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Basic Audit Procedures Consistent with Good Accounting Practice

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BASIC AUDIT PROCEDURES CONSISTENT WITH GOOD ACCOUNTING PRACTICE

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The audit procedures outlined here are an outgrowth of the need for audit or work programs to serve as a guide to minimum procedures for commercial and industrial audits to be used by firms with a staff of ten to twenty accountants. These procedures are readily adaptable for organizations having smaller or larger staffs.

Much has been written and published by recognized authorities on the subject of audit procedures. Although the available material makes reference to "medium-sized" organizations, it has been written primarily by partners or staff members of large accounting firms, and the material resulted in more detailed and elaborate instructions than are required for a satisfactory audit of small businesses such as many accounting firms have as clients. The result has been a trend toward the other extreme—a completely informal type of procedure. This may be dangerous, not only in its immediate effect on the work done, but in its lasting effect on the professional standing of small accounting firms.

There seems to be no questioning the fact that an organization with a small staff can and should do an audit covering all procedures which are necessary in engagements undertaken to give clients service sufficient for their needs, and, at the same time, conform to the standards set by the American Institute of Certified Public Accountants.

The procedures described in this article are not to be considered as an auditing text. They are based on the assumption that they will be of use to academically qualified accountants. Neither is there any intention that they be all-inclusive, nor that they must be followed at all costs. They are to be considered merely as signposts to direct the way. It is obvious that an article of this length can include a description of only those audit procedures applicable to the major balance sheet categories. It is therefore necessary for any accountant planning to use this as a guide for a specific audit to provide for an adequate examination of any other significant items. The comments that follow are listed in usual balance sheet order, rather than in order of importance.

Cash

All cash funds should be counted simultaneously, or, if only one accountant is on the job, all funds should be controlled to avoid substitution to cover shortages. Notes receivable and securities should be counted at the same time as cash funds. If investments are held by a custodian, they should be confirmed at the date of cash count, as well as at the balance sheet date, if these dates differ. (See procedures outlined under "Investments".) Cash funds held outside the main office should either be counted or be confirmed by the holders of the funds at the date of the main office cash counts and as at the balance sheet date.

The working paper schedule of the cash counts should show the date, the time, and the initials or signature of the accountant making the count. Upon completion of the count and a careful, complete listing of all items in the fund, the schedule should be signed by the holder of the fund below a notation similar to "counted in my presence and returned to me intact." Funds should be counted in the presence of the person on the client's staff who is responsible for the fund—never by the accountant alone.

Vouchers covering advances to employees need investigation. If not properly authorized, authorization should be obtained and any irregularities noted. Unusual items in cash funds must be explained fully and proper authorization obtained. If checks with old dates are included in the fund, they must be investigated and their authenticity established.

Unless insignificant in amount, vouchers relating to the period under review are journalized. Care must be exercised to see that cash funds are used only for the purpose for which they were established. All cash funds are reconciled to the date of the balance sheet, and should be in agreement with the ledger balances. Discrepancies, if any, are to be noted and a satisfactory explanation obtained. When cash funds include receipts from sales, these are to be traced to sales slips and to the cash receipts book to detect any receipts which may have been used to cover a shortage in the petty cash fund.

Vouchers covering petty cash reimbursements should be examined. In this connection, the auditor should insist that some provision be made for canceling vouchers to prevent their being used for subsequent reimbursement. All petty cash vouchers in the period reviewed are to be examined to see that they have been properly authorized and are substantiated by invoices or other data. In this connection the possibility of duplication of payments through regular cash disbursements must be kept in mind.

In confirming bank balances directly with depositaries, the form printed by the American Institute of Certified Public Accountants is recommended. This provides for the client's authorization to the bank, for confirmation of loans, for contingent liabilities as endorser of discounted notes, and for other direct or contingent liabilities. It is important that all inactive bank accounts be confirmed.

Cash receipts in transit at the end of a month should be checked to subsequent bank statements to make sure that all receipts have been deposited promptly. Old outstanding checks which have been voided during the period under review should be scheduled and all pertinent facts noted. Bank funds subject to restriction should be indicated and segregated on the balance sheet with the proper notation.

On an annual balance sheet audit, at least three months' cash receipts and disbursements should be checked in detail, including the last month of the year. For the months selected the outstanding checks returned by the bank should be compared with the cash book. Schedule checks of substantial amounts drawn to cash for other than payroll or petty cash during the months in which bank accounts were reconciled, indicate the purpose for which drawn and the reason no payee is indicated, note the endorsements and indicate on the schedule. The accountant must satisfy himself as to the adequacy of the explanation he receives.

Endorsements on checks for the months reconciliations are made should be scrutinized, double endorsements are to be examined, and the vendor's invoice and endorsement checked. Care should be exercised to see that payment was not made for a duplicate invoice. Should there be any instance where the second endorsement is that of an employee of the client, the matter should be fully investigated and explained in the working papers. Cash disbursements for the months not reconciled should be scrutinized, and all large or unusual transactions investigated. The extent to which these need to be scheduled can be determined only at the time the audit is made.

In all instances where more than one bank account is maintained, transfers should be scheduled. It is important to check dates of issue and deposit to bank statements and to cash books to make certain that both transactions were recorded properly in the same month.

Notes Receivable

As previously indicated, notes and acceptances receivable should be examined, whenever possible, on the same day the cash is counted. If this is done subsequent to the balance sheet date, all cash received during the interim in payment of notes receivable, either in full or on account, must be traced to the cash receipts book and bank statements. Notes receivable out for collection are to be confirmed by direct correspondence.

Unless the amount involved is not material, notes receivable should be separated on the balance sheet into the following categories: trade, officers and stockholders, employees, affiliates, and others. Only the current portion is to be included in current assets.

Interest receivable should be accrued on all notes bearing interest, unless management has determined the note to be uncollectible and a full reserve has been provided.

The contingent liability on discounted notes receivable is to be shown on the balance sheet. Notes receivable from affiliated companies should not be shown as current assets on the balance sheet unless the affiliate's current position is such that payment can be made currently, and unless the note is shown as a current liability on the balance sheet of the affiliate.

Accounts Receivable

If the client's system of internal control has been determined to be adequate, a test check of the trial balance of accounts receivable prepared by the client's staff is sufficient. However, a complete adding machine tape should be taken by the auditor, as the client's tape must never be relied upon. If there are not many individual accounts in the detail subsidiary ledger, or if the system of internal control is determined to be inadequate, it is necessary to prepare an independent trial balance of accounts receivable. In any event, a test must be made of footings of a number of accounts sufficient to satisfy the auditor that there are no forced figures, and that the detail is in agreement in total with the general ledger control account. This control account should be carefully scrutinized, all postings compared, and any unusual entries and adjustments investigated.

Detail accounts in subsidiary ledger should be scanned or scrutinized, depending upon the number of accounts, number of entries in each account, and other pertinent factors. Care must be exercised to see that no expense accounts or other accounts not actually receivables are included. Payments on account should be investigated. Such payments may be the result of manipulations of receipts, or, if bona-fide payments, an inspection of the correspondence files may indicate claims for credits or allowances which have not been entered. Payments of current items leaving old balances unpaid should also be investigated.

Confirmations of accounts receivable are either positive or negative. Positive confirmations are the best proof of the correctness of the amount, and should always be used if there are relatively few accounts of large individual amounts. (This presupposes an audit on which an opinion is to be expressed and the client's consent to confirmation.) If there are many accounts and a positive confirmation is used, confirmation requests are usually sent to a selected group of accounts, either those with large balances, or a random selection, or preferably a combination of both. Negative confirmation requests may be sent to a similarly selected group of accounts; or, as is generally done, they may be attached to statements, either in the form of a "sticker" or by a rubber stamp.

All confirmation requests should accompany the client's statements, or be affixed to them, as indicated above. The auditor should be present at the client's office when the statements are prepared, should take possession of them, and make whatever check he deems necessary. After that, under no circumstances may the statements be released to the client or his employees. The client provides the auditor with stamped envelopes, either addressed or open face, bearing the auditor's address as the return address, not the client's. This is important! Except in unusual circumstances the auditor accepts the addresses furnished by the client, but to guard against the use of fictitious addresses, undelivered statements are returned to the auditor's office. Positive confirmation requests always contain a postage-paid return envelope addressed to the auditor's office, but this is not necessary when negative confirmations are used.

If confirmation requests are mailed to all customers, the trial balance of accounts receivable may be used as a confirmation schedule. If a selected number of accounts are used, a separate schedule is required. In confirming accounts receivable by positive confirmation, if the first request does not result in a satisfactory percentage of replies, it is frequently advisable to send second requests. This is particularly important in the case of accounts with substantial open balances. If, at the client's request, certain specific accounts are not confirmed by direct communication, such accounts should be examined carefully and the auditor must satisfy himself that there is an adequate reason for failure to confirm. The working paper schedule should contain a full explanation.

Any unusually large credit balances should be examined and, unless satisfactorily explained, should be discussed with the credit manager or someone in authority. Direct confirmation of credit balances in accounts receivable is generally omitted. However, the accountant in charge of the audit should satisfy himself as to the validity of the balance, and the schedule in the working papers should indicate the extent of the examination.

Careful inspection should be made of all accounts receivable which have been written off as uncollectable during the year. Unless the files disclose incontrovertible evidence as to the authenticity of these write-offs, material amounts, at least, should be investigated.

In order to establish the adequacy of the provision for bad debts, an aging schedule is generally required. Such a schedule prepared by the client's employees may be used if it is tested in sufficient detail to satisfy the auditor as to its accuracy. If provision for bad debts is made on a monthly basis, the method used should be reviewed and the computations checked.

Sales invoices should be compared with shipping records to ascertain that everything shipped has been billed. This is particularly important during the last few days of the period being examined. Conversely, receiving records should be examined to ascertain that all returned merchandise has been properly credited to the account receivable and has been taken into inventory. The sales journal is to be examined to make certain that all items billed have been shipped. This will normally include an inspection of the shipping records. Merchandise consigned to customers is eliminated from accounts receivable and included in merchandise inventory.

Those audit procedures pertinent specifically to retail stores are not included in this article.

Investments

As discussed under "Cash", investments are to be examined and counted on the same day as the cash is counted to prevent substitution of one asset for another to cover shortages. Securities not held in the office are confirmed by direct communication with the custodian. The auditor examining securities must, as is done with cash, make his examination in the presence of an authorized company representative, and under no circumstances should he remove the securities and inspect them alone. It is advisable to secure the signature of the company's representative for the return of the securities.

A physical examination of securities includes a comparison of the numbers of the securities with the numbers shown for the prior year, any variations being traced to make certain that there have been no substitutions between audit dates. All securities not in the name of the company should be endorsed in blank or to the company and properly witnessed, or should be accompanied by a properly executed power of attorney.

Mortgages receivable should be inspected, and brokers' statements and other supporting vouchers examined for purchases and sales of securities subsequent to the last audit date. Corporate minutes should be inspected to determine if security transactions have been properly authorized with necessary notations in the working papers.

Interest and dividends received on securities and investment should be test-checked or checked in detail if few in number. Coupon bonds are to be examined to make sure that all coupons subsequent to the balance sheet date are intact, and that all coupons prior to the balance sheet date have been included in income. Issuance of stock dividends, rights, and other situations which may arise in security transactions should be audited in accordance with approved accounting and auditing procedures. These are too varied to warrant discussion in this article.

Inventories

Unless an exception is taken as to inventory valuation in the opinion paragraph of the auditor's report, the physical inventory taking must be observed by representatives of the auditor's office. The count must be tested to the extent deemed necessary and the procedures reviewed. It is important to meet with the client before the date of the inventory taking, especially in an initial audit, to make certain that the client's inventory instructions meet with the auditor's approval. A copy of these instructions is made part of the working paper file. It is generally considered advisable to compare the instructions for the current audit with the instructions for prior engagements to discover any material changes in procedure which might affect the count or valuation of the inventory.

All inventory sheets should be numbered and controlled. They should be prepared by the client in duplicate with the copy made a part of the working paper file. This is of particular importance when the auditor is present at the inventory taking and gives an unqualified opinion. All inventory sheets are scanned to make certain that nothing has been included which is not trading merchandise. The examination should include an inspection of the physical inventory schedules at the beginning of the period and a comparison with the ending inventory as to methods, pricing, etc. The beginning and ending inventories should be scanned to discover any merchandise which may not have "moved" during the period, and the necessary price adjustments made.

The summary of the inventory sheets is to be checked in detail as to transcription from original inventory sheets, mathematical accuracy, and classification. Costs used for pricing raw materials are to be test-checked to the most recent invoices. The working papers should show in detail the items tested and should be extended and totaled to show the dollar amount of inventory tested as compared with the dollar amount of the inventory. Intercompany profits are eliminated in pricing inventories. Extensions on inventory sheets should be tested. Frequent sources of errors in inventory calculations are:

1. Using a cost for a unit different than the unit used in the count.
2. Placing of decimal points. In this connection all large amounts should be eye-tested.
3. Footings of individual pages.

If there are well-kept perpetual inventory records and the internal controls indicate they may be relied upon, it is satisfactory to have management take properly supervised departmental physical inventories at specific interim dates, tying in each item to a physical count observed by the auditor at least once a year. Here, as in all facets of the audit, the specific facts determine the extent of the audit procedures required. The physical count should be test-checked to perpetual inventory records whenever these are available.

Inventories held at public warehouses should be confirmed by direct correspondence. Warehouse receipts should be examined and scheduled. Where considerable time has elapsed between the balance sheet date and the date of examination, warehouse receipts for the intervening period should be reviewed. Although theoretically merchandise held by warehouses cannot be released without producing the receipt, this is not always done. Therefore care must be taken to see that merchandise is on hand for all warehouse receipts. Merchandise held by outside processors and others should also be confirmed by direct correspondence.

The general ledger accounts for inventory, purchases, and sales should be scrutinized carefully to insure that no purchases or sales beyond the cut-off date have been recorded. Purchase commitments are scheduled. Variations in prices from costs at the balance sheet date should be noted. If there is any liability, actual or contingent, in this connection, it should be included in the comments, or mentioned in a footnote. Sales subsequent to the balance sheet date should be scrutinized to see that no sales were made below inventory prices.

Work-in-process inventory is to be test-checked. Care must be exercised to insure that work-in-process and finished goods inventories have been stated at proper raw material cost plus labor and factory burden applied on the same basis as in prior years. The working papers should include a schedule showing the method used in pricing work-in-process, totaled and compared with the balance sheet figure.

The finished goods inventory should also be scheduled with information as to the extent of the examination.

Inventories for retail stores generally require procedures other than those applied to industrial or other commercial inventories and are too lengthy for inclusion here.

An inventory certificate signed by the client or an authorized representative should be obtained.

Unexpired Insurance

It is desirable to schedule insurance policies by classes of coverage. Policies should be inspected and all necessary details noted on the working paper schedule. Whenever practicable, the book value of the assets covered should be indicated. Premiums on policies should be compared with the general ledger accounts. It is important to see that a full year's premiums are charged to expense in each year. Prepaid or unexpired insurance should be treated consistently with prior year's practice.

If the client's staff has computed the unexpired insurance premiums, these computations should be checked, if few in number, or test checked with the corresponding postings. Accountants are not required to be, nor should they imply that they are, insurance experts. However, obviously inadequate coverage, just as any other defect encountered during the examination, requires investigation and, if deemed necessary, disclosure.

Workmen's compensation insurance policies require an advance premium payment with a recalculation of the premium based on actual payroll at stated intervals during the policy period. This advance or deposit premium should be checked to the policy. The accrual, if prepared by the client's staff, should be checked or calculated by the accountant and the adjusting journal entry prepared. Liability policies based on payrolls, receipts, etc. should be treated in like manner.

Other Assets

The audit procedures in connection with other assets depend upon the nature of the assets and the general characteristics of the accounts. The auditor should adopt those procedures which will assure him that the asset exists and is stated at the proper value.

Fixed Assets and Accumulated Depreciation

The auditor's permanent file should include working papers of fixed assets prepared in an initial audit and brought up to date in repeat or continuing engagements with additions and deductions during the period included. Additions during the period should be vouched. In this connection, the repairs and maintenance account and similar expense accounts must be scrutinized to see if purchases which should have been capitalized were charged to expense. Trade-ins should be vouched. Care must be exercised to see that new purchases are properly recorded and that necessary adjustments have been made to accumulated depreciation.

In connection with the acquisition of real estate, it is essential that deeds be inspected; that the statement of closing be examined; that any mortgages encumbering the property are recorded; and that the costs, taxes, insurance and other prorata adjustments are correct. If there are any questions in connection with the title, it may be advisable to confirm the details of the transaction with the attorney handling the purchase. Transactions relating to the sale of real estate require the same care and examination.

Depreciation schedules should show the method used, the estimated life, residual or scrap value, and any other pertinent information. If the depreciation taken differs from the depreciation used for federal income tax purposes, the working papers must contain a schedule showing both accumulations, and the statements furnished the client must contain a footnote or other appropriate comment. If the client's staff has prepared depreciation schedules, these should be verified and the rates for additions during the period reviewed. In establishing rates for new fixed assets, consideration should be given to current federal income tax provision.

If a Treasury Department examination has resulted in a change in depreciation rates, a schedule should be included in the working papers giving complete details and journal entries necessary to reflect the adjustments. If the client's staff has already journalized the adjustments, all entries should be checked.

It is desirable that fixed assets be recorded by the client in a manner that automatically indicates when the individual asset is fully depreciated. If the existing records do not give this information and the value of the assets is substantial, the client should be advised to set up a plant ledger. An examniation of the records should be made to determine if all fully depreciated assets no longer in use have been removed from both the asset account and the accumulated depreciation reserve.

Details of leases should be scheduled. It is important to know the dates covered, renewal privileges, rentals based on sales, and other matters. Leasehold improvements are amortized over the lease, not over the life of the building unless the building is not expected to last until the expiration of the lease.

Construction work in process presents its own specific problems. Contracts, and invoices for materials purchased, should be inspected and traced to the proper accounts. If the liability for the balance due on contracts is not entered until the work is completed, an appropriate footnote or comment should be made on or in connection with any financial statements which are submitted.

Prepaid or Deferred Expenses

In connection with the examination of prepaid or deferred expenses, such as taxes, licenses, rents, the working paper schedules should indicate dates or periods covered, inspection of tax bills, vouching of invoices, inspection of leases and other agreements. It is important that the operations of the company reflect only the portion of the expenses applicable to the period under review and that this be done on a consistent basis. Care must be exercised to see that one period is not burdened with double expense, while the preceding or following period escapes being charged.

Intangible Assets

Working papers should contain a detailed schedule of goodwill, patents, trade-marks, and similar intangibles. This schedule should be prepared at the initial audit, made a part of the permanent working paper file, and kept current at each examination.

Liabilities—General Comment

In any examination of liabilities it is important to bear in mind that it is more likely that liabilities will be understated rather than overstated. Therefore the auditor must be continually alert to any evidence of undisclosed liabilities.

Accounts Payable

Accounts payable are generally set up in a subsidiary ledger controlled by an account in the general ledger. Whether or not we accept the trial balance taken off by the client's staff is determined in the same manner as for accounts receivable. In monthly and other interim audits, and in year-end audits where confirmations by direct communication are not obtained, vendors' statements should be checked to the individual accounts payable, differences investigated and necessary adjustments prepared. All postings to the general ledger control account should be checked, and all entries therein scrutinized carefully. Any unusual items must be investigated.

If the client does not enter accounts payable as invoices are received — in other words, if purchases are recorded only when paid — it is necessary to schedule unpaid invoices at the balance sheet date. This schedule should include all necessary information, including the distribution. An inspection of cash disbursements in the month succeeding the date of the balance sheet will be helpful in ascertaining that all payables have been included. There are various methods used to select invoices to be vouched:

1. Select a test period in which *all* invoices are inspected. A list of any invoices not available should be prepared, and the auditor must satisfy himself that there have been no unusual circumstances connected with the failure to produce these invoices.
2. Select *all* invoices over a certain specified amount and a sampling of the invoices of lesser amounts.
3. Select *all* invoices distributed to one or more categories and a sampling of other distributions.

Whatever method is used for selecting invoices to be vouched, the invoices should be eye-tested for mathematical accuracy. All supporting papers — purchase order, receiving ticket, bill of lading, should be inspected. Here, too, as in all other phases of the audit, the adequacy of the client's system of internal control determines to a large extent the detail work which the auditor must do. Vouching of invoices should include a review of classification to determine if purchases have been distributed to proper accounts. Examination of a purchase order file, where one is available, may reveal unrecorded liabilities. Receiving records should be inspected for the periods immediately prior to and subsequent to the date of the balance sheet to determine any liabilities which may not have been properly recorded.

In confirming accounts payable by direct communication with vendors, it is desirable to include:

1. Some vendors whose accounts were active during the period under review even though they show no open balance at the date of the balance sheet.
2. Vendors from whom large nonrecurring purchases have been made during the period under review.
3. Vendors whose accounts show debit balances.

Accounts payable to affiliates should be reviewed and compared with the corresponding account on the books of the affiliated company, or, if this is not practicable, confirmed by direct communication with the affiliate.

Notes Payable

The confirmation form used for cash in banks also provides for the confirmation of notes payable to banks. All canceled notes should be inspected, and interest paid checked or tested. Notes payable to others than banks should be confirmed with the makers. However, in the case of affiliates, wherever possible, the outstanding notes should be checked to the books of the affiliates. Care must be exercised to see that bona fide notes (especially in the case of renewals) are in fact issued in connection with intercompany transactions.

Accrued Expenses

Accruals for interest payable will be automatically checked if working paper schedules for liabilities have been prepared properly. Accruals prepared by the client's staff should be checked, or tested, once again depending upon the adequacy of the client's internal control.

The liability for federal income taxes for the period under review should be calculated and the necessary journal entry prepared.

A schedule should be prepared showing the basis of accrual of salaries and wages, indicating the regular pay periods covered and the date payments are made. Any bonuses based on either written agreements or previous practice should be accrued, if this has not already been done by the client. Reference to payments made in the period immediately following the balance sheet date will frequently disclose this type of liability. The circumstances surrounding each individual audit must be considered. Federal and state payroll tax returns should be scrutinized or checked and compared with the amounts stated on the company's records.

Bonds Payable—Funded Debt

If there is a new bond issue, or additions to or retirement of bonds during the period being examined, the minutes of the corporation must be inspected and the details shown in the working papers. The original indenture agreement should be examined and the pertinent facts noted in the permanent file schedule, if this has not been done in the preceding audit.

Mortgages Payable

Mortgages on real estate should be listed, the schedule being made part of the permanent file and kept up to date in subsequent audits. The principal payments due within one year from the balance sheet date are a current liability. Accrued interests should be calculated and compared with the client's computation.

Capital (Capital Stock)

The permanent file should contain complete details of capital stock issued and be kept current at each audit showing additional stock issued and any stock retired or canceled. The minutes should be examined for proper authorization in this connection; the general ledger account should be reviewed, and all entries examined. Where there are minority stockholders' interests, it is essential that the audit encompass all procedures necessary to protect such interests.

The auditor should see that the minute book and stock records are up to date. If this is not the case, or if they are not available for examination, management should be so advised and steps taken to secure the necessary data. Obviously, these procedures are not intended for large corporations listed on Stock Exchanges. Such corporations are under the control of the Securities and Exchange Commission, and the auditor's responsibilities in connection with such an audit are clearly defined by the Commission.

Capital accounts of partners or individual proprietors should be analyzed in the working papers, and this schedule kept current. The capital accounts should be compared to the corresponding general ledger accounts and all entries must be vouched.

Surplus (Retained Earnings)

The permanent file should contain a complete analysis of surplus (retained earnings) from the inception of the corporation. All entries in this account should be compared to the general ledger and vouched.

Dividends

The audit procedures in connection with dividends require little explanation. Minutes authorizing dividend payments should be examined. Where there is preferred stock with cumulative dividends, care must be exercised to see that common stock does not receive dividends until all cumulative dividends are paid; and cumulative dividends in arrears must be set up as a liability or, at the very least, commented on in a footnote on any statements submitted.

If dividends are customarily paid at regular intervals and inspection of the cash disbursements for the succeeding period shows such a payment, the liability for the final dividend for the year should be set up, even though actual declaration of the dividend is not formally made in the minutes. Dividends declared prior to the balance sheet date, but not paid, must be set up as a current liability and compared with the capital stock record.

Surplus Accounts Not Arising from Earnings

Paid-in-surplus, capital surplus, and other surplus accounts not arising from earnings should be scheduled with full details of all transactions invloved.

Contingent Liabilities

It is important that the working papers contain a description of any and all contingent liabilities disclosed during the course of the examination. In all instances where the auditor is required to express an opinion on the financial statements, it is advisable to secure a liability certificate from the client. Where the examination discloses either a retainer being paid to an attorney, or legal expenses incurred during the period, it is important to secure from the attorney a confirmation of litigation, claims, and contingent liabilities.

Sales

Most of the procedures in connection with the examination of sales are automatically completed when the accounts receivable are audited. The extent to which billings are examined and their mathematical accuracy tested varies with the circumstances and terms of each audit engagement.

Purchases

Audit procedures relating to purchases have been described throughout this article in connection with the examinations of inventories and accounts payable.

General Ledger Trial Balance

The general ledger is the key to the client's financial records. Setting up the trial balance in the working papers should not be considered a mechanical listing designed to see if the books are in balance. An intelligent scrutiny of the accounts will disclose much to the alert auditor. Although this step is indicated at the end of the discussion of audit procedures, it is frequently of more value if done first. For instance, changes in the previously prepared audit program can be made profitably at

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expenditures for needed expansion. All of this because of lack of necessary recorded information.

If new machinery and tools are purchased and a cost department has not been established, the predictions of the supplier could not be verified that the production would be increased and that the machines would pay for themselves in a short time through decreased costs. For the first few runs attention would be given to the production per hour, and word of mouth reports would be accepted. Six months or a year later when the novelty of something new had worn off or a change in personnel had occurred, would management remember the production per hour or the estimated cost of thousands of parts and assemblies? No! Put it on record, and judge from numerous recorded performances.

Cost Accounting is a special study of its own which has a primary importance within the general subject of accounting. Since its scope is so large, the following is just a very brief review of its component parts.

Prime cost is the basic figure of material and direct labor cost.

Manufacturing cost is prime cost to which has been added the overhead or burden cost to manufacture or assemble.

Gross cost is manufacturing cost or merchandise cost to which has been added the selling and administrative costs.

Sales price is gross cost to which is added an amount which will represent the possible profit.

The methods or types of cost systems are many and it is very possible for more than one method to be co-ordinated within one system. Some of the better known methods are:

Specific Order or Job Order. This method has a job cost sheet to which is entered all cost information beginning with the raw material consumed to the final finished stage. Generally this method is used where companies do special work such as contractors, construction concerns, manufacturers, public utilities, and motion picture productions.

Standard Costs. This method involves a predetermination of what the cost should be with the information being supplied from scientific engineering standards. Any variances from the standard cost when it is compared with the actual cost must be noted and corrective measures taken.

Process Costs. This method has a process cost sheet to which is entered all costs for the process and accumulated for a week, month or some other process period. It is used principally for continuous or mass production of a single product or a variety of products using the same productive facilities such as different types of brick, tile, or ceramic products.

By-Product Costs. This method is usually that of process cost since the by-products very often result from continuous process industries such as meat packing, chemical, oil and coal where the major production is accompanied by lesser or minor products.

Generally speaking, sales prices are not changed because of a fluctuating cost due to various runs of a product, but in a free competitive field it is necessary to keep a weather eye open for attractive sales by being able to offer a better product at a lower price. It has been said that Henry Ford the First, was satisfied with a dollar profit per car, but he *knew* he had the dollar profit.

Therefore, it is imperative that current, active, actual costs be recorded.

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this time. Especially in an initial audit, the trial balance is set up at the beginning of an audit and the initial audit program is prepared simultaneously. The important fact to bear in mind is that the time used to take off a general ledger trial balance should be made as productive as possible.

General Journal

All general journal entries should be carefully scrutinized. Any adjustments which result in a loss of income to the client, or any others of like nature, should be approved by someone in authority. The auditor must satisfy himself that the general journal has not been used as a cloak for inefficiency on the part of the client's staff, and that all entries are factually as well as mathematically correct.

Once again it is important for the reader to note that this article is not to be con-

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IDEA EXCHANGE

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TRANSPOSITION ERRORS

When two sets of figures do not balance and the difference is divisible by 9, we suspect that the error is due to the transposition of two figures, e.g., 19 for 91.

There are a limited number of combinations of figures to look for in each transposition error, which simplifies your checking. Thus, if the difference is 45 there are 5 sets of numbers to check for a transposition.

To get the combinations quickly, divide 9 into your difference, then use this figure and its reverse to form the first combination. By adding 11 to the lowest figure in the combination, and reversing this number, you can obtain all the possible combinations.

The following chart shows how this system works:

Difference	09	18	27	36	45	54	63	72	81
Combinations	01	02	03	04	05	06	07	08	09
by	10	20	30	40	50	60	70	80	90
sets	—	—	—	—	—	—	—	—	—
	12	13	14	15	16	17	18	19	
	21	31	41	51	61	71	81	91	
	—	—	—	—	—	—	—	—	
	23	24	25	26	27	28	29		
	32	42	52	62	72	82	92		
	—	—	—	—	—	—	—		
	34	35	36	37	38	39			
	43	53	63	73	83	93			
	—	—	—	—	—	—			
	45	46	47	48	49				
	54	64	74	84	94				
	—	—	—	—	—				
	56	57	58	59					
	65	75	85	95					
	—	—	—	—					
	67	68	69						
	76	86	96						
	—	—	—						
	78	79							
	87	97							
	—	—							
	89								
	98								
	—								

—Etheldreda T. Collier
New York

FOR THE TAX OFFICE DURING TAX SEASON

A columnar work sheet and a card file will help to keep tab on the status and location of tax returns of the firm's clientele during the busy season. When the client's information is received, his name is listed on the work sheet and assigned a number, noting the number in the card file. The card file facilitates checking on any particular return by indicating the assigned number on the work sheet.

Columns on the work sheet will indicate the date the information is received, whether any additional information is necessary, the date and initials of the person completing the return and the date and initials of the person checking the calculations. Other columns may be used for typing, checking, and assembling. Three columns could signify type of delivery—mail, pick-up or personal delivery. With columns added or deleted to fill the needs of the individual office, the progress of the returns can be determined at a glance.

Catherine Ryan, Los Angeles

QUICK REFERENCE — Do not waste time looking through work papers for the needed schedule. If you make a pencil notation in the lower right hand corner of each work paper as to the account number or name of the schedule, it will only take seconds to thumb through the right hand corner of the file to find the right schedule.

—Lurena Deutsch, Los Angeles

(Continued from page 12)

strued as an all-inclusive text on auditing procedures. Basically, this material is the nucleous of what will some day be a staff accountant's manual. It is hoped that the procedures outlined will be helpful as a practical guide to the development of good auditing habits for "small" staffs working with "small" business.