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Steel fabrication companySmall restaurant; Case studies in auditing procedure no. 08

American Institute of Accountants. Committee on Auditing Procedure

NUMBER 8

CASE STUDIES IN AUDITING PROCEDURE

A STEEL FABRICATING COMPANY
A SMALL RESTAURANT

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

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Case Studies

IN

AUDITING PROCEDURE

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A STEEL FABRICATING COMPANY
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FOREWORD

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

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

Auditing Standards

During recent years the committee has given a great deal of consideration to the development of a more explicit statement of the meaning of generally accepted auditing standards. In 1947, it issued a special report, *Tentative Statement of Auditing Standards*, in which it presented the results of its deliberations. The substance of generally accepted standards, as set forth in that report and as adopted by the membership of the American Institute of Accountants in September, 1948, 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.

Auditing Procedures

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

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

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

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

The accompanying case studies describe the auditing procedures which were actually followed by two practitioners in particular instances. The procedures used may be applicable only due to particular circumstances surrounding the examinations; furthermore, alternative procedures might conceivably have been used to accomplish the general audit objectives. The case studies have not been reviewed by the various members of the committee and are not intended as representations of the views of the committee on auditing procedure.

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

July, 1950

A STEEL FABRICATING COMPANY

INTRODUCTION

The purpose of this study is to outline the auditing procedures applied in the examination of a small, closely-held manufacturing corporation. The accounting records are, in great measure, in the hands of a sole bookkeeper assisted by a billing clerk. Very little internal control, if any, is present. Any segregation of accounting functions that does exist is the result of procedures set up primarily to meet other needs of the business, and the accounting controls obtained thereby are incidental benefits.

DESCRIPTION OF THE BUSINESS

This corporation fabricates two lines of products from steel sheet. Control of the corporation since its organization has been in the hands of the same family although there are approximately fifty minority stockholders with small holdings. Members of the controlling family have always held the principal executive offices and, in addition, have maintained a direct association with the operations of the corporation. There are approximately 150 factory employees and 20 office employees, including the officers. Production consists of standard items and related items made to customer specifications.

Sales originate through manufacturers' agents and directly by the corporation with governmental agencies, industrial users and other consumers. The large majority of sales orders call for shipment on a "knock down basis" of finished standard parts which are assembled to fit customers' specifications at the customers' site or plant. Erection of the finished units may be performed either by the customers' own personnel or by hired outside erectors. Other orders may call for shipment on an erected basis, in which case erection would be performed on the company's premises before shipment. However, no finished units are erected for stock purposes. Terms of sale are net 30 days.

SCOPE OF THE ENGAGEMENT

The annual audit is performed on a quarterly basis.

Interim reports are prepared primarily for submission to the board of directors and for internal management use. However, copies of all reports are also sent to the corporation's banking facility where a line of credit has been established to meet working capital needs. The interim reports are submitted with a disclaimer of an opinion, pending the performance of certain generally accepted auditing procedures at the close of the fiscal year. The final report for the year includes the certifying accountant's unqualified opinion. All reports are prepared in the long-form style. A letter-form of stockholder report is also prepared at the end of the year for distribution to the minority stockholders.

The accounting capacity of the corporation's accounting personnel is such that the responsibility of preparing the financial statements, of computing prepayments and accruals, and of originating adjusting and closing entries in connection with the actual closing of the books by the bookkeeper, necessarily must be assumed by the certifying accountant.

The work is assigned to a senior accountant who reports directly to the partner in charge of the engagement. The senior is assisted in the field work by an accountant of junior grade. Audit reports and all tax returns are prepared by the senior accountant and reviewed by the partner in charge. Normally, the year's services require about four days of partner's time, twenty days of senior's time, and thirty days of a junior's time.

The following balance sheet and statement of profit and loss are indicative of the size of the corporation, but do not purport to represent actual figures.

STATEMENT OF PROFIT AND LOSS AND RETAINED INCOME

Year ended December 31, 1949

	Total	Product A	Product B
Factory sales, net of erection costs, freight and agents' commission	$800,000	$650,000	$150,000
Cost of manufacturing	550,000	450,000	100,000
Gross manufacturing profit	$250,000	$200,000	$ 50,000
Shipping expenses	$ 60,000	$ 40,000	$ 20,000
Selling expenses	25,000	15,000	10,000
Administrative expenses	80,000	65,000	15,000
	$165,000	$120,000	$ 45,000
Profit from operations	$ 85,000	$ 80,000	$ 5,000
Other income	2,000		
Profit before provision for federal and state income taxes	$ 87,000		
Provision for income taxes	34,000		
Net profit for the year	$ 53,000		
Add—Retained income balance, January 1, 1949	174,000		
	$227,000		
Less—Dividends paid	30,000		
Retained income, December 31, 1949	$197,000		

ASSETS

CURRENT ASSETS

Cash in bank and on hand		$ 55,000
Trade accounts receivable	$120,000	
Less—Estimated doubtful accounts	7,500	
		112,500
United States securities and accrued interest		50,300
Inventories—at the lower of cost or market:		
Raw materials	$100,000	
Work in process	83,000	
Finished parts	46,000	
Supplies	2,500	
		231,500
Prepaid insurance		3,700
TOTAL CURRENT ASSETS		$453,000

FIXED ASSETS, at cost

Land	$13,000	
Buildings	75,000	
Machinery, equipment and fixtures	84,000	
	$172,000	
Less—Amortization to date	60,000	
		112,000
		$565,000

SHEET

31, 1949

LIABILITIES

CURRENT LIABILITIES

Notes payable, bank		$ 50,000
Accounts payable, trade		75,000
Customers' credit balances		3,000
Accrued salaries and wages		6,000
Accrued social security, and withholding taxes		3,000
Accrued federal and state taxes		36,000
TOTAL CURRENT LIABILITIES		$173,000

LONG-TERM LIABILITIES

Notes payable, secured by mortgage, due after one year		20,000

CAPITAL AND RETAINED INCOME

Capital stock		
Common, class A, 5,000 shares authorized and issued, par value $25 per share	$125,000	
Common, class B, 5,000 shares authorized and issued, par value $10 per share	50,000	
	$175,000	
Retained income	197,000	
		372,000
		$565,000

AUDIT PROGRAM

Cash in Bank and on Hand

The corporation maintains two general bank accounts and an imprest account for the disbursement of dividends.

Incoming mail is opened by the assistant secretary of the corporation, who is also the credit manager. Checks received in the mail, which constitute practically all of the cash receipts of the corporation, are compared by this employee with a file of uncollected duplicate sales invoices maintained by him. If a check is in payment of an invoice or invoices in full, such invoices are removed from the file and attached to the check. Partial payments are noted on the invoice and a partial payment cash receipts form is prepared showing customer's name, invoice number, and amount paid by the customer. Such forms are also prepared for miscellaneous receipts, showing source, amount, and accounts to be credited.

The checks and other data are turned over to the bookkeeper who prepares bank deposit slips in duplicate. The duplicate deposit slips are attached to the related invoices and cash receipts forms, and then placed in a binder to form the detailed cash receipts record. Only a summary of the day's receipts is entered in the cash book.

Check disbursements are prepared and entered in the disbursements record by the bookkeeper. Signatures of two officers are needed to validate checks issued.

The bookkeeper also has charge of the office petty cash fund.

In the audit of the cash account all recorded cash receipts are compared with deposits shown by bank statements of the two general bank accounts for one month during each quarter. Recorded check disbursements are compared with canceled checks returned by the banks for the same month. The deposits indicated by the summary cash book are then compared with the duplicate deposit slips and the items on the duplicate deposit slips are compared with the attached duplicate sales invoices and cash receipts forms for evidence of "lapping" of receipts. Canceled checks for the test month are scrutinized for proper signatures and endorsements.

Bank reconciliations are prepared as of the end of each month selected for test. Deposits in transit and outstanding checks revealed by these reconcilements during the interim or quarterly examinations are cleared during the following quarter's examination.

In connection with the last quarter's examination, bank statements covering a period of about the first fifteen days after the end of the year are obtained directly from the banks and deposits in transit and outstanding checks appearing in the year-end reconcilements are verified. The examination of all checks returned with this bank statement is expanded to include a review of the bank's cancellation date for evidence of non-issuance of such checks prior to the close of the fiscal year. Also, the checks returned with this short period statement covering disbursements recorded subsequent to the end of the fiscal year are examined to disclose unrecorded checks dated prior to the close of the fiscal year. Any outstanding items not cleared by this short-period bank statement are investigated for any indications of irregularity.

All transfers between bank accounts during the test months are traced.

The cash books are footed for the test months and post checked to the general ledger.

All bank account balances are confirmed with the depositories at the reconcilement dates.

Disbursements from the imprest dividend bank account are recorded in a separate cash book. When a dividend is paid during a quarter under review, the related canceled checks are compared with the recorded disbursements. The amounts of the larger checks are verified by reference to a list of stockholders in the audit work papers. In other fiscal quarters the bank statement is reviewed to clear outstanding checks in the previous reconcilement. Old outstanding checks are discussed with the president to determine, if possible, why they have not been presented for payment. The dividend bank account is reconciled at the end of each quarter.

The imprest office cash fund is counted during each quarterly examination. Petty cash vouchers are examined in connection with the verification of reimbursement vouchers entered in the voucher register during the month selected for the vouching test.

Trade Accounts Receivable

The accounts receivable ledger is kept by the bookkeeper. Aged trial balances of accounts receivable, prepared by the bookkeeper at the end of each quarter, are compared with the accounts receivable ledger. Collections made between the close of the quarter and the date the trial balance of receivables is checked with the ledger are posted on this trial balance by the accountant. A summary of the ageing is then prepared as indicated on page 16.

Adding machine tapes are then run of the open invoices dated prior to the audit date in the file of the credit manager to determine if they are in agreement with the uncollected balances shown by the above summary. Differences, if any, are investigated and resolved.

Age of Account	Amount	Collections to Audit Date	Uncollected Balances
Under 30 days	$ 85,000	$60,000	$25,000
30 to 60 days	30,000	23,500	6,500
60 to 90 days	4,000	3,500	500
Over 90 days	1,000	—	1,000
	$120,000	$87,000	$33,000

As of the close of the fiscal year, in addition to the above procedures, detailed, positive-type confirmations of balances are prepared and mailed by the certifying accountant to all individual debtors. There are usually about 100 to 150 active accounts. Replies received generally verify approximately 70% to 80% of the dollar total of accounts receivable. In view of this result, second requests for confirmation are not made.

The quarterly provision for bad debts based on a fixed percentage of sales is computed by the senior accountant and entered by him in a standard, quarterly journal entry book. Credit files are reviewed to determine the validity of bad debts charged off. All accounts over 90 days old are reviewed with the credit manager to evaluate their collectibility.

Investments

The corporation's security investments are kept in a safe deposit box under the exclusive control of the president of the corporation. All transactions during the year are verified by reference to purchase and sale confirmations. A running schedule of investment transactions is maintained in the audit work papers. The certificate or bond numbers of the securities obtained from the confirmations are noted in the schedule. Securities are examined after the end of the fiscal year, at which time the certificate numbers are carefully compared with those in the audit work papers.

Receipt of income is traced to the cash book. Accrued income is computed at the statement dates.

Inventories

The quarterly inventories of raw materials and finished parts are determined from a perpetual inventory record which shows quantities only. This record was installed primarily to aid the production and sales personnel in planning purchasing, production, and delivery schedules.

At the end of each quarter, physical inventories are taken of items not carried in the perpetual inventory records. The quantities so obtained are priced by the cost estimating personnel from purchase invoices along with cost estimates. The cost records are not controlled by the general ledger.

At the close of the fiscal year a complete physical inventory is taken and the perpetual records are adjusted, if necessary.

Quantities shown by the interim inventories are used without verification for statement purposes. They are, however, tested for mathematical accuracy of computations and footings, and as to the basis of pricing. A further over-all test is also made by a comparison of the percentage ratio of material cost to net factory sales for the current quarter with the similar percentage ratio for previous quarters by lines of product.

At the close of the fiscal year, the taking of the physical inventory is observed by the accountant. The original counts are made by the factory personnel, who enter the counts and material description on prenumbered inventory tags and attach these tags to the material. During these counts the accountant's representatives circulate through the plant to observe the actual counting. When a particular department has been completely counted by the factory personnel, a representative of the accountant and the supervisor of the department then make test counts and remove the inventory tags from the stub attached to the material. The tags are controlled by the accountant until all tags issued have been accounted for.

The accountant makes a record of all the items that he has test counted and also a record of other items selected at random which were not actually counted by him. These items are compared later with the completed inventory. The tags are then turned over to the company for processing into the final inventory. The tags are compared by company personnel with the perpetual record. Recounts because of substantial differences are made by the supervisors and a representative of the accountant.

Raw material prices are substantiated by comparison with purchase invoices. Work in process and finished parts prices are substantiated by reference to the records maintained by the cost estimating personnel.

These cost records are reviewed to establish the fact that they are based on current material prices and current direct labor rates. The rate of factory burden applied is checked to see that it does not differ materially from the rate experienced during the year. Cost prices are also compared with market prices and the prices of unfilled sales orders.

Footings and extensions on the completed inventory are thoroughly checked.

Prepaid Insurance

The prepaid insurance account is analyzed and vouched against invoices. A complete schedule of all insurance coverage is prepared for the work papers, showing policy number, insuring company, coverage, premium, quarterly expense, and prepaid amount at the end of the year. This schedule is used to prepare the quarterly entry for insurance expense. Policies are examined against this schedule at the end of the year.

The certifying accountant is also required to compute the quarterly workmen's compensation expense and prepare the quarterly entry therefor. The monthly accrued pay roll entries are summarized into the wage classifications called for by the policy and the rates shown therein are applied to the classifications. These computations are later verified by comparison with the quarterly bills received from the insurance company which are not available until after the audit is completed.

Fixed Assets

All fixed asset accounts are analyzed quarterly and transactions reflected by the analyses are vouched against invoices. As in the case of prepaid insurance, no depreciation schedules or computations are made by the client, so it is necessary for the certifying accountant to prepare complete schedules for his work papers. Depreciation rates are set after consultation with the plant superintendent. The schedules are used as a basis for preparing the quarterly entry for depreciation expense. Large additions shown by the analyses are often physically inspected.

The company does not maintain a plant ledger. However, it reports all additions and retirements of plant assets periodically to an appraisal company in connection with its fire insurance coverage. Periodically this record is reviewed by the certifying accountant and disposals or retirements reported therein are investigated to determine if they have been properly reflected in the accounting records.

Notes Payable

Notes payable accounts are analyzed. Confirmation of bank loans and collateral therefor is obtained quarterly, in connection with the confirmation of bank balances, by use of the long-form of bank confirmation printed under the auspices of the American Institute of Accountants. All other notes payable and collateral therefor are confirmed with the holders only at the close of the fiscal year.

Accounts Payable

An open line voucher register system is used to record purchases. Invoices are approved by the purchasing agent, who receives informal notice of the receipt of material and notes the same on his open purchase orders. He also verifies invoice prices. Invoice extensions are checked by the assistant secretary of the corporation before they are passed to the bookkeeper for entry and payment.

The quarterly trial balances of accounts payable are checked to the open items in the voucher register. Available vendor's statements are compared with this trial balance and reconciled where differences exist. Larger items entered in the voucher register for the period subsequent to the period under audit are checked for receiving date to the purchasing agent's unfilled order records. Invoices in possession of, but not passed by, the purchasing agent or assistant secretary are reviewed to determine if they apply to the period under examination. In addition to the aforementioned procedures, confirmation of the correctness of balances is requested at the end of the fiscal year of vendor's accounts for which no vendor's statements are available.

Accrued Salaries, Wages, and Commissions

When the end of a quarterly period does not coincide with the end of a pay roll week, an accrual is made for earned but unpaid compensation. This accrual equals an apportionment of the pay roll for the week in which the period ends, based on the number of working days that fall in the period over the total working days in the week. At the end of the fiscal year this last week's pay roll is verified, but the corresponding week's pay roll in the quarterly examinations may not be verified.

Accrued Social Security and Withholding Taxes

The social security tax expense is verified by applying the rates in effect to the total compensation for the quarter indicated by the accrued pay roll account after eliminating therefrom the amount of non-taxable compensation. Federal withholding tax is tested in connection with the verification of payrolls.

Accrued Federal and State Taxes

The accrued federal and state tax account is analyzed for the year.

The certifying accountant computes the federal and state income tax liability, and estimates a provision for state capital stock tax.

Capital Stock and Retained Income

A schedule of capital stock outstanding is maintained in the work papers, showing names of shareholders, certificate numbers, and number of shares registered. Current transactions reflected by the certificate books are entered in this schedule. Certificates returned for transfer are examined and the transfer stamps verified. At the end of the fiscal year the open certificate stubs are compared with the schedule in the work papers.

The retained income account is analyzed for the year.

Corporate Minutes

The corporate minutes are read and notes are made for the work papers of all resolutions or directives affecting the corporate accounts, such as dividend declarations, officers' salaries, authorization to purchase or sell securities, etc. This information is traced to the accounting records to see if the transactions have been properly recorded.

Sales

The sales record is a binder consisting of copies of the sales invoices. The billing clerk receives the shipping memoranda directly from the shipping clerk, and prepares the customer's invoice from the shipping record as to quantities and from the customer's order as to description, prices, etc. The shipping clerk does not maintain an independent shipping record of any kind. The billing clerk also prepares for the president a cumulative record of orders received during the month and a cumulative record of the dollar value of shipments. A quarterly listing of unfilled orders is made by the billing clerk and reconciled with the unfilled order balance as reported to the president.

The sales total for one month out of each quarter is proved by adding machine tape and post checked to the appropriate general ledger accounts. The total sales for the quarter are compared with the total shipments shown in the report of unfilled orders prepared for the president. During the observation of the physical inventory taking at the year-end a careful record is made by the accountant of all items packed for shipment and these items are traced to sales invoices in the subsequent period.

Purchases

During each quarterly examination one month's recorded purchases are vouched against vendor's invoices. Special attention is given to the account distribution since separate material and direct expense accounts are maintained for each of the two lines of product. The vendor's invoices are also reviewed for approval of receipt of material and checking of extensions.

The voucher register is footed for the test months and post checked to the general ledger.

The method of checking the purchase "cut-off" at the end of the year has been outlined in the discussion of accounts payable procedures.

Pay Rolls

One week's factory pay roll in each quarter is selected for test. Time cards are used to substantiate the hours recorded on the pay roll sheets. Pay roll rates for factory employees are obtained from the union contract. The computations are verified and the pay roll sheets are footed.

Federal taxes withheld from employees are test verified by use of the employee's exemption certificates and a withholding table.

The pay roll for office employees is similarly verified except that in the absence of a union contract the rates of pay are reviewed with a responsible officer of the corporation.

The weekly pay roll summary is traced into the monthly summary. The monthly summary is footed and post checked to the general ledger.

All pay rolls are compiled and distributed by the same employee, and are paid in cash. Once a year the certifying accountant, without prior notification of intention, observes the distribution of pay envelopes. Any pay envelopes not distributed are controlled by the accountant, and those not claimed before the completion of the examination are reviewed with a responsible officer.

Expenses

The following expense accounts are analyzed and all purchased items over $50 included therein are tested by reference to vendors' invoices or other documentary evidence such as real estate tax bills:

Building repairs	Officers salaries
Machinery repairs	Office supplies and expense
Real estate taxes	Legal and accounting expense
Fuel, light, heat, and power	Interest expense
Advertising	Profit and loss

Miscellaneous income and expense

Labor charges included in these accounts are accepted in that they have been tested in connection with the pay roll verification procedures.

Other expense accounts are scrutinized and where the amount for any month is abnormally high or low an investigation is made to determine the reason therefor.

Other Procedures

A trial balance is taken of the general ledger and is footed.

The correspondence file with the corporation's counsel is reviewed, primarily from the standpoint of contingent liabilities, and inquiry is made of the responsible officers as to contingent items not shown by the books. State tax settlements are examined and internal revenue agent's reports are reviewed. A state tax lien certificate is also obtained from the state authorities.

CONCLUSION

The preceding discussion emphasizes the absence of internal control as this term is commonly used. Undoubtedly, this is a major characteristic of small business as exemplified by the corporation herein portrayed. Procedures could be developed and additional personnel could be hired so that internal control could be made a reality but this would be accomplished only for the sake of internal control and at increased cost of doing business. Perhaps even in this example, some procedures could be developed which would give rise to the impression of internal control. But internal control in form is not internal control in fact.

A SMALL RESTAURANT

A SMALL RESTAURANT

INTRODUCTION

This case study represents an actual audit of a small restaurant located in a city of approximately 60,000 persons. The business is operated as a proprietorship with one location in the main shopping district of the city. The requirements of the engagement call for an annual examination and the preparation of the proprietor's federal and state income-tax returns. Annual sales approximate $80,000 and invested capital $15,000. One senior accountant performs the engagement.

OPERATIONS AND INTERNAL CONTROL

The restaurant operates along conventional lines with a day manager, a night manager, waitresses, and cooks. It opens for business at 7 A.M. and closes at 2 A.M. the following morning, six days per week. On Sundays the hours are from 8 A.M. to 10 P.M. The proprietor works in the actual operation of the restaurant only during rush hours.

The restaurant serves food at booths and wine and fountain products at the counter or at booths. Orders for booth service of food, beer, wine, or fountain products are taken by a waitress and written in duplicate on a sales slip. If the order calls for food to be prepared in the kitchen, the duplicate sales slip is turned over to the chef. The original sales slip is given to the customer, who presents it to the cashier with payment of the amount shown thereon upon leaving the restaurant. Orders for beer, wine, coffee, and fountain products to be served at the counter or fountain are not recorded on sales slips, as customers pay when served. The waitress turns the cash over to the cashier immediately. No food tickets are offered for sale.

The cash register is located near the exit of the restaurant and the manager rings up all sales. The register prepares a tape of all rings and also prints a consecutive ring number. No breakdown of sales between items is made. When the day manager goes off duty, he totals the register. This total is printed on the tape, but the total is not turned back to zero until the end of the month. Each manager reconciles his cash with the difference between the register totals and places his cash receipts in a separate money bag in the safe. The night manager removes the tape from the register after printing the total thereon, and turns in the tape with his receipts. The next morning the bookkeeper, who does not ring up sales, counts each manager's cash, reconciles it with the register tape, and makes the bank deposit. The key to the cash register total is under the control of the owner.

It may be observed that no practical method of determining that all sales are rung up on the register exists. The sales slips are of no value in the audit, as they are not prepared for every sale. The variance of the percentage of gross profit on sales might disclose any large amount of cash discrepancy, and this percentage was compared with prior periods for this purpose. A study of the amount of sales by days of the week indicated very little variance between the amount of sales on the same day from week to week, except during the Christmas shopping season.

Minor disbursements are made from cash receipts by the managers, all of which are supported by receipts. About 98% of cash disbursements are made by check, signed by the proprietor or his bookkeeper. The accounts are kept on the calender year basis.

AUDIT PROCEDURES

Cash

Because of the importance of cash accountability, considerable verification was made of the cash books and supporting records. The cash balance in bank was confirmed by correspondence with the bank at the balance-sheet date, and deposits made between the balance-sheet date and the date the work began were also confirmed. Cash on hand at the date the work began was counted and reconciled with the register totals. Receipts between the balance-sheet date and the date of count were strictly accounted for and compared with the deposits reported by the bank during the same period. Cash-register tapes and receipts for expenditures during this period were examined 100%.

For verification of receipts and expenditures during the year, the following procedures were applied:

1. Examined canceled checks and compared with the cash disbursements book for entire year
2. Examined in detail three months of cash-register tapes and receipts for cash expenditures; compared sales as shown by the tapes with the amounts shown on the cash receipts book. Observed if ring numbers were in consecutive order, and investigated the reason why any number was not printed on the tape.
3. Traced net cash receipts recorded on the cash receipts book to the deposits shown on the bank statement 100%. Observed if an unreasonable period of time elapsed between the receipts and the bank deposits.
4. Reconciled the bank account as of the balance-sheet date. The bank account was not reconciled as of the date of the cash count. This procedure was not deemed necessary in this case for several reasons:
   (a) Bank deposits between the balance-sheet date and the date of the cash count were confirmed by correspondence with the bank and compared with register tapes and the cash receipts book. Therefore, all cash receipts during this period were fully accounted for as being on hand or in bank.
   (b) Checks outstanding at the balance-sheet date were listed on the cash disbursements book as payable to local business firms and employees for salaries and were supported by invoices or pay roll records. None of the checks was unusually large in amount.
   (c) Payments made during the period between the balance-sheet date and the cash count were supported by invoices. These invoices were examined as described under the procedures regarding Accounts Payable—Trade.

In view of the foregoing procedures, a reconciliation of the bank account as of the "cut-off" date was deemed unnecessary.

5. Added the cash columns and crossfooted the cash receipts and disbursements book 100%.
6. Counted the change fund at the time of counting cash on hand.

Inventories

Inventories were small in this case and represented about one day's meat requirements and one week's fountain and staple goods supply. Therefore, the physical count was made by the proprietor without the auditor being present. Verification was limited to additions of all the inventory sheets, tests of extensions and prices of large amounts, and the obtaining of a letter from the proprietor that all items had been counted by him. In addition, purchase invoices during the last fifteen days of the year were observed to determine if unusually large quantities of supplies, staple goods or meats were acquired which were not included in the inventories. A statement was included in the report to the effect that the auditor was not present at the physical count, but had satisfied himself as to the accuracy of the inventories by other procedures. However, because the amount of the inventory was small in relation to the total assets, an exception in the "opinion" paragraph was deemed unnecessary.

Deferred Charges

Prepaid insurance was computed, and at the same time the insurance coverage was listed by examination of the policies. The insurance expense account was analyzed 100% to pick up new coverage for which policies had not been presented and cancellations of policies revealed by refunds credited to insurance expense.

Fixed Assets

The proprietor owned the restaurant building, subject to a first mortgage lien for the unpaid balance. Other fixed assets consisted of restaurant and office equipment. The deed to the land was requested in order to determine the following information:

1. Ownership of the land.
2. Liens on the property at date of purchase.
3. Any reservations made by the seller which may affect the financial position of the client.

Additions to restaurant and office equipment were verified by inspection of invoices. Depreciation was computed by the auditor on a detailed schedule of fixed assets maintained in his permanent file. Certain items of restaurant equipment became useless, or were discarded during the year, and the proprietor prepared a list thereof which was presented to the auditor for adjustment of the fixed asset and reserve for depreciation accounts. The client did not maintain a detailed equipment ledger; the auditor's depreciation schedules taking the place thereof. Liens against the fixed assets were verified by direct correspondence with the holders of the notes or mortgage. China, glassware, and kitchen utensils were carried at the original investment when the business was established. Replacements for breakage and theft were charged to expense when purchased. The insurance coverage was compared with asset values to ascertain adequate protection.

Accounts Payable—Trade

Unpaid bills and creditors' statements were listed as to vendor and amount and compared with the general ledger account. Confirmation of the balances by correspondence with creditors was not made. Invoices paid during the period between the balance-sheet date and the time of the examination were examined in detail to discover omission of payables from the accounts at the balance-sheet date. Accounts payable were accrued on the books only at the year end.

Notes and Mortgages Payable

The amounts owed for the mortgage on the land and building and chattel mortgages on equipment were confirmed by correspondence with the holders thereof. An analysis of each note or mortgage payable account was made. Interest was paid to the balance-sheet date on all loans.

Accrued Salaries

Examination of the pay roll sheets for the week following the balance-sheet date was made to determine accrued salaries. The number of days on the pay roll before the balance-sheet date was counted and became the numerator of the fraction applied to the total wages on the pay roll. No attempt was made to accrue wages to the exact penny. Four days of the year under audit remained unpaid, therefore four-sevenths of the total pay roll was set up as accrued. The proprietor was questioned regarding profit-sharing arrangements with his managers. In this case there were no such arrangements.

Accrued Pay Roll Taxes

The accrued amounts for old-age benefits and unemployment taxes were verified by the following procedure:

1. Obtained the total salaries for the year from the general ledger.
2. Determined the excess over $3,000 paid to each employee and subtracted this amount from the total salaries.
3. Multiplied the remainder by the rate of each tax to obtain the total of the accrual for the year.
4. Listed payments made during the year, and compared with the pay roll tax returns; deducted the total payments from the amount in No. 3.
5. Compared the unpaid amounts per computation in No. 4 with the amount shown in the liability accounts on the general ledger. The minor difference was not adjusted.

Employees' Federal Income Tax Withheld

The amounts deducted from employees' wages for income taxes was verified by tracing these deductions from the pay roll sheets to the cash disbursements book and subsequently into the general ledger liability account. Copies of the quarterly returns to the Treasury Department were compared with debits to the account. The remaining balance in the account was compared with the amount paid during the month subsequent to the balance-sheet date.

Drawings and Capital Accounts

A complete analysis was made of each of these accounts. The payments for federal and state income taxes of the proprietor charged to the drawing account were segregated for disclosure in the report. Any items deductible for income-tax purposes, which had been charged to the drawings account, were segregated. The beginning balance in the capital account was compared with the closing balance as shown in the report for the year preceding the year under review, and all changes during the current year were set forth in the analysis.

Contingent Liabilities

The proprietor was asked to sign a statement describing any contingent liabilities, of which he had any knowledge. In addition, a letter was written to the client's attorney, asking for disclosure of any suit or other pending action which might result in a liability. Income-tax returns for the past three years were reviewed and the proprietor was asked to present the latest revenue agent's report for examination.

Income Taxes of Proprietor

Personal income taxes of the proprietor for the current year were not accrued on the business books, but were charged to drawings when paid out of business funds. An estimated return was filed by the proprietor on which payments were made during the year, except the remaining one-fourth payment due on January 15 of the subsequent year. This fact is set forth in a footnote on the balance sheet giving the amount of the unpaid installment. The income statement was also described as being before deduction of income taxes of the proprietor. This procedure was necessary because other income of the proprietor is included in the tax returns.

Income

Because of the fact that practically all income was recorded through the cash register, the verification procedure for sales was included under the auditing procedures set forth for cash accountability. Miscellaneous items of income were analyzed, but were not verified beyond the cash book because of the small amounts involved. In this case miscellaneous income consisted of the restaurant's share of proceeds from the music machine, cash overages, and sales of small items of equipment.

Expenses and Purchases

Practically all bills and all salaries were paid by check. Invoices for purchases and expenses were examined in detail for three months of the year selected at random. Every invoice was either examined for the months selected, or a list was made of those missing and given to the bookkeeper for location. Some invoices were not located and the canceled checks in payment thereof were re-examined carefully. The auditor was satisfied as to the validity of the expenditures and no further action was taken. Complete analysis of the following accounts were made and invoices inspected for entries therein:

1. Repairs (Amounts over $50 only)
2. Supplies (Amounts over $25 only)
3. Insurance Expense
4. Taxes and Licenses
5. Legal and Auditing Fees
6. Office Expense
7. Miscellaneous Expense
8. Miscellaneous Income
9. Interest Expense
10. Gain or Loss on Sale of Equipment

Payments to employees were made by special pay roll check and were evidenced by pay roll sheets prepared by the bookkeeper. No time clock or other recording device is maintained. Hours worked were entered on the pay roll sheets along with the rate per week. The pay roll checks were on a special form, but were paid through the client's regular business checking account. Each week the net pay as shown by the pay roll sheet was entered in total in the cash disbursements book. Examination of canceled checks under Cash included the inspection of pay roll checks. In addition the following procedures were followed as to pay rolls:

1. Added net pay columns of pay roll sheets and crossfooted totals for three months selected at random. As indicated above, all employees were paid by special check, which checks were paid by the bank through the regular checking account. These checks were examined as set forth under Cash. Deductions from employees' pay included Federal Old-Age Benefits Tax, Federal Income Taxes Withheld, and meals furnished. The deductions for taxes were traced to liability accounts and from there to returns filed with the Collector of Internal Revenue. The deductions for meals furnished were credited to an account representing a reduction of the cost of goods

sold. The amount deducted for meals furnished was computed at an average cost per meal by the proprietor and was previously added to the cash salary on the pay roll. It may be observed that no cash was handled in connection with the pay rolls, all deductions were properly accounted for, and no further benefit could be derived by adding the gross pay and deductions columns when the pay roll totals crossfooted.

2. Scanned pay roll sheets for the three months for overtime pay computations; verified overtime pay amounts.
3. Accounted for unused or voided pay roll checks.

General Ledger Entries

A trial balance and work sheet was prepared from the general ledger. The client did not prepare a balance sheet or income statement. All postings from the cash receipts and cash disbursements books were traced to the general ledger accounts. Entries in the journal were examined and traced to the ledger accounts. The beginning balances in the assets, liabilities, and capital accounts were compared with the audit report for the previous year at the time of taking off the trial balance. Adjusting entries were prepared as the need for them was discovered.

ACCOUNTANT'S REPORT

The engagement required a "long form," or "Management," type of report. Comparisons were made of the financial position with the preceding year and ratios of working capital were computed under the heading "Financial Position." Attention was also called to significant changes in the current position, and increases in debt were explained. Under the heading "Results of Operations" a summary was made of the current year's results and compared with those of the preceding year. Percentages of cost of sales, gross profit on sales and profit from operations, to sales was compared with those for the previous year. A detailed balance sheet, statement of profit and loss, statement of capital (Exhibits A, B, and C), and schedule of insurance coverage was included in the report, together with the accountant's opinion thereon (Exhibit D). The report was prepared in five copies.

ADJUSTING JOURNAL ENTRIES AND TAX RETURNS

Adjusting journal entries were prepared by the auditor and mailed to the client's bookkeeper after completion of the report. The bookkeeper posted the adjusting entries, closed the books, and posted the reversing entries. Preparation of income-tax returns was completed and forwarded to the client.

FINANCIAL STATEMENTS AND OPINION

EXHIBIT A: BALANCE SHEET

EXHIBIT B: STATEMENT OF PROFIT AND LOSS

EXHIBIT C: STATEMENT OF CAPITAL

EXHIBIT D: ACCOUNTANT'S OPINION

ASSETS

CURRENT ASSETS

Cash on hand and in bank	$ 5,000
Inventories (at cost):	
Food, fountain, beer, and wine	1,100
Deposit on new equipment	150
Prepaid insurance	350
TOTAL CURRENT ASSETS	$ 6,600

FIXED ASSETS

	Cost	Reserves for Depreciation	Book Value	
Land (subject to mortgage payable)	$ 3,000	$	$ 3,000	
Building (subject to mortgage payable)	18,400	5,000	13,400	
Automobile	1,000	400	600	
Restaurant equipment (See Note 1)	8,490	3,500	4,990	
China, glassware, and kitchen utensils	1,000		1,000	
TOTALS	$31,890	$8,900	$22,990	22,990
				$29,590

NOTES:

(1) Air conditioning equipment which cost $1,000 is subject to a chattel mortgage of $600, payable $50 per month.

(2) Land and building are subject to a first mortgage of $12,000, payable $2,000 per year.

SHEET
31, 1948

EXHIBIT A

LIABILITIES AND CAPITAL

CURRENT LIABILITIES		
Accounts payable—trade		$ 700
Accrued salaries		350
Mortgage payable—portion due currently		2,000
Chattel mortgage on equipment		600
Employees' federal income taxes withheld		150
Accrued taxes:		
Federal old-age benefits	$ 120	
State and federal unemployment insurance	195	315
TOTAL CURRENT LIABILITIES		$ 4,115
OTHER LIABILITIES		
Mortgage payable—secured by lien on land and building	$12,000	
Less: Portion due within one year, included in current liabilities	2,000	10,000
CAPITAL (Exhibit "C")		15,475
		$29,590

(3) The proprietor's 1948 income taxes have been paid quarterly, except for the final installment of $200 due January 15, 1949. Income-tax returns for the years 1946, 1947, and 1948 have not been examined by the Treasury Department.

EXHIBIT B

STATEMENT OF PROFIT AND LOSS

For the Year Ended December 31, 1948

			Amount	Per Cent of Sales
SALES			$80,000	100.00
COST OF GOODS SOLD:				
Inventory—January 1, 1948 . .		$ 900		
Purchases		44,000		
TOTAL		$44,900		
Deduct:				
Meals furnished employees . .	$ 2,000			
Inventory—December 31, 1948	1,100	3,100	41,800	52.25
GROSS PROFIT			$38,200	47.75
OPERATING EXPENSES:				
Salaries (including meals furnished employees)		$18,000		22.50
Gas, lights, telephone, and water .		2,000		2.50
Taxes and licenses		1,500		1.88
Supplies		1,900		2.37
Repairs		1,700		2.13
Depreciation:				
Building	$ 1,000			
Restaurant equipment	700			
Automobile	300	2,000		2.50
Advertising		1,400		1.75
Stationery and office expense . .		300		.38
Insurance		700		.87
Auto and travel expense		300		.37
Laundry		75		.09
Auditing and legal fees		400		.50
Miscellaneous expense		200		.25
TOTAL OPERATING EXPENSES			30,475	38.09
PROFIT ON OPERATIONS . . .			$ 7,725	9.66
OTHER INCOME:				
Music machine receipts		$ 500		
Miscellaneous income		300	800	1.00
TOTAL			$ 8,525	10.66
OTHER DEDUCTIONS				
Interest		$ 600		
Cash over and short		100		
Loss on sale of equipment		50	750	.95
NET PROFIT FOR THE YEAR (EXHIBIT "C") BEFORE INCOME TAXES OF THE PROPRIETOR			$ 7,775	9.71

NOTE: Income from the business is included in the proprietor's personal income-tax return and no part of the tax has been allocated to the business.

EXHIBIT C

STATEMENT OF CAPITAL

For the Year Ended December 31, 1948

BALANCE—JANUARY 1, 1948		$15,000
ADD:		
Net Profit for the Year (Exhibit "B")		7,775
		$22,775
DEDUCT:		
Drawings	$ 6,500	
Payments on state and federal income taxes	800	7,300
BALANCE—DECEMBER 31, 1948 (EXHIBIT "A")		$15,475

EXHIBIT D

OPINION

Mr. John M. Blank, Proprietor,

Blank Restaurant,

Blankville, Virginia.

Dear Sir:

We have examined the balance sheet of the Blank Restaurant, Blankville, Virginia, as of December 31, 1948, and the related statements of profit and loss and capital for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

We did not follow the generally accepted procedure of being present at the physical count of inventories, but satisfied ourselves as to their substantial accuracy by other methods.

In our opinion, the accompanying balance sheet and statements of profit and loss and capital present fairly the financial position of the Blank Restaurant, Blankville, Virginia, at December 31, 1948, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Respectfully submitted,

DOE & COMPANY

Certified Public Accountants