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NUMBER 4

CASE STUDIES

IN

AUDITING PROCEDURE

A PUBLIC UTILITY

This is the fourth 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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Case Studies

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A PUBLIC UTILITY

CONTENTS

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.

Standard 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 public utility. 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.

September, 1947.

No. 4: A PUBLIC UTILITY

NATURE OF BUSINESS

The company is a mid-western public utility operating company, engaged principally in the production, purchase, transmission, distribution, and sale of electricity and manufactured gas. Approximately 95% and 5% of its gross operating revenues are derived from its electric and gas business, respectively. Before the war the company sold electric and gas appliances, to a large extent, on the installment basis. The merchandising operations were not conducted as a source of direct profit as such but rather as a sales promotion activity for electric and gas services. The territory provided with either electric or gas services by the company had a population of approximately 180,000 persons of which approximately one-half lived in municipalities of from 2,500 to 20,000 each and the remainder on farms or in municipalities of less than 2,500 each. The company has approximately 60,000 customers of which approximately 8,000 are served with both electricity and gas. The principal activities of the territory served comprise agriculture, manufacturing, mining, and quarrying.

The total assets of the company at December 31, 1945 were approximately $25,000,000, of which approximately $22,000,000 represented utility plant, approximately $2,000,000 United States government obligations (temporary investments) and approximately $1,000,000 current assets substantially equally distributed between cash, accounts receivable, and materials and supplies. The aggregate of prepayments, deferred debits and other assets was negligible. The equity accounts consisted of common stock and surplus accounts aggregating approximately $5,000,000 and preferred stock of $3,000,000. Liabilities and reserves consisted of long-term debt of $9,000,000, reserve for depreciation of utility plant of approximately $6,000,000 and current liabilities, deferred credits and other reserves aggregating approximately $2,000,000.

Gross operating revenues were approximately $6,000,000 for 1945.

PREPARATORY PLANNING OF WORK

The examination on which this study is based consisted of the examination of the company's balance sheet at December 31, 1945, the statements of income and surplus for the year then ended and the presentation of a short form report thereon, and the examination of financial statements and schedules included in the company's annual report on Form 10-K to be filed with the Securities and Exchange Commission. A similar examination had been made for the preceding year.

The selection of the auditing firm was made by the Board of Directors in September and the firm was advised of such appointment by a vice-president of the company.

The supervisor in charge of this engagement for the preceding year was advised by the partner in charge of the engagement that the firm had been formally selected to make an examination of the company's accounts similar to the preceding year's examination and that he was to supervise the current engagement. He was instructed to arrange with the personnel supervisor for the necessary personnel requirements and to get the work started as soon as practicable. The supervisor prepared an engagement memorandum on a standard form which was approved by the partner in charge and is for use by the firm's personnel and accounting department. The supervisor also prepared a personnel requisition which is addressed to the personnel supervisor and indicates the number and rank of staff men estimated to be required, the inclusive dates and the location where they will work. A senior and two juniors were assigned for five weeks before the balance sheet date and a senior (the same as for preliminary work) and one junior for three weeks after the audit date. The senior on the engagement for the preceding year was made available and two assistants who had not been on the preceding engagement were selected. The supervisor discussed with the senior, those phases of the examination which were to be given more or less attention than in the preceding year and advised him of any known new problems which the senior might be expected to encounter. The juniors were given the program of audit, which had been prepared in a preceding year, and the previous year's working papers and advised of what their duties would be. However, they were requested to read the entire audit program and scan the entire working papers so that they would have a general knowledge of the entire engagement as well as detailed knowledge of the particular phase in which they were to participate. The supervisor arranged the specific starting date with the company's comptroller, who was chief accounting officer of the company.

Since the company wanted its final report as soon as possible after the books were closed in January it was mutually advantageous, and plans were made, to do as much audit work as possible prior to the audit date so that the pressure of work after the books were closed would be minimized. Another advantage of extensive preliminary work was the identification of major accounting or auditing problems sufficiently early in the engagement to permit discussion by the supervisor with the partner in charge of the engagement and, if necessary, to arrange conferences at which the partner, supervisor and the company's chief accounting officers could reach decisions in time to allow any required adjustments to be made in the company's accounts before the books were closed.

The nature of the operations of a public utility are such as to result in an unusual volume of accounting detail. Accordingly, it is customary for the auditors to make tests of various phases of accounting procedures as a basis for their opinion with respect to certain accounts, which because of the immense detail, are not susceptible to verification as at the audit date. For example, it is not practicable to prove the details of 60,000 accounts receivable from customers with the control account (as described later herein) at any specific time, but examination and tests of the accounting procedures with respect to the billing of revenues, accounting for cash receipts and uncollectible accounts and the continuous balancing of accounts do enable the auditors to form an opinion as to the adequacy and dependability of the accounting procedures to produce reliable balances at the end of any month. Tests which can be advantageously made prior to the audit date include:

(1) Tests of revenue and billing procedures (these involve revenues, accounts receivable, customer deposits, and reserve for uncollectible accounts);
(2) Test of payrolls (these have a bearing on the accounts in general; particularly with respect to the distinction between charges to expenses and to construction, and forms a basis for computation of social security taxes, pension expense, and various deductions from employees' earnings);
(3) Tests of material requisitions (these have a bearing on inventory accounts on the one hand and expenses and construction on the other and form a basis for distribution of stores handling expense);
(4) Voucher tests (these have a bearing on the accounts in general and particularly accounts payable);
(5) Tests of quantities and prices of material and supplies and perpetual inventory procedures;
(6) Tests of cash transactions and cash counts.

The extent of the foregoing tests is described more fully in this study under "audit procedures."

MAJOR ACCOUNTING POLICIES

The company is subject to the jurisdiction of Federal Power Commission and the state commission of the state in which it operates and accordingly employs the uniform systems of accounts prescribed by such regulatory commissions. The accounts are maintained on an accrual basis except that no accounting is made for unbilled electric and gas revenue. This is generally accepted practice for electric and gas companies. All bills are prepared and mailed from a central billing office and the individual accounts are maintained in ten districts. The entire gross profit from installment sales of electrical and gas appliances (when available) is recorded when the sale is made and the net profit or loss from such sales is reflected in the sales promotion section of the operating expenses. Income from finance charges on such sales is reflected in other income at the time sales are made.

It is the general policy of the company, in conformity with the prescribed systems of accounts, to charge the cost of current repairs and replacements of less than a complete unit of property to appropriate maintenance and clearing accounts and to capitalize the cost of replacements of a complete unit (or more) of property. When a complete unit of property is retired from service, the cost thereof and the cost of removal, less salvage are charged to the reserve for depreciation. The company follows a list of units, suggested by the Federal Power Commission, in its determination of what constitutes a unit of property.

The company does a large portion of its construction work but does not capitalize any general overhead and engineering expense which cannot be charged directly from the payroll distribution. Social security taxes and workmen's compensation insurance are capitalized in the same proportion as total payroll. Interest during construction, at the rate of 6% per annum, is added to all construction which is in progress more than one month and credited to income.

The company prepares detailed monthly reports for administrative purposes. It publishes unaudited quarterly financial statements and, in its annual report to stockholders, audited annual financial statements. It also files unaudited annual reports with Federal Power Commission, the state regulatory commission and an audited report with the Securities and Exchange Commission.

AUDIT PROCEDURES

The audit program followed in this engagement had been prepared in a previous year and approved by the supervisor and partner in charge of the engagement at that time. The scope of the program had been determined with a thorough knowledge of the company's accounting procedures and the degree of internal control. Since the company is well seasoned and the nature of its business has not changed, the previouslv prepared program could be followed without difficulty and with littl: or no deviation.

Comments regarding the company's procedures with respect to various accounts and the audit procedures applied are outlined hereunder.

Revenue and receivables

Revenue and customers' accounts receivable

Revenue and customers' accounts receivable in an electric and gas utility are so closely connected that it is logical to treat the two as a unit in describing the accounting and applicable auditing procedures. As previously stated, all billing is done from the general office. However, separate controls are maintained for the accounts of each of ten districts. Individual accounts are maintained in the respective districts. All power or industrial accounts for the entire company are included in a separate ledger maintained in the general office. The accounts of each district are further broken down into ledgers each containing 250 to 400 accounts. Billings are made on every business day throughout the month. Each bill covers a month's service and bills for any particular ledger are dated as near the same day of the month as possible. Because of weekends and holidays some variation is unavoidable. Ledgers are balanced each month immediately before new bills are issued and the proved balance represents the balance (arrears) on the current bill. Such method of billing is commonly referred to as "cycle billing," the billing date as the "cycle date" and the balance at that date as the "cycle balance." Control sheets are maintained for each ledger to which cash receipts, adjustments and transfers are posted daily and totaled separately for the portions of the month before and after the cycle date. At the end of a month, the ledger control sheets are summarized and the balance in accounts receivable determined by adding the cycle balances and the current month's billing for service, deducting cash collection from the various cycle dates to the end of the month and applying the miscellaneous adjustments. No proofs of detailed accounts to controls are made at the end of the month except in those cases where the end of the month corresponds to the cycle balance date.

The survey of internal control developed the following:

(1) Routes of meter readers are changed periodically to the extent possible, taking into consideration the small size of some districts;

(2) Amounts to be billed are computed independently by two employees; results are compared and corrections are made before bills are released;

(3) Duties of the accounts receivable bookkeepers are divorced from any cash functions;
(4) Disputed items are investigated by someone other than the bookkeepers;
(5) Accounts for which a bookkeeper is responsible are changed from time to time to the extent possible;
(6) Accounts written off and adjustments are approved by an officer and provision is made to insure collection of written-off accounts before a customer is given service at another location;
(7) The company's internal auditors periodically confirm cross sections of accounts receivable.

The audit procedures enumerated in the succeeding paragraphs were selected with due consideration to the internal control and were designated primarily to establish whether the company was following the aforesaid accounting procedures rather than to check any appreciable portion of the company's revenue and accounts receivable:

(1) Selected one district which had not been the subject of such examination in a recent year and proceeded as follows:
   (a) Obtained from the company a photostatic copy of the summary of ledger controls for the month of July and traced the balance at the beginning and end of the month into the general ledger
   (b) Scanned the accounts shown on the summary for cycle balances and monthly billings and investigated any ledgers which showed abnormally large cycle balances in relation to billings, to detect possible evidence of generally slow collections or the existence of a few large accounts which might not be collectible
   (c) Proved the amounts shown for revenue and for cycle balance for ten ledgers by running adding machine tapes of individual accounts and, at the same time, made a note of, and investigated, any accounts which appeared to be more than two months in arrears
   (d) Determined the consumption of electricity (or gas) by deducting the June meter reading from the July meter reading for all accounts in three ledgers of the ten selected in (c) above
   (e) Compared the consumption of electricity (or gas) shown by the meter books for the same accounts as in (d) above with the amounts shown on the ledgers
   (f) Verified the computation of customer bills for the same accounts by using rate schedules approved by the state regulatory commission
   (g) Noted any accounts which produced revenue considered by the company as exempt from federal energy tax, determined that the reasons for exemption were proper, and reviewed the method of accumulating such revenue which is used as a basis for the accrual and payment of such tax;
(2) Selected at random and listed in duplicate the meter number and

location of about thirty industrial and commercial customers. One copy was sent to the meter department with the request that the meter constants (the multiplier applied to meter reading to determine the kilowatt hours of electricity used) be supplied and upon the return thereof, the constants were compared with those shown in the meter books. Investigations along similar lines in preceding years had caused the company's internal auditors to make comprehensive tests of meter constants which, if continued in future years, may make this test unnecessary;

(3) Investigated the procedure for billing discontinued or final accounts and ascertained that such accounts are billed promptly and segregated from the active accounts;

(4) Confirmed approximately 500 accounts. The accounts selected for confirmation consisted of all the power and industrial accounts billed during one week that had old balances on the bills rendered and all of the regular residential and commercial accounts in 18 ledgers which had old balances. This covered a cross section of approximately 5,500 accounts. The negative type of confirmation used consisted of a sticker attached to the bill asking the customer to examine the bill carefully and, if not correct, to please write promptly to the auditors giving details of differences. The bills were then mailed in the auditing firm's envelopes with the auditing firm's business reply envelopes enclosed. All replies were followed through to the complete satisfaction of the auditors. Replies that required answers were turned over to the proper company employees to follow up;

(5) Examined and traced cash receipts stubs for one day for the selected district as outlined below:
   (a) Traced stubs to daily cash report and noted that the dates and customer folios on the stubs were in agreement with those on the cash report
   (b) Traced postings of credits from daily cash report to individual customer ledger accounts and control accounts (or to transfer sheets if applicable to another district) and traced the total of cash receipts to cash receipts book
   (c) Examined stubs for same day for cash collected in another district and transferred into the district under examination and traced postings to customer ledgers, noting that the customer was given credit as of the date of collection in the district from which the transfer was made;

(6) Balances of customer accounts receivable, as shown by district office reports as at the balance-sheet date, were compared or reconciled with the general ledger balances;

(7) Obtained from the company a schedule of revenue by classes for each month of the audit period; compared the totals on the schedule with

the account entries and obtained explanations for any substantial variations between months.

Merchandise accounts receivable

Merchandise accounts receivable during 1945 were negligible. In subsequent years it will be necessary to supplement the audit procedure to prove the details with controls for a representative number of ledgers and to request confirmations for a cross section of the accounts. It will also be necessary to review billing procedures, computation of finance charges, accounting for anticipation of instalment payments and controls over repossessed appliances.

Miscellaneous accounts receivable

(Consisting principally of amounts billed for damages to company property, rentals for pole attachments and wiring and electrical work performed for industrial customers):

(1) Obtained detailed listing of accounts as at the audit date, checked with individual ledger accounts, noting age of each account and its origin, verified the footing thereof and compared the total with the general ledger balance;

(2) Reviewed the accounts subsequent to the balance-sheet date and noted extent to which collections had been made;

(3) Discussed accounts with old balances not collected prior to date of review indicated in (2) above with the employee responsible for collection to determine if any accounts should be written off;

(4) Requested confirmation of major balances at the balance-sheet date.

Reserve for uncollectible accounts

(1) Analyzed the changes in the reserve accounts during the year, indicating (a) the provision for uncollectible accounts, (b) accounts written off, (c) recovery of written-off accounts and (d) other debits and credits;

(2) Investigated the method of making provision for uncollectible accounts and determined that the reserve is adequate to cover estimated losses at the balance-sheet date.

Notes receivable

The company had no notes receivable.

Costs and expenses of operation

(1) The special examinations of vouchers, payrolls and material requisitions hereinafter outlined constitute a test of charges to all expense accounts (as well as to other accounts);

(2) The provision for uncollectible accounts was checked in connection with the examination of the reserve for uncollectible accounts;
(3) Tax expenses were verified in connection with the examination of accrued taxes;
(4) Depreciation expense was verified in connection with the examination of reserve for depreciation of utility plant;
(5) Fuel expense was verified along with the fuel inventory analysis;
(6) Insurance expense was verified in connection with the examination of unexpired insurance;
(7) Interest was verified in connection with the accrued interest accounts;
(8) Amortization of premium on debt was verified in connection with unamortized premium on debt;
(9) The following expense accounts were analyzed and vouchers were examined with respect to the larger items charged thereto:
   (a) Legal expense
   (b) Other services
   (c) Rent accounts
   (d) General expenses
   (e) Miscellaneous income deductions
(10) Verified the computation of pension expense by the application to pay roll accounts of rates determined by the consulting actuary and vouched the payments for pensions to the pension trustee;
(11) Compared amounts charged to other expense accounts with preceding years' charges and investigated abnormal variations. The auditors' permanent file contains a list of expense accounts on columnar paper which accommodates the trial balances of detail expense accounts for several years.

Inventories

Inventories consist of fuel, principally for the generation of electricity, and materials and supplies for construction and maintenance. Merchandise for resale was negligible in amount. Perpetual inventory records are maintained. Physical inventories are taken at December 31st for fuel and at other dates during the year for materials and supplies. Inventories are priced at the running average cost for each item.

Fuel

(1) Obtained an independent engineer's estimate of coal on hand at the balance-sheet date based upon a physical survey of the storage pile and coal in hoppers, conveyors, and cars;
(2) Summarized the activity in the major fuel account (for main generating plant) during the year, showing the balance (quantity, unit price, and amount) at the beginning of each month, receipts and consumption during the month and balance at the end of the month;

investigated any irregularity in amounts or in average prices during the period; and checked or reconciled the amount shown thereon as consumed in the production of electric energy with the amount charged to fuel expense;

(3) Analyzed and examined vouchers in support of amounts charged to the major fuel account for one month during the year.

Materials and supplies

(1) Examined the most recent physical inventories taken by the company employees and investigated adjustments necessary to bring perpetual inventory record into agreement with physical counts;

(2) Investigated the method of taking physical inventory, and by whom taken. It was found to have been taken by the storekeepers, a procedure which was criticized. The company's comptroller has decided that in future years representatives from his office will make tests of inventory counts;

(3) Visited one of the larger storerooms, made test counts of a representative number of items selected at random, and compared or reconciled amounts shown on perpetual inventory records with amounts counted;

(4) Investigated to what extent obsolete materials or other materials in excess of probable requirements were reflected in the inventory and were satisfied that such amounts were negligible;

(5) Obtained an inventory certificate from the company's comptroller in which he summarized the inventory at December 31, 1945, and stated, to the best of his knowledge and belief, that

    (a) The quantities were correct and were determined by actual count, weight, or measurement as at various dates during the year and reflected subsequent transactions from stock records

    (b) The entire inventory was the unencumbered property of the company

    (c) Each item of the inventory was priced at average purchase price, the same basis of pricing as was used the preceding year

    (d) No obsolete, slow-moving, damaged, or unusable materials were included in the inventory at prices in excess of net realizable value

    (e) The amount at which the total inventory was stated was a fair and proper valuation of inventory for inclusion in the balance-sheet at December 31, 1945.

Utility plant, depreciation and maintenance

Utility plant

Practically all additions to utility plant are made on work orders through construction work in progress. Work orders are of two types, viz., specific work orders for major additions (over $500 each) and blanket work orders for routine additions of services, meters, transformers, line extensions, etc. During 1944, the company completed an analysis and reclassification of its plant accounts as at January 1, 1938, and received permissive orders from regulatory authorities to record the results. The analysis provided a break-down of utility plant into units priced at original cost (cost when first devoted to public service) with different unit prices for each year's additions or, in the case of very old property, unit prices for all property constructed prior to a certain date. Since January 1, 1938, the company has analyzed all work orders and tabulated the units of property added and at the end of each year allocated the annual costs charged to the various primary plant accounts over the units of property included in the respective primary accounts. These unit prices are used in pricing retirements.

Retirements of utility plant are cleared through retirement work in progress on retirement work orders which show in separate columns: (1) the cost of plant retired, (2) salvage, and (3) cost of removal. These three columns are compared with one another for each retirement work order to determine any apparent irregularities as to plant retired, salvage or cost of removal. Units retired are reported by the engineers by years of construction for each retirement order and are priced in the plant accounting office at the unit prices described in the preceding paragraph. The company's procedure calls for the preparation of a material recovery ticket for all material removed whether or not it has any value other than for scrap. These recovery tickets are compared with the units of property reported by the engineers as retired and any discrepancies are reconciled. This procedure practically eliminates the possibility of failure to record retirements and is a major factor in the determination of the check of retirements required by the independent auditors.

Furthermore, the company's operating department maintains a record of units of property (no dollars) by location and by years of construction. Once each year representatives from the plant accounting department compare the accounting department's record of units added and retired with the corresponding records of the operating department. Any errors in either set of records are corrected.

In view of the company's procedures as outlined above, which are considered excellent, the following audit procedures were applied:

(1) Prepared a summary of changes during the year by general ledger accounts, showing the following for each account:

- (a) Balance at beginning of year
- (b) Regular additions (this involves only construction work in progress accounts)

(c) Transfers from construction work in progress to plant in service
(d) Retirements
(e) Miscellaneous (such items as the purchase of private line, etc.)
(f) Balance at the end of the year;

(2) Obtained from the company and checked with the subsidiary plant ledgers schedules of changes in plant in service (electric and gas) by primary accounts with subtotals for each functional group showing for each account the data itemized in (1); compared the totals shown with the amounts included in the summary prepared in (1);

(3) Obtained from the company lists of work orders aggregating the amounts shown as item (1)(c); checked the approved authorization for each order on the list, and noted that the amount of expenditure was not materially out of line with the estimated amount per authorization;

(4) Analyzed each blanket work order and the larger specific work orders (per list in (3)) listing separately items of over $100 each and grouping items of smaller amounts; examined purchase vouchers or journal vouchers for each item listed in detail noting that charges were properly approved and appeared to be reasonable charges to construction, to the particular work order and to the ultimate primary account indicated;

(5) Examined journal entries transferring amounts from construction work in progress to plant in service and investigated procedure followed in summarizing charges to the various primary accounts;

(6) Summarized the various retirement journal entries to aggregate the amounts shown in (1)(d) and made tests of data appearing therein, such as a comparison of retirement prices used with the unit cost prices for the years of construction and units involved, proofs of extensions and footings and tests of postings. These tests were limited in view of the internal control over retirements;

(7) Investigated the details of items appearing in item (1)(e) and ascertained the other accounts affected by these items;

(8) Obtained from the company a list of work orders aggregating the balance in construction work in progress accounts at the balance sheet date and followed the procedure outlined in (4) with respect to the work orders with larger balances;

(9) Tested the computation of interest capitalized during construction;

(10) Reference is made to the special examination of vouchers, payrolls and material requisitions (outlined later in this study) which have particular significance in connection with the verification of utility plant additions.

Reserve for depreciation of utility plant

(1) Analyzed changes in reserve accounts during the year indicating (a)

accrual, (b) cost of removal, (c) salvage, (d) retirements of plant, and (e) other debits and credits;

(2) Verified the computation of accruals at the rates approved by the company's board of directors and the state regulatory commission and compared the amount of accrual with the amount of depreciation to be claimed in the federal income tax return;

(3) Reconciled amounts charged to the reserves with respect to property retired with amounts shown as retirements from plant as indicated in item (1) (d) under "Utility plant."

Maintenance

(1) Scanned the detailed trial balance of expense accounts (see item (11) under "Costs and expenses of operations") and selected the larger maintenance accounts and the accounts as to which balances for the year appeared abnormal compared with balances in preceding years for analysis and examination of supporting data of sufficient scope to be satisfied as to the substantial accuracy thereof;

(2) Inquired as to the possibility of deferred maintenance arising from inability to obtain materials and was informed that due to high priorities for obtaining material the amount was not substantial. The audit program did not provide for such an investigation but the abnormal conditions were such that a deviation was considered advisable with respect to the current examination.

Prepaid expenses, deferred charges and clearing accounts

Unexpired insurance

The company prepared and presented to the auditors a schedule of insurance policies showing for each policy:

(1) Its number
(2) Insurance company
(3) Coverage
(4) Premium
(5) Period covered
(6) Unexpired premium at beginning of year
(7) Premium expired during the year
(8) Premium added or canceled during the year
(9) Premium unexpired at the end of the year.

The audit procedure was:

(1) Examined policies and checked the data appearing in items (1) to (5), inclusive;

(2) Compared amounts in item (6) with the amount of unexpired premiums at the beginning of the year;

(3) Examined vouchers supporting the payments of larger premiums;

(4) Verified computations of amounts shown in items (7) and (9); reconciled the amount of item (7) with charges to insurance expense accounts; and compared amount of item (9) with general ledger balance for unexpired insurance.

Deferred charges

Deferred charges consist of:

(1) Preliminary survey and investigation charges with respect to projects for which specific work orders have not yet been prepared or which have not yet been formally approved. Upon the approval of work orders the charges in connection therewith are transferred to construction work in progress. If the related work order is not approved, the accumulated charges are written off to expense as abandoned projects;

(2) Retirement work in progress, which includes charges and credits made to retirement orders until such orders are completed and closed to the reserve for depreciation;

(3) Other work in progress, which includes charges in connection with work done for others and repairs of damages (by others) to company property. Upon the completion of the specific job, the accumulated charges are billed and charged to miscellaneous accounts receivable.

The balances in deferred charges are normally not material. The audit procedure consists of analyses of the balance at the balance-sheet date of each account by job orders, verification of major charges to such orders and investigation concerning the method and promptness of billing or transferring balances to other accounts.

Clearing accounts

Clearing accounts consist of (1) automobile expense to which charges are made for depreciation, maintenance, and operating expenses pertaining to automobiles and trucks and to which credits are made by charges to various operation and construction accounts on the basis of use of cars and trucks and (2) stores expense to which charges are made for purchasing and handling costs pertaining to material and supplies and to which credits are made by charges to operation and construction accounts on the basis of material used.

Audit procedures consist of analyses of the charges to the accounts, verification of the most important charges, an investigation of the method of making clearings from the accounts, and test of the application of such methods. Reference is made to the procedure in connection with "Material requisitions" for the detailed test of application of method of clearing stores expense.

Cash in banks

Bank deposits are made in the various small towns where collections originate and are recorded on daily cash reports prepared in the district offices. One copy of the daily cash report is sent to the accounts receivable section (see item 5 under "Revenue and customers' accounts receivable") and one copy, accompanied by authenticated duplicate deposit slips is sent to the treasury department and becomes the basis for entries in the cash receipts book.

All cash disbursements from general bank accounts, including bank transfers, are made on regular vouchers requiring two officers' signatures and are cleared through vouchers payable. Imprest bank accounts are maintained for the payment of payrolls, freight bills, petty cash items and the refund of customer deposits. All bank accounts and those persons authorized to sign checks are approved by the Board of Directors. All bank statements, together with paid checks are received directly by the comptroller's office and reconciled by someone who has nothing to do with the cash records or the signing of checks. Checks are not prenumbered and voided checks are not retained, but due to the number of employees involved in the handling of cash records and the reconciliation of bank accounts, this deviation from preferred practice is not considered objectionable.

Pursuant to the auditor's request, the company's treasurer wrote a letter to each bank requesting it to confirm the company's balance on deposit at December 31, 1945, to the auditors and to send them a bank statement together with paid checks for the period from January 1 to 8, 1946. The letters to the banks also requested pertinent information with respect to any securities held for safekeeping, items for collection, letters of credit, discounted notes, and any other direct or indirect liability. The auditors enclosed return envelopes and mailed the letters in envelopes which carried the return address of the auditing firm. Upon receipt of replies from the banks, the amounts confirmed were compared with the amounts reconciled to the balances shown by the company's records, a summary of which balances agreed with the general ledger.

A detailed examination was made of all cash transactions for the month of July and for the period between the audit date and a selected date which in this instance was January 8, 1946. Such examination consisted of the following for each bank for each period unless otherwise indicated:

(1) Obtained the company's reconciliation at the end of the preceding month and verified its arithmetical accuracy;

(2) The arithmetical accuracy of each bank statement at January 8, 1946

and the fact that all checks charged to the account were returned were proved by running tapes of checks returned (not bank statement charges) and of deposits and other items per the bank statement;

(3) Examined all checks returned by the bank with respect to proper signatures and endorsements and checked the amounts thereof to the previous reconciliation or the cash disbursements records. Since the cash disbursements records did not include names of payees, it was also considered advisable to check the payees, amounts and dates drawn with corresponding data in the voucher register;

(4) Traced all deposits shown by the bank statement to deposits in transit on the previous reconciliation or recorded cash receipts;

(5) Prepared a reconciliation at the end of the period and obtained explanation of those items included in the January 8th reconciliation which were also in the company's reconciliations at the balance-sheet date;

(6) Verified footings of the cash book for the month of July and proved the recorded cash receipts and disbursements for the eight days of January, 1946, by summarizing deposits and checks paid (see item (2)) and reconciling items at beginning and end of period;

(7) Traced all transfers between banks and noted that they were cleared in the accounts on the same day and through the banks without unreasonable delay;

(8) In connection with the examination of July transactions, all reconciling items appearing on reconciliations for December 31st of the preceding year and not cleared before the completion of the preceding audit were followed up and paid checks, or evidence of cancellation or stop payment were examined; any December 31, 1944 items still outstanding at July 31, 1945 were noted and satisfactory explanations therefor were obtained;

(9) Obtained checks returned with bank statement for January 31st following the balance-sheet date, and examined those appearing on the December 31st reconciliation, indicating on the reconciliation that such checks had been examined.

Cash on hand

Cash on hand consists of small imprest petty cash funds and change funds for the various business offices. The $500 fund in the general office is the only one over $100. These funds are counted by the internal auditors at various times during the year.

During the preliminary examination, the general office petty cash fund and two business office funds were counted. The count of business office funds involved not only the change fund but also all collections made during the day and an examination of customers' stubs, receipts for deposits and other transactions entering into the day's business. Due to the small amounts involved, it was not considered necessary to count all business office funds and small petty cash funds.

All change and petty cash funds at the balance-sheet date were confirmed directly to the auditors by the responsible employees.

Reimbursement vouchers subsequent to the audit date were examined for expenditures applicable to the period prior to the balance-sheet date. Such expenditures were found to be negligible.

Investments and related income

The only investments owned by the company were United States government obligations purchased with funds accumulated as a result of inability to obtain materials for plant construction. These securities were held in a safekeeping account by a large city bank. The audit procedures consisted of analyzing the changes in investments during the period, the examination of purchase and sale advices, computation of accrued interest purchased or sold, checking authorization or ratification of purchases and sales by Board of Directors and confirmation of the amounts held at the balance sheet date by the custodian. The computations of accrued interest receivable at the balance-sheet date and interest earned during the year were verified and the receipt of interest collected was traced to the cash receipts records.

Liabilities

Liabilities consisted of the following which will be discussed separately in the order named:

1. Long-term debit and interest thereon
2. Accounts payable
3. Customers' deposits and accrued interest thereon
4. Accrued taxes
5. Other current and accrued liabilities
6. Other liabilities

Long-term debt and interest thereon

There were no changes in long-term debt during the year. The only audit procedure considered necessary was the confirmation with the trustee under the indenture of the amount outstanding and of the fact that all covenants in the indenture were being complied with. The computations of accrued interest at the audit date and of interest expenses for the year were verified. Vouchers for the payment of interest to the paying agent (in this case also the trustee) were examined.

Accounts payable

(1) Proved details of vouchers payable with general ledger control by running tape of items unpaid at the balance sheet date.
(2) Examined vouchers entered in voucher register in January, 1946, and unentered vouchers on hand at a date near the completion of the examination for items applicable to the audit period for which liability had not been provided at the balance sheet date; such items were not material.
(3) Examined journal entries and other supporting data for miscellaneous accounts payable representing liability for bills received too late for recording in voucher register, pay roll deductions from employees for social security tax, income tax, etc.

Customers' deposits and interest thereon

The details of customers' deposits are maintained in each of the ten districts where there are several ledgers (number depending upon size of district) each consisting of a card file for a group of customers arranged in alphabetical sequence. The company's employees prove the details with the respective ledger control at various times during the year, but never prove all balances at any one time. Interest on the entire balance of active deposits is computed monthly in the general office but no attempt is made to break down the interest accrued by individual deposits. Payments of interest or applications to customers' accounts are made when a customer is disconnected from service or makes a request for interest. Therefore, the balance in the accrued interest account includes amounts provided against certain deposits for many years. The auditors have discussed this situation with the company's comptroller who intends to have the account cleared up by making payments or applications to accounts for all accumulated accrued interest and, thereafter, to adopt the policy of making annual payments or applications to accounts. This has been deferred because of the manpower shortage and since the auditors were satisfied that the accounts reflected the proper liability, they could do no more than suggest that the situation be cleared up as soon as possible, before the state regulatory commission forces the company to do so.

The audit procedures applied were:

(1) At the time of the preliminary examination of revenues and customers' accounts receivable, the details of five ledgers in one district were proved with the control as of the end of the month preceding the time of the examination. These balances were traced into the summary for the district and thence to the general ledger. Since the card file contains only active accounts, it is necessary to prove balances as of a date very near the time of examination;

(2) Balances as at the balance-sheet date, as reported by district offices, were summarized and found to agree with the general ledger balance;
(3) Verified the accrual for interest by applying the rate approved by the state regulatory commission (4% per annum) to the mean average monthly balance of all active deposits.

Accrued taxes

(1) Prepared a summary analysis of changes in accrued taxes, showing columns for the following for each class of tax:
    (a) Balance at beginning of year
    (b) Taxes accrued during the year and charged to expenses (total of column was reconciled with total tax expense)
    (c) Charges to other than tax expense
    (d) Payments during the year
    (e) Other debits
    (f) Balance at end of year;
(2) Examined tax bills and copies of returns and supporting data and made computations and reconciliations to the extent required to prove the substantial correctness of the amounts shown in columns (b) and (c) of item (1). In this connection, the auditor relied on data reported by the revenue accounting department for use in computing federal energy tax, which data were tested as indicated in the examination of revenue and customers' accounts receivable. On the basis of tests made during the examination of payrolls, he also relied on data from the payroll department in computing social security taxes;
(3) Ascertained the basis and propriety for taxes charged to other than expense accounts and included in column (d) of item (1);
(4) Examined properly approved vouchers in support of substantial payments recorded in column (d) of item (1);
(5) Ascertained that amounts shown in column (f) reflected the proper liability for current year taxes accrued but unpaid as of the balance-sheet date;
(6) Ascertained the extent to which tax returns, particularly for federal income tax, have been examined by tax authorities for prior years; the nature of any proposed deficiency or over-assessment of taxes; the effect on returns not examined which may result from findings in returns examined; and that the company's accounts reflect proper provision for probable liability for prior year taxes and penalties and interest thereon.

Other current and accrued liabilities

(1) Obtained details of balances of other current and accrued liability accounts, such as accrued legal expense, other services accrued, etc.;

(2) Examined vouchers for substantial charges to accrual accounts for any indication of partial payments or of additional liability;
(3) Examined related transaction in month subsequent to the balance sheet date to assist in determining the adequacy of the accrued liability.

Other liabilities

The only other liability at December 31, 1945 was for a preferred stock dividend payable on January 1, 1946. This was verified by applying the dividend rate to the number of shares outstanding and by reference to the Board of Directors' minutes with respect to the formal declaration at the regular rate and the payment date.

A liability certificate was obtained from the company's comptroller to the effect that an effort had been made to reflect in the accounts all liabilities as at the balance-sheet date and that none of the company's assets was pledged except under the first mortgage securing the company's long-term debt. It also indicated the nature of any contingent liabilities and the amount of contractual obligations for construction at the balance-sheet date and any substantial charges between the balance-sheet date and the date of signing the certificate. The certificate was obtained at the conclusion of the examination and near the date of the auditors' report.

Deferred credits

Unamortized premium on debt

Unamortized premium on debt consists of the unamortized balance of the excess of premium received on sale of bonds in 1944 over the expenses in connection with the issuance and sale of such bonds. This balance is being amortized in equal monthly amounts to the maturity of the issue. Since the amount of such premium and expense and the monthly amortization had been verified in the preceding audit and since there were no changes during the year in the amount of bonds outstanding, the only procedure necessary was to ascertain that amortization had been recorded at the predetermined monthly amount.

Customers' advances for construction

These advances represent amounts paid by customers for line extensions beyond those points where the company is willing (or required by the regulatory commission) to finance such extensions. Such advances are made under agreements between the company and customers specifying that, if revenues, over a ten-year period following service connection, derived from the extension are in excess of specified minima, some portion or all of the advance will be refunded. If the revenues are not sufficient to warrant the refund, the balance remaining is forfeited by the customer and is transferred by the company into an account called "Contributions in Aid of Construction."

Audit procedures in connection with this account were as follows:

(1) Analyzed the changes in the account during the year and traced one month's credits to the cash receipts book or other records and examined vouchers, journal entries, and supporting data for one month's charges;
(2) Proved the aggregate of individual account balances at the balance-sheet date with the general ledger account;
(3) Listed all balances of advances over ten years old and made further investigation to determine if the service connection for which the advance was made was also over ten years old. There were a few such items upon which the final refund, if earned, would be made within the next few months upon receipt by the general accounting office of certain revenue data from the billing department. Any remaining balance would be transferred to contributions in aid of construction. A notation was made in the working papers to follow up these items during the next audit;
(4) Noted that proper disposition had been made of items listed during the preceding audit similar to items described in (3) above;
(5) Inquired as to the existence of any liability arising from agreements to purchase private lines by means of signing refund agreements with the value of the line constituting the deposit.

Contributions in aid of construction

This is a unique account in that no charges may be made thereto without approval of regulatory commissions and in the state in which the company is located, there are no precedents for any charges except where the company sells an entire department. Credits to the accounts arise through forfeited deposits for extensions as previously described and through donations of cash, services or property from states, municipalities, individuals, and others.

The credits to the account during the year were analyzed and tests made of journal entries and other supporting data.

Capital stock and surplus accounts

Common stock

Since all the common stock of the company is in the name of a holding company and directors (as qualifying shares), the company acts as its own registrar and transfer agent. There were no changes during the year in the number of shares outstanding and the stated value thereof. The capital stock certificate book and ledger were examined, a list of stockholders prepared, and canceled stock certificates which had been canceled since the last examination were inspected.

Preferred stock and premium thereon

There were no changes during the year in preferred stock and premium thereon. The amounts thereof had been verified at the time of sale in the preceding year. The number of shares outstanding at the balance-sheet date was confirmed directly by both the registrar and the transfer agents which were large city trust companies.

Surplus accounts

The company maintains two surplus accounts, viz., capital surplus and earned surplus. There were no changes during the year in the former account and only the routine items of net income and dividends entered into the changes in earned surplus. Dividends charged during the year were computed by multiplying the number of shares outstanding by the rates appearing in the Board of Directors' resolutions declaring such dividends.

The company's mortgage indenture under which the outstanding bonds were issued has a covenant restricting the payment of dividends on common stock to earnings accumulated since the date of the mortgage indenture after providing for depreciation of utility plant an amount equivalent to the minimum provision (based on a percentage of revenue) as stipulated in the indenture. Since the company had a quasi-reorganization as of date of the indenture and its earned surplus is dated from such time, there will be no restrictions on the earned surplus as stated unless the amount provided for depreciation by the company since the date of the indenture should become less than such minimum depreciation requirement.

The auditors' permanent file contains a cumulative computation of the minimum depreciation requirements under the indenture as compared with the actual depreciation provided by the company pursuant to rates approved by the regulatory commission. If, and when, the actual depreciation provision since the indenture date becomes less than the computed minimum requirement as defined in the indenture, a note to the company's financial statements indicating such difference will be necessary.

General

The remaining audit procedures outlined in this study are not directly applicable to any specific account but are tests of accounting procedures in general and have a bearing on all accounts. Such tests can be made before the end of the audit period at a time convenient for both the auditor and the company.

Examination of vouchers

A review of internal control with respect to purchasing, receiving, and payment of invoices revealed the following:

(1) All purchases are made on prenumbered purchase orders for material and services requisitioned by department heads;

(2) Invoices are received in the accounting department where they are checked with the purchase orders as to prices, terms, and quantities and listed for control purposes before being sent to the appropriate department heads for approval, certificate of receipt of material or service, and distribution of charges. When invoices are returned to the accounting department, vouchers are prepared covering one or more invoices and entered in the voucher register. When payment is due, a check is prepared for each voucher and sent, together with supporting voucher approved for payment by the comptroller and supporting invoices, to the treasury department for signatures and entry in the cash disbursement record;

(3) Invoices are not stamped or perforated after payment is made since it would be practically impossible for an invoice to be paid twice without being detected. When invoices are first received in the accounting department and entered by the voucher clerk for control purposes, they are clear of any rubber stamp markings for approvals, coding receipt, etc. If the voucher clerk should purposely try to re-use a paid invoice the duplicate charge would be detected since all charges for materials for inventory are controlled by the storekeeper, all charges for construction are scrutinized by construction engineers and the plant accountant and charges to various expense accounts are scrutinized by the various departments concerned;

(4) Postage is metered.

The following auditing procedures were applied with respect to all vouchers entered in the voucher register during the month of July:

(1) Examined vouchers for proper approval for payment, certificate of receipt of goods or services, proof of check of prices, extensions, footing, terms and coding of accounts to be charged;

(2) Tested extensions, footings, summarization of invoices and noted that proper accounts were charged;

(3) Ascertained that discounts were taken in accordance with terms noted on invoices;

(4) Ascertained that freight or cartage was allowed or paid in accordance with terms of invoices;

(5) Made a comparison of a representative number of purchase orders with corresponding invoices as to prices, terms, quantities, etc.;
(6) Tested postings of individual invoices to the face of voucher and tested postings on voucher;
(7) Checked totals on vouchers to entries in voucher register and noted that proper general ledger accounts were charged;
(8) Tested postings from vouchers to subsidiary ledger accounts;
(9) Verified footings of voucher register and traced postings to general ledger accounts.

Payroll examination

A review of internal control revealed the following:

(1) Preparation of payrolls was distributed among a number of employees;
(2) Clerical operations in the preparation of payroll were double-checked before payment;
(3) Employees were paid by checks drawn on an imprest bank account and signed by employees who did not participate in the preparation of payrolls. The bank accounts were reconciled monthly by employees who did not participate in the preparation of either checks or payroll;
(4) Substantial examinations of payrolls had been made by the company's internal auditors, particularly with respect to authorized rates.

In view of the foregoing, the following audit procedures were applied:

(1) Traced daily time sheets prepared by foremen to time books for the week ended July 13th for employees paid on an hourly basis, noting that accounts charged were as designated by the foremen and appeared to be reasonable;
(2) Footed hours recorded in time books for the week ended July 13th;
(3) Examined authorization for rates for approximately 25% of the employees for the week ended July 13th;
(4) Verified computations of wages for approximately 25% of the employees for the week ended July 13th;
(5) Examined authorizations for payroll deduction for insurance, hospitalization, etc., and checked computations for deduction for social security taxes and income taxes withheld for the week ended July 13th, and the semi-monthly payroll (executive) for July 15th;
(6) Traced total payroll, deductions, and net payroll from time books to payroll (check) register for the week ended July 13th and the semi-monthly payroll for July 15th, and footed the payroll register. The examination of payroll payments was made in connection with the examination of cash in banks, as previously outlined;
(7) Traced postings from time books by accounts charged to the payroll distribution book for the week ended July 13th and the semi-monthly payroll for July 15th;

(8) Tested footings of payroll distribution book for the month of July and traced postings to the payroll distribution summary book;
(9) Computed the rates for allocating social security taxes and compensation insurance, on the basis of labor charges, to accounts other than operating expenses, and verified the application of such rates to payroll charges; the amounts of such taxes and insurance allocable to operating expense accounts are charged to the expense account for taxes and insurance, respectively;
(10) Traced postings from the payroll distribution summary book to the monthly journal entry and thence to general ledger accounts and tested postings to subsidiary ledger accounts.

Material requisitions

The following examination was made of the accounting for materials issued from storerooms during the month of July:

(1) Examined all material requisitions, scrutinized accounts charged, and traced amounts to the details supporting the monthly journal entry for materials issued;
(2) Tested extension and footings on requisitions;
(3) Tested prices on a representative number of requisitions and the postings of amounts on such requisitions to the perpetual inventory records;
(4) Traced the totals appearing in the summary of charges for each account to summary of accounts charged on the journal entry;
(5) Verified the application to material charges of a rate to allocate stores expenses on the basis of material cost; the rate used (15% for July) is kept constant to the extent possible but must be changed occasionally as the ratio of stores expenses to cost of materials changes;
(6) Footed the summary and supporting detail;
(7) Traced all postings from journal entry to general ledger accounts and tested postings to subsidiary ledger accounts.

Minutes

Pursuant to requests made in past years, the company provided the auditors with a copy of all Board of Directors and Executive Committee minutes. These minutes were compared with the signed copies of minutes in the corporate files. Such minutes were read and all resolutions which affected accounting matters were followed through for proper performance.

CONTROL OF WORK

As mentioned heretofore, the preliminary field work was performed by a senior and two juniors and the final field work by a senior and one junior. The senior closely supervised all work performed by the juniors and discussed the scope of work and extent of tests from time to time with the supervisor. Daily time reports were made by each man on the engagement showing a brief description of the work performed and the amount of time required. Such reports of assistants were reviewed and approved by the senior.

Upon the completion of the preliminary field work, the supervisor reviewed the working papers and time reports, discussed various phases of the engagement with the senior and formulated plans for additional work to be performed after the balance-sheet date. The supervisor discussed with the partner in charge of the engagement the status of the work and any extraordinary findings or special problems which required partner consideration and decision.

When the final work was completed, the senior prepared a draft of the financial statements and short form report which were, in turn, reviewed by the supervisor in conjunction with his review of the final working papers, and by the partner. The changes suggested by the supervisor and partner were cleared by the supervisor with the company's comptroller and the statements were ready for typing. The final typed statements were read and approved by the supervisor before presentation to the partner for signature.

The supervisor made the necessary arrangements with the company's comptroller to get copies of printer's proofs of financial statements for the company's annual report for comparison with the typed report and cleared any necessary corrections with the company's comptroller.