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Students' Department

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AMERICAN INSTITUTE EXAMINATIONS

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Examination in Auditing

November 15, 1928, 9 A. M. to 12:30 P. M.

The candidate must answer all the following questions:

No. 1 (5 points):

Name and define three classes of proprietorship, and state how the equity of each class is shown on the balance-sheet.

Answer:

Three classes of proprietorship are:

1. Single proprietorship—a proprietorship vested in one person who is the sole owner of the business.

2. Partnership—a voluntary association of two or more persons, based upon a contract to carry on a business as co-owners and to share in the profits. The contract may be either expressed or implied.

3. Corporate—"an artificial person created by law, consisting of one or more natural persons united in one body under such grants as secure a succession of members without changing the identity of the body, and empowered to act in a certain capacity or to transact business of some designated form or nature like a natural person" (*Standard Dictionary*).

The equity of each class of ownership defined above is shown on the balance-sheet on the credit side either at the bottom or top of the statement as follows:

1. Single proprietorship—

Net worth:		
John Clark, capital		
Balance, January 1, 1928	$10,000	
Profit for year ended December 31, 1928	15,000	
Total	$25,000	
Withdrawals	5,000	
Balance, December 31, 1928		$20,000

2. Partnership—

Net worth:	John Clark	John Jones	Together	
Balance, January 1, 1928	$5,000	$5,000	$10,000	
Profit for year ended December 31, 1928	7,500	7,500	15,000	
Total	$12,500	$12,500	$25,000	
Withdrawals	2,500	2,500	5,000	
Balance, December 31, 1928	$10,000	$10,000		$20,000

3. Corporate ownership—

Net worth:

Capital stock:			
Common—authorized and issued.......	$5,000		
7% preferred—authorized and issued...	2,500		
		$7,500	
Surplus:			
Balance, January 1, 1928.............	$2,500		
Profit for year ended December 31, 1928	15,000		
Total..............................	$17,500		
Dividends paid......................	5,000	12,500	
			$20,000

No. 2 (17 points):

You are called upon to install an accounting system for a manufacturing concern. State in detail the system you would suggest for
(a) Cash
(b) Purchases
(c) Payrolls

Answer:

(a) The following forms are suggested for a system accounting for cash:
1. Daily report of remittances received
2. Cash-receipts book (columnar)
3. Cash-disbursements book (columnar)
4. Petty-cash vouchers (prenumbered)
5. Cheques (prenumbered)
6. Cash-disbursements vouchers.

Collections received by a manufacturing concern would consist largely of mail remittances which should be opened and listed on form No. 1 by a trusted employee who should not have access to the records of the cashier or bookkeeper. The remittances should then pass to the cashier, who should prepare deposit slips in triplicate, one copy of which should be sent to the employee who opened the mail, one copy to the bank, after the cashier has made his cashbook entries in form No. 2, and the third to the bookkeeper to be used as a posting medium. Cash received should be deposited daily.

Disbursements, other than petty-cash items, should be paid by cheques supported by vouchers. These vouchers should contain the authority for the payment and show the account to be charged. The cheques should be entered in the cash-disbursements book. Petty-cash disbursements should be made from an imprest petty-cash fund and supported by an approved voucher. This fund should be reimbursed when necessary by a cheque drawn to "petty cash" for an amount equal to the approved vouchers and distributed in the cash-disbursements book to the accounts for which the payments were made.

The reconciliation of the bank accounts should be made at the end of every month by someone not in the cashier's office.

(b) In accounting for purchases, the following forms may be suggested:
1. Purchase requisitions (in duplicate)
2. Purchase orders (in triplicate)
3. Receiving report (in triplicate)
4. Voucher wrappers (prenumbered)
5. Voucher register

Purchase requisitions should be prepared by those authorized to pass upon the purchase of materials, etc. and forwarded to the purchasing agent who in turn should prepare a purchase order in triplicate, one copy for the company with which the order is to be placed, one copy for the person who made the requisition, and the third for the files of the purchasing agent.

As the goods are received by the receiving department, a report, form No. 3, should be prepared in triplicate, one copy for the purchasing agent, one for the originator of the purchase and the third for the files of the receiving department. The accounting department should accept responsibility for checking against the purchase orders the description, prices, terms, etc. on the invoices, and for verifying the extensions and footings. Approved invoices should be attached to the voucher wrappers, form No. 4, and entered and distributed in the voucher register.

(c) In accounting for payrolls, the following forms may be suggested:

1. Time cards or clock cards.
2. Payroll sheets (columnar)
3. Employees' record cards, showing wage rates, etc.

Payrolls should be prepared by the clerk from the time cards and employees' record cards, and entered and distributed. When completed they should be approved by the department heads. If possible, payment should be made by cheque, but if by cash receipts should be obtained from the employees at the time they are paid.

No. 3 (12 points):

Engaged by a small corporation to prepare its federal income-tax return, you are given the balance-sheets as of the beginning and end of the year, a profit-and-loss statement for the year and free access to the books. The accounts are assumed to be correct.

State what steps you would take to insure the accuracy of the figures for the schedules and items of the return, and how you would make up the required working papers for future inspection by treasury agents.

Answer:

A copy of the tax return for the previous year should be obtained to verify the reconciliation of the surplus account with the surplus shown in the return. The reserves for depreciation and bad debts should also be compared with those shown in the return. The stockholdings of the officers should be obtained, and an analysis of their salary accounts, taxes paid, depreciation, depreciation reserves, bad-debt reserves, insurance and surplus accounts should be made.

The balance-sheets at the beginning and at the end of the taxable year and the profit-and-loss statements for the current and previous taxable years should be compared and any material changes should be investigated.

The next step would be to fill in the return, using information obtained from the previous return, the analysis prepared, and the financial statements of the current period. If the income and deductions appeared reasonable, and the surplus and other schedules could be reconciled the accountant could be assured that he had prepared a correct return per the books without audit and should so state in his letter transmitting the return to his client.

Working papers for future inspection by a revenue agent should consist of a copy of the return, the balance-sheets and profit-and-loss statements obtained from the client, the analyses made, any summaries used to combine related accounts and a copy of the letter of transmittal.

No. 4 (8 points):

Name eight points the auditor must ascertain in making a balance-sheet audit.

Answer:

In making a balance-sheet audit the auditor must ascertain the following:

1. That all assets recorded on the books belong to the company whose books are being audited.
2. That all assets belonging to the company are recorded on its books.
3. That all assets of the company are verified by inspection, confirmation, or other satisfactory documentary evidence.
4. That the assets of the company are correctly valued.
5. That the liabilities recorded on the books of the company were actually and properly incurred.
6. That all the liabilities of the company are recorded on its books.
7. That the capital stock is shown correctly and according to authorization.
8. That the profit-and-loss account for the period "ties up" with the surplus account and the balance-sheet.

(A balance-sheet audit does not require an audit of the nominal accounts).

No. 5 (12 points):

Auditing a manufacturing concern for the year 1927, you find, on the balance-sheet, the item "Cost of patent, $4,900." Turning to the account in the ledger, you find the following items debited:

1925	Legal expenses defending validity of our patent No. —	$2,000
1926	Legal expense prosecuting infringement of our patent No. —	1,000
1927	Legal expense prosecuting same	500
	Improvements made on machine covered by our patent No. —	1,400
		$4,900

There are no credits to the account and no amortization reserve has been set up on the books.

Upon inquiry, you learn that the patent covering the machine in question was issued in 1919 and that no additional patent has been sought for the improvements made to the machine. The expenditures for fees, experiments, etc., for the invention, amounting to $510, were charged to current expense in 1919.

(a) State what criticism of the above account you have to offer, (b) prepare the journal entries necessary to correct it, (c) show the book value of the patent as of December 31, 1927, and (d) state the advantages or disadvantages to the concern in thus re-casting the patent account.

Answer:

(a) The account as stated fails to reflect an amount to represent the present value of the original cost of the patent, namely $510. The amounts in the account, excepting improvements of $1,400, for legal expenses protecting the patent may be justifiable additions to the patent account. If so, they, as well as the original $510, should be amortized over the remaining valuable or legal life of the patent from the date incurred. The exception of $1,400 represents experimental expense which should be absorbed in expense or deferred over as short a term of years as possible.

Conservative accounting practice would require the legal expenses to be absorbed currently, as they may be recurring charges and they do not in any way increase the cost of the patent itself.

(b) The necessary journal entries to correct the account follow:

Cost of patent			$240	
Surplus				$240
To restore 8/17 of cost of patent ($510) obtained in 1919.				
Surplus			3,000	
Legal expense—patent			500	
Experimental expense			1,400	
Cost of patent				4,900
To transfer expenses incurred in connection with patent and patented machine:				
1925 legal expense	$2,000			
1926 legal expense	1,000			
		$3,000		
1927 legal expense		500		
1927 experimental expense		1,400		
Total		$4,900		

(c) Book value of patent at December 31, 1927:		
1919 cost	$510	
1919 to 1927 amortization of cost—9 years at $30 a year		$270
December 31, 1927 book value		240
	$510	$510

(d) The treatment outlined should prove advantageous to the company. For credit purposes it removes a fairly large intangible asset which has no value unless profits are being made from the use of the patent. For income-tax purposes it decreases the taxable income. It also reduces the amount of charges to be borne in the future. Such treatment does not seem to work a disadvantage to the company, for if profits are being made the company officers should not hesitate to write off its intangibles. If a profit is not being made, the presence of intangibles in a balance-sheet does not in any way strengthen a company's financial statement.

No. 6 (10 points):

State three methods of accounting for the profits made on sales on the instalment plan and what reserves you would provide in each instance.

Answer:

Three methods of accounting for profits made on sales on the instalment plan and for reserves to be provided in each instance are outlined as follows:

1. Treatment of the sale as an ordinary sale by taking into profit and loss the entire gross profit on the sale. In this case an attempt should be made to provide adequate reserves for doubtful accounts, and for collection and clerical expenses to be expended in the future on these accounts.

2. Treatment of collections from these sales as both gross profit and recovery of cost. For example, in case $100 was collected on a $1,000 sale on which

the company's gross profit was 30 per cent., $70 should be considered as a recovery of cost and $30 as gross profit. Instead of considering the remaining gross profit of $270 as earned it should be transferred to a deferred-gross-profit-on-sales account to be transferred to earnings as collections are made. The only reserve to be provided under this method should be to cover possible losses on repossessed merchandise.

3. Treatment of collections from these sales as, first, a return of cost, and, second, collection of the profit on the sale. The only reserve necessary would be to cover possible losses on repossessed merchandise as the deferred gross profit would be sufficient to care for collection losses and other future expenses arising from these accounts.

No. 7 (8 points):

Engaged to audit the records of a small retailer, you find there is but one book kept, viz.: a columnar book of some fifty-odd columns containing all the accounts—real, personal and nominal—usually found in an ordinary ledger. The book is kept on the double-entry plan.

State the first steps you would take to assure yourself of the general accuracy of the bookkeeping *before* proceeding to verify the accounts themselves.

Answer:

A copy of the financial statements prepared from the record should be obtained and studied to ascertain the degree of completeness of the record. A scrutiny of the pages to obtain a general idea of the correctness of the distributions and a test of cross-footings should follow. An analysis of the transactions for one month should be made to obtain information to use as a basis for an audit programme.

No. 8 (10 points):

In examining the books of a corporation having subsidiaries you find that, in addition to inter-company accounts receivable and payable, there are notes receivable from, and payable to, an affiliated company the accounts of which are not being examined. On the consolidated balance-sheet only the excess of the notes receivable over the notes payable is shown. Is this procedure permissible? State the reasons for your answer.

Answer:

In preparing a consolidated balance-sheet the inter-company receivables and payables should be eliminated, and only those receivables due from and payables due to outsiders should be shown. The purpose of the consolidated balance-sheet is to show the financial condition of a group of closely affiliated companies as if they were a single company. Notes payable due to outsiders (companies not included in the consolidation) should not be deducted from notes receivable due from outsiders, for in offsetting such items the facts would be misstated.

No. 9 (8 points):

The capital stock of the A company of California is wholly owned by the B company of New York. You are engaged each year to examine the accounts of the former company and to render a report thereon to the New York company. In verifying these accounts for the year 1927, you discover that on January 3, 1927, the manager of the A company withdrew $50,000 from its funds and it was charged to his personal account on the books; that the amount was repaid in full on December 27, 1927; and that on January 3, 1928, the same amount was again withdrawn and charged to his personal account as before.

What would you say in your report to B company regarding these transactions?

Answer:

The auditor should bring the facts to the attention of his clients by letter, requesting authority for the withdrawal should there be no such authority on hand for his inspection at the offices of the "A" company.

In his report, under the comments on cash, amounts due to or from officers and employees, or under the general comments the auditor might state:

"On January 3, 1927, cash was withdrawn by Mr. ——— in the amount of $50,000. This amount was repaid to the company on December 27, 1927. A like amount was again withdrawn on January 3, 1928, and at (date of report) was unpaid. When we inquired for written authority for the withdrawal, we were informed that such authority was not available."

No. 10 (10 points):

The X department store owns and occupies its building. In 1923, the president of the company executed a lease for a portion of the building without the knowledge of the other officers or directors. No rent was collected from the tenant by the company. In 1927, the tenant, threatened with bankruptcy, offered a settlement to all his creditors including his landlord, the X department store.

The accounts of the department store had been audited annually by a public accountant. Should he have discovered the omission of this lease and accrued rents? If so, how?

Answer:

The accountant should have discovered the omission of the lease and accrued rents. It is his duty to obtain sufficient knowledge of the activities of his client so that the report and statements prepared by him may represent as accurate an opinion of the financial condition and the results of operations as is possible to obtain. Had the accountant personally inspected the premises, equipment, and facilities of his client, he should have discovered in his audit of the books and records of the company, that certain operations were not recorded. An investigation made of that section of the store should have led to an admission that the lease had been executed and that the rents had not been recorded upon the books.