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Students' Department

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AMERICAN INSTITUTE EXAMINATIONS

(Note.—The fact that these answers appear in The Journal of Accountancy should not lead the reader to assume that they are the official answers of the board of examiners. They represent merely the personal opinions of the editors of the *Students' Department.*)

Examination in Auditing

May 13, 1926, 9 a. m. to 12.30 p. m.

The candidate must answer all the following questions:

No. 1 (10 points):

Is it within the province of the auditor to draw attention to the following?

(a) Inefficiency of office management and office staff.

(b) Slack methods of operating a working cash fund subject to cheque signed by the treasurer alone.

(c) Apparently excessive compensation paid to officers.

(d) Deficiency in income taxes as claimed in "deficiency letter."

(e) Purchase of its own capital stock by a corporation in its first year of operation.

(State the reasons for your conclusions.)

Answer:

(a) Inefficiency of office management and office staff is a proper subject for discussion with the management of the business. In most cases informal discussion during the course of the audit, or, at most, a letter or supplementary report will be the most advisable method of drawing attention to such inefficiency. Rarely is it desirable to mention such things in the audit report, unless a report thereon was contemplated as a part of the engagement.

(b) Slack methods of operating a working cash fund subject to cheque signed by the treasurer alone, should, in practically every case, be brought to the attention of the management. This should be done by comments in the report or by means of a separate communication, it being important for the auditor's protection that he be on record as having pointed out the undesirability of the methods followed. If discrepancies have been discovered resulting from the methods used, reference should be made in the report to the cause, provided that the discrepancies are important enough to mention in the report; otherwise, it depends upon circumstances as to whether such matters should be mentioned in the audit report or in a separate communication.

(c) Compensation paid to officers is a matter subject to the discretion of the board of directors. It is usually advisable to set out officers' compensation as a separate item, and in so doing the auditor, having verified, of course, authorization of such compensation by the board of directors, has largely fulfilled his responsibility.

(d) Claims by the treasury department for additional taxes for prior years should always be carefully examined by the auditor. It would seem that some reference to such a claim, either by means of a footnote to the balance-sheet or by comment in the report, should, without exception, be made. Some accountants take the view that the auditor should attempt to determine whether the claim is well founded and base his treatment of it with relation to his report accordingly, omitting reference thereto or minimizing the importance thereof, if the claim is in his opinion one which can be successfully opposed by the taxpayer. Others take the view that it is not the province of the auditor to pass upon the validity of the claim and that, at most, the auditor should show the claim and perhaps indicate his opinion as to whether it is one that is likely to be successfully maintained by the department.

(e) The purchase of its own capital stock by a corporation in its first year of operation should be commented upon in the report by the auditor. Stockholders, prospective investors and creditors are entitled to such information to determine whether or not their rights and interests are being jeopardized.

No. 2 (10 points):

A large concern, manufacturing several kinds of steel for commercial uses, has mills in various cities. The materials and supplies which it uses comprise ores, iron and steel in various forms, chemicals, precious metals, lime, coal and oil; also small machine parts, tools, and numerous other items. One month after the close of the fiscal year you are called upon to prepare and to certify to a balance-sheet as at the end of the year. What would you do with regard to the verification of inventories?

Answer:

Inquiry should be made to ascertain whether or not the company was operating with a cost system, and, if so, whether this was a part of the general accounting records. A study of the cost records should be made to determine their accuracy, and, consequently, the reliability of any information obtained therefrom. If the stock records were tested periodically against the physical inventories and were adjusted accordingly, the auditor should check the stock records against the physical inventory as of the close of the fiscal year, especially with respect to quantities. Raw material prices should be checked against the original purchase invoices; work-in-process, and finished-goods valuations could be obtained from the cost records if these are considered complete and accurate. Extensions and footings should be tested, comparisons should be made with previous inventories, and the gross profit test applied.

The foregoing is based on the assumption that the company has in operation a complete and accurate cost system forming a part of the general accounting records. This assumption seems a reasonable one in view of the fact that the company is a large concern with mills in various cities, and, accordingly, would find it rather difficult to operate successfully without an accounting system which controlled its various branches or plants.

If the auditor found that he could not obtain his information as outlined above, he would be required to qualify his certificate with respect to quantities unless other members of his staff were assigned to the other branches or plants to make a test of the quantities on hand, and were able to "work back" to the physical inventories as of the closing date.

No. 3 (5 points):

The product of your client is shipped in containers which are returnable by the customer. These are kept in repair and used for new shipments. The containers are charged to customers as shipped at $2.00 each. Their average cost to your client is 75 cents each. At the end of the audit period you find that 1,000 containers billed to customers were not returned and that 800 are on hand at the plant. Show how these items should appear on the balance-sheet of your client.

Answer:

No difficult question arises with respect to the 800 containers on hand at the plant. These should be shown at cost (75 cents each), less a reserve for depreciation.

The containers charged to customers at a rate of $2.00 each present a question which can not be answered satisfactorily on the facts given, unless certain assumptions are made. If the business has been established for some time, its accounting department has probably built up reliable statistics which should show the ratio of containers returned to the total invoiced. The auditor should test these percentages and, if convinced of their dependability, apply the percentage rate to ascertain the number of containers which might be expected to be returned. Assume for our purpose that 900 of the 1,000 containers outstanding may be expected to be returned, we should make the following adjustments:

Sales (container sales)	$1,800.00	
Accounts receivable		$1,800.00
To reverse charges made for containers to be returned.		
Containers with customers	675.00	
To—Cost of containers sold		675.00
To set up the cost of containers in the hands of customers, 900 @ 75 cents each.		

Containers:		
In customers' hands	$675.00	
On hand	600.00	
Total	$1,275.00	
Less: Reserve for depreciation	?	$?

If there are no reliable statistics at hand, a more conservative method may be used. This method would require, whenever financial statements are prepared, the reversing of the charge to accounts receivable of the 1,000 containers billed at $2.00 each and the taking up of these containers at cost (75 cents each) as a part of the inventory. No profit would be taken up until containers are paid for by customers. Under this method, these items would appear in the balance-sheet as follows:

Containers:		
In customers' hands (1,000)	$750.00	
On hand (800)	600.00	
Total	$1,350.00	
Less: Reserve for depreciation	?	$?

The type of container, the kind of commodity and other facts not given would determine whether the container inventory should be shown as a fixed asset, current asset or a prepaid expense.

No. 4 (10 points):

(a) What is the effect, on the accounts, of the use of arbitrary instead of actual rates of exchange for the entry of imported merchandise purchases?

(b) What is the proper basis for exchange rate cost on goods shipped C. I. F., also on goods shipped F. O. B.?

(c) State three different methods commonly employed of making payment for imported merchandise.

Answer:

(a) Where actual rates of exchange are used, imported merchandise purchases are entered on the books of the importer in terms of domestic money converted at the rates of exchange prevailing on the day of the purchases. When remittance is made in payment of such invoices, the rate of exchange may or may not be the same rate which prevailed on the day of purchase. Any difference between the amount of the purchase as entered and the amount of the remittance is entered in an exchange fluctuation account. This account should be closed against the purchase account in order that the actual cost of purchases may be determined, although this exchange fluctuation is sometimes considered a financial earning or expense.

In other words, the cost of the imported merchandise is the amount actually paid for it, not the amount entered at the day of purchase.

The use of an arbitrary rate is an expedient well worth considering, especially in cases of numerous purchases and more or less stable exchange conditions, but its use will not give accurate costs unless the difference between the exchange rate at the time of payment and the arbitrary rate as entered is treated as an addition or subtraction from the cost of the purchases.

(b) As outlined in the preceding, (a), the cost would be the amount remitted, regardless of the terms of purchase.

(c) Payment for imported merchandise may be:

(1) Made in advance, by the importer establishing a credit with some bank or banker in the exporter's country with instructions for payment to the exporter upon the surrender of shipping documents (bills of lading, invoices and insurance policy).

(2) Made at the time of delivery, by the exporter drawing a draft on the importer with documents attached thereto for delivery when the draft is paid, which, by custom in many cases, is not until the arrival of the goods.

(3) Made after the receipt of goods by the importer, a documentary acceptance bill being used, documents passing to the importer upon acceptance by him of the bill of payment at some later date, when presented through banking channels or possibly by an agent of the exporter if he have one in that market.

No. 5 (10 points):

You are making an audit of a company which erected an office building on which work was started April 1, 1922, and finished April 1, 1923. Your audit covers the fiscal year ended March 31, 1924. The work has been financed by an issue of bonds and an issue of stock. What special points would you consider in making the audit and reporting thereon?

Answer:

Consideration should be given particularly to the agreement covering the issues of the capital stock and the bonds and to a complete analysis of the building account.

The requirements of the stock and the bond issues, especially the sinking-fund requirement, if any, should be thoroughly understood by the auditor so that he may determine whether or not the company has fulfilled its obligations to the stockholders and the bond owners under such agreements. Current asset ratios, dividend payments, sinking-fund deposits, and sinking-fund reserves are a few of the important terms usually included in such an agreement. These the auditor should carefully check against the accounts affected and report thereon.

Receipt of the proceeds of the stock and the bond sales should be verified, and any stock or bond discount or premium arising from the sale of the securities should be set out in the accounts as stock or bond discount or premium, and not treated as a cost, or deduction from the cost, of the building. In the case of bond discount, however, some accountants charge the building cost with that portion of bond discount applicable to the period of construction. There can be no serious objection to this practice inasmuch as interest (and amortization of bond discount is another form of interest), insurance and taxes accrued during the period of construction are generally recognized as proper capital charges.

While it is usually regarded as permissible to capitalize the bond interest and the discount amortization applicable to the construction period, the case is different with dividends. The claim is not infrequently made by companies such as the one described in this question that a dividend may be paid at the end of a construction year and charged to property, the argument being that if the funds had been obtained by additional bonds instead of stock the interest would have been properly chargeable to property. The distinction lies in the fact that bond interest is an expense actually incurred, and the charging of this expense to the property account is entirely different in nature from the distribution of paid-in capital (no profits having yet been earned) to the stockholders and the concealment of this impairment of capital by an arbitrary charge to property.

No. 6 (10 points):

What ratios (of one item, or total, to another) are most significant from a credit standpoint in the comparison of balance-sheets and income statements for the same company for several years? Mention at least three ratios and explain why they are significant.

Answer:

The ratios which may be computed from financial and operating statements are numerous and vary in significance according to the uses to which they are to be put. It is conceivable, also, that even for any one purpose, such as the determination of credit rating, circumstances may alter the importance of any one ratio.

As a general rule, however, it may be stated that from a credit standpoint the most significant ratios are as follows:

(a) Those which measure the present financial strength of the company.

(b) Those which measure the ability of the company to maintain or increase financial strength.

Under (a) would be placed the measure of a company's working capital position, usually referred to as the working capital or current ratio. This is probably the first ratio that is examined and consists of the ratio of current assets to current liabilities. The importance of this measure lies in its indication of the ability of the company to meet its currently maturing obligations without exhausting or seriously impairing its working capital. This is but another way of saying that the current ratio is a measure of the adequacy of the company's working capital. There is also another significance to this ratio, in that it measures the adequacy of the sources of funds with which to meet at maturity the proposed obligation arising from the granting of credit.

A second significant ratio from a credit standpoint is that between profits and the volume of business. This would be classed under (b) above as a measure of the ability of the company in maintaining or increasing financial strength. Surplus net profits may be measured in relation to net sales, and a comparison of these ratios for successive years will indicate the trend of the business from the viewpoint of profitableness to its owners. A better measure, sometimes, is that shown by the ratio of operating profits to net sales. In using this ratio the effect of non-operating income and expenses is eliminated and the ratio is an unqualified measure of operating efficiency, becoming especially valuable when determined for successive years.

The ratio of operating profits to total capital used in operations indicates the efficiency in the use of plant facilities and working capital. The changes in this ratio between succeeding periods indicates whether or not progress is being made in operating efficiency.

Other significant ratios are:

The rate of inventory turnover, which indicates, in the absence of wide fluctuations in prices, the degree of success of the business from a strictly merchandising viewpoint.

The ratio of amounts due from customers to annual sales, indicating, when examined with relation to terms of sale, the condition of such accounts and the efficiency of the credit and collection departments.

No. 7 (10 points):

You are making a detailed audit of a public-service corporation supplying a district with electric light, heat and power. In addition to preparing the final accounts and a balance-sheet, you are to certify the amounts of capital expenditure during the year, so as to permit the corporation to demand new mortgage bonds, in payment of this expenditure, from the trustee for the bondholders. During the course of the audit you learn, unofficially, that a physical inventory of all the properties of the corporation has been recently made by the chiefs of the resident engineering staff, recently changed, in order to satisfy themselves as to the correctness of the book inventories, which have been used in previous audits for the preparation of the balance-sheet. You also learn that the engineers have reported, to the management company which controls the corporation, that fixed assets standing on the books at present at $350,000 have been scrapped or replaced by new construction since the last physical inventory, made five years previously. Since that inventory, and to the present time, all new construction certified during the annual audits has been paid for by the issue of other mortgage bonds to the corporation, which has sold them through the management company. The new construction during the year you are now auditing amounts to $550,000. The engineers' report has not been approved by the management company and no mention of it, nor of any intended new physical inventory, has been made in the minutes of the meetings of directors or stockholders of the public-service corporation. What notice, if any, should you take of the engineers' report?

Answer:

In deciding what notice should be given to the engineers' report, the accountant should consider its significance with respect to both the certificate of capital expenditure required under the bond indenture and also the report on the detailed audit.

As to the certificate for the trustee, the question states that the accountant is to certify to "the amounts of capital expenditure during the year." This seems to mean the gross expenditure without regard to property abandonments, and if this is the correct interpretation of the indenture no consideration of the abandonments disclosed by the engineers' report would be required.

On the other hand, if the indenture provides that the amount of bonds to be called down in consideration of fundable construction is to be determined on the basis of net capital additions, the accountant would be charged with the responsibility of verifying the amount of the abandonments, and should follow up the clue provided by the engineers' report.

As to the audit report the accountant's responsibility is more definite. An unqualified certificate could not be given to the balance-sheet if the property accounts have not been relieved of the carrying value of abandoned assets. Unless the clue can be followed up and adjustments made for such abandonments there should be a qualification in respect of "such unrecorded property abandonments, if any, as may have been made since the date of the last appraisal (giving date)."

No. 8 (10 points):

State and discuss the two most important points for a concern to take into consideration which is in the business of selling machinery on long-term instalments. In auditing a current year's operations, to what extent, if at all, should the auditor concern himself in such a case with future years?

Answer:

The two most important points to be taken into consideration by a concern in the business of selling machinery on long-term instalments are (1) the adequacy of its capital and (2) the quality of the credit risks of its customers.

The customers' open accounts or notes receivable, because they are long-term, can not be considered in their entirety as current assets. The company, therefore, must fortify itself with an investment adequate to carry, if not all of these accounts, a considerable portion of them and to finance its other operations.

If the company holds customers' notes of a high grade, the notes may be sold or discounted under favorable terms, or used as collateral under collateral trust loans, and the burden on the company's working capital thus reduced. Bad debt losses, collection costs and the quantity of re-acquired machines will be lessened as the credit risk is reduced.

The auditor in auditing the operations of the current year should concern himself with the methods used in allocating the income of the company as between the current year and that of future years, and should verify these amounts. Sufficient reserves should be set aside to provide for future bad debt losses, costs of collection and repossession of machines, and the depreciation applicable to such machines.

No. 9 (5 points):
State briefly the advantages and disadvantages, as regards (a) the issuing company, (b) the stockholders, and (c) intending investors, of shares of no par value, as compared with par-value stock.

Answer:

The advantages and disadvantages of no-par-value shares as compared with par-value stock may be listed as follows:

Advantages:

1. The par value as shown on a stock certificate is not a true indication of its real value.

2. Par-value stock is easily sold to the credulous buyer who may be convinced of his business sagacity and acumen in purchasing a $100 par-value certificate for any price less than that amount.

3. Unless there is fraud in the consideration, a purchaser of no-par-value stock is relieved of any discount liability.

4. No-par-value stock is an aid in securing new or additional capital inasmuch as the stock may be sold at any price without incurring the burden of stock discount.

5. In the use of no-par-value stock a company has less incentive to overvalue its assets or to resort to the treasury stock subterfuge.

6. In reorganizations no-par-value stock is readily adaptable to the exigencies which may arise.

Disadvantages:

1. Shares bearing no par value inscribed on the certificates are difficult to market.

2. Because of the difficulty in arriving at the amount of the license fee, some states have refused to license foreign corporations.

3. Arbitrary bases are often used by some states in determining stock taxes, organization, operating and transfer fees of corporations with stock of no par value.

The first advantage listed above is not a direct advantage to (a) the issuing company, (b) the stockholder and (c) intending investor, but may be considered in the answer because of the indirect effect.

The second advantage may be considered important to the intending investor, who also shares the remaining advantages (numbers three to six, inclusive) with (b) the stockholder.

The issuing company is concerned chiefly with numbers four and six, and indirectly with such advantages as accrue to its stockholders or prospective investors.

All three classes are affected by the disadvantages given because of their mutual interest either present or prospective.

No. 10 (10 points):
With regard to the use of qualified audit certificates (a) state the occasion for qualified certificates and their proper and justified use, (b) state what implication is contained in the use of such words as "accepting" when used with reference to certain asset valuations or other conditions shown on the books.

Answer:

(a) Qualified certificates are occasioned by circumstances which prevent the verification of the item or items with respect to which the certificate is qualified.

These circumstances may consist of limitations placed by the client upon the scope of the audit or the absence of data necessary for verification of the item in question. As to the propriety and justification of qualified certificates, these must depend wholly upon the surrounding circumstances and the auditor must exercise careful judgment in regard thereto. If the auditor suspects that the statements prepared by him would be materially affected as a result of examining the items in point he could not with propriety give even the qualified certificate. On the other hand, should he feel that the items are substantially correct and not likely to affect the results shown by his statements, it would be perfectly proper for him to prepare a certificate qualified with respect to the items not verified. His judgment must necessarily be based upon the attendant circumstances, the nature of the items and the purport of the statements to which the certificate applies.

(b) The term "accepting" or others similar thereto, used in reference to certain asset valuations or other conditions shown by the books, implies that there has been no verification by the auditor of the item or condition referred to and that it is reflected in his statements just as it is shown by the client's books, appraiser's certificate or other source of information.

No. 11 (10 points):

What is meant or implied in audit certificates (a) by the phrase "properly drawn up" as applied to a balance-sheet; (b) by the phrase "to show the financial position of the company as at December 31, 1925, and the results of operations for the year ended on that date?"

Answer:

(a) "Proper" and "properly", "improper" and "improperly" are terms used very loosely by persons whose task it is to review the work of others. The literal implication of the word "properly" when used with reference to the manner in which a balance-sheet is drawn up would no doubt be that its particular style and content constitute the one approved and correct presentation of the facts which it presumably portrays. It may safely be said, however, that the usual meaning behind the phrase "properly drawn up" as applied to a balance-sheet means that the assets, liabilities and net worth portrayed therein are correctly stated as to titles and amounts and that the form in which they are arranged is a recognized and generally accepted method of setting forth the facts represented.

(b) That part of the phrase reading "to show the financial position of the company as at December 31, 1925," means to set forth the assets and liabilities of the company at December 31, 1925, classified and arranged in such a way as to show the nature and amount of the various items, and to show also the excess of assets over liabilities as the net worth or proprietorship interest in the business, duly analyzed to show the nature and amount of the various elements thereof, or the reverse as the deficiency of assets when measured against the company's liabilities.

The second part of the phrase, "and the results of operations for the year ended on that date," means the expression in terms of income and expenses of the various transactions in which the company has engaged during the year ended December 31, 1925, showing the details of how the proprietorship interest has been increased or decreased.