1962

Medium-sized "small loan" companyElectonic equipment manufacturer; Case studies in auditing procedure no. 12

American Institute of Accountants. Committee on Auditing Procedure

NUMBER 14

CASE STUDIES

IN

AUDITING PROCEDURE

A MEDIUM-SIZED DAIRY

This is the fourteenth of a series of case studies sponsored by the Committee on Auditing Procedure of the American Institute of Certified Public Accountants to illustrate actual application of auditing procedures.

Published by

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

666 FIFTH AVENUE, NEW YORK, N. Y. 10019

Case Studies IN AUDITING PROCEDURE

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Published by the American Institute of Certified Public Accountants, 666 Fifth Avenue, New York 19, N. Y.

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A MEDIUM-SIZED DAIRY

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FOREWORD

THE short-form accountant's report or certificate recommended by the committee on auditing procedure of the American Institute of Certified Public Accountants in 1948, and now in general use, summarizes the accountant's representations as to the scope of the examination in these two significant statements:

(1) "Our examination was made in accordance with generally accepted auditing standards," and (2) the examination, "accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances."

Auditing Standards

During recent years the committee has given a great deal of consideration to the definition of generally accepted auditing standards. In 1947, it issued a special report, *Tentative Statement of Auditing Standards,* in which it presented the results of its deliberations up to that time. In September 1948, a summary of generally accepted standards, as presented in that report, was adopted by the membership of the American Institute of Certified Public Accountants. In November 1949, the membership of the American Institute of Certified Public Accountants also approved Statements on Auditing Procedure No. 23 (Revised), *Clarification of Accountant's Report When Opinion Is Omitted.* In 1954, the committee issued a revised report on auditing standards under the title, *Generally Accepted Auditing Standards,* in which the substance of Statement No. 23 (Revised) was added to the previous summary of auditing standards. The revised summary is as follows:

General Standards

1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment an independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

Standards of Field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.
3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Standards of Reporting

1. The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.
2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an over-all opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

Auditing Procedures

A consideration of the foregoing summary of standards will indicate that auditing procedures are the means by which the independent auditor attains or complies with the generally accepted auditing standards applicable to field work. Auditing procedures are so numerous and should be varied so greatly to meet particular circumstances that it is not possible to make an enumeration of procedures which would be applicable generally, or even widely. It is natural that this is the case because if the examination of accounts and financial statements could be reduced to a stereotyped check list of instructions, there would be no need for a public accounting profession. Experienced professional judgment determines the scope and nature of audit procedures to be followed in each individual engagement.

It is the view of the committee on auditing procedure that the most satisfactory method of presenting auditing procedures is through case studies illustrating the auditing procedures adopted and applied in actual examinations. Accordingly, an invitation has been extended to a number of practicing accountants requesting each to submit a comprehensive description of audit work performed on a complete engagement. The following excerpts from a memorandum submitted for the guidance of those preparing case study manuscripts indicates the general nature of the studies:

"The principal objective of the committee on auditing procedure, in publishing the series of case studies, is to illustrate typical procedures by which the independent public accountant complies with generally accepted auditing standards in specific situations. Because of the great variety of situations found in performing audit work for different organizations, the public accountant must select and apply those procedures which he feels are necessary and most appropriate in the circumstances. The exercise of sound judgment in the light of the facts of the particular case is of paramount importance in meeting the profession's standards. For that reason, it is believed that case studies, giving rather complete information as to the auditing procedures employed and indicating the considerations involved in selecting and applying those procedures, will do much not only to assure the continuance of high standards within the profession but also to assist those preparing to enter it."

. . . .

"The pattern that has been established for the case studies is to cover an entire examination selected by the author from a case within his own practice. Using such a case as a basis, the author has prepared an audit program to describe the work which actually took place. In this connection, it is important that actual procedures should be described even though the author may feel upon reconsideration and with the benefit of hindsight that certain modifications of the program should have been made. The principal purpose of the case study material is to illustrate current practices and not to set forth perfect or ideal models which might be misleading and perhaps even dangerous to hold out as representative of current practice."

. . . .

"The case studies so far issued have described the audits in considerable detail. There has been some feeling among committee members, however, that a large proportion of that detail could well be reduced in future case studies by omitting detailed descriptions of procedures which are pretty much the same in all audits and by concentrating instead upon the phases of the audit which, in the author's opinion, are somewhat distinctive to the particular engagement."

The accompanying case study describes the auditing procedures which were actually followed by a practitioner in a particular instance. The procedures used may be applicable only due to particular circumstances surrounding the examination; furthermore, alternative procedures might conceivably have been used to accomplish the general audit objectives. This case study has not been reviewed by the various members of the committee and is not intended as a representation of the views of the committee on auditing procedure. However, the committee wishes to express its appreciation to Rollin M. Dick, CPA, who prepared the case study.

The committee hopes that the case study material will serve a useful purpose not only within the profession, but also in the various colleges and universities throughout the country which offer advanced instruction in accounting and auditing subjects.

Committee on Auditing Procedure

September, 1962

A MEDIUM-SIZED DAIRY

INTRODUCTION

This corporation's operation consists of obtaining raw milk and cream, processing as necessary, and distributing the products for wholesale, retail and institutional use.

Substantially all raw dairy products are purchased through a local co-operative "Milk Shed" maintained by the dairies in the area. The principal products processed by the dairy are milk and cream in bottles, cartons or dispenser cans; cottage cheese; ice cream; chocolate drink; buttermilk and other specialties. In addition frozen foods, eggs, butter, etc. are handled on a jobber basis to a limited extent.

Distribution is accomplished by 45 door-to-door routes serving 12,000 homes 3 days a week and by 15 commercial routes serving 700 businesses 6 days a week. Special orders for parties, etc., are also delivered. Cash sales made at the plant are negligible. The customers are located in a dozen localities within a 50 mile radius of the plant. The routes and trucks are owned by the company; the drivers are employes of the company.

The company has been under the same management for many years. The majority of the capital stock is held by several individuals no longer active in day to day management, and the balance of the stock is held by employes. Condensed financial statements for the year under review and a summarized organization chart are as follows:

BALANCE

December

ASSETS

Current assets:		
Cash	$ 70,000	
Marketable securities, at cost (Market value $194,000.00, pledged on notes payable)	130,000	
Accounts receivable, less allowance for doubtful accounts ($10,000.00)	206,000	
Inventories, at lower of cost or market	52,000	
Prepaid expenses	22,000	$ 480,000
Fixed assets (land and buildings subject to real estate mortgage note payable):		
Cost	$1,448,000	
Less accumulated depreciation	764,000	684,000
Other assets:		
Notes and accounts receivable	$ 14,000	
Cash value of life insurance	4,000	18,000
Total assets		$1,182,000

SHEET

31, 1962

LIABILITIES AND CAPITAL

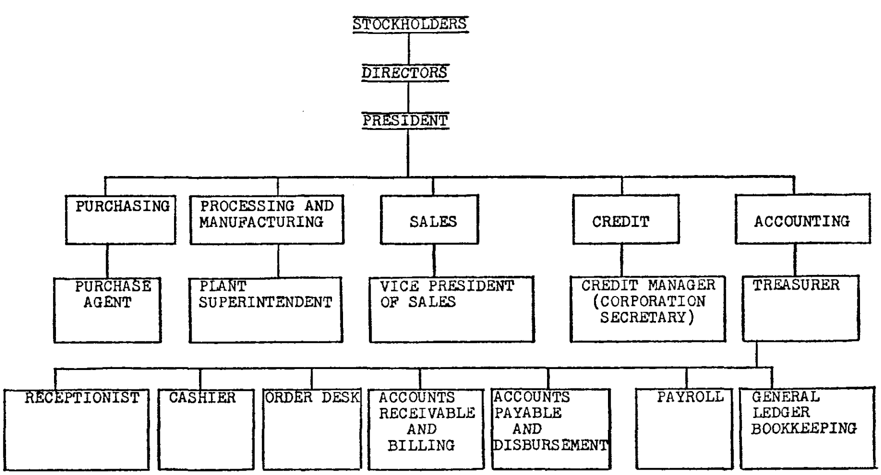
Current liabilities:			
Notes payable		$ 112,000	
Accounts payable		106,000	
Accrued expenses		36,000	
Provision for income taxes		16,000	$ 270,000
Long-term liability—note payable, secured by real estate mortgage on land and buildings, less currently maturing installments included in current liabilities			150,000
Capital:			
Common stock, par value $100.00 per share: Authorized	$1,000,000		
Issued and outstanding		$ 615,000	
Retained Earnings: Balance, January 1, 1962	113,000		
Add-net income for the year ended December 31, 1962	34,000	147,000	762,000
Total liabilities and capital			$1,182,000

STATEMENT OF INCOME

For the Year Ended December 31, 1962

Gross sales	$3,064,000	
Less returns and allowances	55,000	$3,009,000
Material and processing costs		1,569,000
Gross income		1,440,000
Operating expenses		1,402,000
Operating income		38,000
Other income, net		12,000
Income before provision for income taxes		50,000
Provision for income taxes		16,000
Net income		$ 34,000

ORGANIZATION CHART



ACCOUNTING POLICIES AND PROCEDURES

The management, typical of many older concerns, is conservative and not overly anxious to adopt new, or to change, its accounting methods. Consequently, the records encountered on the audit engagement are very detailed and complete. The firm maintains its records on a calendar year.

The records in use are listed below:

Record	***Description***
General ledger	Usual
General journal	Usual
Fixed monthly journal	General journal for recurring entries
Cash receipts journal	Summary of daily deposits supported by cash credit tickets
Cash disbursements journal	Numerical list of checks drawn, contra entry being to accounts payable
Voucher register	Numerical list of vouchers, columnar distribution to expenses
Sales journal	Detailed sales records are summarized by source to determine the monthly sales and accounts receivable entry
Sales adjustment journal	Summary of adjustments to accounts receivable

Record	Description
Payroll journal	Pegboard system prepared manually
Accounts receivable records	Driver route books and other office files
Charged-off accounts register	Alphabetical ledger of accounts charged off
Perpetual inventory records for supplies	Usual
Corporate minutes and stock records	Usual, transfer agent maintains stock records

Cash

A minor imprest cash fund is maintained by the cashier. He obtains an invoice or receipt for each disbursement and submits a listing, together with the documents, for repayment as necessary and always on the last day of the month.

An imprest checking account is maintained for payroll; and other check disbursements are made from one account. In addition, six bank accounts are maintained in neighboring localities for deposit of local route collections, subject only to home office withdrawal transfering them into the general account.

The mail is opened by the receptionist, sorted and delivered (without preparation of a cash list) to the proper departments. Mail receipts from route customers are delivered to the route driver for recording with his regular collections. Other mail receipts are delivered to the cashier and are recorded by preparation of a cash credit slip. Route drivers deliver their collections to the cashier daily. The cashier gives a receipt for the total and retains a copy thereof as the cash credit slip.

The cashier prepares a deposit daily for delivery to the bank by an armored car service. The cash credit slips are balanced with the deposit and are filed as the daily cash receipts detail record. Vouchers prepared for each disbursement are approved by the purchasing agent as to the receipt of merchandise and correctness of prices, terms, and mathematics and by an officer as to final approval. At the payment date the bookkeeper types the checks and remittance advices and submits all documents to the chairman of the board, president, or treasurer for two signatures. The checks are mailed and all data is then returned to the bookkeeper for filing.

Monthly bank reconciliations are prepared by the treasurer.

Marketable Securities

Investments in marketable securities are kept in the bank safe deposit vault. It is necessary that two officers be present to open the box. All changes in the investments are authorized by the Board of Directors.

Accounts Receivable

Accounts for sales of dairy products are classified as route accounts or special accounts.

Route Accounts — These accounts include all retail accounts and some wholesale accounts and are maintained by each driver in a route book.

The driver makes daily entries to each customer's account in the route book for merchandise delivered to, and for collections received from, the customer. At the end of each month these route books are turned in to the office, where they are balanced and summarized on a route summary card. Charges to customers are compared with the load charged to the driver and adjustment is made charging the route driver for load shortages. Load overages are not credited to drivers' accounts. The total cash collections from customers, as credited to their accounts, are compared with the total cash turned in by the driver and any overage or shortage is adjusted to the driver's account.

Monthly statements are prepared in the office from the drivers' route book. These statements are generally delivered by the driver, but occasionally the credit department mails statements directly to the customers if any irregularities are suspected.

The credit department reviews monthly the accounts noting delinquencies, customers who have ceased ordering, and other irregularities.

Special Accounts — The accounts for special deliveries, certain wholesale customers, and ice cream customers are maintained in the general office by filing sales tickets after they have been priced and totaled in the accounts receivable file. The sales tickets are removed from the accounts receivable file when paid.

Monthly statements are prepared from the unpaid sales tickets and after review by the credit department, are mailed to the customers.

Adjustments of accounts receivable are recorded on detailed debit or credit slips. Each is adequately explained and approved. These are summarized monthly by route and entered in the sales adjustment journal.

Inventory

Separate control accounts are maintained on dairy products, manufacturing materials, resale items and supplies. The purchase agent maintains Kardex perpetual records on all items except dairy products.

A physical inventory of dairy products is taken monthly and the control account adjusted thereto. Other inventory accounts are adjusted monthly based on material-used slips as prepared by the storekeeper or purchase agent.

A complete physical inventory is taken at year-end and is priced at the lower of cost or market. The cost used for dairy products is computed monthly and includes material, labor and overhead. The purchase agent supervises all inventory procedures.

Prepaid Expense

Insurance premiums and other prepaid expenses are recorded in a register and are amortized over the proper period of time.

Fixed Assets

The company generally capitalizes all acquisitions costing more than $100.00 with an expected life of more than one year. The treasurer of the corporation makes the determination as to the capitalizing or expensing of any particular acquisition.

A detailed fixed asset ledger is maintained and balanced with the controlling accounts. Depreciation is computed in the fixed asset ledger on each item based on the estimated life of the particular asset. Generally the declining balance method is used.

All major fixed asset acquisitions are approved in advance by the Board of Directors. In addition a detailed list of each month's additions is approved by the Board of Directors.

Other Assets

Subsidiary ledgers are maintained on non-current accounts and notes receivable. All new accounts have prior executive approval.

Accounts Payable

The purchase agent prepares purchase orders based on requisitions from department heads.

Invoices from suppliers are delivered to the purchase agent for matching with purchase orders and receiving reports. When the purchase agent has completely processed an item for payment it is delivered to an officer for final approval and then to the bookkeeper for recording in the voucher register. The vouchers are generally paid immediately, but any unpaid vouchers will comprise the accounts payable detail.

Capital

All transactions involving capital stock are recorded by the company's transfer agent and a list of stockholders is submitted when needed. The minutes of corporate meetings are recorded by the secretary who is a full-time employee.

Payroll

Payrolls are prepared by the payroll clerk and the payroll checks are signed by an officer. The twenty office and administrative personnel are paid on an hourly or monthly basis and changes in rates are authorized by an officer. Plant employees, 45 in number, are paid in accordance with union contracts. The 50 route salesmen are also paid in accordance with union contracts, generally on a commission basis. The time of hourly paid employees is recorded by time clocks.

Interim Reports

Detailed comparative operating statements and statistical reports are prepared monthly by the treasurer and are reviewed by all officers and the Board of Directors.

Federal Milk Control Administration

This federal agency is responsible for insuring an adequate and wholesome milk supply and accordingly exerts much control over the dairy. Some of the control features which have audit significance are as follows:

1. The company's treasurer submits a report monthly reconciling quantities of milk purchased, sold and on hand. A shrinkage or overage quantity and ratio is computed on this report.
2. Federal auditors visit the dairy and audit each month's report. Reported purchases are reconciled by the auditor with his audit records of the supplier of raw milk. Reported sales quantities are reconciled by the auditor with bottling reports, loading reports, and other similar records.
3. Based on monthly reports by all dairies under the jurisdiction of this agency, an average cost of milk used for Class I uses (fluid milk) and Class II uses (ice cream, cottage cheese, etc.) is computed. The dairy is then charged or credited with the difference between its actual cost and the computed average cost of all dairies in the area. The dairy is also charged with an administrative assessment to cover the costs of the agency.

Summary

In general it is felt this company has excellent internal control. Constant review by management of inventory quantity reconciliations, route cash and load shortages, accounts receivable records, operating reports, special cost studies, etc., give adequate assurance that any substantial deviation from company policy would be detected.

WORK PREPARATORY TO AUDIT

During the year, this client regularly contacts our office for routine consultation, and the initial arrangements for the audit were made at one of these conferences. During the fall, the partner in charge, a senior accountant, and an assistant visited the client's office to review internal control, prepare the audit program and conduct preliminary audit procedures.

Permanent File

This file was reviewed and revised as needed to show present organization structure, management and accounting personnel and duties, documents in use, accounting procedures, important contracts, and similar data.

Audit Routine

Our firm uses a preprinted audit routine and internal control questionnaire. This form indicates the common audit procedures and provides space for additional audit procedures needed to fit each individual engagement.

This routine is completed in conjunction with the partner's review of internal control, procedures, permanent file data, etc. When completed this routine will indicate to the staff men the method and extent of testing to be completed and will provide reminders for increasing or re-examining the extent of the test if certain situations arise. In addition the staff men prepare memorandum indicating specifically the procedures followed and the conclusions reached when an unusual or complicated situation is encountered.

From time to time during the course of the examination the audit routine will be reviewed by the partner in charge to determine its adequacy.

Trial Balance

As a part of the preliminary work the trial balance of the general ledger is headed. Columns are provided to show the prior year's balance, account number, account title, audit disposition, balance per ledger, adjustments and adjusted balance. The prior year's balances are used for comparative purposes and to determine that the proper opening balances were used in the current year's ledger. The audit disposition column is used to supplement the formal audit routine and to provide a final check list to determine that each account has been considered in the examination.

AUDIT PROCEDURES

Cash on Hand

In addition to counting the cash on hand at the close of business December 31, we performed the following audit procedures:

1. Deposit slips, cash credit tickets and other data for several days immediately before and after the end of the year were reviewed and footed. Comparisons were made between cash credit tickets and payments recorded in accounts receivable records. Proper cut-off procedures were examined.
2. The procedure for reimbursing petty cash for December was reviewed to determine that all petty cash disbursements were properly recorded.
3. Several petty cash reimbursement vouchers during the year were reviewed for proper documents and approvals.
4. The cash collections on hand at the end of the year were traced to prompt deposit in January.
5. Inasmuch as the receptionist does not prepare a cash list when the mail is opened, the foregoing procedures 1 and 4, procedures 1 (b) and (c) of Cash in Bank routine, and numerous procedures in connection with accounts receivable and income must be relied upon to determine that all cash received is recorded and deposited. This defect is not believed to be serious because of other controls over accounts receivable and income which require the recording of cash receipts.

Cash in Bank

1. The following routine was completed for all bank accounts for one month during the year, the month of December and a ten day cut-off period following the close of the year.
   (a) Compare cancelled checks returned by bank during the period with record of checks drawn. Verify payee, dates, endorsements, signatures and amount. Verify footing of check register. Determine that all withdrawals from route collection bank accounts represent transfers to the general account.
   (b) Verify immediate deposit of all cash receipts, including interaccount transfers, with the bank. Foot cash receipts, including a complete footing of the monthly summary, a

test footing of one-third of the days' cash credit tickets and deposit slips with the cash receipts monthly summary.

(c) Prepare bank reconciliation by following this procedure: Obtain client's bank reconciliation for the previous month. Compare checks clearing the bank during the current month with previous outstanding list and current check register to determine the current outstanding list. Check out other reconciling items on previous month's reconciliation. Trace bank balance and book balance used in previous month's reconciliation to source. Prepare the reconciliation work paper from the information developed by this procedure. Compare with client's reconciliation.

2. Trace all postings to general ledger control accounts for the two months, paying particular attention to general journal and other unusual entries. Foot the general ledger control account for the year.
3. Determine that checks outstanding at the beginning of the current year have properly cleared or remain outstanding.
4. Pay particular attention to in transit items between bank accounts at the end of the year. Also investigate outstanding checks at the end of the year, particularly those that do not clear during the ten day cut-off period following the end of the year. Determine all deposits in transit have been audited in preceding routine for cash collections.
5. Secure direct confirmation from all depositories covering balances at the end of the year and at the end of the cut-off period.

Marketable Securities

1. Prepare schedules showing all investments on hand at the beginning of the year, purchases during the year, dispositions during the year and balance at the end of the year. Balance this schedule with the general ledger control account.
2. Verify all footings and postings to the general ledger control account.
3. Compute or ascertain by reference to dividend services the income that should have been received from these investments during the year and compare with the recorded income.
4. Inspect the securities or confirm those held for safe keeping.
5. Determine market values from available quotations and determine if a reserve is required for balance sheet purposes.

6. In connection with notes payable or other liabilities, determine if any investments are pledged as security.
7. Review Capital Changes Reporter for activity during the year such as stock dividends, issuance of stock rights, etc. Determine that proper accounting and income tax procedures have been followed.
8. Review minutes of directors' meetings for authority for investment transactions.

Accounts Receivable

1. Retail routes:
   - (a) Prepare trial balance at December 31 of route summary cards to equal general ledger control account.
   - (b) Foot 20% of drivers' route books and balance to summary card totals at December 31.
   - (c) Review route summary cards for December and the first period of the new year. Watch for unusual fluctuation in accounts receivable balance, average customer balance, ratio of accounts receivable to month's sales, and unusual adjustments. Determine that established policy for charging off delinquent accounts is being followed. Note any December adjustments or allowances recorded in January.
   - (d) Review selected route books with credit manager inquiring of delinquent accounts and his department's activity thereon. Inquire as to monthly customer statements which have been mailed by his department recently. Secure his impression of unfavorable ratios and trends noted in item c above.
   - (e) Determine drivers' surety bonds are sufficient to protect the company in case of driver defalcation.
   - (f) Inasmuch as these accounts are represented by a mass of small retail accounts, the accuracy of which is the direct responsibility of a bonded route driver, an extensive confirmation program was believed to be necessary. However, based on the information gained in the foregoing inquiries, selected accounts should be confirmed by direct correspondence. This confirmation program will cover less than 1% of the accounts and will be co-ordinated with the company's treasurer and credit manager.

2. Wholesale routes (where accounts receivable records are maintained in driver route book):
   (a) Summarize, foot and review these accounts as described for retail routes above.
   (b) Confirm selected accounts, paying particular attention to those delinquent or of material amount.

3. Special accounts not maintained in driver account book:
   (a) Because the only detailed record of these accounts is the unpaid billings file, it is most practical to balance and confirm these accounts at December 31. Balance the accounts by running an adding machine tape of the unpaid billings file and comparing the total with the general ledger control account.
   (b) Confirm selected accounts. Because many substantial balances are included in this category, the portion confirmed exceeds the portion of retail or wholesale routes confirmed under items 1 and 2 above.
   (c) Review the unpaid billings file at a later date and inquire of delinquent accounts remaining unpaid. Determine that company policy for charging off delinquencies has been followed.

4. Interim Testing. For one month during the year complete the following procedures:
   (a) Reconcile quantities of raw materials purchased with inventories and quantities sold. The client already has made extensive reconciliations for management statistics and for reporting to the Federal Milk Market Administrator and we are able to check these out for our purposes. Convert quantities sold to dollars based on unit selling prices and compare with recorded sale. Convert quantities purchased to dollars and compare with recorded purchases and with purchase invoices.
   (b) Co-ordinate the foregoing reconciliation of quantities sold with quantities sold as shown by route commission computations as discussed in a later comment on "Payroll."
   (c) Check computation of route load shortage and overage for 20% of the routes. This computation compares the retail value of products loaded onto the driver's truck, as shown by signed load receipt, with the actual sales recorded in

the driver's route book for the month. Verify proper charge to driver's account in event of shortage.

(d) Check the computation of the cash overage or shortage on 20% of the routes for the month. This computation compares total cash turned in by the driver with the collections credited to customers' accounts in his route book. Trace overage or shortage to entry in driver's account.

(e) Balance route summary cards for month with general ledger control account.

(f) Check computations on 20% of route summary cards with route book by footing sales, collections, adjustments, balances, etc. Compare total of route adjustments with sales adjustment journal.

(g) Trace data developed in preceding tests to sales summary journal. Foot sales summary journal. Trace totals to general ledger account.

(h) Review accounts receivable adjustment slips for proper approval. Determine that allowances are in accordance with company policy and are properly computed.

(i) Foot 20% of route summaries of adjustments. Trace route summaries to sales adjustment journal.

(j) Review all other postings to general ledger accounts receivable control accounts. Audit all unusual items and adjustments.

Allowance for Doubtful Accounts

1. Analyze the general ledger activity for the year, and reconcile with expense charged to current operation.
2. For one month compare accounts charged off with those turned over to collecting agency. Determine reasons for those not turned over for further processing. Consider possibility of confirmation on accounts charged off.
3. Review correspondence with collecting agency. Trace collections to cash receipts record.
4. Review the client's permanent record of charged off accounts. Trace selected collections shown therein to cash receipts records.
5. Determine adequacy of reserve, considering collecting experience and present status of accounts.

Inventories, Including Supplies

1. Quantities:
   (a) At close of business December 31, review client's physical counts of merchandise and supplies. Verify by actual count or sight test major items. Since client's counting was finished prior to our verification we were able to scan count sheets and verify all major items and in addition scan the warehouse and storage areas and verify that all major quantities were included on the client's count sheet.
   (b) Also at December 31, review the client's method of inventorying the quantities of merchandise in delivery trucks and test these counts.
   (c) Convert quantities of dairy products into a number-of-days supply and determine the reasonableness of the result. Such quantities must be sufficient to provide for deliveries the following morning, but normally would not be sufficient for two days' deliveries.
   (d) Compare quantities of dairy products used for inventory purposes with the quantities reported in connection with the Federal Milk Control program. Reconcile quantities of purchases and sales for December as shown on that report with entries to general ledger.
   (e) Compare quantities used for inventory purposes with perpetual inventory records. Scrutinize perpetual inventory records for adjustments or other unusual entries near the end of the year.
   (f) Determine that proper inventory cut-off procedure has been followed as to purchases, sales and usage near the end of the year. Review year-end receiving report and purchase invoices to determine the proper handling thereof.
   (g) Determine if the company's policy in connection with quantities of supplies has been followed. This policy includes counting only new items in unbroken lot.

2. Prices:
   (a) Raw, unprocessed milk ($4,000), trace cost to Federal Milk Administrator's price settlement statement for final month of the year.
   (b) Processed milk, ice cream and other products manufactured by the dairy ($18,000):
      (i) Check details of client's cost work sheet for several

products. These estimates include the cost of raw milk, other flavors or ingredients, and labor and overhead of pasteurizing, cooling, mixing, freezing, packaging, etc.

(ii) Compare costs of several items with their selling prices to determine proper ratio.

(c) Purchased finished products and manufacturing supplies ($30,000)—compare cost with purchase invoice for significant items. (This category includes frozen foods, sugar, flavors, chocolate, and packaging materials.)

3. Mathematical accuracy:
   (a) Sight test all extensions and footings, noting particularly decimal points.
   (b) Actually compute about 5% of extensions and footings.
   (c) Check computation of summaries.

4. Miscellaneous:
   (a) Review current year's inventory with prior year's inventory and perpetual records to determine excess stocks, obsolete merchandise, slow moving merchandise, etc. Determine if any adjustment is required.
   (b) Review client's procedures as well as auditing procedures with the treasurer. Determine that company's policies and his directives have been carried out.
   (c) Determine consistency with prior years in connection with all foregoing steps.
   (d) Obtain certificate from management containing usual references as to accuracy, consistency, etc.

5. Work papers for audit files:
   When the inventory audit procedures are completed, the work paper file should include the following documents:
   (a) Summary of inventory general ledger accounts, reconciled with amounts shown in audit report and amounts showing on inventory certificate received from client. This would include a breakdown as to raw materials, finished goods, prepaid supplies, etc.
   (b) A recitation as to inventory procedures followed by client and audit procedures completed during the engagement.
   (c) Work sheets prepared in the process of verifying quantities and prices with notation as to disposition of any questionable item.

Prepaid Expenses

1. Insurance:
   - (a) Test and review client's computations in insurance register. Reconcile prepaid amount at the beginning of the year, purchases, expenses and prepaid amount at the end of the year.
   - (b) Sight the policies or other evidence of insurance. During this procedure compare the amount of coverage, amount of premiums and other provisions of the policy with the insurance register.
   - (c) Summarize coverage and compare with asset valuation.
   - (d) Review coverage with insurance agent. Inquire as to additional premiums or refunds due in connection with audits, liability claims in process of settlement and other information pertinent to the audit.
   - (e) Review insurance coverage with client. Review adequacy of all insurance and all coinsurance clauses. Review surety bonds on employees and route drivers.
2. Prepaid Supplies:
   This audit procedure has been covered under the comment on Inventory.
3. Other Prepayments:
   - (a) Check client's schedule and summarize for work paper files.
   - (b) Determine mathematical and theoretical accuracy of each item.

Fixed Assets

1. Obtain copies of monthly schedules of additions and deductions as approved by the Board of Directors and compare with entries to the general ledger.
2. Vouch monthly schedules with invoices and other supporting documents.
3. Trace entries to fixed assets subsidiary ledgers.
4. Test depreciation computations on selected fixed assets ledger cards. Consider rates and methods in this connection.

5. Prepare summary of general ledger fixed assets and depreciation accounts for the year, reconciling the beginning balances, additions, deductions and ending balances. On a test basis foot fixed asset ledger cards to agree with the foregoing summary.
6. Test truck asset records with fleet insurance policies, certificates of title, and licenses and inquire regarding any exceptions.
7. Review documents reflecting legal title to real estate.
8. In connection with disposals of fixed assets, analyze the profit or loss on such dispositions.

Other Accounts Receivable (Reflecting Miscellaneous Sales and Other Transactions)

1. Analyze the activity in the accounts for the year under review.
2. Confirm ending balances directly with the debtors.
3. Compute interest or other income to be accrued on these accounts.
4. Determine authorization of new accounts during the year.
5. Review collateral or other documents accompanying these accounts.

Life Insurance

1. Update permanent file schedule of life insurance policies to reflect current year's activity. Reconcile beginning asset value, premiums paid, ending value and current year's expense.
2. Confirm coverage and cash surrender value with insurance company.

Notes Payable (Including Long-Term Liability)

1. Analyze the activity in the account for the year. Sight cancelled instruments. Verify postings and footings of general ledger account.
2. Confirm balances at December 31 together with collateral or other security held by the creditor.
3. Accrue interest payable at December 31. Reconcile interest expense for the year with the general ledger expense account.
4. Determine authorization for borrowings.

Accounts Payable—Trade

1. Obtain schedule of unpaid vouchers at balance sheet date to agree with general ledger control account. Vouch as required to invoices, statements and other documents.
2. Confirm selected items, particularly those not properly documented, directly with creditor. Send confirms to major suppliers including those having no open account.
3. In connection with item 1 (f) under Inventory, review year-end cut-off procedures by examining invoices, inventories, receiving reports, etc., both prior to and after December 31.
4. Compare recorded December purchases with the purchases as reported to the Federal Milk Market Administrator and with the Administrator's price settlement adjustment.
5. Consider other methods that may be helpful in proving proper year end cut-off. Review operations for month following close of year for items applicable to period under review. Examine unpaid invoices on hand for unrecorded liabilities.
6. Verify all postings to the general ledger account for December and one other month.

Accounts Payable—Other

1. Verify employee payroll taxes withheld for transmittal to the taxing authorities by examination of returns filed and payments made in January and by review of payroll records.
2. Compare sales tax account with returns filed for final taxable period of the year.

Accrued Expenses

1. Payroll:
   - (a) Verify client's computation of accrued payroll at December 31 through review of year-end payroll journal and December route driver commission computations.
   - (b) Reconcile computation of December route driver commissions with December recorded sales.
   - (c) Review union contracts and accrue any liabilities provided therein.
   - (d) Inquire of bonuses, profit sharing plans or other compensation plans which require accruals.

(e) See also comments on Payroll Expense regarding reconciliation with payroll tax returns.

2. Interest—This item has been discussed in comments regarding Notes Payable.
3. Property Taxes:
   (a) Analyze the account for the year, reconciling the beginning liability, payments made during the year, expense for the year and liability at the end of the year.
   (b) Compare this information with tax statements, assessor's rolls, tax rates, etc. and determine its accuracy.
4. Payroll Taxes—Determine that the liability account is in agreement with information developed in the payroll reconciliation as described in the comments on Payroll Expense.

Provision for Income Taxes

Our firm prepares Federal and state income tax returns for this client and accrues the income tax liability accordingly. Inquire as to recent correspondence or conferences with the taxing authorities regarding examination of prior years' returns.

Other Liability Procedures

1. Prepare standard form liability certificate for signature by company officials.
2. Review correspondence files with attorney and others for possible additional liability. Confer with attorney if required.
3. Ascertain if contracts have been negotiated which will require unusual expenditures.
4. Search public records to determine judgments or pending law suits.

Capital

1. Confirm with transfer agent capital stock outstanding at December 31.
2. Trace any activity in capital stock during the year to the general ledger accounts.
3. Determine any changes in authorized capital during the year.
4. Review minutes of Board of Directors' and stockholders' meetings, determining compliance with all directives included in such minutes, and check out such data as affects the financial statements.

5. Verify dividends paid, if any.
6. Determine stock options or restrictions and proper accounting thereof.

Income Accounts

1. Sales:
   (a) The sales for one month have been reconciled with inventories and purchases, and with reports filed with the Federal Milk Market Administrator in connection with the interim testing of accounts receivable.
   (b) The recorded sales for one month have been reconciled with the commissions paid to drivers in connection with the computation of route drivers' commissions.
   (c) Sales for December have been tested in connection with the year end cut-off work.
   (d) In addition to the foregoing scan all entries to the sales account for the year and verify unusual items.
   (e) Reconcile recorded sales with sales tax returns submitted to the state taxing authorities.
   (f) Sales returns and allowances were tested as a part of the interim and year-end testing of accounts receivable. Review general ledger entries for unusual items needing further audit.
   (g) Compare sales returns and allowances ratio with prior years and investigate significant fluctuation.
2. Investment Income:
   The balance of this account will have been verified in connection with the audit of marketable securities and other notes and accounts receivable.
3. Profit on Disposal of Assets:
   This account will have been verified in connection with the routine on fixed assets and marketable securities.
4. Purchase Discount:
   Review the ledger account to determine that all entries emanate from the monthly posting of check register totals. Further audit of these amounts is described in the general comment on expenses.
5. Miscellaneous Income:
   Analyze this account to determine source of income.

Expenses

1. General:
   (a) For two separate weeks during the year perform the following audit functions.
      (i) Vouch each general check drawn to the invoices, statements, receiving reports, purchase orders and other documents on file. Verify that all are properly approved for payment and that discounts and other allowances have been deducted from the check; trace to the entry in the check register.
      (ii) Since all checks have been charged to accounts payable in the check register, locate the corresponding entry or entries in the voucher register and verify classifications therein.
   (b) Trace postings of selected items for one month from the voucher register to the general ledger.

2. Payroll and Commission Expenses:
   In connection with the audit of the payroll bank account the payroll checks were compared with the payroll register; the bank account was reconciled and the check registers were footed. These additional audit functions were also completed in connection with the payrolls.
   (a) For one payroll period a week locate time record card for each hourly paid employee; test computation of gross and net earnings; compare wage rates with authorizations and union contracts.
   (b) Compute total commission expense for the week based on total recorded sales in accordance with the union contract terms; reconcile this total commission expense with the commissions actually paid the drivers.
   (c) Review client's computation of commissions actually paid to ten drivers, including checking the computation of the net payroll check for the week.
   (d) Trace data developed in preceding three steps through detailed payroll journal and into summary entry for the month. Trace postings to general ledger accounts.
   (e) Trace 50% of entries for the week to individual earnings records. Review other data shown on individual earnings records, regarding authorized rates, average earnings, etc.

(f) Reconcile payroll expense as shown by the general ledger with total payroll reported for Federal and state payroll tax purposes. Determine that proper reporting procedures are in use.

(g) Reconcile total payroll tax expense per general ledger with data developed in payroll reconciliation. Also determine proper accrual of payroll taxes at year-end.

(h) Review with the client's treasurer any questions regarding compliance with union contracts, Federal or state payroll tax regulations and Fair Labor Standards Act.

3. Purchases of Dairy Products and Supplies:
   (a) In connection with the testing of accounts receivable and sales, the purchases for one month have been reconciled with sales and inventories.
   (b) In connection with year end cut-off procedures, purchases for December have been audited.
   (c) Purchases audited in items (a) and (b) above have also been reconciled with reports filed with the Federal Milk Control Agency.
   (d) Postings to the general ledger accounts for the remaining months of the year should be scanned for unusual entries.

4. Depreciation, Insurance, Taxes and Interest:
   These expenses have been verified through the analysis of the contra accounts on the balance sheet.

5. Other Expense Accounts:
   (a) Scan postings to general ledger for the year and verify unusual entries.
   (b) Consider possibility of fixed asset purchases being misclassified as repairs, supplies, etc.
   (c) Analyze unusual accounts such as rent expense, miscellaneous expense (where balances are excessive), etc. Be alert for possible additional expenses that should be accrued.

Final Procedures

1. Prepare journal entries for any required adjustments.
2. Submit proposed journal entries to client for written approval. Compare client's ledger after posting adjustments with our adjusted trial balance.

3. Review work paper file for completeness of all papers. Determine that all papers agree with adjusted trial balance. Review any pertinent work papers with client.
4. Following completion of manuscript copy of long form audit report, review in detail with client and inquire as to client's suggestions. If desired, review report with client's banker, attorney, or other interested parties.
5. Prepare memos for following year's audit regarding any refinement of audit procedures, particular points to be verified, etc.
6. Present complete work paper file, audit routine and audit report for review by partner who has not been directly connected with the engagement. This review will include appraisal of the audit routine, scrutiny of the work paper file for completeness, and detailed checking and reading of the audit report.

Work Scheduling

The scheduling of the audit functions is summarized as follows:

1. Preliminary work completed prior to the end of the year.
   (a) Review internal control and permanent file, prepare audit routine and trial balance forms.
   (b) Complete all interim tests and reviews. Head work papers wherever possible.
   (c) Make definite arrangements for year-end work and schedule final audit date.
2. Work completed at December 31st.
   (a) Count and reconcile cash.
   (b) Test inventory quantities.
   (c) Balance and confirm accounts receivable ledger where the only record is the unpaid invoice file which will not be intact at the date of the final audit.
3. Final audit commencing approximately one month after the end of the year.

Supervision

1. Supervision is accomplished by the partner in charge. He personally reviews internal control and accounting procedures, outlines the audit program, computes income taxes, writes the report and periodically reviews the status of the work in process. He accounts for approximately 20% of the hours on this en-

gagement, the senior and junior accountants each make up about 40% of the hours.

2. Because of the small size of the engagement and the close supervision of the partner in charge no formal time budget is used. The following listing sets out the approximate percentages of time applicable to the various audit functions:

Function	*Percentage*
Permanent File, Audit Routine and Supervision	9%
Bank and cash routines	15%
Accounts Receivable, as to year-end balance	12%
Inventories	10%
Prepaid Expense	2%
Fixed Assets	4%
Liabilities	8%
Capital	2%
Income	16%
Expense and Payroll	8%
Report and Review	10%
Conferences with client, miscellaneous	4%
Total	100%