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Auditing liabilities

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ful in showing the utilization of proceeds derived from bond issues or other obligations for special purposes. It does not take the place of an income statement, but on the other hand it supplies information as to capital fluctuations which the income statement does not show.

(*To be continued*)

Auditing Liabilities

FOR some years text books on auditing emphasized the procedure incident to beginning an audit. That there was such a thing as ending an audit seemed to have been entirely overlooked.

In similar manner the tendency seems always to stress the verification of assets. Volumes have been written on the subject. Instructions galore have detailed the procedure. But the important matter of auditing liabilities has received relatively little attention. We, therefore, reproduce certain suggestions which have been used and found helpful in covering the principal items under this head.

All liabilities may be divided into three main classifications, and those subdivided further as follows:

1. DIRECT OR SPECIFIC:
   - (a) Notes payable discounted at banks
   - (b) Notes payable sold through brokers
   - (c) Notes payable to individuals for loans
   - (d) Notes payable and acceptances to trade creditors

   All of the above may be again classified as:
   - Notes secured by collateral
   - Notes unsecured
   - (e) Accounts payable—trade creditors
   - (f) Accounts payable—miscellaneous
   - (g) Consignments (in)
   - (h) Unclaimed wages
   - (i) Unclaimed dividends
   - (j) Deposits or prepayments on account
   - (k) Judgments
   - (l) Contracts
   - (m) Mortgages
   - (n) Bonds
2. CONTINGENT:
   - (a) Notes receivable discounted
   - (b) Acceptances
   - (c) Endorsements (accommodation notes)
   - (d) Guarantees
   - (e) Unfulfilled contracts
   - (f) The minute book
3. ACCRUING:
   - (a) Pay roll
   - (b) Taxes
   - (c) Interest
   - (d) Rent
   - (e) Gas, electricity, water, heat, etc.
   - (f) Freight
   - (g) Commissions
   - (h) Traveling expenses
   - (i) Legal expenses (litigation in process)
   - (j) Damages
   - (k) Dues and miscellaneous accruals
   - (l) Audit fees
   - (m) Liability insurance

DIRECT OR SPECIFIC:

(a) Notes payable discounted at banks:

There is greater possibility of deliberate deception being practised in connection with notes payable than in almost any other liability, and the greatest vigilance is necessary to be sure all are accounted for. Those payable at banks if at the regular banks of deposit are readily verified by certificate; the danger lies in the possible use of other banks and the use of the resulting funds without entry on the books.

(b) Notes payable sold through brokers:

The verification of these transactions is usually difficult owing to the inability to trace the paper further than to the brokers. However, the minutes should be examined for authority to sell the company's paper in this manner and a certificate requested from the brokers handling it.

(c) Notes payable to individuals for loans:

Unless shown on the books, when the ordinary process of certification can be resorted to, this liability is most difficult of verification, and if skillfully handled, fraud of this nature can usually go undetected until the company is called on to meet the obligation. Any hint of such a condition should be followed up carefully.

(d) Notes payable and acceptances to trade creditors:

These are less likely to be omitted from the records than any other class of notes payable and except for the fact that they are payable at predetermined dates and frequently bear interest, their omission is not so serious, due to the circumstance that the liability for which given is usually found and verified through other sources. This class of notes is readily verified by correspondence or examination of creditors' statements.

The paid and canceled notes of each class for the entire period under review should be called for and examined carefully, not only for the purpose of vouching the disbursements, but in order to thoroughly understand the system employed in handling same, which may be valuable in tracing other transactions.

Trade acceptances, however, are sometimes difficult for an auditor to discover if not entered on the records. The creditor's statement will not show them as they are closed transactions. Goods might readily be received, placed in stock, and acceptances issued without any entry until they became due. The only safeguard in this instance would be an examination of the order and receiving records and purchase invoices to see if the latter have been properly and regularly entered on the records.

Wherever collateral to any note is given, it should be verified and listed with full particulars.

(e) Accounts payable—trade creditors:

The balances in this account should be verified by comparison with creditors' statements and an examination made into all discrepancies between the statements and the books. Where no statements are produced it is well to request that they be asked for.

To locate and verify items not shown on the books, all vouchers or purchase record entries made between the date of closing the books and date of examination should be scrutinized. Further, the order and receiving records for a sufficient period prior to the date of closing books should be examined to discover liability for materials received but not entered.

Steps should then be taken to secure the inclusion of all such liabilities; and, in the case of materials, if not entered on the inventory, that should also be done.

(f) Accounts payable—miscellaneous:

The open personal accounts on the general ledger should receive careful consideration. They may consist of borrowings for which notes have not been given. The minute book should be examined for authority in such event and, if more than a nominal sum, the procedure of securing written acknowledgment should be employed.

Sometimes where the transactions with trade creditors are complicated by many returns or claims, partial payments, etc., the accounts are carried in the general ledger. All such demand close scrutiny and verification, as the creditors' claims may widely differ from the clients' record.

Accounts for commissions and other dealings with employes or officers of the company come under this heading and should be verified, rather than accepted at book figures.

(*To be continued*)

But again, where inter-company accounts are under current liquidation, that is, the accounts and notes receivable from related companies are being collected as rapidly as those from outsiders, there appears to be no logical reason why such accounts should not be included under current assets. It is of course desirable that such items as have been discussed should be clearly identified in the balance sheet, so that the amounts involved and relations may be apparent; and while from a practical banking point of view there may be some good purpose in considering them when granting or withholding credit, certainly from a point of view of good accounting there can be no such excuse for excluding them from the current assets.

(*To be continued*)

Auditing Liabilities

(Continued)

(g) Consignments (In):

Goods may be received on consignment and part or all sold without the liability therefor being spread on the books. If it is found that any goods are handled on consignment all records of such should be called for and carefully reviewed to establish the liability therefor.

(h) Unclaimed wages:

Unclaimed wages are frequently redeposited without proper liability being shown. In every audit the method of treating such items should be the subject of inquiry and if not properly handled steps should be taken to have the liability set up.

(i) Unclaimed dividends:

The next preceding remarks apply to this item.

(j) Deposits or prepayments on account:

These are usually easy of verification through the letter file or otherwise. In cases where interest on the deposit is involved as in public service companies, or where the company does a pseudo-banking business, receiving monies from its employes, both principal and interest should be carefully checked.

Prepayments on accounts are usually very temporary in nature, but they should be scrutinized to make sure that they should not have been transferred to the accounts receivable ledger.

(k) Judgments:

Disputed accounts sometimes give rise to litigation and judgments adverse to the client may have been secured. The particulars of all such items must be obtained and steps taken to have the liability therefor set up.

(l) Contracts:

Every contract the terms of which are specific such as land contracts, etc., forms a direct liability. The agreements should be seen and noted and the liability as shown by the books should be adjusted to the terms of the contracts.

(m) Mortgages:

(n) Bonds:

These liabilities should be verified by certificate and the documents should be read to ascertain if all the contractual requirements have been complied with.

Contingent:

(a) Notes receivable discounted:

These should be listed and verified by certificate from the banks where discounted. This is not sufficient, however; the status of all notes under discounts should be investigated and if it is probable that any will not be paid when due, a suitable reserve should be established to cover. If it is found that notes are renewed frequently it is a danger sign that should not be ignored.

(b) Acceptances:

The instructions next above are applicable to acceptances with the difference that there will be no renewals to look for.

(c) Endorsements (accommodation notes):

This is a form of liability difficult to discover if no records are made on the books. The minute books should be examined for authority to make such endorsements, and hearsay or other evidence pointing to such a condition should be closely followed up to ascertain the facts. Occasionally an official will secure endorsement of his private paper, by his company, with or without authority.

Solvent, creditable concerns do not ordinarily seek the endorsement of others except under stress and if "hard up" such endorsements are very likely indeed to develop into real liabilities of the endorser.

(d) Guarantees:

The above remarks under endorsements apply to guarantees with equal force.

(e) Unfulfilled contracts:

Has the client binding contracts to accept delivery of goods contracted for prior to date of audit? In normal times that fact would not affect his condition adversely, perhaps, but supposing a falling market, or a diminution of orders for future business, with the compulsion to accept delivery and pay for the goods. In that event, it would be of vital import, and outstanding contracts of this nature should be examined and taken into consideration, if not in the balance sheet, at least in the commentary. Full notes should be included in the working papers of all salient facts.

(f) The minute book:

The minute book should be carefully read and studied in all its bearings on the financial position of a client, whether affecting assets or liabilities. Small matters are not likely to be found in the minutes, but large items of authorized expenditures, contracts, litigation, etc., should be developed from that source.

ACCRUING:

(a) Pay roll:

When the close of the pay period coincides with the date of audit, the accrued pay roll is usually entered on the books and may readily be verified by seeing that the disbursements agree with the amount accrued. When the close of the pay period does not agree with the audit date, it becomes necessary to compute and set up the liability for the broken period.

(b) Taxes:

There are in many places franchise, corporation, excise and other taxes, known under various names and levied for different periods. Such taxes should be looked into carefully to be assured that all are properly accounted for. Local property taxes are particularly important and vary greatly as to periods, terms, times of payment, etc. Federal income and profits taxes are of course subject to special consideration.

(c) Interest:

Notes payable, contracts payable, mortgages, bonds, accounts payable, and in fact practically every liability may be subject to an accrual of interest which should be set up accordingly.

Accounts payable when overdue frequently bear interest, and all accounts of this nature should be inquired into with that thought in mind.

Overdue taxes bear interest and usually a penalty as well.

Deposits usually bear interest.

(d) Rent:

Rent is usually paid in advance, but it may be in arrears either by the terms of agreement or by failure to pay when due. It should be included as a liability.

(e) Gas, electricity, water, heat, etc.: These expenses are usually metered and but rarely is the reading by the public utility of the date of audit, consequently there will always be an account of these items. Whenever possible, and if of sufficient importance, the client should be asked to make a reading of meters at closing date so that the accrual may be accurate; failing that, to read them as early as possible and compute therefrom the amount due on closing date.

(*To be concluded*)

Is Single-entry Obsolete?

ONE can scarcely imagine credence being given in these swift days of advanced ideas to the thought that the principles of single-entry bookkeeping have any practical value. As a system of bookkeeping it is rarely found; although occasionally a public accountant in attempting to take off a trial balance awakes suddenly, when the two sides fail to agree, to the fact that he has actually encountered what he thought was a matter of history. Once discovered by the accountant, he makes so much fuss about the single-entry system that the client is usually put to shame and the installation of a system of double-entry follows.

Textbooks and practice sets used for instruction rarely fail to introduce the subject of single-entry, and occasionally the principal purpose thereof is to show the transition from single- to double-entry. But even this has little practical value since the system is now so seldom used.

As originally conceived and used, it probably embraced four accounts: cash, accounts receivable, accounts payable, and proprietorship. Profits were determined by the asset and liability method, which consisted in supplementing the accounts on the books by such assets or liabilities as might be determined through inventories, establishing the net worth and comparing the proprietorship at two dates, taking into consideration additions to or withdrawals from the capital during the interim.

Single-entry today probably has no practical value of any importance; but the asset and liability method of determining profits, which presumably was an outgrowth of the single-entry system, is frequently useful. This is particularly true in cases where it is necessary to approximate results quickly.

A practical example of such use occurred on one occasion when a client wished to know how the result, from a financial point of view, of analyzing an account running over several years would compare with the expense of the work involved. Instead of the somewhat usual reply that it would be impossible to make such comparison in advance of the completion of the work, the client was advised within twenty-four hours that the result would show approximately $225,000 of profit to which he would be entitled; that the expense of analyzing the account would probably not exceed $3,000.

The facts surrounding the case were as follows: On a certain date an account with a stock broker was opened with various securities received into the account. The books under examination were those of the broker showing the account with his customer. From time to time other securities were received in, and delivered out; checks for cash received and for cash paid appeared on the respective sides of the account; interest was both charged and credited. The account ran through several ledgers, in and out of the regular and various special accounts, and was closed finally by the representative ratio based on experience. This normal or standard ratio may be that of one organization taken for certain seasons, periods, or stretches of years, groups of typical organizations in certain lines, or business organizations in general. The first two classes are likely to be the more satisfactory for comparison. When used for comparative purposes the receivables to merchandise ratio probably has certain usefulness in indicating tendencies and drawing attention to weakness in the item of receivables which requires attention.

(To be continued)

Auditing Liabilities

(Concluded)

ACCRUING: (continued)

(f) Freight:

For one reason or another, freight bills are sometimes held up, returned for correction, etc. All items of this character should be included when discovered.

Goods are frequently shipped f.o.b. destination. When that is the case there is a liability for freight to point of delivery which should be ascertained and provision made therefor. Clients should be questioned as to basis of sales in order to secure this data. This class of freight charges should be treated as a deduction from sales, and if taken up by the customer, treated as a reduction of the accounts receivable.

(g) Commissions:

Provision should be made for inclusion of all accrued commissions. Frequently they are only payable upon settlement by the customer and are only spread upon the books at intervals. Inquiry should be made in order that all accruing commissions may be taken care of.

(h) Traveling expenses:

Salesmen generally are fairly prompt in getting in their expense accounts, but officers of companies and those whose trips are infrequent, quite often neglect to report them, particularly if, as usually happens, the funds have been advanced to cover. Expense accounts should be requested and included in all cases.

(i) Legal expenses (litigation in process):

Attorneys are as a class very slow in rendering accounts for services. Inquiry should be made if any litigation is in progress and if so, request that the company lawyer be asked for his bill or an approximation of it so as to include this item.

(j) Damages:

While liability insurance is carried by most companies for protection, that does not cover their liability for damages in all cases, as the insurance companies seldom assume unlimited liability. Claims in excess of the amounts covered by insurance should be taken cognizance of in an audit.

Other damages may consist of claims for breach of contract, failure or delay in delivery of goods, claims by employes for damages on account of dismissal, etc.

While not found everywhere, damage claims are sufficiently frequent to warrant a little quiet investigation to develop the facts.

When found, they might be either accrued or contingent and should be treated accordingly.

(k) Dues and miscellaneous accruals:

Club and other dues and miscellaneous items of accruals need not be enlarged on.

(l) Audit fees:

Inasmuch as audit fees are always applicable to a prior period, it is well to have the liability shown at least by a reserve to at least approximate the expense of the audit, carrying the expense into the operations of the period reviewed.

(m) Liability insurance:

In taking out liability insurance (as the premium is based on the amount of the payroll, computed at different rates according to the classes of employment and its relative dangers), the practice is to estimate the amount of the payroll for each class for the ensuing year and compute the premium to be paid accordingly. Usually also these initial premium payments are on an under-estimated payroll and the actual premium is only determined at the close of the insured period as the result of an audit made by a representative of the insurance company.

While at the beginning of such an insurance period it is obvious that there would be a substantial prepayment, it is equally obvious that such payment could not be divided into twelve equal parts (as in fire and other insurance), for the purpose of charging into operations, but that the charges for each month's liability insurance cost should be predicated on the actual payrolls for that month.

Accordingly, dependent on the measure of accuracy with which the initial premium has been computed, this account ordinarily changes, sooner or later, from an asset to a liability, usually after from six to eight months have elapsed.

It becomes necessary, therefore, in auditing this account, to tabulate the payrolls from the date of taking out the insurance to date of audit and work out the accrued premium in accordance with the rates indicated on the policy. That being done, any adjustments necessary should be applied and the resultant balance carried to the balance sheet.

It is very important to verify the fact that any liability arising from the previous insurance period has been properly taken into the operating accounts.

Should the account for liability insurance stand closed in the ledger, it is necessary to verify the fact that no asset or liability actually exists at the time of audit.

The Echo

ATTORNEY-General Daugherty in asking for an injunction against the striking railway shopmen:

"The underlying principle involved in this action is the survival and supremacy of the Government of the United States.

"No union or combination of unions can, under our law, dictate to the American Union. When the union claims the right to dictate to the Government and to dominate the American people and deprive the . . . people of the necessaries of life, then the Government will destroy the unions, for the Government of the United States is supreme and must endure."

Inscription on monument to the forefathers erected on hill at Provincetown, Massachusetts (tip of Cape Cod where the Pilgrims first reached land):

"On November 21, 1620, the *Mayflower*, carrying 102 passengers, men, women, and children, cast anchor in this harbor 67 days from Plymouth, England.

"The same day 41 adult males in the company solemnly covenanted and combined themselves together 'into a civill body politick.'

"This body politic established and maintained on the bleak and barren edge of a vast wilderness a state without a king or a noble, a church without a bishop or a priest, a democratic commonwealth, the members of which were 'straightly tied to all care of each other's good and of the whole by everyone.'

"For the first time in history they illustrated with long suffering devotion and sober resolution the principles of civil and religious liberty in the practices of a genuine democracy.

"Therefore the remembrances of them shall be perpetual in the great republic that has inherited their ideals."