and it is found that 5,000 lbs. will make yarn selling for \$0.60, 3,000 lbs. selling for \$0.80, and 2,000 lb. selling for \$1.00 a pound, what cost prices would you assign to each of the three grades of wool?

136. Which of the two following entries do you regard as preferable where goods are purchased in a foreign market with fluctuating exchange rates?

Accounts Payable	10,000	
Cash		9,000
Gain on Foreign Exchange		1,000

or

Accounts Payable	10,000	
Cash		9,000
Purchases		1,000

137. What action would you take, in the preparation of a balance sheet, where the following situation was encountered?

CONTRACT FOR THE FUTURE DELIVERY OF 10,000 UNITS OF ARTICLE A

Market Price Per Unit (at balance sheet date)	\$1.00
Contract Price Per Unit	\$1.10

138. What inquiries would you make if you found, in a small organization that you are auditing, the following condition of affairs?

	Employees	Sales
Current year	40	\$102,000
First preceding year	35	105,000
Second preceding year	34	100,000

139. What procedure would you follow, when conducting a pay-off of employees, when you have left over a dozen uncalled-for pay envelopes?

140. Comment upon the situation presented in Form 95.

141. Give your views on the following entry.

Fuel Expense	1,500	
Raw Materials		1,500

Entry to charge former account for value of reclaimed
cocoanut shells burned for fuel.

142. What conclusion would you draw regarding the current year's inventory turnover rates, from the following data?

	Turnover Rate
Current year	4
First preceding year	5
Second preceding year	5

143. Give your opinion regarding the current year's average collection period, after giving due consideration to the following rates.

	Average Collection Period
Current year	100 days
First preceding year	90 days
Second preceding year	91 days

144. What inference would you draw regarding the current year's gross profit percentages, from the following data?

Current year	60%
First preceding year	50%
Second preceding year	50%

145. Discuss the situation with respect to balance sheet footnotes as presented in Forms 98 and 99.

146. Would the refusal by the client to submit the minute book for examination necessitate a qualifying statement in the independent accountant's certificate?

147. What is generally claimed to be the main benefit derived from comparative financial statements?

148. Make use of the following data and draw two curves, on cross-section paper, showing the monthly sales and monthly profit or loss on the operations of the ZZ silk throwing mill. Indicate the "break even" point in the company's operations.

Month	Sales	Profit (Loss)
January	\$65,000	\$26,000
February	64,000	25,000
March	62,000	20,000
April	58,000	12,000
May	54,000	0
June	50,000	(10,000)
July	49,000	(9,000)
August	56,000	2,000
September	60,000	13,000
October	64,000	20,000
November	66,000	24,000
December	68,000	27,000

149. Make use of the following data and draw lines showing the sales, and cost of sales together with expenses, on semi-logarithmically ruled paper. What were the annual rates of increase indicated by the two lines?

THE XT DRY GOODS Co.

Year	Sales	Cost of Sales and Expenses
First	\$100,000	\$100,000
Second	120,000	115,000
Third	144,000	132,000
Fourth	173,000	152,000
Fifth	207,000	175,000
Sixth	249,000	201,000
Seventh	299,000	231,000
Eighth	358,000	266,000
Ninth	430,000	306,000
Tenth	516,000	352,000

150. Revise the following balance sheet of The A. B. Co., Inc. (as prepared by the company), so as to give effect to the accompanying auditor's notes.

THE A. B. CO., INC.

BALANCE SHEET (as prepared by company)

As of December 31 (year)

Assets

CURRENT ASSETS

Cash	\$ 175,000
Notes Receivable (customers)	30,700
Accounts Receivable	375,000
Inventory (at lower of cost or market)	410,000
Investments (at cost)	1,000,000

Total	\$1,990,700
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Furniture, Fixtures, and Machinery, less \$200,500 reserve for depreciation	801,500
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Total	\$2,792,200
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Liabilities and Capital

CURRENT LIABILITIES

Notes Payable	\$ 100,000
Accounts Payable	375,000
Accruals Payable	180,500

Total	\$ 655,500
-------	------------

CAPITAL

Capital Stock—20,000 shares of no-par value, issued and outstanding; stated value \$100 per share	\$2,000,000
Surplus	136,700

Total Capital	2,136,700
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Total	\$2,792,200
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Auditor's notes.

(1) Cash includes \$80,750 received subsequent to the balance sheet date (owing to having kept the cash receipts book open for a week after the balance sheet date).

(2) No reserve for bad debts has been provided by the company, although the bad debt losses have averaged 1 per cent of the sales for several years past.

(3) Included in the inventory are \$90,000 of articles at cost price, the market value of which was \$65,000 at the balance sheet date.

(4) Investments account includes \$250,000 of marketable bonds at cost prices, while the market value of the bonds at the balance sheet date was \$175,000.

(5) A proposed \$20,000 assessment of federal income taxes for prior years which had been consented to by the company had not been entered on the books or shown on the balance sheet.

(6) One thousand shares of the company's no-par-value capital stock have been set aside for sale to employees at \$50 a share.

151. Revise the statement of income of The C. D. Company (as prepared by the company) so as to give effect to the accompanying auditor's notes.

THE C. D. COMPANY (A PARTNERSHIP)	
STATEMENT OF INCOME (as prepared by company)	
For year ended December 31 (year)	
Sales	\$750,000
Less: Returns and Allowances	85,000
	<hr/>
Net Sales	\$665,000
Cost of Sales	410,000
	<hr/>
Gross Profit	\$255,000
Selling Expenses (Schedule 1)	195,000
	<hr/>
Net Operating Profit	\$ 60,000
Less: Interest Expense	10,000
	<hr/>
Net Income	<u>\$ 50,000</u>

SCHEDULE 1, SELLING EXPENSES

Commissions	\$145,000
Salaries	30,000
Rent	13,000
Taxes	2,000
Supplies	1,500
Miscellaneous Expenses	3,500
	<hr/>
Total	<u>\$195,000</u>

Auditor's notes.

(1) The partnership's sales for the year are overstated \$65,000, owing to the sales book having been kept open for a week subsequent to the balance sheet date.

(2) Twelve thousand dollars of goods returned by customers prior to the balance sheet date had not been recorded on the books and were not shown on the partnership's statement of income.

(3) The current year's unincorporated New York State business tax of \$2,500 is not shown.

(4) The rent expense includes a prepayment of \$1,000.

(5) Salaries include partners' drawings of \$15,000 (C. \$7,500; D. \$7,500).

(6) Interest expense includes \$6,000 payments of interest to partners on their capital (C. \$3,000; D. \$3,000).

(7) The partnership agreement provides that capital contributions shall be equal for partners C. and D. and that profits are to be shared equally.

152. Revise the statement of income and surplus of The E. F. Co., Inc. (as prepared by the company), after giving due consideration to the accompanying independent accountant's analysis of the company's surplus account.

THE E. F. CO., INC.

STATEMENT OF INCOME AND SURPLUS

For year ended December 31 (year)

Net Sales	\$750,000
Less: Cost of Sales	480,000
	<hr/>
Gross Profit	\$270,000
Selling Expense	93,000
	<hr/>
Operating Profit	\$177,000
Interest Paid	12,000
	<hr/>
Net Profit, carried to surplus	\$165,000
Credits to Surplus	6,500
	<hr/>
Total	\$171,500
Charges to Surplus	147,000
	<hr/>
Surplus, December 31 (year)	<u>\$ 24,500</u>

Independent accountant's analysis of Surplus account of The E. F. Co., Inc.

CREDITS

Profit for current year	\$165,000
Profit on sale @ \$12 per share of 1,000 shares of the company's own \$10 par value treasury stock	2,000
Write-off of old balance to Reserve for Foreign Exchange Fluctuations	4,500
	<hr/>
Total	\$171,500

DEBITS

Dividends on company's capital stock	\$ 10,000
Reduction of accounts receivable control to agree with trial balance of subsidiary ledger	12,000
Addition to Reserve for Depreciation of Buildings, applicable to prior period	25,000
Fire loss (nonrecurring expense)	100,000
	<hr/>
Total	147,000

Remainder: Surplus, December 31 (year)	<u>\$ 24,500</u>
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INDEX

- Account, Analysis of, Form 68, 203
 Receivable, a bad situation, Form 39, 127
 detection of fictitious, Form 38, 126
 improper charge to, Form 42, 132
Accountant's check list, 40
Accountants, appointment of, 2
 registered, 7
Accountants' certificates, revised S.E.C. rule on, 403
Accountants' reports and certificates, 2 societies, 8
 time and expense records, 38
 time report, Form 10, 39
 traveling expenses, 40
Accounting practice, principles, generally accepted, accountant's check list, 43
 records, examination of, 4
 services, 18-20
 statement, erroneous, Form 95, 279
 violation of, Form 76, 233
Accounts, analysis of, book publishing, 322
 kept on a consistent basis, accountant's check list, 43
Accounts payable, in-transit, 191
 program of audit, book publisher, 313
 report comments, department store, 398
 manufacturer, 371
 trial balance, instructions to client, 25
Accounts receivable, book publishing, 118, 326
 circularization statistics, Form 43, 133
 comments, 297
 detection of overstatement, Form 40, 128
 program of audit, 119
 book publisher, 312
 report, manufacturer, 336
Accounts receivable, report comments, 395
Accruals payable, accounts, 195
 report comments, manufacturer, 372
 schedule, Form 65, 199
Accrued interest, purchases, 104
 receivable, 105
Additions, adding machine tapes, 57
 verification of, detailed audit, 50
 general audit, 50
Adjustment entries, accountants', 34
 placing on books, accountant's check list, 43
Administrative and selling expense, report, manufacturer, 347
Admissions sales, 255
Advice on accounting matters, 20
Aging customers' accounts, 120
American Institute of Accountants, admission requirements, 9
Amortization of appreciation, 164
Amortization Reserves, 220
Analysis, of account, Form 68, 203
 of accounts, book publishing, 322
Analytical review, 19
 comparisons, accountant's check list, 43
 payrolls schedule, Form 89, 271
 sales, Form 84, 251
 work program, 282
Asset, overstatement of, Form 61, 187
Assets, depreciable fixed, additions to, schedule, Form 56, 174
 fixed depreciable, schedule, Form 53, 169
 intangible, schedule, Form 55, 172
Audit, *see also* Detailed audit and General audit
 detailed, 18
 general, 19
Audit program, *see also* Program of audit

- Audit program, checking postings, proof of cash statement, verification of additions, vouching entries, 49
 - interim, supplementary, manufacturer, 349
- Audit report, outline of typical, 289
 - review of accountant's check list, 43
- Auditing, 1
 - procedures, 5
 - adoption of, 5
 - standards, 5
- Auditors, 1
 - internal, 2
- Average cost, inventories, 145

- Bad account receivable situation, Form 39, 127
- Bad debts over \$100 written off, Form 94, 278
- Bad debts report, manufacturer, 342
- Balance sheet, book publisher, 306, 308
 - department store, 393
 - manufacturer, 378
 - ratios, department store, 399
 - manufacturer, 369
 - report, manufacturer, 343
- Balance sheet treatment, 91
 - accounts receivable, 136
 - capital, 236
 - cash items, 77
 - current liabilities, 204
 - depreciable and intangible assets, 173
 - inventories, 155
 - land, 164
 - noncurrent liabilities and deferred credits, 213
 - notes receivable, 115
 - reserves, 227
- Bank balance, detection of inflation of, by deposit of "NG" check, Form 28, 90
- Bank confirmation, Form 27, 88
- Bank confirmations, 87, 325
- Bank deposit tickets, verification of, 87
- Bank reconciliation, manufacturer, 359
 - second, 86
 - statements, 83
- Bank reconciliations, 81
 - book publishing, 324
- Base stock cost, inventories, 145
- Bonds, and mortgages payable, comments, 299
 - investment, schedule, Form 31, 101
- Books of original entry, 52

- Capital, accounts, changes in, 234
 - and revenue, failure to distinguish between, Form 14, 55; Form 15, 56
 - overstatement of, Form 81, 241
 - program of audit, 232
 - stock, 230
 - comments, 299
 - schedule, Form 77, 235
 - situation, Form 78, 237
- Cash, account, 81
 - book manipulations, detection of, Form 20, 65, 66
 - comments, 296
 - fund, imprest, schedule, Form 23, 75
 - funds on hand, 71
 - in bank, detection of an overstatement of, Form 25, 84
 - on deposit, questionnaire, 81
 - program of audit, book publisher, 312
 - report, manufacturer, 336
 - statement, proof of, Form 18, 63
 - surrender values of life insurance policies, 183
 - transactions, detection of irregularities, Form 19, 64
- Cashed bank checks, control of, 70
 - detection of "NG," Form 22, 74
- Certificate, covering accounts receivable, book publishing, 327
 - liability, 204
- Certificates, opinion paragraph, 3
 - qualifications in, 6
- Certified checks, 83
- Certified public accountants, 7
 - New York State requirements, 7
- Changes, in capital accounts, 234
 - in depreciable asset accounts, 168
 - in intangible asset accounts, 171
 - in mortgages and bonds payable accounts, 210

- Changes, in personnel, schedule, Form 88, 270
- Chart, ratio, showing five-year comparison of monthly revenue from room rentals in a hotel, Form 100, 295
showing sales compared with net income, Form 97, 286
- Checking, allocations of expenses to accounting periods, 181
postings, program of audit, 49
- Circularization, of creditors, 195
of customers, detection of lapping through, Form 44, 135
statistics, accounts receivable, Form 43, 133
notes receivable, Form 34, 114
- Circularizing savings banks, 87
- Collateral, valuation of, 112
- Collection period, 136
comparison, accountant's check list, 43
- Comments, accounts receivable, 297
bonds and mortgages payable, 299
capital stock, 299
cash, 296
current liabilities, 298
depreciable assets, 298
inventory, 297
investment securities, 297
miscellaneous assets, 298
notes receivable, 297
operating accounts, 299
- Commercial letters of credit, 87
- Commission, error of, Form 16, 58
errors of, 12
- Commitments, purchase, schedule, Form 87, 264
- Comparative balance sheets, book publisher, 306
manufacturer, 367
- Concealment of cash shortage, 89
- Confirmation, bank balances, 325, Form 27, 88
of engagements, 23
of miscellaneous assets, 183
of mortgages and bonds payable accounts, 210
of sundry revenue receipts, 257
- Confirmation letter, life insurance, 186
- Confirmation request, accounts receivable, direct method, 124
indirect method, 124
- Confirmations, accountant's check list, 43
advance preparation of, 36
current file, 30
- Consignment, goods held on, 144
- Contingencies, reserve for, omission of, Form 73, 223
- Contingent liabilities, report comments, manufacturer, 338, 372
schedule, Form 74, 224
- Contributions, 255
- Control, internal, 48
- Copyrights, program of audit, book publisher, 313
- Corporate surplus, 231
- Cost, depletion, overstatement of, Form 52, 163
ledger, Form 7, 26
of land, 159
or accounting systems installations, 20
- Creditors, circularization of, 195
- Current liabilities, comments, 298
described, 190
program of audit, 193
- Customers', accounts, aging, 120
circularization of, 121
credit balances, balance sheet treatment, 136
- Declared dividends receivable, 105
- Deferred charges, 188
- Deferred credit, and unrealized profit accounts, 212
- Depletion cost, overstatement of, Form 52, 163
- Deposits, confirmation of, 183
in night depository of bank, examination of, 70
in transit, 83
- Depreciable asset accounts, changes in, 168
- Depreciable assets, comments, 298
- Depreciation, methods, violation of, Form 70, 218
reserve for, schedule, Form 71, 219

- Depreciation, reserves, 215
- Detailed audit, 18
 - checking postings, 51
 - proof of cash statement, 51
 - verification of additions, 50
 - vouching entries, 49
- Detection of, an overstatement of cash
 - in bank, Form 25, 84
 - cash book manipulations, Form 20, 65, 66
 - error in addition of cash disbursements book, Form 17, 60, 61
 - existence of kiting of bank check, Form 26, 86
 - existence of secret reserve, 222, Form 75, 225
 - fictitious account receivable, Form 38, 126
 - fictitious guarantee, Form 41, 130
 - inflation of bank balance by deposit of "NG" check, Form 28, 90
 - irregular cash transactions, Form 19, 64
 - lapping through circularization of customers, Form 44, 135
 - "NG" cashed checks, Form 22, 74
 - overstatement, of accounts receivable, Form 40, 128
 - of discounts allowed customers, Form 29, 92, 93, 94
- Direct costs of engagements, 25
- Directors' fees schedule, Form 92, 276
- Discounts allowed customers, detection of overstatement, Form 29, 92, 93, 94
- Discovery of shortage in petty cash, Form 13, 54
- Disposals of depreciable assets, 257
- Dividends, income, 256
 - paid and payable schedule, Form 66, 200
 - receivable declared, 105
- Engagement cost records, 25
- Engagement memorandum, manufacturer, 348
- Engagement record, client, 12
 - clients' special requests, 22
 - copies of audit report required, 21
- Engagement record, date when audit report is required, 21
 - date when work is to be commenced, 21
 - fee to be charged for services, 22
 - locations where services are to be performed, 21
 - number of accountants required, 21
 - period of time required for audit, 22
 - service classifications, 21
 - state of incorporation, 12
 - tax returns required, 21
- Engagement records, 20
- Engagements, auditing, continuing, 24
 - direct costs of, 25
- Entries, reclassification, 34
 - report, 34
- Erroneous accounting statement, Form 95, 279
- Error, in addition of cash disbursements book, detection of, Form 17, 60, 61
 - of commission, Form 3, 13; Form 4, 14; Form 16, 58
 - of omission, 17, Form 6, 16
- Errors of commission and omission, 12
- Ethics, rules of professional conduct, American Institute of Accountants, 407
 - New York State Society of Certified Public Accountants, 404
- Examination of, accounting records, 4
 - expense accounts, 272
 - financial condition, 19
 - note debtors' accounts, 111
 - securities, 98
 - subsequent transactions, 194
- Excerpts from minutes of board of directors, Form 9, 37
- Exchanges, 62
- Expense account, investigation of, Form 90, 274
- Expense accounts, large, schedule, Form 93, 277
 - schedule, Form 91, 275
- Expense ledger, trial balance, instructions to client, 25
- Expense ratios, department store, 401
- Expenses, prepaid, schedule, Form 60, 185

- Factory labor and overhead, graphic chart of manufacturer, 376**
Failure to disclose information, Form 99, 292
Failure to distinguish between capital and revenue, 53, Form 14, 55; Form 15, 56
Fi-fo inventory price method, 145
Financial condition, examination of, 19
Financial statements, footnotes to, 7
Fire insurance coverage, report, manufacturer, 339
First-in, first-out cost, inventories, 145
Fixed assets, depreciable, additions to, Form 56, 174
schedule, Form 53, 169
Fixed percentage of diminishing value, depreciation method, 215
Fixed proportion of cost depreciation method, 215
Footnote, necessity for a balance sheet, Form 98, 291
Footnotes to financial statements, 7
Form; see individual titles of forms
Funded debts, 210
Furniture and fixtures memo, book publisher, 332

General audit, 19, 51
proof of cash statement, 51
verification of additions, 50
vouching entries, 49
General ledger, arrangement, 34
trial balance and working sheet, Form 8, 33
General procedure for handling confirmations, 36
Goods, held on consignment, 144
in transit, 144
in unopened cases, inventory schedule, Form 46, 143
last received, schedule, Form 63, 197
on consignment outside, 144
Graphic charts, 287, 376
Gross profit, percentage, 283
percentage test, 152
Grouping sheets, 36
Guarantee, detection of fictitious, Form 41, 130

Imprest cash fund schedule, Form 23, 75
Improper charge to account receivable, Form 42, 132
Income, additions to, book publisher, 310
deductions from, book publisher, 310
miscellaneous, schedule, Form 85, 258
Income and profit and loss statement, book publisher, 307, 309
manufacturer, 373, 382
Income statement, procedure, 250
treatment, payrolls, expenses, and interest, 280
purchases and returned purchases, 265
sundry revenues, 259
Independent accountants' adjustment entries, 34
Independent accountants' certificate, 377
department store, 402
Independent accountants' opinion, 301
Installment, basis, 214
contracts' receivable schedule, Form 36, 122
Instructions to client, accounts payable trial balance, 25
accounts receivable trial balance, 25
examination of securities, 25
expense ledger trial balance, 25
fixed assets, additions to, schedule, 25
insurance policies schedule, 25
investments, bonds, schedule, 25
stocks, schedule, 25
mortgages receivable schedule, 25
notes payable schedule, 25
notes receivable schedule, 25
Insurance, program of audit, book publisher, 314
unexpired, premiums and risks insured schedule, Form 59, 184
Insurance coverage, adequacy of, accountants' check list, 43
report, manufacturer, 364
report comments, department store, 399
manufacturer, 373
Intangible asset accounts, changes in, 171

- Intangible assets schedule, Form 55, 172
- Intercompany profits, 155
- Interest, element of cost, 152
 - income, 255
 - receivable, accrued, 105
- Interim reports, 289
- Internal auditors, 2
- Internal control, 5, 48
 - assignment of duties inquired into, 5
 - purchases and returned purchases, 261
 - sales, 244
 - weaknesses, accountant's check list, 43
- Inventories, duplicate copies, 141
 - memo, book publishing, 328, 329
 - program of audit, 138
 - supplies, 151
- Inventory, certificate, 154
 - book publishing, 330
 - classifications, accountant's check list, 44
 - comments, 297
 - goods in unopened cases, Form 46, 143
 - instructions, 140
 - prices, 144
 - prices tests schedule, manufactured goods, Form 48, 148
 - purchased materials, Form 47, 147
 - program of audit, book publisher, 313
 - quantities test schedule, Form 45, 142
 - report comments, department store, 396
 - manufacturer, 370
 - retail, test schedule, Form 49, 149
 - taking, observance of, 140
 - turnover rate, 152
 - valuations, principles of, 152
- Investigation of expense account, Form 90, 274
- Investment securities, bonds, schedule, Form 31, 101
 - book value of, 104
 - comments, 297
 - confirmation of, 103
 - market quotation value of, 105
 - stocks, schedule, Form 30, 99
- Investments schedule, manufacturer, 360
- Journal entries, adjustment, book publisher, 319, 320
 - manufacturer, 358
- Kiting of bank checks, detection of existence of, Form 26, 86
- Labor and expense report, manufacturer, 346
- Land, buildings, and equipment schedule, manufacturer, 344
- Land accounts, verification of, 160
- Land schedule, Form 51, 161
- Lapping, 134
- Large expense accounts schedule, Form 93, 277
- Last goods received, schedule, Form 63, 197
- Last shipments made, schedule, Form 82, 248
- Last-in, first-out cost, inventories, 145
- Leasehold improvements, memo, book publisher, 332
- Ledger, cost, Form 7, 26
- Letter confirming engagement, 23
- Letter of instructions to client, 24
- Letters of credit schedule, manufacturer, 361
- Liabilities, contingent, schedule, Form 74, 224
 - current, understatement of, Form 67, 202
 - report, manufacturer, 337
 - understatement of, Form 62, 192
- Liability, accounts, miscellaneous, 195
 - and deferred credits, noncurrent, program of audit, 209
 - certificate, 44, 204
- Life insurance, confirmation letter, 186
 - values, balance sheet treatment, 188
- Li-fo inventory price method, 145
- Loans and advances receivable schedule, Form 58, 182
- Lots, repossessed, 162
- Making selective test checks, 141
- Market price quotations, 150
- Material fact, omission of, Form 5, 15
- Material facts, misstatements of, 9
- Membership dues and fees, 254

- Memorandum, goods held on, 144
of engagement, manufacturer, 348
- Minutes, excerpts of, 36
accountant's check list, 43
- Minutes of board of directors, excerpts of, Form 9, 37
- Miscellaneous income schedule, Form 85, 258
- Misstatement of material facts, Form 1, 10
- Misstatements of material facts, 9; Form 2, 11
- Misunderstanding of principle of accounting, Form 54, 170; Form 57, 175
- Mixed control account situation, 201
- Mortgages and bonds payable accounts, changes in, 210
confirmations of, 210
- Mortgages payable schedule, Form 69, 211
manufacturer, 362
- Mortgages receivable schedule, Form 32, 102
- Natural resource properties, 162
- New York State Society of Certified Public Accountants, purposes of, 8
- Noncurrent liabilities and deferred credits, program of audit, 209
- Note debtors' accounts, examination of, 111
- Notes on audit, book publishing, 323
- Notes payable to banks, report comments, manufacturer, 372
- Notes receivable, balance sheet treatment, 115
circularization statistics, Form 34, 114
comments, 297
confirmation of, 113
examination of, 109
program of audit, 109
manufacturer, 349
report, manufacturer, 337
schedule, Form 33, 110
- Obsolete goods, 151
- Omission, error of, Form 6, 16
errors of, 12
- Omission, of a material fact, Form 5, 15
of a reserve for contingencies, Form 73, 223
- Operating, accounts, comments, 299
ratios, department store, 401
- Operations, report comments, department store, 400
summary of, 293
- Opinion of independent accountants, 6
- Other income, book publisher, 310
- Overstatement, of an asset, Form 61, 187
capital, Form 81, 241
of depletion cost, Form 52, 163
- Ownership of working papers, 45
- Partners' capital accounts schedule, Form 80, 239
- Pay-offs, supervising, 269
- Payrolls, analytical review of, schedule, Form 89, 271
examination of, 268
- Permanent file of working papers, 28
review of, accountant's check list, 43
- Personnel, changes in, schedule, Form 88, 270
- Petty cash, discovery of shortage in, Form 13, 54
- Plates and plate boxes, memo, book publishing, 331
- Post dated checks, verification of, 71
- Postings, 59
checking of, detailed audits, 51
general audit, 51
- Prepaid expenses schedule, Form 60, 185
- Preservation of working papers, 45
- Prices, inventory, 144
tests schedule, inventory, manufactured goods, Form 48, 148
purchased materials, Form 47, 147
- Principle of accounting, misunderstanding of, Form 54, 170
misunderstood, Form 57, 175
- Principles of inventory valuations, 152
- Program of audit, accounts receivable, 119
book publisher, 312

- Program of audit, capital, 232
 cash on deposit, 79
 checking postings, 49
 current liabilities, 193
 depreciable and intangible assets, 167
 inventories, 138
 land, 158
 miscellaneous assets, 180
 noncurrent liabilities and deferred credits, 209
 notes receivable, 109
 manufacturer, 349
 proof of cash statement, 49
 reserves, 226
 verification of additions, 49
 vouching entries, 49
 Proof of cash statement, 62, Form 18, 63
 detailed audit, 51
 general audit, 51
 program of audit, 49
 Purchase commitments, report, manufacturer, 338
 schedule, Form 87, 264
 Purchase invoices, examination of, 261
 Purchases, test of, schedule, Form 86, 263
- Qualifications, in audit reports, 300
 in certificates, 6
 lack of conformity to generally accepted principles, 6
 limitations on scope of audit, 6
 omission of, 6
- Questionnaire, accounts receivable, 119
 capital, 234
 cash on deposit, 81
 cash on hand, 70
 current liabilities, 194
 depreciable and intangible assets, 168
 inventories, 140
 investment securities, 98
 land, 159
 miscellaneous assets, 180
 noncurrent liabilities and deferred credits, 209
 notes receivable, 109
- Ratio chart, labor and overhead, manufacturer, 389
- Ratio chart, sales and income, manufacturer, Form 97, 286
 sales and selling expense, manufacturer, 388
 showing sales compared with net income, Form 97, 286
- Ratios, expense, department store, 401
 operating, department store, 401
- Real estate, report comments, department store, 398
- Receipts, undeposited, schedule, Form 21, 72
- Receiving book, 152
- Reconciliation of subsidiary ledgers, book publishing, 321
- Registered accountants, 7
- Relationships, sundry, discussed, 283
- Rental deposits, confirmation of, 183
- Rental revenues, 254
- Report, data, accountant's check list, 43
 entries, 34
 illustrative, manufacturer, 335, 336, 337
 of in charge accountant on assistant, Form 11, 41
 procedure followed upon completing, 40
 review of draft, 301
 sheet, Form 12, 42
 short form, 288
 statistics, book publisher, 314
- Reports, audit, format of, 301
 qualifications, 300
 comments section, 297
 interim, 289
- Reserve, accounts, sundry, schedule, Form 72, 221
 for contingencies, omission of, Form 73, 223
 for depreciation schedule, Form 71, 219
 for losses on sales contracts for future delivery, 222
 secret, detection of existence of, Form 75, 225
- Reserves, amortization, 220
 for contingencies, 222
 for maintenance, 220
 program of audit, 226

- Retail system of inventory control, 250
 Royalties, memo, book publishing, 333
 Royalty accounts, program of audit,
 book publisher, 314
 Rules of professional conduct, American
 Institute of Accountants, 407
 New York State Society of Certified
 Public Accountants, 404

 Sales, and accounts receivable, 283
 and inventory relationship, 283
 and profits, graphic chart of, manu-
 facturer, 376
 and selling expenses, graphic chart of,
 manufacturer, 376
 of salvage, 256
 Sales records, examination of, 245
 Salvage values, 217
 Second bank reconciliation, 85
 Secret reserve, detection of existence of,
 Form 75, 225
 Secured accounts receivable schedule,
 Form 37, 123
 Securities, examination of, 98
 Securities and exchange commission
 engagements, 19
 Securities sales, 255
 Selling and general expenses, book pub-
 lisher, 310
 Selling expenses schedule, Manufac-
 turer, 384
 Service classifications, 18
 Significant relationships, Form 96, 285
 Sinking fund depreciation method, 216
 Societies of accountants, 8
 Specific article cost, inventories, 145
 Standard practice instructions of com-
 pany, review of, 4
 Standing audit instructions, 25
 Statement of application of funds, 367
 Statistical data, 294
 Statistics for report, book publisher, 314
 Subfunds, verification of, 73
 Suburban development properties, 162
 Sundry audit schedules, 196
 Sundry reserve accounts schedule, Form
 72, 221
 Supervising pay-offs, 269
 Supplies inventories, 151
 Surplus, corporate, 231

 Surplus accounts, errors in, 12
 Surplus analysis, 368

 Tax returns, 20
 Test checking, substitution for com-
 plete checking, 5
 Test, of purchases schedule, Form 86,
 263
 of sales schedule, Form 83, 249
 Time report, accountant's, Form 10, 39
 Traveling expenses, 40
 Trial balance and working sheet, ar-
 rangement of, 32
 book publisher, 316, 317, 318
 general ledger, Form 8, 33
 manufacturer, 351-357
 Turnover rate, inventory, 152

 Ultra vires Act, Form 79, 238
 Unclaimed wages, 77
 schedule, Form 24, 76
 Undeposited receipts, 70
 checking, 70
 schedule, Form 21, 72
 Understatement of, current liabilities,
 Form 67, 202
 liabilities, Form 62, 192
 Unentered liabilities schedule, Form 64,
 198
 Unexpired insurance premiums and
 risks insured schedule, Form 59,
 184
 Unrealized profit account, 212

 Valuation of collateral, 112
 Verification of additions, program of
 audit, 49
 Verifications of loans and advances re-
 ceivable, 181
 Violation, of generally accepted ac-
 counting conventions, Form 50,
 153
 of generally accepted accounting
 practice, Form 76, 233
 of generally accepted depreciation
 methods, Form 70, 218
 Vouching, additions, 171
 entries, 52
 program of audit, 49

- Vouching, significant charges to miscellaneous asset accounts, 180
- Voucher stamp, 47
- Wages, unclaimed, schedule, Form 24, 76
- Window dressing, flagrant case of, Form 35, 116
- Working papers, current file, accountants' tick marks, 30
- analysis numbers, 29
 - analysis of accounts, 30
 - analysis sheets, 29
 - arranging and indexing of, 29
 - confirmations, 30
 - contingent liabilities, 30
 - descriptions, 29
- Working papers, current file, miscellaneous folder, 31
- signing, 31
 - ownership of, 45
- permanent file, 28
- accounting procedures of company, 29
 - agreements and contracts, 29
 - bond indenture, 29
 - bylaws of corporation, 28
 - certificate of incorporation, 28
 - cumulative index, 29
 - partnership agreements, 29
 - preservation of, 45
 - signing of accountant's check list, 43
 - stock listing application, 29
- Working sheets, sizes of, 31

