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Robert J. Gummer

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## ADMINISTRATIVE ASPECTS OF A "LARGE" AUDIT

by Robert J. Gummer  
Partner, New York Office

*Presented before the Accounting  
Internship Seminar, Wilkes College,  
Wilkes-Barre, Pennsylvania --  
February 1971*

In administering any audit, whatever the size, many questions must be resolved, arrangements made, and details planned and executed before, during, and after the field work. In an audit of a large corporate enterprise, however, this administration and planning can become much more complex and varied. Obviously, therefore, in the latter instance the time devoted to these matters will be considerably more important.

Let us look at some of the complexities inherent in an audit of a large corporate enterprise. To place this subject in proper perspective a few exhibits are introduced later on to assist us in comparing the condensed financial statements of a typical "small" company (the Minor Manufacturing Company — a closely-held company operating from one manufacturing and accounting location) with those of a large corporate enterprise (identified for our purposes as The Diversified Corporation — a publicly-held company operating from many locations). Please note that in neither case do the financial data shown relate to existing companies, and as is frequently said in the writing of fiction, any resemblance to existing companies is purely coincidental. The financial statements, of course, are typical of those usually found for companies such as these. For example, compared with the ranking in *Forbes Magazine's*<sup>1</sup> 500 Biggest Listings, Diversified's total assets of \$1,630,215,000 would entitle it to rank as the 140th largest corporation in the United States (on the basis of total assets) and its net income would enable it to rank 58th. Also, in identifying Minor as a small company, we do so only from the standpoint of relative audit complexity and in relation to its size compared with that of the typical large publicly held corporation. Obviously, by some standards a company with total assets of over \$9,000,000 is large, but not when compared with companies such as Diversified.

Looking first at the balance sheets (Exhibit 1), you will note quite a few similarities — i.e., each has cash, receivables, inventories, fixed assets,

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<sup>1</sup> "Dimensions of American Business," 2nd Annual Directory Issue, *Forbes Magazine*, May 15, 1970.

accounts payable, accrued expenses and taxes, debt, and various equity accounts; but in each case, Diversified's amounts are substantially larger. The increased size of the company and its transactions can present additional administrative problems for the auditors. In any audit, we strive to obtain the assistance of the client's personnel. Although such help is very desirable in an audit of a company such as Minor, it is usually of critical importance in an audit of a company as large as Diversified. For example, Diversified's \$110,481,000 of cash will possibly be on deposit in one hundred or more bank accounts, each requiring a reconciliation and confirmation. Should one of our own accountants prepare these or would it not be more efficient (and less costly) to request the client to do so under our control? Also, a great deal of advance planning and constant coordination are necessary to ensure that all such accounts are reconciled and confirmed. With respect to receivables, inventories, and property, companies of the size of Diversified would normally have such assets in many locations throughout the United States and in foreign countries. Thus, we must devote considerable time to arranging for the timely participation of others of our offices in auditing these accounts. Some of the administrative aspects of this coordinating effort I will discuss later in my remarks. Also, companies such as Diversified would usually make extensive use of data processing equipment. If so, we must make whatever arrangements with the client that are necessary to enable us to use their equipment most efficiently. Typically, in such cases, we would make extensive use of our "Auditape System", which is a set of generalized computer programs enabling us to perform, efficiently, various routines on a client computer file of any size. In those instances in which data processing is not used, arrangements can be made to hire comptometer operators to perform any manual footing operations required. Thus, in a large engagement, efficient administration and performance, whether accomplished by using client or other personnel or data processing equipment, etc., are of paramount importance. For example, this year we prepared, in conjunction with a client, a "critical path" analysis, with related flow charts, showing the dates and interrelation of procedures performed by the client with those of Haskins & Sells personnel.

What of the accounts that appear on Diversified's balance sheet but not on Minor's? Do they present any administrative considerations? First, we find marketable securities of \$46,733,000 owned by Diversified and investments of \$71,848,000 in affiliated companies. In such instances, we must determine whether or not the securities evidencing such ownership are held in a safe deposit box and, if they are, arrange to inspect them on the balance sheet

date and obtain a letter from the bank verifying that the client has not had access to the safe deposit box between the time of our inspection and the close of business on the balance sheet date. In the event that the securities are held by an independent custodian, we must arrange for confirmation as of the balance sheet date. In either case, additional correspondence must be generated and arrangements made. Of course, such investments may also be found in the accounts of a small enterprise, but the point to be kept in mind is that they are commonly found in a large enterprise and therefore we should be prepared for the additional administrative procedures.

The existence of investments in subsidiaries (both consolidated and unconsolidated) also points to various other questions that must be answered, such as: Where are these subsidiaries located? Are we to audit their financial statements? If so, we must notify our other offices concerned and coordinate their work. Are the financial statements of these subsidiaries to be audited by other independent accountants? If so, should we review the other accountants' working papers and take responsibility for their work or should we review their report and refer to it in our opinion on the consolidated financial statements? I will discuss the administrative problems related to questions such as these later when we examine more closely the organization of The Diversified Corporation.

The other important accounts found on Diversified's balance sheet and not on Minor's relate to long-term debt. Typically, such debt will be publicly held and in such cases will usually be administered by a trustee under an indenture. If not publicly held, the debt will commonly be covered by a note or similar debt instrument. In either case, arrangements must be made to obtain copies of the indenture, note, or other debt instrument. In addition to the usual confirmation procedures concerning the amounts and terms, etc., of the debt, we must review the loan documents for default provisions, restrictive covenants, and any related reporting requirements on our part. It is important that we arrange for the client to complete, on time and for our verification, any computations required by any restrictive covenants. Frequently we are asked to report separately to the client on such matters for the benefit of the trustee or lender.

**EXHIBIT 1****BALANCE SHEETS**

(Condensed for illustrative purposes)

	Minor Manufacturing Company	The Diversified Corporation
<b>Assets</b>		
<b>Current Assets:</b>		
Cash . . . . .	\$ 64,000	\$110,481,000
Marketable Securities . . . . .		46,733,000
Trade Receivables . . . . .	1,691,000	173,982,000
Inventories . . . . .	3,324,000	498,612,000
Other . . . . .	<u>11,000</u>	<u>75,483,000</u>
 Total Current Assets . . . . .	 <u>5,090,000</u>	 <u>905,291,000</u>
 Investments in Affiliated Companies, at Equity . . . . .		 <u>71,848,000</u>
 Property, Plant and Equipment, at Cost . . . . .	 5,762,000	 816,021,000
Less Accumulated Depreciation . . . . .	<u>(1,590,000)</u>	<u>(412,314,000)</u>
 Property, Plant and Equipment – Net . . . . .	 <u>4,172,000</u>	 <u>403,707,000</u>
 <b>Other Assets:</b>		
Excess of Cost Over Net Assets of Businesses Acquired . . . . .		115,047,000
Unamortized Debt Expense . . . . .		75,452,000
Trademarks . . . . .		52,436,000
Deferred Charges and Sundry . . . . .	<u>100,000</u>	<u>6,434,000</u>
 Total Other Assets . . . . .	 <u>100,000</u>	 <u>249,369,000</u>
 <b>Total . . . . .</b>	 <b><u>\$9,362,000</u></b>	 <b><u>\$1,630,215,000</u></b>

**EXHIBIT 1 (Continued)**

	<u>Minor Manufacturing Company</u>	<u>The Diversified Corporation</u>
<b>Liabilities and Shareholders' Equity</b>		
<b>Current Liabilities:</b>		
Notes Payable . . . . .		\$ 73,078,000
Current Maturities of Long-Term Debt . . . . .		75,418,000
Accounts Payable and Accrued Liabilities . . . . .	\$3,333,000	222,506,000
Accrued Federal and Foreign Income Taxes . . . . .	<u>296,000</u>	<u>70,598,000</u>
<b>Total Current Liabilities . . . . .</b>	<u>3,629,000</u>	<u>441,600,000</u>
<b>Long-Term Debt, Less Current Maturities . . . . .</b>		
Deferred Income Taxes . . . . .	<u>538,000</u>	<u>478,825,000</u> <u>75,644,000</u>
Minority Interest in Subsidiaries . . . . .		<u>77,295,000</u>
<b>Shareholders' Equity</b>		
Preferred Stock . . . . .		1,975,000
Common Stock . . . . .	400,000	45,333,000
Capital in Excess of Par Value . . . . .	972,000	117,257,000
Retained Earnings . . . . .	3,823,000	399,228,000
Less Common Stock in Treasury, at Cost . . . . .		<u>(6,942,000)</u>
<b>Total Shareholders' Equity . . . . .</b>	<u>5,195,000</u>	<u>556,851,000</u>
 <b>Total . . . . .</b>	 <u>\$9,362,000</u>	 <u>\$1,630,215,000</u>

**EXHIBIT 2****STATEMENTS OF INCOME**

(Condensed for illustrative purposes)

	<u>Minor Manufacturing Company</u>	<u>The Diversified Corporation</u>
<b>Revenues:</b>		
Sales and Operating Revenues . . . . .	\$18,164,000	\$2,111,946,000
Other — Net . . . . .	<u>32,000</u>	<u>48,746,000</u>
Total Revenues . . . . .	<u>18,196,000</u>	<u>2,160,692,000</u>
<b>Costs and Expenses:</b>		
Cost of Goods Sold and Operating Expenses . . . . .	11,148,000	1,470,620,000
Selling, Advertising, and Administra- tive Expenses . . . . .	4,335,000	346,912,000
Interest and Debt Expense . . . . .	200,000	63,418,000
Depreciation and Amortization . . . .	430,000	25,777,000
Provision for Income Taxes:		
Federal . . . . .	1,015,000	117,002,000
Foreign and Other . . . . .	<u>                    </u>	<u>6,481,000</u>
Total Costs and Expenses . . . .	<u>17,128,000</u>	<u>2,030,210,000</u>
Income Before Minority Interest . . .	1,068,000	130,482,000
Income Applicable to Minority Interest . . . . .	<u>                    </u>	<u>25,482,000</u>
Net Income . . . . .	<u>\$1,068,000</u>	<u>\$105,000,000</u>
<b>Earnings Per Share:</b>		
Primary . . . . .	\$2.67	\$2.32
Fully-Diluted . . . . .	\$2.67	\$1.55

If you examine the income statements of Minor and Diversified you will find, as shown by Exhibit 2, that other than the substantial differences in amounts, the accounts are the same; accordingly, the related audit and administrative procedures will generally be similar. Several exceptions that come to mind however, are:

Generally, a company with operations of the size and scope of Diversified's, and with potential U.S. tax obligations in such substantial amounts, would have its own competent tax personnel; thus we would not usually be called upon to prepare their tax return, as we would frequently be for clients the size of Minor. This does not, however, lessen our responsibility in this regard. Early in our work for Diversified we must arrange with the client for the review of the client's tax accrual by our tax specialists. This is important, not only from an audit standpoint but also in order that we may provide tax planning and other constructive tax services for our client. For this reason we would also ordinarily arrange for one of our tax specialists to review the client's tax return prior to the time it is filed. In any event, effective coordination of our audit work with that of our tax specialists is an important administrative task with respect to large clients such as Diversified.

As mentioned earlier, companies of the size of Diversified usually make extensive use of data processing equipment. If the client has a particularly sophisticated EDP system it may be necessary for us to have data processing specialists from our management advisory services group review the controls over their EDP system. Frequently, in such situations, their retention procedures for underlying sales and other data stored on computer tape or disk packs provide for the periodic erasure of such data and re-use of the tapes or disks. Therefore, in connection with our audit of transactions, it is imperative that we establish procedures with the client's data processing personnel whereby we are notified prior to the erasure of any tape or disk file of audit interest so that we can perform our necessary audit procedures currently. Generally, this is accomplished by establishing in advance a schedule for the performance of our tests throughout the year.

Typically, a company such as Minor is located in only one city, with all accounting-related matters in a single office, frequently on the same floor as the auditor. A company such as Diversified, on the other hand, may have accounting centers in several cities or several centers in one city. Because of the large volume of transactions and personnel involved, relevant accounting data may be found on many floors or areas within the same accounting



center. Thus, even in the simplest situation for a large client, the senior accountant in charge must provide effective administration and coordination to ensure that all areas within the local accounting center are covered by his assistants, and he must acquaint himself and his assistants with the client personnel responsible for these areas. In the more complex situation, i.e., a client having accounting centers in many locations, effective administration and coordination becomes paramount and generally requires substantial effort on the part of the partner and principal responsible for the engagement. Without such administration and coordination it would be impossible to complete the audit successfully. In my view, this problem, which I believe to be most crucial in administering a large audit, is one of communication — not just between accountants within the Haskins & Sells office but between accountants in many offices. If we have communication, we succeed; if we have a communication gap, we may fail.

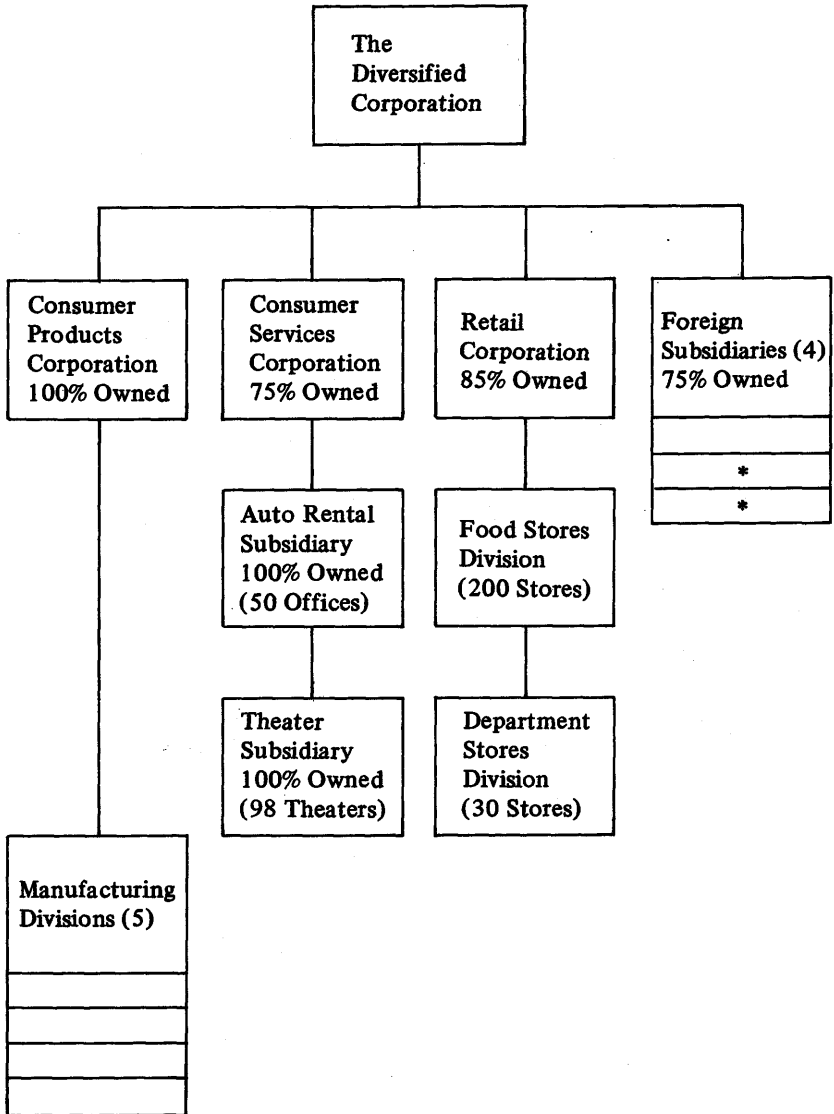
Perhaps if we contrast the organizations of our two illustrative companies, you can get a better understanding of this problem. As mentioned earlier, Minor is closely held and operates from one manufacturing and accounting location. But what of Diversified? Let's take a look at Exhibit 3 which illustrates its organization.

As can be seen, Diversified has four basic lines of operation: (1) the Consumer Products Corporation (100 per cent owned), with its five manufacturing divisions; (2) the Consumer Services Corporation (75 per cent owned), with its two subsidiaries and 148 locations; (3) the Retail Corporation (85 per cent owned), with its two underlying operations (including 230 stores); and (4) the four foreign subsidiaries (75 per cent owned). I think you will agree that to complete this audit successfully, more than one Haskins & Sells office will have to be involved. Not only is the corporate organization intricate, but to complicate our communication problem more, two of the foreign subsidiaries are audited by other accounting firms.

Let us see the magnitude of our problem by examining the comparative data shown on Exhibit 4. Notice the captions relative to store outlets, to theater and auto rental locations, reporting requirements, and also the audit data. Do you agree that we have a communication problem of considerable magnitude?

The question then is: How do we solve this problem? In most succinct terms, we do it in four ways:

**EXHIBIT 3**  
**ORGANIZATION STRUCTURE**



\*Subsidiaries audited by other independent accounting firms

**EXHIBIT 4****COMPARATIVE AUDIT DATA**

	Minor Manufacturing Company	The Diversified Corporation
<b>Client Data:</b>		
Major Consolidated Subsidiaries . . . . .	None	9
Subsidiaries not Consolidated . . . . .	None	1
Affiliated Companies . . . . .	None	3
Divisions . . . . .	None	7
General Office Accounting Locations (Sub-Consolidations) . . . . .	1	4
Other Major Accounting Locations . . . . .	None	12
Store Outlets . . . . .	None	230
Theater and Auto Rental Locations . . . . .	None	148
Number of Reports Required . . . . .	1	8
<b>Audit Data:</b>		
Other Firms of Certified Public Accountants Involved . . . . .	None	2
<b>Haskins &amp; Sells Accountants (By Class; U.S. Only)</b>		
Partners . . . . .	1	49
Principals . . . . .	1	80
Seniors . . . . .	1	94
Senior Assistants . . . . .	1	213
Assistant Accountants and Interns . . . . .	<u>2</u>	<u>225</u>
<b>Total</b> . . . . .	<u>6</u>	<u>661</u>
<b>Haskins &amp; Sells Offices Participating:</b>		
United States . . . . .	1	36
Foreign . . . . .	<u>None</u>	<u>6</u>
<b>Total</b> . . . . .	<u>1</u>	<u>42</u>

1. Through the distribution of a detailed engagement memorandum supplemented by specific instructions for each participating office. The details included therein usually consist of (a) nature of work to be performed, (b) dates when work is to be commenced and completed, (c) special instructions concerning physical inventories, etc., and (d) reporting instructions, etc., and any other matters of significance.
2. Through the design of general audit programs to be used at each location of the entity. For example such a program, tailored for the types of business involved, could be adopted for the auto rental and theater subsidiaries and food and department stores divisions of Diversified.
3. Through constant exchange of information and monitoring of correspondence between offices during the course of the audit. Frequently, this will include visits to other offices by the partner and/or principal having over-all responsibility for the engagement.

If our foreign offices participate in the engagement (as they do with Diversified), communication becomes more complicated and critical, for now we are at the mercy of foreign postal systems and are faced with longer delays in exchange of correspondence. Frequently, international cable and telex communications must be used to expedite the exchange of audit information. Potential problem areas in foreign currency translation, foreign taxation, or foreign accounting principles must be investigated and resolved as early as possible. Whether the offices are foreign or domestic, we must ensure that the work is commenced and completed on time and that all important matters noted during our audit at each location are brought to our attention and, where necessary, to the attention of the client. A means I have found to be particularly helpful in accomplishing this on a large audit is our fourth way of curing the communication problem, i.e.,

4. Through the design and advance distribution of an informal reporting form. Such a form may consist of (1) a series of questions requiring affirmative or negative answers concerning accounting and auditing matters; (2) a brief outline setting forth the dates and nature of various financial and other data that must be provided by the participating offices prior to rendering our opinion; and (3) a brief outline setting forth other data such as SEC schedules required but which may be forwarded after the date of our opinion. To illustrate such a form, let us review briefly Exhibit 5. I think you can appreciate that a report such as this provides – in a concise and complete manner – the partner, principal, and senior accountant resident in the office originating the engagement with all the critical information they may require

to make an informed judgment concerning the results of our audit at the various locations.

Using these four approaches as tools, we are able to ensure that the engagement is properly planned, commenced, and completed in an orderly manner and on time, the reports promptly rendered, and our charges for services at the various locations properly billed. To accomplish this in an audit of any size, effective administration is essential, and the auditor must be more than simply an accountant. He must be a planner and organizer (to plan and organize the engagement), a communicator (to correspond and deal with his associates and the client), a teacher and supervisor (to train and supervise his subordinates), a personnel counselor (to advise and counsel his subordinates), a writer (to write the various audit reports); and at the same time he must be an expert on accounting and auditing. ●

**EXHIBIT 5**INFORMAL REPORTUNIT OR LOCATION \_\_\_\_\_  
\_\_\_\_\_

YEAR ENDED DECEMBER 31, 19\_\_

Furnish the following:

Name of Practice Office \_\_\_\_\_

Names of:

Accountant in charge of  
examination \_\_\_\_\_Partner or Principal  
who reviewed the work-  
ing papers \_\_\_\_\_Partner who performed  
over-riding review of  
working papers \_\_\_\_\_Accountant who prepared  
this report \_\_\_\_\_Partner who reviewed  
this report \_\_\_\_\_

\*\*\*\*\*

This report should be sent to H&S New York as soon as possible, but, in any event, not later than \_\_\_\_\_ as to Parts I and II and \_\_\_\_\_ as to Part III. If, however, during the examination any conditions develop requiring correction or adjustment that by January 31 are not expected to be made locally, communicate with the New York office immediately.

Information required herein to be sent or otherwise communicated to H&S New York should, in the absence of contrary instructions, be sent or communicated to the attention of the H&S Representative at the client's corporate offices.

PART I

In the spaces following please furnish the information requested. If additional space is necessary, attach a supplemental sheet. If you have no comments, please so state.

1. Were there any unusual items, improper accounting practices or deficiencies in internal control that should be brought to the attention of company officials in New York? Your comments, if any, covering these matters should be set forth in full detail and should include your suggestions for improvement in the light of local conditions. Three copies of such comments, typewritten and in our customary format for rendering to the client, should be attached to this report. At the end of your comments, to avoid any misunderstanding of the facts, state in a final paragraph the name of the local representative of the client with whom the comments were reviewed and his response (if any) relating to the matters mentioned above.

**EXHIBIT 5 (continued)**

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2. Are you satisfied that the books (as adjusted, if necessary, as the result of the audit) have been kept in accordance with generally accepted principles of accounting, and that there have been no major inconsistencies in the application of such principles in the current year as compared with the preceding year? Stated another way, are you satisfied that the unit presents fairly and consistently its financial position and results of operations to the extent that they are recorded at that location?

3. (a) Were there any possible adjustments in excess of \$ suggested by H&S that were not recorded in the accounts? (If your answer is yes, describe such items, in journal entry format, and the reasons why such adjustments were not recorded.)

(b) Do you agree with the unit's account classifications on the trial balance? (If not, please state clearly how you would classify the items to which you take exception and your reasons for reclassification, and prepare a suggested journal entry.)

4. Did your examination disclose any material amount of obsolete, slow-moving, unusable, or unsalable inventories that would necessitate establishing a reserve on the books? Give complete details.

5. Are you satisfied that there are no unrecorded liabilities or inadequate accruals and reserves? (Supply detail for the same if they exceed \$ in aggregate. If not satisfied, please give complete details and the name and title of the local official conferred with in regard thereto and his name and your conclusions thereon.)

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6. Give complete information concerning any items that could not be checked properly from supporting data on file or by conferring with local officials.

7. In order that we may properly review the Federal income tax accruals in New York, it is necessary that we be informed of items that may require a treatment for tax purposes different from that required for accounting purposes. State below the nature and amounts of any such items.

8. On a consolidated basis, we have determined that the monetary precision to be used for statistical sampling purposes should not exceed \$ \_\_\_\_\_ at any unit. In no case should a monetary precision limit be used at any unit exceeding the aforementioned amount without the concurrence of H&S New York.

If you made use of statistical sampling techniques in connection with your examination of the local unit, state below each such application, the related monetary precision (MP) used, and the adjusted MP for each application. Also state the over-all adjusted precision errors for your unit. (Please note that this information must be furnished to H&S New York, on or before the date specified on page one.)

9. Prepare and enclose confirmation statistics for accounts receivable giving details as to adjusted precision errors, if any, where exceptions resulted in monetary errors.



**EXHIBIT 5 (continued)**

PART II

The information required below is for use by H&S New York in verifying the client's assembly of the consolidated financial data and for determination of notes to the financial statements, etc.:

ACCOUNTANT

1. Your working papers should contain a detail trial balance (including adjusting and reclassification entries) and account groupings as of December 31. A copy of the unit's internal financial statements submitted to client's corporate office in New York is to be reconciled to your detail trial balance and forwarded to H&S New York together with a copy of the detail trial balance and an analysis of any reconciling items. \_\_\_\_\_  
 a. Are there any new or different classifications or changes in the formats since last year? If "yes," provide details. \_\_\_\_\_
2. Submit an audited copy of the unit's information to be included in the notes to financial statements. \_\_\_\_\_  
 a. Is any additional disclosure required? \_\_\_\_\_
3. Schedules of transfers of cash for the period December \_\_\_ to January \_\_; (This schedule should be submitted by January \_\_.) \_\_\_\_\_
4. Schedule of intercompany balances. \_\_\_\_\_
5. Schedule of intercompany purchases and sales and the profit to be eliminated in consolidation. \_\_\_\_\_
6. Schedule of supplementary information concerning loan agreements (to be prepared by client). \_\_\_\_\_
7. Insurance for all units is purchased by the client's Corporate office with the related prepaid and expensed amounts accounted for on the unit's books. \_\_\_\_\_  
 a. Forward a copy of the analysis of prepaid and expensed insurance for the year to H&S New York. (This analysis will be used for verification work to be performed by H&S New York at the corporate office.) \_\_\_\_\_  
 b. Does the insurance described above appear adequate for your location? Explain if answer is "no." \_\_\_\_\_
8. H&S New York will provide you with a list of local key personnel. You are to verify that said personnel are employed at your location or note exceptions (giving full details). \_\_\_\_\_
9. On day before opinion date (approximately \_\_\_\_\_ as to \_\_\_\_\_ and \_\_\_\_\_ as to \_\_\_\_\_) obtain from client the usual liability and inventory representations. Notify H&S New York promptly by phone and send originals of representations to H&S New York by mail. \_\_\_\_\_

PART III

The information required below need not be submitted to H&S New York prior to the opinion date. It should, however, be submitted as soon thereafter as possible.

1. The client has been asked to prepare the standard H&S working paper forms for applicable Form 10-K schedules.

Furnish H&S New York with an audited copy of each of the following:

- a. SEC Schedules V and VI (show clearly transfers to or from other divisions). \_\_\_\_\_
  - b. SEC Schedule IX. \_\_\_\_\_
  - c. SEC Schedule XII. \_\_\_\_\_
  - d. SEC Schedule XVI. \_\_\_\_\_
  - e. Are all other schedules omitted because of the absence of the conditions under which they are required or because the information required is shown in the financial statements or notes thereto? (See steps 1 and 2 to Part I.) Explain, if answer is "no." \_\_\_\_\_
2. Have informal comments been submitted? \_\_\_\_\_
3. a. State below the total actual audit time for the current and prior year's examinations. Explain significant differences comprehensively and clearly enough to enable H&S New York to discuss them, if necessary, with client officials. Be specific with respect to abnormal or changed conditions that cause significant changes in amount of audit time.
- |                     |       |
|---------------------|-------|
| Current year        |       |
| Prior year          | _____ |
| Increase/(Decrease) | ===== |
- b. State below your estimate of audit hours to be budgeted for next year's examination and reasons for any significant change in budget.
4. Submit below your comments or suggestions for improvement with respect to this informal report.