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NUMBER 2

CASE STUDIES

IN

AUDITING PROCEDURE

A NEWSPAPER PUBLISHER

This is the second of a series of case studies prepared by individual members of the Committee on Auditing Procedure of the American Institute of Accountants to illustrate actual application of auditing procedures

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IN

AUDITING PROCEDURE

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NEWSPAPER PUBLISHER

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FOREWORD

IN 1941, when the short form of auditors' report now in general use was recommended by the American Institute of Accountants, it incorporated for the first time two significant statements relative to the scope of the examination. These were (1) "Our examination was made in accordance with generally accepted auditing standards," and (2) The examination "included all procedures which we considered necessary." During recent years the Committee on Auditing Procedure of the American Institute of Accountants has given a great deal of consideration to the development of a more explicit statement of the meaning of generally accepted auditing standards. Comprehensive papers were presented by members of the Committee at the last annual meeting of the Institute and the Committee expects to publish a statement on the subject in the near future. The substance of the generally accepted standards tentatively adopted by the Committee may be summarized 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.

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 the preparation of a series of case studies illustrating the auditing procedures adopted and applied in actual examinations. Accordingly, each member of the Committee has been requested to submit a comprehensive description of audit work performed on a complete engagement. The following excerpt from the memorandum submitted for the guidance of the members of the Committee will indicate the general nature of the studies:

"It is believed that the case study material would be rendered more valuable, both to the practitioner and student, if an entire examination is covered. It is suggested therefore that each member of the Committee on Auditing Procedure should select a case within his own practice which he considers typical of current practices and procedures and that he should prepare a complete written audit program which will be fully descriptive of the work which actually took place. In this connection, it is important that actual procedures should be described even though the member 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 typical 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. If rather complete information can be given as to the system of internal control and other pertinent circumstances the cases should bring out the importance of professional judgment in the selection and application of procedures as the principal means by which the independent accountant complies with generally accepted auditing standards."

The accompanying memorandum represents a case study submitted by one of the members of the Committee covering an examination of a newspaper publisher. This case study is not a representation of the views of the Committee on Auditing Procedure; it has not been reviewed by the various members of the Committee. It represents the description of the auditing procedures which were actually followed in the particular case by one member of the Committee. The auditing procedures described may be applicable only due to particular circumstances surrounding this examination and, even in this case, alternative procedures might have been used to accomplish the general audit objectives.

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.

October, 1947.

No. 2: A NEWSPAPER PUBLISHER

DESCRIPTION OF BUSINESS

The newspaper chosen for this study is located in a city of approximately 50,000 people and is affiliated with other newspapers of a corresponding size located throughout the United States. It publishes an evening paper each weekday and a morning paper on Sundays. It falls into the 20,000 to 25,000 circulation grouping.

The basic business policies of the client are very similar to those of other newspaper companies of about the same size. Advertising is sold at an open rate and also on yearly contracts scaled according to the number of inches of advertising ordered for the year. Carrier distribution of the newspaper is handled on what is commonly known as the "little merchant plan." Under this plan each carrier is an independent contractor buying his papers from the newspaper at a wholesale price.

In volume of transactions, this newspaper had an average of about 6,000 individual cash collections during each month; wrote approximately 250 checks per month; carried an average of approximately 2,350 local display ads each month from about 450 local advertisers; ran about 750 national display ads per month; had about 100 legal advertisements each month; and published approximately 3,200 items of classified advertising each month, including transient, contract, and classified display advertising.

As a result of the company's affiliation with other newspapers, a portion of the accounting work was done by a service company set up primarily to provide financial, operating, and accounting assistance to the various affiliated publishing companies. This arrangement provided a greater degree of internal control than might be found in many individual newspaper operating units of the same approximate size.

The audit engagement was recurring; annual audits having been made in prior years. In addition, it was our practice to make a general survey of the company's accounting system and of its system of internal control prior to the auditing date. Suggestions for improving these systems were incorporated in a report prepared for the management of the company. These pre-audit date surveys enabled us to determine the major accounting policies of the company and to ascertain the strong points and the major weaknesses in its system of internal control.

MAJOR ACCOUNTING POLICIES

The company recorded all of its transactions on an accrual basis of accounting, using a calendar year accounting period. Monthly balance sheets and profit and loss statements were prepared and normally were in the hands of the publisher sometime between the 10th and the 15th days of the month following the date of the statements.

The company sold local display, national display, legal and classified advertising, with all advertising revenue being recorded on the corporate records during the month as it was actually earned. Revenue from circulation was also recorded on a strict accrual basis. In this connection an unearned subscription liability account was maintained to indicate the unearned portion of long term subscriptions collected by the company in advance.

Notes and accounts receivable were carried at the actual amounts due from the debtors and were divided on the records into the following subdivisions:

Accounts receivable

Local advertising
National advertising
Legal advertising
Classified advertising
Circulation

Notes receivable

Due from employees
Others

A reserve for doubtful notes and accounts receivable was carried; the monthly provision thereto being calculated by applying to the monthly revenue a percentage determined from historical experience. The balance shown in the reserve account was adjusted quarterly in the light of needs revealed by an actual aging of notes and accounts. The company also maintained a reserve for discounts, rebates, and allowances to reflect the anticipated reduction in the value for accounts receivable due to allowances of cash discounts, allowances made because of errors in publication, etc. Provisions to the reserve for discounts, rebates, and allowances were based upon historical experience. Periodically, the size of the reserve was examined and compared with the accounts receivable balances to insure that the reserve was being carried at a reasonable figure.

Costs and expenses of operations were recorded in separate expense ledgers, such treatment serving as an expedient to the preparation of monthly operating statements.

All inventories were carried at actual cost to the company. In this operation inventories were confined to newsprint, ink, and coal, the aggregate dollar amount of which was not material as compared to the total assets of the company. Certain supplies were treated as prepaid expenses and were not carried as inventory items and, therefore, will be discussed under prepaid expenses. It was the practice of the company to take a physical count of its inventories each month and to reconcile the physical quantities of inventory on hand with the perpetual records maintained.

The assets recorded in the property accounts were carried at actual cost to the newspaper. The property accounts were divided into appropriate subdivisions supported by detailed fixed asset cards showing the cost basis and the status of the depreciation reserve for each fixed asset. Depreciation was provided on the straight-line method of accounting at rates which the Bureau of Internal Revenue had found to be allowable for the different classes of fixed assets used in newspaper publication. The fixed assets were compared against the fixed asset cards annually to verify the physical existence and condition of the individual fixed assets carried in the property accounts. Totals of balances shown on the individual fixed asset cards were at the end of each year proved to the controlling general ledger balances for the different classes of fixed assets and their related reserves for depreciation.

Prepaid expenses were recorded at their cost to the company and were amortized on a monthly basis over the useful life of the individual prepaid expenses. Included in the prepaid expense classification, under the company's accounting policies, were such items as miscellaneous supplies used in the operation of the business but not carried as inventory items; prepaid insurance of all types; prepaid taxes; prepaid postage; and other miscellaneous prepaid expenses, including items of expense the useful life of which extended beyond the month in which the expenditure was made.

It was the client's policy to carry its intangible assets at cost with no provision for amortization. In dollar amount, goodwill was the only significant intangible. The net profits from operation of the newspaper, however, have been such that, based upon the Treasury Department's formula for evaluation of goodwill promulgated as the Committee of Appeals and Review Memorandum No. 34, the goodwill had an evaluation as great as its carrying value. The only intangible asset that might logically have been amortized was organization expense. However, it was the company's policy to retain the organization costs on its records as an asset until the year in which the corporate charter expires.

The client employed imprest petty cash and change funds. Cash received each day in the operation of the business was deposited intact daily in one of the client's operating bank accounts. It was the company's policy that all disbursements, except minor disbursements from imprest petty cash funds, be made by check from an operating fund bank account.

All investments owned by the newspaper were carried on its records at the cost to the corporation and all income arising from the investments was recorded on an accrual basis of accounting. Contrary to good accounting practice, no reserve for shrinkage or decrease in realizable value was provided. In this connection it should be pointed out, however, that the securities owned by our client, other than U. S. Government securities, amounted to less than ½% of the total assets of the company.

Since the newspaper records were kept on an accrual basis, all liabilities were recorded by means of a voucher system at the date the liabilities were incurred by the company.

Capital stock outstanding was carried at par value. Since a previous examination had revealed that cash had been paid into the corporation for the entire par value of the stock outstanding, this basis was acceptable from a sound accounting viewpoint.

The balance shown in the surplus account represented the accumulation of the excess of net profits from operations over dividends paid since the beginning of corporate operations. No capital appraisal write-up or other extraneous types of surplus were included in the surplus account. It was the policy of the company to make minor adjustments of prior years' earnings through the current operating accounts.

In the preceding paragraphs we have explained the major accounting policies and methods employed by our newspaper client. We deemed it necessary to ascertain the major accounting policies followed by the client so that we could have a basis for determining the consistency of accounting methods and policies followed and also to find out whether any of the major accounting policies employed by the client were such that they were not in accord with accepted accounting principles.

SURVEY OF INTERNAL CONTROL

In connection with the accounting system survey, considerable stress was placed upon the system of internal control employed by the client. The adequacy or inadequacy of the internal control in the newspaper's accounting system served a major role in our determination of the necessary auditing procedures and the extent to which test checks of transactions were made.

The basic points involved in the newspaper's system of internal control were discovered mainly through the interrogation of personnel employed in the accounting department and the personnel, in other departments, involved in the initial assembling of information used in the accounting process. This interrogation enabled us to ascertain the strong points and the principal weaknesses in the client's system of internal control.

In this particular case, there were a number of major elements of internal control present which would tend to insure the proper handling of certain corporate transactions. For disbursements, a voucher-check system was used by the newspaper and all disbursements, except those made out of imprest petty cash funds, were accounted for under this method. All checks used were prenumbered and all vouchers, as they were prepared each month, were assigned numbers in consecutive order. All the prenumbered checks and voucher numbers were subsequently accounted for. Disbursements made from petty cash funds were supported by prenumbered petty cash vouchers to which the supporting evidence to the expenditures were attached. In connection with disbursements, it was normal procedure to have the invoice authorized for payment and the voucher prepared in the accounting department, the check for payment being signed by the publisher.

A fundamental point of internal control, particularly important in the case of disbursements, was the maintenance of a budget for the year which was prepared at the beginning of the year under review. This budget was set up on a monthly basis and periodically reconciled to the satisfaction of management with the actual operating results. This budget was prepared in the office of the publisher and was reviewed by executive personnel of the service company.

Another strong point in the newspaper's system of internal control was that, with the exception of classified advertising cash and circulation cash, persons handling accounting records did not handle cash receipts. As a matter of actual practice, one group of persons received the collections and another group recorded the cash credits to the various customers' accounts.

As was previously stated, a certain amount of the client's accounting was done by a service company set up to assist the client and affiliated publishing companies. Functions of accounting performed by this service company were the maintenance of the general journals, the general ledger, individual employees' payroll records and individual fixed asset cards. It also prepared monthly balance sheets and operating statements for the newspaper and was charged with the responsibility for the preparation of all types of tax returns due from the corporation. This division of accounting duties segregated the keeping of the various controlling accounts from the detailed accounting done in connection with the various controlling accounts thus subjecting the detailed accounting work to a certain amount of internal auditing.

Another major strong point in the internal control system was that perpetual inventory records were maintained on all inventory items. These records, which were kept on both physical quantities and dollar cost, were reconciled monthly with an actual physical count of the inventory on hand. The perpetual inventory records were under the control of a person who did not have access to the inventories themselves and consequently, very good internal control on inventories resulted from the maintenance of these records.

It was found from our accounting system survey that each month proof sheets for local and national display advertising revenue were prepared in the accounting department to prove that all display advertising carried by the newspaper during the month had been billed to an advertiser. These sheets showed that the linages of the individual ads were charged properly, that the advertisers so charged with the linages were billed at their proper rates and that the individual extensions of the charges were made accurately.

Another feature of the system of internal control was that cash receipts were deposited intact daily in one of the company's operating bank accounts.

In our discussion of the major accounting policies relating to revenue, it was stated that in order to record circulation revenue on an accrual basis an unearned subscription liability account, indicating the unearned portion of long-term subscriptions collected by the company in advance, was maintained. Detailed subscriber records were priced quarterly to determine the individual amounts of unearned subscription liability. The total of these pricings was reconciled to the general ledger controlling account. Since this pricing was done by personnel who did not handle cash receipts from long-term subscriptions, a degree of internal control was accorded by this procedure.

Our survey revealed various points where internal control was lacking or otherwise inadequate; thus indicating that in these areas the testing procedures involved in examining the financial statements of the client should be amplified.

One of the main weaknesses in the system was that employees were paid by cash rather than by checks payable to the individual employee.

Adequate protective measures were not provided to insure proper handling since, under the payroll procedure in effect, the pay envelopes were prepared and distributed to the employees by the same person preparing the payroll voucher and the voucher check covering the net payroll for the week. When it was considered that the employee did not sign a receipt for his pay envelope, a definite weakness in internal control was apparent. Although the segregation of duties secured by having the service company maintain individual employees' payroll records and by having it prepare the payroll tax returns and other information which must be furnished to the Treasury Department tended to lend certain internal control to payroll accounting, this internal control weakness was such that we believed testings of payroll data should be substantial.

Perhaps the most glaring weakness in the system of internal control discovered by our accounting system survey occurred with respect to classified advertising. According to the advertising rate structure employed by the company in its classified department, two rate charts were in use. One rate was known as a "cash rate" and was available to advertisers if they paid for their ad within 48 hours after the initial insertion date of their ad copy. The other rate charged was known as a "charge rate" and was used when an advertiser did not pay for advertising within the stipulated 48 hour period. Under the accounting policies followed, the only classified advertising which was charged in the accounting department to the customer's account, and later cleared by a cash or non-cash credit, were the items of classified advertising charged under the "charge rate." All classified advertising which came under the "cash rate" classification was entered in the classified revenue account each day as one figure by the accounting department under the caption "cash classified."

In view of the fact that it was impossible to maintain a monthly proof sheet for classified advertising similar to the one maintained by the client for local and national display advertising, an automatic proof that all classified advertising run by the newspaper had been billed and properly accounted for was not present. Moreover, under the physical setup existing in the client's plant, a person serving as an ad taker sometimes received cash over the counter. This being the case, it was possible for an ad taker to abstract corporate receipts arising from "cash rate" classified advertising. This possibility resulted not only from the absence of adequate cross-checks in accounting for the advertising run in the newspaper, but also from the fact that customers' counter cash receipt forms were not prenumbered.

Another weakness in the method of internal control was that, under the client's accounting system, balances existing in the operating bank accounts were reconciled monthly by the person in charge of preparing the vouchers and the voucher checks. However, he was not authorized to sign checks. Although the check signing feature tended to create a certain amount of control, it was not adequate since one person was responsible both for controlling the voucher-checks and also for reconciling the bank accounts.

Each year after the initial survey, the company's accounting system and methods of internal control should be reviewed again before deciding upon the auditing procedures to be followed in the current year's audit. Since the basic elements of the accounting and internal control system had been recorded at the time of an initial survey, relatively little time was required to review the system before making the audit used for this case study. In making this yearly survey, the procedures were investigated so that we would be aware of any changes which were made during the year under review and could alter our auditing methods accordingly.

PREPARATORY PLANNING OF WORK

After completing the accounting and internal control survey, as outlined in the preceding section, we next decided upon the auditing procedures which would be followed to make a satisfactory examination of the client's statements.

In preparing the Work Schedule we first reviewed the balance sheet and profit and loss statement items, considering thoroughly the strong and weak points of the internal control. In this connection, we took into consideration any internal auditing functions which were performed by employees of the company as well as the functions of auditing which had been undertaken by the national circulation auditors, the Audit Bureau of Circulations. After considering all of these factors, we planned audit procedures which were to be applied on a comprehensive basis in the verification of elements where internal control was lacking. Where internal control was sufficient or exceedingly strong, we selected auditing procedures appropriate to reasonably assure us that any major irregularities or errors would be detected.

After listing the auditing procedures which we were to follow, time estimates were allocated to the various auditing functions to be performed. It should be emphasized that these estimates were considered to be elastic, however, and it was our intent that the actual time spent on the various auditing functions would be dependent upon our findings as the engagement progressed.

After making the time estimates, we divided the functions to be performed between the classes of personnel to be used in the engagement. This separation of time was very helpful in planning what personnel would be necessary to carry out the engagement in the most efficient and economical manner. It was readily apparent from this analysis of time that it would be desirable to use one senior and two junior accountants.

After preparing the work schedule, it was reviewed to determine the auditing procedures which could be done conveniently before the end of the client's fiscal year. These procedures were selected and scheduled in such a manner as to create a minimum of interference with the client's accounting department in their year-end closing operations. Examples of procedures which were performed conveniently before the end of a fiscal year are: tests of footings and posting of books of original entry; examination of vouchers and their supporting evidence; examination of cancelled checks and tests of bank reconciliations; tracing of cash receipts to bank accounts, etc.; preparation of earned rate statistics for the first eleven months of the year; analysis of newsprint consumption for the first eleven months of the year and preparation of a recapitulation of circulation statistics for the first eleven months of the year.

AUDIT PROCEDURES APPLIED

Sales and Revenues

Advertising

In order adequately to verify the advertising revenue for the period under review, we employed the following procedures:

1. Earned rate statistics were computed for all types of advertising. This was done by dividing the monthly revenue for local display, national display, legal and classified advertising by the number of inches of the respective classes of advertising run during each month of the year, as shown by the monthly linage record. The monthly trends of earned rates were scrutinized and it was found that there were no material variations in earned rates from month to month.

We found that the newspaper received the following average rates per inch during the years 1943 to 1945, inclusive:

Year	Local Display	National Display	Legal	Classified
1943	$.945	$1.06	$1.09	$1.23
1944	.911	1.06	1.31	1.28
1945	.904	1.06	1.32	1.30

It can be noted from this schedule that there had been a downward trend in the average rate per inch realized from local display advertising.

Upon investigation we discovered that the reason for this downward trend was that, during the years 1944 and 1945, two customers who had contracts in the low-rate, high-volume bracket had increased their advertising linage to a much greater extent than the over-all increase in total advertising linage during that period. Since the large volume advertisers were charged a much lesser rate than 94.5c per inch, the increased linage run by the two large advertisers resulted in a decreased average rate per inch.

Throughout the entire year period the national display advertising rate per inch was $1.06. A reconciliation of this average rate per inch with the "per line" rates listed in the national display advertising contracts verified that all of the national display advertising had been recorded properly on the client's records. It should be pointed out that our client charged the same national display advertising rate to all national advertisers.

The average rate per inch obtained for legal advertising was relatively stable in 1944 and 1945. The substantial increase in average rate per inch for 1944 and 1945 over 1943 was the result of a general rate increase.

In the case of classified advertising the average rate per inch had steadily increased from 1943 to 1945, inclusive. Our investigation of the upward trend revealed that the reason for the increase in average rate was that, as certain commodities advertised for sale in the classified transient or liner ads were getting progressively more difficult to obtain during the war when civilian production was at a standstill, the advertiser tended to obtain quicker results from his transient or liner ads with a consequence that a larger percentage of the classified advertising was done on a short-term basis which carried a much higher rate per inch.

In preparing the average rate statistics it was possible for us to compute the average rates from January to November, inclusive, before the end of the client's fiscal accounting period. By doing this, we were able to investigate certain minor deviations in earned rates from month to month before our rushed season began in January.

2. After computing and investigating variances in earned rate per inch realized in various classes of advertising, as explained above, we made test checks to verify the accuracy with which the client's linage record was kept. Since a large part of our verification of advertising revenues was dependent upon the consistency of average rates per inch, it was necessary to establish that the linage record used in the calculation represented a true picture of the advertising actually run in the newspaper. In order to do this we made an independent measurement of all

advertising run in the newspaper during the month of November, 1945, and found that our independent measurements agreed with the linage shown in the linage record.

3. Another step taken in the verification of local and national display advertising was to rework the monthly proof sheets supporting the detailed transactions for the month in which we made our measurement test supporting the linage record. This proof was made by going through the accounts receivable cards and listing the advertising run by the various advertisers during the month of November in columnar form under the rate classification into which the various advertisers fell as a result of their advertising contracts. After the rate columns were totaled, the computed revenue for the month was determined by multiplying the number of inches run during the month under the various rate classifications by the appropriate rate. The total linage distributed on the monthly proof sheet was compared with the total linage measured in our independent measurement and found to be in agreement. We then compared our computed display revenue with that shown in the income account for the month and found that they were within 50 cents of being in agreement.

4. In order to test check classified advertising revenue—a classification of revenue on which internal control was somewhat deficient—we traced all classified advertising "kills" during a two-week period directly to the classified advertising revenue account. In this connection we traced all "cash rate" ads contained on the kill sheets for the two-week period to the cash receipts records. Our investigation revealed that all classified advertising transactions during the two-week period tested had been handled properly. These tests required approximately 14% of the total time devoted to the entire examination.

Circulation

In order to substantiate circulation revenue we adopted the following auditing procedures:

1. A recapitulation of the monthly circulation totals shown in the A.B.C. Book was compiled under the following classifications: city zone carrier circulation; city zone dealer circulation; street vendor circulation; counter sales; retail trading zone carrier circulation; retail trading zone dealer circulation; retail trading zone mail subscriptions; "all other" dealer circulation; "all other" mail subscriptions; total unpaid copies; net press run; and gross press run. After completing this recapitulation for the entire year under review it was determined how many papers were circulated in the various classes during the year.

2. The number of unpaid copies was then compared with the number of paid copies to determine whether the relationship was reasonable. The net press run for the year was also compared with the gross press run to determine that the copies spoiled in printing were not excessive. In our examination we found that both the unpaid copies and the copies spoiled in printing represented reasonable percentages. Since the percentages of unpaid and spoiled copies were reasonable, we were certain that a major defalcation had not been perpetrated by an overstatement of these factors.

3. The total circulation revenue for the year was then compared with a hypothetical revenue computed by multiplying the yearly total paid circulation under the various classifications of our recapitulation by the amount of revenue per copy which should have been realized under the various classes of paid circulation. Since the hypothetical revenue came within approximately two per cent of being in agreement with the actual circulation revenue shown on the corporate records and since such variation could logically be accounted for by the fact that in our hypothetical computation we did not take into consideration the higher circulation price charged on mail subscriptions ordered for less than six months, we deemed that, based upon the circulation shown in the A.B.C. book, proper verification had been made of the circulation revenue.

4. In order to prove that the figures shown in the A.B.C. book were not materially misstated, we computed the gross number of pages printed during the year. The figure was then divided by the number of pages which could be printed from a pound of newsprint in order to ascertain the approximate newsprint consumption which would have been necessary to provide the gross press runs shown in the A.B.C. book. Approximated poundage was substantially in agreement with the actual pounds of newsprint consumed, thus assuring us that the gross press run was accurately stated on the A.B.C. record.

5. Our detailed testing of circulation transactions was confined to an analysis of one month's circulation charges and credits.

In ascertaining the auditing procedures which we would use in verification of circulation revenue we deemed it necessary to make an extensive proof of the total revenue for the year, since the internal control features of the circulation department were not adequate to insure satisfactorily the proper handling of corporate transactions. The foregoing steps of auditing procedure were, we believe, entirely sufficient to uncover any major irregularities even though there was an insufficiency of proper cross-checks in the accounting system.

Miscellaneous Elements of Revenue

Our procedures in auditing the miscellaneous elements of revenue, were confined to analyzing their composition. In so doing we made detailed testings of approximately 10% of the transactions.

The examination of sales and revenues required approximately 27% of the total time required in the entire examination.

Notes and Accounts Receivable

Notes Receivable

All of the notes receivable held by our newspaper client were notes from employees. During our verification we applied the following procedures:

1. From an examination of the notes we prepared a list showing the dates, makers' names, due dates, original amount of notes, unpaid balances at audit date, and the rates of interest charged on the notes.
2. The unpaid balances of the notes were confirmed directly to the debtors. In this confirmation it was ascertained that the company held no collateral for the notes.
3. The interest earned during the year under review was traced to the interest income account.

For balance sheet purposes the notes receivable were carried under the "other assets" caption on the balance sheet.

Accounts Receivable

1. The open customers' balances at December 31, 1945, were analyzed and classified according to the following age groups: current; 30 to 90 days old; 90 to 180 days old; 6 months to a year old; and balances carried for over one year. In preparing the list of customers' balances notations were made of amounts collected since December 31, 1945, the close of the period under review.
2. In preparing our aging, particular stress was placed on the composition of the individual balances to discover items of long standing which might have been unpaid as a result of a dispute or because a credit memorandum was not properly posted to the customer's account.
3. Since individual account ledgers were kept for local display, national display, legal and classified advertising and circulation, the totals on the lists of outstanding accounts were reconciled with the controlling accounts in the general ledger for the various types of receivables.
4. At the time the December 31st statements were being mailed to customers, we placed a negative confirmation stamp on all accounts and

handled the mailing of statements to the customers. The statements were mailed in envelopes bearing our return address. All inquiries received from customers relative to account balances were satisfactorily explained.

5. All non-cash credits, other than regular cash discounts, to accounts receivable during the year under review were examined and found to have been properly authorized.

6. We then checked the adequacy of the reserve for doubtful notes and accounts. Past experience indicated that the use of the client's aging formula would result in a reserve for doubtful notes and accounts sufficient to cover the normal requirements. The adequacy of the reserve for discounts, rebates, and allowances was tested also and found to be adequate as of the audit date.

We found that there were no non-customer items included in the accounts receivable and that none of the accounts were attached or wholly or partly pledged as security for loans or advances.

The time required to perform the major functions of auditing the notes and accounts receivable accounts was 11% of the total time required for the entire audit.

Costs and Expenses of Operation

1. Recorded expenses for the year under review were compared with the corresponding expenses for the prior year and with the budgeted figures for the year. All major variances were investigated.

2. We examined vouchers for two months paying particular attention to the approvals contained thereon, the supporting invoices and the distribution on the vouchers. Postings of the vouchers to the expense ledger during the two months' period were traced.

3. The payroll accounts were tested by a complete examination of payroll records for the two months' period. In this examination the time cards supporting the payroll vouchers were compared with personnel records to insure that no fictitious persons were listed on the payroll. Rates of pay were also checked to the personnel records, which included a history of pay raises, etc., for the individual employees. Extensions and footings of the payroll summary sheets were made and the amount shown on the payroll summary sheets as being the net payroll was traced to the payroll vouchers. We deemed that the examination of payroll should be at least as comprehensive as the one described herein, since the internal control was not adequate to prevent defalcation.

4. Detailed analyses were made of the following accounts: payroll taxes; other taxes; miscellaneous expenses; donations; repair and main-

tenance accounts; professional fees; depreciation; discounts, rebates and allowances; and provisions for doubtful notes and accounts.

5. In this connection reserves for discounts, rebates, and allowances were also analyzed with special attention being given to approvals of discounts in excess of the cash discounts, rebates, and allowances, and notes and accounts charged off during the year.

Approximately 12% of total time required to complete the audit was applied to the examination of costs and expenses of operation.

Inventories

1. A physical count of the newsprint inventory on hand at the end of the year was made and compared with the perpetual records maintained on newsprint.
2. We measured the ink and coal on hand and compared the physical quantities with those shown on the perpetual records.
3. All pricings, extensions, and footings were verified.
4. It was ascertained that any liabilities for items included in the inventory had been recorded.
5. In making the physical count of inventory, it was ascertained that all items included in the inventory were in usable condition.
6. A standard form of inventory certificate was obtained from management.
7. The newsprint expense for the year was verified by the use of gross press run figures, as explained under our discussion of Circulation Revenue.

The auditing procedures followed with respect to the inventories required 3% of the total time consumed in the entire audit.

Property Accounts and Related Reserves for Depreciation

Land

During the first audit we made for this newspaper, we verified the land used in publishing operations in the following manner:

1. A transcript of the land ledger account was prepared.
2. We examined the deeds, abstracts, and title opinions covering the various parcels of land making up the land on which the newspaper building was located.
3. We examined the various bills of sale covering the parcels of land in substantiation of the cost of the land.
4. Real estate tax receipts were examined as evidence of ownership.
5. As further evidence that the land was the unencumbered property

of the newspaper, we corresponded with the county recorder and found that the land was registered in the company's name and that no liens were recorded against it.

There were no changes in the land account during the year under review, so to support the client's ownership of the land at December 31, 1945, we repeated the following audit procedures:

1. We examined the real estate tax receipt for 1945.

2. We contacted the county recorder and found that the land was still registered in the name of our client and that no recorded liens were on file against the property.

Depreciable Fixed Assets

1. Adding machine tapes, by fixed asset groupings, of the balances shown on the individual fixed asset cards were run. The asset and reserve for depreciation totals shown on the tapes of each of the fixed asset groupings were compared with the balances shown in the fixed asset and related reserves for depreciation accounts in the general ledger and were found to be in agreement.

2. We vouched all fixed asset additions during the year by examining the vouchers and checks prepared to cover the expenditures, together with their supporting bills of sale, vendors' invoices, etc.

3. We ascertained that during the year under review no fixed assets were retired. If we had found that fixed assets had been retired, we would have traced the retirements to ascertain that they had been handled properly.

4. Test checks of depreciation rates used showed them to be reasonable. Test checks of approximately 20% of the depreciation computations for the year were made and found to have been made accurately.

5. In order to verify the physical existence of the depreciable fixed assets, we selected individual fixed asset cards aggregating approximately 50% of the total dollar cost of the fixed assets and traced the cards directly to the individual fixed assets. In selecting the assets to be verified, the larger assets were generally selected although we tried to take representative samples of smaller items included in the fixed asset accounts.

6. We corresponded with the county recorder to ascertain that there were no recorded liens on any of the fixed assets owned by the newspaper.

The time required to perform the functions of auditing on the Property Accounts and Related Reserves for Depreciation required 4% of the total audit time.

Prepaid Expenses and Intangible Fixed Assets

Prepaid Expenses

Unexpired Insurance

1. A schedule of insurance coverage showing the policy numbers, the insuring companies, coverage, types of insurance, effective dates of insurance coverage, the expiration dates on the policies, the dollar amounts of insurance coverage, and the insurance premiums, was prepared from an examination of the policies on hand. Notations were made also of all restrictive clauses contained in the policies such as coinsurance, etc.
2. We computed, independently, the unexpired portion of the premiums at December 31, 1945. The aggregate of these unexpired premiums so computed were found to agree with the balance shown on the company records.
3. We analyzed the insurance expense account to determine that no insurance premiums had been paid and charged directly to the expense account instead of being entered in the unexpired insurance account to be amortized over their useful life.
4. We examined the insurance coverage and found that it was reasonably adequate. It was also found that the company was carrying adequate insurance to adhere to the coinsurance clauses placed in its fire and extended coverage insurance policy. The types of insurance carried were also reviewed to determine whether there were any of the usual types of insurance carried by newspapers which had not been investigated by the client.

Other Prepaid Expense Items

Our verification of other prepaid expense items was confined to analyzing the accounts to determine the items contained therein. The cost of the items was vouchered to ascertain that they were being amortized over a reasonable period of time.

Intangible Fixed Assets

In a previous examination we had ascertained that the intangible assets carried on the corporation records had been recorded at their cost to the company. During the year under review there was no change in any of the intangible asset accounts. As was previously stated in the "Major Accounting Policies" section of this case study, the only intangible asset of a material amount was goodwill.

The earnings of the company since acquisition of the business demonstrated that there was no basis for requiring that the goodwill be written-off to income or surplus. The carrying basis of the goodwill was set out specifically on the balance sheet submitted with our audit report and a complete disclosure of the circumstances and facts surrounding the acquisition of the goodwill was set forth in the comments section of our audit report.

The time consumed in auditing prepaid expenses and intangible fixed asset accounts was 7% of the total audit time.

Cash

Our audit of the cash accounts was divided into the following three classifications: imprest petty cash and change fund; undeposited cash receipts on hand; and cash in bank. The following audit procedures were adopted in the verification of each:

Imprest Petty Cash and Change Funds

1. The cash in the imprest petty cash and change funds was counted at the conclusion of the business on December 31st.
2. Unreplenished vouchers supporting disbursements from petty cash funds were listed and it was ascertained that evidence supporting each voucher was such that the disbursements were authentic. Notations were made on the listing of the vouchers indicating the dates upon which the disbursements were made.
3. The sum of the cash and the total dollar amount of the supporting vouchers in the individual funds was proved to the general ledger controlling accounts.
4. We examined all petty cash replenishment vouchers during a three-month period to determine that all of the prenumbered petty cash vouchers were being accounted for and were properly authorized by someone other than the petty cash cashier. Particular attention was directed to seeing that supporting evidence appeared to be authentic and that there were no irregularities to indicate that any of the individual vouchers had been altered to conceal a petty defalcation.

Undeposited Cash Receipts on Hand

1. We counted all undeposited cash receipts on hand at the close of business on December 31st.
2. The individual items contained in the undeposited cash receipts on hand were traced to the counter cash receipts issued to the customer and to the original listing of individual mail cash collections.
3. Particular note was paid to determine that none of the checks

included in the undeposited cash receipts on hand were old checks, held as a part of the cash balance, which were uncollectible or were worthless checks from employees.

4. The composition of cash on hand was scrutinized and it was found that no checks drawn on any of the company's bank accounts were included as a part of the cash on hand balance.

5. The total of undeposited cash receipts on hand was compared with the balances shown on the cash register tapes as being the amount of the cash collections on December 31st.

6. The total of the undeposited cash receipts on hand at December 31st was traced and found to agree with the amount of the bank deposit recorded by the bank on January 2nd. This verification established that the undeposited cash receipts on hand were duly and regularly deposited.

Cash in Bank

1. All checks issued during the period under review were examined and compared to the check register. The names of the payee, amounts, and endorsements were examined and all applicable detailed information was traced to the check register. We judged it necessary to make such a comprehensive examination of the checks issued during the period because of the lack of internal control resulting from the bank reconciliation during the period under review being made by the person in charge of preparing the checks and vouchers.

2. The cash receipts records for the months of June, November, and December were footed and the bank deposits for the same three-month period were compared in detail to determine that all cash receipts were being deposited intact in one of the company's bank accounts daily.

3. Independent bank reconciliations were made for the three months with respect to which the cash receipts were traced to the bank deposits.

4. We made the original bank reconciliations at the end of the company's fiscal year, the bank statements having been obtained by us directly from the depositories. We also obtained written confirmations from each bank regarding the company's balance at December 31st.

5. We checked with the various banks and determined that all items deposited prior to the end of the year and all of the listed items in the deposit from the last day of the fiscal period were actually collectible items.

The time required to perform the functions of auditing on the cash accounts was 6% of the total audit time.

Investments and Related Income

1. All securities held by the company were examined at the same time the cash count was made on December 31st. From the actual examination of the securities on hand, a list was prepared showing the certificate number, a description of the security (including the interest rate, the date of issuance, and the maturity date in the case of bonds) and the face value shown on each marketable security.

2. Our examination of bonds and stocks consisted of the following:

(a) *Bonds*

1. Examined for evidences of genuineness.
2. Unmatured coupons on the individual bonds were examined. It was found that none of the unmatured coupons had been clipped.
3. In the case of registered bonds, it was ascertained that they were made out in the name of our client.
4. Where purchases during the year were made through brokers, invoices were examined to establish the cost price. The cost price of other purchases during the year were vouched by an examination of the voucher and canceled check supporting the purchase.
5. The market value of the bonds held was determined and found to be greater than cost.

(b) *Stocks*

1. The stock certificates were examined for evidences of genuineness, watching particularly to detect any alteration in the number of shares shown on the individual certificates.
2. The cost price of stocks acquired during the year was verified.
3. Since all of the stock owned by the company was of companies whose securities are unlisted on the stock exchanges, published financial statements of the companies were reviewed. It was found that the book values per share were in excess of the cost per share to our client and that the companies had favorable results of operations.
4. It was determined that all stock certificates held were made out in the name of our client.

(c) *Excess-Profits-Tax Refund Bonds*

1. The Excess Profits Tax Refund Bonds were examined and the amounts shown thereon were compared with the postwar refund credits shown due to the company on its excess profits tax returns.
2. The bonds were examined and its was noted that the certificates were made out in the name of the company.

3. The question of disposition of the bonds and stock was discussed with the management in order to discover which items held would be converted into cash within the coming year.

4. The costs of the bonds and stocks shown on the aforementioned

listings were totaled and traced to the financial statements. The carrying basis of the securities was found to be cost to the company.

5. Dispositions of bonds and stocks during the year under review were traced and found to have been recorded correctly.

6. The interest receivable accrued at the end of the period under review was independently computed by us and proved to the general ledger controlling accounts.

7. The interest income and dividend accounts were analyzed and proved to the securities owned during the year.

8. During the period under review there were no changes in the real estate investment account. The method of verification employed during our audit of the current year was identical to the one set out for Land in the "Property Accounts and Related Reserves for Depreciation" section.

The time consumed in auditing Investments and Related Income therefrom was 2% of the total time.

Liabilities

Vouchers Payable

1. An adding machine tape of the dollar amounts of all unpaid vouchers listed in the voucher register at the end of the company's fiscal period was run and the total proved to the vouchers payable account in the general ledger.

2. We examined the vouchers drawn in the month succeeding the fiscal period in order to determine that all liabilities at December 31st had been vouchered at that date.

3. In our examination of vouchers payable we found that trade and cash discounts were being properly taken and recorded.

4. We did not confirm any vouchers payable directly to the company's creditors. Instead, creditors' statements were compared with the vouchered amounts to the extent we deemed necessary to insure that the vouchers payable at December 31st were accurately stated.

Unearned Subscription Liability

1. In the verification of the mail subscription liability at December 31st, we supervised the running of a mail subscription galley proof from the addressograph plates used in the mailing operation of the mail subscriptions at that date. The addressograph plates used in mailing the newspapers to subscribers had imprinted upon them the expiration date of the subscription.

2. The liabilities to the individual subscribers for the unexpired portion of their mail subscriptions were computed by the employees of

the management and the general ledger liability account at December 31st adjusted to agree with the aggregate amount shown on the priced galley proof.

3. We made tests of pricings and extensions of the individual computations by making independent recomputations of every fifth calculation.

4. After testing the computations, we refooted the entire mail subscription galley and found that it totaled the liability shown in the unearned subscription liability account on the financial statements.

Carrier Deposits

1. A list of the detailed carrier deposit balances at December 31st, as shown by the subsidiary records, was made. The total of these balances was found to be in agreement with the controlling account.

2. We did not request carriers to confirm individual carrier deposit balances.

Employees' War Bond Deposits

1. A list of the individual balances in the subsidiary records for employees' war bond deposits was made. The total of the individual balances was found to be in agreement with the general ledger controlling account.

2. Confirmation of the individual balances in these liability accounts was not requested.

Liability for Withholding Tax

1. We vouched the payments made by the company to the withholding depositories and to the Treasury Department. The total payments made during the year under review were reconciled with the aggregate amount of tax withheld from employees, as shown by the individual payroll records.

2. The withholding tax liability at December 31st was compared with the withholding tax return filed by the company in the following January and was found to be in agreement therewith.

Federal Income Taxes

1. As a part of our engagement we prepared the federal income tax return for our client. The liability shown on the return prepared by us was set up as a liability at December 31st on the financial statements of the company.

Payroll Taxes

1. The liabilities for payroll taxes at December 31st, were traced to

the respective liabilities shown on the payroll tax returns filed in the following January and were found to be in agreement.

2. A reconciliation between the salary and wages expenses, as shown on the corporate records, and the salaries and wages reported on federal and state payroll tax returns was made. It was found that all salaries and wages paid by the company during the period under review had been properly reported to the taxing agents.

3. As further proof of the payroll taxes, we made an over-all computation of the payroll tax expense for the year by applying the various tax rates to the taxable wages for the period. A satisfactory reconcilement of the payroll tax expense, as shown by the company records, and our computed payroll tax expense was effected.

Accrued Wages and Salaries

1. The liability for accrued wages and salaries, as shown by the company records, was verified by examining the method of allocating between the years the first payroll made in the year following the period under review.

2. In order to determine that there were no unusual items of accrued salaries or wages which had not been set up on the records, and to discover the existence of any possible unrecorded liability at December 31st for items such as retroactive pay increases, special bonuses, etc., which might have existed as a liability at December 31st, we scrutinized payments made in the following January. Also, in reviewing the minutes of stockholders' and board of directors' meetings, special attention was paid to discover the existence of any agreements or resolutions made relative to salary and wage items.

Contingent and Possible Unrecorded Liabilities

In addition to examining the vouchers drawn in the month following the end of the fiscal period in order to discover possible unrecorded liabilities, we also examined the composition of legal fees incurred during the year under review. The examination of legal fees did not indicate that the company was engaged in any litigation which might result in liability to the company. We also requested the company's attorneys to inform us whether they had any knowledge of any possible litigation in which the company was currently engaged or might be engaged in the near future.

As additional evidence, we obtained statements from the management to the effect that all liabilities existing at December 31st were recorded on the company's records and that the company was complying with all governmental regulations applicable to its business such as the wage stabilization order; wage and hour law; credit regulations; War Production Board inventory control regulations; etc.

The time employed to perform the major functions of auditing liabilities was 7% of the total audit time.

Capital Stock and Surplus Accounts

At a prior date we had ascertained that the capital stock at the beginning of the year had been issued in accordance with the terms of the Articles of Incorporation and that cash had been paid into the company in an amount equal to the total par value of the outstanding capital stock. It had also been determined that all stock outstanding was common stock carrying full voting privileges. In prior examinations stock transfer stamps covering the original issue and subsequent transfers had been checked and found to be adequate.

From previous examinations it was also found that the surplus account at the beginning of the year under review was made up of earned surplus items properly handled in accordance with accepted accounting principles.

At the time of this examination we performed the following auditing procedures with respect to the capital stock and surplus accounts:

Capital Stock

1. We examined the capital stock books of the company and prepared a list of the open stubs; showing the certificate numbers, the person in whose name the certificate was registered, the date of issuance, the number of shares and the aggregate par value of the shares represented by the stub.
2. We traced the stock transfers occurring during the year under review and found that proper state and federal stock transfer stamps had been affixed on the stubs in the certificate book.
3. The aggregate par value of the open stubs, as shown on our list, was compared with the capital stock account on the financial statements and found to be in agreement.
4. The certificates representing treasury stock were examined at the same time as the other securities and the carrying value of the treasury stock verified in accordance with the procedures set out for stock in the "Investments and Related Income" section of this case study.
5. We examined all stock turned into the company for reissuance during the period under review and found that it had been mutilated and affixed to its proper stub in the stock book, as protection against the possibility of improper reissuance.

Surplus

1. We analyzed the changes in the surplus account during the year under review and found that all changes were proper earned surplus items.

2. In reading the minutes of meetings of the board of directors, we made notations regarding dividends declared during the year under review and also ascertained that there were no special restrictions placed upon the surplus account. The dividends actually paid during the year under review were proved, based upon the outstanding shares and the dividends per share declared by the board of directors. By this means it was determined that all dividends declared had been properly recorded on the corporate records and that at December 31st there was no liability for dividends which had been declared but were unpaid.

The time consumed in auditing "Capital Stock and Surplus Accounts" was 1% of the total.

Other Work Performed

During our engagement we read the minutes of all corporate meetings held during the year and made notations of all points which were pertinent to accounting matters. These pertinent points were traced to applicable corporate transactions to determine that the provisions were correctly and completely fulfilled.

Our testings of footings and postings of original books of entry were confined to a complete testing of three months' operations. As previously noted the months selected for our testings were June, November, and December. We did all of the work on the footings and postings for June and November prior to the close of the company's fiscal year.

Other functions which were an integral part of the engagement, included the general supervision by the principal, preparation of the working trial balance, and the preparation of the report and statements covering the engagement. A review of the system of internal control was also made before the end of the company's accounting period and, as previously explained, was used in the formulation of the work schedule. Of the total time expended on the audit 19% was applied to supervision and miscellaneous audit functions.

MODIFICATIONS IN AUDIT PROGRAM FOR FOLLOWING YEAR

The auditing procedures selected and followed in the case of the engagement described in our case study were reasonably adequate, we believe, to serve as a basis for our opinion regarding the fairness of the presentation of the results of operations and the financial position of the newspaper company. However, in reviewing the procedures followed, we found that, as in practically all auditing engagements, it was possible to detect possibilities for improvement in the auditing procedures followed. In preparing our modifications in the auditing program for the following year, we made the following relatively minor procedural changes.

From reviewing our working program, we decided that it might be of benefit to include more extensive testings of individual sales transactions, particularly as regards circulation revenues, than was actually done in the case study.

Another point where we believe there was room for improvement in our procedures was in the matter of verification of vouchers payable, carrier deposits and employee's war bond deposits. In our case study engagement, test confirmations were not made directly to the persons or companies to whom our client purportedly owed money at the audit date. Although our auditing procedures, coupled with the internal control existent in the accounting system, were probably comprehensive enough to detect unrecorded liabilities or a misstatement of liabilities, direct confirmation would give further competent evidence.

In our confirmation of accounts receivable at the end of the client's fiscal year, we did a very complete job in confirming accounts showing balances at December 31st. However, in the following year we set up our auditing program so that we would confirm a number of active accounts showing no balances at audit date. By failing to do this in our case study engagement, we did not have an auditing procedure relating to the possible discovery of unrecorded credit balances, which might be unrecorded as the result of an abstraction of cash receipts.

In the following year, after making the modifications outlined above, we planned to follow essentially the same procedures as were outlined in this case study but detailed audit tests were varied so that identical periods would not be used in two successive years. Whereas, we had used the months of June, November, and December for testings in our case study, the following year we used the months of February, September, and December for the testing of footings, postings, etc.