Journal of Accountancy

Volume 59 | Issue 5 Article 6

5-1935

Students' Department

H. P. Baumann

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H. P. BAUMANN, *Editor*

AMERICAN INSTITUTE EXAMINATIONS

[NOTE.—The fact that these answers appear in THE JOURNAL OF ACCOUNTANCY should not cause the reader to assume that they are the official answers of the board of examiners. They represent merely the opinions of the editor of the *Students' Department.*]

EXAMINATION IN AUDITING

November 15, 1934, 9 A. M. to 12:30 P. M.

The candidate must answer all the following questions:

No. 1 (5 points):

(a) State how a straight voucher system is used, recorded and controlled.

(b) May it be used in conjunction with an accounts-payable ledger, and in what way?

(c) Under what conditions is it preferable in conjunction with an accounts-payable ledger?

Answer:

(a) A "straight" voucher system requires the preparation of a voucher for every disbursement. These vouchers, when properly approved, are entered in the register in numerical order, recording the date, payee, terms, the amount (under the column heading "Vouchers payable"), and the distribution to the cost, expense, asset, or other accounts. The total of the vouchers-payable column is posted, at the end of the month, to the credit of the vouchers-payable account in the general ledger. The accounts to which the expenditures are chargeable are debited.

The cheque register should contain columns showing the number of the cheque, the number of the voucher, the amount to be charged to vouchers payable (the total of the amount of the cheque, plus discounts earned, allowances, etc.), amount of discounts earned, allowances, etc. The total of the vouchers-payable column in the cheque register should be posted to the debit side of the vouchers-payable account in the general ledger at the end of the month.

When cheques are drawn, the voucher number should be entered in the cheque register, on the line with the recorded disbursement; and the cheque number and date paid should be entered in the voucher register on the line of the corresponding voucher.

After the totals of the voucher-payable columns in the voucher register, cheque record, journal, etc., have been posted, the balance in the general-ledger account should agree with the total of the unpaid vouchers as shown in the voucher register.

(b) The voucher system may be used with an accounts-payable ledger, by opening ledger accounts with each creditor and recording each voucher in the creditor's account.

(c) The accounts-payable ledger is desirable when there are many partial payments, returns, allowances, and adjustments, which may produce complications and frequent errors if ledger accounts are not maintained.

No. 2 (10 points):

In the annual audit of the firm of John Doe & Co. you find it has sold a substantial part of its accounts receivable to the X Discount Co., receiving an advance of 60% of their face value, the balance to be received when and as the accounts are collected from customers.

The advance was credited to the account of The X Co. when received, but in closing its books for the year the firm has deducted it from the total accounts-receivable balance on the theory that the accounts sold no longer belong to the firm and that the 40% equity in them is due from the purchaser.

You are requested to certify the resulting balance-sheet in this form without mentioning the sale of the accounts, if possible.

(a) Analyze the above transaction, and

(b) State three methods from which you could choose in order to give a certificate, qualified or unqualified.

(c) Which method would you adopt? Give your reasons.

Answer:

While the question states that the firm of John Doe & Co. "sold" a part of its accounts receivable it is probable that the firm has guaranteed the collection. It would be misleading to show the unassigned accounts and the equity in the assigned accounts under the one heading, "Accounts receivable." The assignment must be disclosed.

Assume the following:

Accounts receivable:	
Unassigned	$50,000
Assigned	20,000
Advanced by discount company	14,000

Three methods in which the above may be shown in the balance-sheet of the firm of John Doe & Co. follow:

(1)

Current assets:		
Accounts receivable	$50,000	
Equity in assigned accounts	6,000	$56,000

A footnote should be appended to the balance-sheet stating that the firm was contingently liable in the amount of $14,000 as guarantor of the assigned accounts receivable.

(2)

Current assets:		
Accounts receivable	$50,000	
Equity in $20,000 of accounts receivable assigned under guarantee	6,000	$56,000

No footnote is necessary.

(3)

Current assets:			
Accounts receivable:			
Unassigned		$50,000	
Assigned	$20,000		
Less: advance thereon	14,000	6,000	$56,000

No footnote is necessary.

The first method is the most desirable because it is simple and it clearly shows the facts.

No. 3 (5 points):

You are employed by the firm of Smith & Jones to close its books and prepare a balance-sheet, profit-and-loss statement, and federal income-tax returns for the firm and for each partner. You are not to audit the books. Neither partner keeps private books but each gives you memoranda of his "other" income and allowable deductions and credits.

With the usual income-tax forms you find additional ones which prescribe:

(1) That the taxpayers must state the fact if they employed anyone, and if so whom, to prepare or advise in the preparation of the return, and to what extent such assistance or advice was received: and

(2) That the person giving such service must make affidavit as follows:

> "I, acting as (advisor or attorney) for the hereto subscribed taxpayer affirm that I prepared the return, that the information set out in the return and accompanying schedules, if any, correctly and truly represents the information furnished or discovered by me during the course of preparation of the return, and that such information is true to the best of my knowledge and belief."

(a) How would you word the taxpayers' statements on these forms in the above cases?

(b) As a certified public accountant with all the responsibilities the title implies, what would you do to protect yourself in respect to the affidavit? Give your reasons.

Answer:

(a) The taxpayer's statements should be worded somewhat as follows:

1. On the partnership return:
   "Return prepared by John Doe from books, without audit."
2. On the individual return:
   "Return prepared by John Doe from unaudited data which I furnished."

(b) The affidavit is so worded that it affords all the protection necessary in most instances, in the words "The information set out in this return . . . correctly represents the information *furnished or discovered* by me, and . . . is true to the *best of my knowledge and belief*." (The italics are the editor's.) The insertion of the word "to" after "furnished" would clearly state the facts that the return was prepared from information furnished to the accountant, and that what information he possessed he believed to be correct.

No. 4 (15 points):

In the course of your audit of the X Machine Corporation for the year 1933 you discover that the plant account has been written down one-half its book value by the journal entry—

"Dec. 31, 1933.	Reserve for depreciation....	\$........	
	To plant account....................		\$........"

You learn that this was authorized by the board of directors, and you are shown a draft of the proposed report to stockholders in which it is recited that the amount represents the net book value, as of January 1, 1933, of plant and equipment which was idle during the entire year; that its purpose is to show the investment in plant at a conservative figure in accord with general conditions due to the depression; that its effect is to confine the annual depreciation charge to plant actually engaged in production during the year; and that the profit-and-loss statement thus shows the true profit made on actual production and sales. It is further intimated in somewhat guarded language that when and as business improves and the idle plant resumes normal production, the value now charged off will be restored to plant account.

State whether or not you will approve this procedure by certifying the corporation's statements, and give your reasons in full.

Answer:

The directors of the X Machine Corporation appear to have arbitrarily reversed one-half of the plant account against the depreciation reserve for the sole purpose of making a better showing by reducing the annual depreciation charge. The statement in the annual report that the purpose was "to show the investment at a conservative figure" appears to be intentionally misleading, since the net value of the fixed assets has not been reduced, but has been actually increased because of the reduction in the amount provided for depreciation for the year.

This seeming deceit throws some doubt on the sincerity of the directors' justification of their action. However, assuming that one-half of the plant (at cost) actually was idle during the year, the situation might properly have been reflected in the accounts in either of two ways:

1. Remove the cost and the accrued depreciation of the "idle" plants as of January 1, 1933, from the accounts by a charge to surplus; or
2. Record depreciation on the "idle" plant for the year 1933 at normal rates by a charge to surplus, or by a charge to profit and loss as a non-operating item; and, if it appears likely that the plant will be idle for some time, set out the net book value in the balance-sheet under the caption "Idle plant."

If either of these methods had been followed, I would certify the company's statements without qualification.

The company's procedure is open to at least three objections:

1. The depreciation for the year is understated.
2. The property accounts are misstated.
3. The wording of the annual report, when coupled with the entry made, appears to be intentionally misleading.

No. 5 (5 points):

How should the executor of an estate charge the following items as between corpus and income?

1. Physician's fees for last illness.
2. Funeral expenses.
3. Expenses of probating will.
4. General expenses of executor.
5. Loss on sale of investment.
6. Legal fees for collection of rents.
7. Legal fees for defending claims against the estate.
8. Executor's commissions.
9. Repairs to office buildings.
10. Estate and inheritance taxes.
11. Fire-insurance premium.
12. Special assessments adding permanent value to real estate.
13. Monthly allowances to beneficiaries.
14. Expenses incident to a change in executor.

Answer:

Chargeable to corpus:

1. Physician's fees for last illness.
2. Funeral expenses.
3. Expenses of probating will.
5. Loss on sale of investment (considered as an asset left by the decedent).
7. Legal fees for defending claims against the estate.

10. Estate and inheritance taxes.
12. Special assessments adding permanent value to real estate.
14. Expenses incident to a change in executor.

Chargeable to income:

4. General expenses of executor.
6. Legal expenses for collection of rents.
8. Executor's commissions.
9. Repairs to office buildings (considered as ordinary expense).
11. Fire insurance premium.
13. Monthly allowances to beneficiaries (considered as income to beneficiaries).

No. 6 (20 points):

Give the program you would follow in making a balance-sheet audit of a small trading corporation.

Answer:

Let us assume that the balance-sheet of the small trading corporation contains the following items:

Assets:
Cash on hand
Cash in bank
Accounts receivable
Notes receivable
Reserve for bad debts
Inventory
Prepaid insurance
Furniture and fixtures

Liabilities:
Vouchers payable
Notes payable
Bank loans

Net worth:
Capital stock
Surplus

The program would be somewhat as follows:

The auditor should satisfy himself that the system of internal check is adequate. The footings of all columns in all books of original entry should be verified for at least one month, and the postings for the month chosen should be checked. Balances of all general ledger accounts should be verified by footing the year's posting in each account.

Cash on hand. The count should be made at the balance-sheet date, if possible. If not, a count should be made during the course of the audit and an examination should be made of the recorded transactions between the balance-sheet date and the date of the count. Any undeposited receipts should be traced into the bank.

Cash in bank. The bank account should be reconciled as of the balance-sheet date and as of the date of the cash and securities count (if any); confirmations as of both dates should be obtained from the depositary direct. At least one month's cash transactions should be checked thoroughly. Bank statements and cancelled cheques as of the date of the cash and securities count (if subsequent to the balance-sheet date) should be obtained from the bank direct; items in transit and cheques outstanding at the balance-sheet date should be traced into the bank. The cancelled cheques, for at least a month, should be examined as to dates, signatures, payees, and amounts, and checked against the cash disbursements record. The endorsements and the bank's perforation indicating payment should be examined. The daily record of deposits should be compared with daily record of deposits as shown by the bank on its statement.

Accounts receivable. If possible, the customers' statements as of the balance-sheet date should be checked against their accounts and mailed by the auditor with the request that the accounts be confirmed to him directly. The envelopes in which the statements are mailed should bear an address which will return any undelivered letters directly to the auditor. A list of the customers' accounts should be prepared showing the name, amount owing, and the aging of the accounts; subsequent collections, allowances for discounts, etc., and returns should be entered thereon. The doubtful accounts should be noted and discussed with the credit department, for the purpose of determining the adequacy of the reserve for bad debts. Credit balances, accounts with officers and employees, advances to suppliers, and all accounts other than those arising from sales transactions with customers should be set out separately in the balance-sheet.

Notes receivable. At the time of the count of the cash, the notes receivable (and any other negotiable securities) should be examined; those out for collection, discount, or collateral should be confirmed directly to the auditor. If there is no reasonable objection, a confirmation should be requested of the maker. All of the notes should be scheduled showing the name of the maker, the date, the date of maturity, the amount of the note, the rate of interest, endorsements, etc. Any notes collected prior to the examination should be verified by tracing the cash collected into the cash records and thence into the bank. The interest-earned account should also be examined to learn if the interest on the notes has been recorded, or if there has been any interest credited in the accounts on notes which were not recorded as such. Consideration must be given to the adequacy of the bad debt reserve applicable to the notes.

Inventory. The extent of the auditor's verification should be set forth in the report, or certificate. As to quantities, it may be by actual supervision, by tests at the date of the audit, or only by examination of the books, records, and inventory sheets. He should investigate as to the method and time of the taking of the inventories, and as to the competency of the persons who took or supervised the taking of them. A comparison of the quantities with previous purchases and sales or with book inventories should be made. The auditor should ascertain that goods held as consignee or as bailee, or goods sold but undelivered, are not included in the inventories, and that any merchandise held by others but owned by the client is included. Merchandise in transit and merchandise for the succeeding season received under post-dated invoices should be included. An examination should be made of the receiving records just prior and subsequent to the balance-sheet date. A certificate should be obtained from responsible officers and employees as to ownership, and as to the correctness of the quantities, costing, and the indication of spoiled, damaged, or otherwise unsalable or unusable materials or merchandise. The pricing may be verified by examination of purchase invoices, market quotations, and sales made immediately after the balance-sheet date. Freight, drayage, duty, handling costs, etc., may be included as a part of the price. A comparison with the prices of previous inventories should be made. The mathematical accuracy of the inventory may be complete or by tests. If copies of the inventories have been submitted to the auditor he should check these copies against the original inventory sheets.

Prepaid insurance. The insurance policies should be examined and scheduled, showing the name of the insurer, the policy number, the kind of insurance, the amount of coverage, the premium, and date of issuance and the date of expiration. The unexpired portion of the premium should be computed and set up as a prepaid expense. The beneficiary under the policies should be noted to ascertain whether an assignment has been made to protect a mortgagee.

Furniture and fixtures. If this is an annual audit, only the changes in this account (and its related reserve) during the year should be verified. The correctness of the provision for depreciation should be determined.

Vouchers payable. A list of the unpaid vouchers should be prepared from the voucher register and the total checked against the controlling account in the general ledger. The receiving records prior to the balance-sheet date should be checked against the recorded vouchers and vouchers subsequent to the balance-sheet date should be examined, to ascertain that the liability had been taken up for all goods received. If direct confirmation from the suppliers is impracticable, the auditor should request that the creditors' statements be held available for him to check against the records. The liability for any merchandise in transit should be taken up, and also included in the inventory; purchase commitments and the corporate minute book should be examined to learn of any unrecorded liabilities or possible losses.

Accrued liabilities, such as accrued wages, salaries, commissions, taxes, interest, etc., can be verified by examining subsequent payments. Expenses applying to one month, but payable in the following month, such as telephone, telegraph, light, power, etc., must be recorded as an expense for the month which received the benefit. Particular attention should be given to the reserve for taxes. A comparison of the accrued liabilities with those set up at the end of the previous period, as to kind and amount, should be made. In addition, a certificate should be obtained from the treasurer, and the bookkeeper, stating that all liabilities for the period or for any previous period have been recorded in the accounts, and setting forth any contingent liabilities of the corporation which have not been entered.

Notes payable. A request should be mailed to all creditors to whom notes were issued during the year to send directly to the auditor a list of any notes (giving the date, maturity, interest rate, names of makers and endorsers, and the amount) held by them at the balance-sheet date. Any notes paid between the balance-sheet date and the date of the examination, and the cheque issued therefor, should be examined. The interest-paid account should be inspected to ascertain whether any interest had been paid on notes which were not a matter of record.

Bank loans. A request should be made of the bank to confirm the dates, maturities, security, if any, the endorsements, the amount of the note, and the accrued or prepaid interest thereon as of the balance-sheet date.

Capital stock. The stock certificate book should be examined, and a listing made of all of the certificates shown as outstanding. All certificates must be accounted for.

Surplus. All entries to surplus account during the year should be traced, and the propriety and the authority for extraordinary entries established.

In addition to the above, the nominal accounts should be scanned, or reviewed.

No. 7 (10 points):

Brown, Smith & Jones, a firm, decide to dissolve partnership and to liquidate the business. Lacking confidence in each other, the partners employ you to conduct the liquidation and to determine the correct amounts due from or to each partner.

Describe in detail the steps you will take.

Answer:

It is important that all of the liabilities of the firm be ascertained and recorded on the books. As cash is received from the sale of the assets, the liabilities should be liquidated in the order of priority. Unsecured liabilities should not be paid until sufficient cash has been accumulated to pay them all; or, if it is apparent that the amount of cash to be realized will be sufficient, payments may be made prorata to these creditors.

At the time of the disposal of an asset, the loss thereon should be charged to the partners' capital accounts in the profit-and-loss sharing ratio. It would be well to have the partners agree that no payments are to be made to them until all of the assets have been converted into cash, and the outside creditors have been paid in full. If they insist upon payments before all assets have been realized, provision should be made for possible losses by considering that no further cash will be obtained from the sale of the remaining assets. After providing for the actual, and the possible losses (all in the profit-and-loss sharing ratio), payments may be made to the partners first, against loans, and second, against capital accounts; provided that no payments shall be made against partners' loans, if such loans, or portions of them, must be transferred to the respective capital accounts to make good present or prospective deficits therein.

No. 8 (10 points):

You are making an audit of the X Corporation, among whose assets you find stocks and bonds of the Y Company of a substantial amount. In support of their value you are offered a balance-sheet of the Y Company certified by a fellow member of the American Institute. After careful study of this balance-sheet you are convinced there are serious errors in it and you can not conscientiously accept it. You explain the matter and point out the doubtful items to the officers of the X Corporation, whereupon, after securing the consent of the Y Company, they instruct you to make an audit of the Y Company also.

Bearing in mind the provision in the Institute's rules of professional conduct —that no member shall encroach upon the business of another member—what will you do? Give your reasons. Also state your understanding of the meaning of this provision of the rules.

Answer:

I would get in touch with the fellow member who certified the balance-sheet of Y Company, and explain the circumstances to him. He would be given an opportunity to explain that there were no serious errors in the balance-sheet. If, after my conference with him I still felt that his work could not be accepted, I would proceed with my audit of the accounts of Y Company.

The rule involved is number 8 of the rules of professional conduct of the American Institute of Accountants which reads: "No member or associate shall directly or indirectly solicit the clients or encroach upon the business of another member or associate, but it is the right of any member or associate to give proper service and advice to those asking such service or advice."

No. 9 (10 points):

You are engaged in auditing the accounts of the American Manufacturing Company, a small corporation, the president owning approximately 96% of the outstanding capital stock. The company had been exceedingly profitable for a number of years and had invested some of its profits in good marketable securities so that funds would be available for an addition to its plant. Examining the securities you find in place of $25,000 par value of bonds, carried on the books at $20,000, a demand note for $20,000 signed by the president. The minutes of the board of directors show that these securities were lent to the president for his use as collateral to secure some personal transactions which have no relation to the affairs of the corporation. The securities are held by the Manufacturers' National Bank as collateral for the president's personal note, and you have received the bank's confirmation.

How will you show this condition in the balance-sheet and how will you qualify your certificate?

Answer:

The question which the auditor should put to himself is—were the bonds loaned, or sold to the president of the company?

The minutes of the board of directors indicate that the bonds were loaned to the president, and remained the property of the company, even though the company did not have possession or control of the securities at the date of the balance-sheet. Hence, the account should be shown as securities, and not as a note receivable, in somewhat the following manner:

Securities loaned to officer (see footnote) $20,000

As a footnote, I would show "securities of a value of $20,000 were loaned to Mr. X, the president of the company, who has given the company his demand note for $20,000 as collateral. These securities were pledged by him as collateral for his personal note to the Manufacturers' National Bank."

If the transaction were shown as discussed above, it would not be necessary to qualify the certificate.

No. 10 (10 points):

You are to audit the accounts of the Kaslek Manufacturing Company at December 31, 1933, and your certified balance-sheet is to be used for credit purposes. On December 28, 1933, the corporation sold a piece of idle property, the terms of sale being one third cash, one third in a note due in 30 days and one third in a note due in 60 days. The price was determined by outside appraisal of October 15, 1933, and your investigation revealed that the transaction was apparently regular in every way. There were the proper resolutions in the minutes and all the necessary documents were produced for inspection. You also find that the cash had been duly deposited. You discover, however, that the purchasing company is controlled by a stockholder of your client, and you suspect that the transaction took place for the purpose of window dressing. On the date of your examination the first note is unpaid and the second note is not yet due. It more than doubled the current assets and therefore greatly improved the current asset position.

How will you deal with these facts in the balance-sheet and certificate?

Answer:

The notes should be shown in the balance-sheet as follows:

Notes receivable—sale of idle plant:		
Due January 27, 1934....................	\$........	
Due February 26, 1934..................	\$........	\$........

Because the note due on January 27, 1934, was not paid at maturity, I would show these notes as a separate item in the balance-sheet, following the current asset section.

The resulting profit or loss on the sale should be shown separately in the surplus section of the balance-sheet.

In the certificate (which should be dated) I would include a paragraph stating that the idle property was sold on December 28, 1933, at a price of \$..... ...., payable one-third in cash, one-third in a note due on January 27, 1934, (which was not paid at the date of the examination) and one-third in a note due on February 26, 1934.

American Institute Examinations, problem No. 7.—November 15, 1934

Palisades Park, N. J.

Dear Sir:

Referring to your solution in the March, 1935, issue of THE JOURNAL of problem No. 7 of the American Institute examinations given November 15, 1934, I would contend, as accountant for the film company, that my client was entitled to \$387.09 in rental.

It is my theory that the expenses should be prorated over the entire sales, and that the gross profit on sales is uniformly 60 per cent. for the period. My solution, using this theory, is attached.

This letter is not written in a spirit of criticism, but merely to present the possible attitude of the officials of the film company.

Very truly yours,

(Sgd.) EDMUND J. CONWAY,
Certified Public Accountant (New York)

Let X = Total rental

Let Y = Gross receipts on which 15% rental is paid

$\$1,000 - Y$ = Gross receipts on which 50% rental is paid

$.15\ Y + .50\ (\$1,000 - Y) = X$

$.60\ Y$ = Profit on gross receipts on which 15% rental is paid

$\frac{X}{2}$ = Profit on gross receipts on which 15% rental is paid

$$.60\ Y = \frac{X}{2}$$

$1.2\ Y = X$ or

$1.2\ Y = .15\ Y + .50\ (\$1,000 - Y)$

$1.2\ Y = \$500 - .35\ Y$
$1.55\ Y = \$500$
$Y = \$322.58$
$\$1{,}000 = Y = \$677.42$
15% of \$322.58 = \$ 48.38
50% of \$677.42 = 338.71

Total rental.. \$387.09

Proof:	Gross receipts on which 15% rental is paid	\$322.58
	Less expenses (40%)	129.03
	Profit thereon or ½ of total rental	\$193.55

Reply:

Several letters have been received commenting upon this problem; the solutions offered by the writers have all been based upon the assumption that the expenses, other than film rentals, should be applied ratably against the receipts, apparently upon the theory that they varied (at 40%) with the gross receipts. There is nothing in the problem to indicate either the nature of these expenses, which total \$400, or the manner in which they are to be applied against the gross receipts. Since from the nature of the theatre business a great part of the expenses (other than film rental) are known to be virtually fixed, the expenses were applied against the first receipts in the published solution. This would appear to be the preferable interpretation.