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# Smaller commercial finance company; Case studies in auditing procedure no. 10

American Institute of Accountants. Committee on Auditing Procedure

NUMBER 10

# CASE STUDIES

IN

# AUDITING PROCEDURE

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## *A SMALLER COMMERCIAL FINANCE COMPANY*

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

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# Case Studies

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# AUDITING PROCEDURE

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## *A SMALLER COMMERCIAL FINANCE COMPANY*

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# FOREWORD

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

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

### *Auditing Standards*

During recent years the committee has given a great deal of consideration to the definition of generally accepted auditing standards. In 1947, it issued a special report, *Tentative Statement of Auditing Standards,* in which it presented the results of its deliberations up to that time. In September 1948, a summary of generally accepted standards, as presented in that report, was adopted by the membership of the American Institute of Accountants. In November 1949, the membership of the American Institute of Accountants also approved Statements on Auditing Procedure No. 23 (Revised), *Clarification of Accountant's Report When Opinion Is Omitted.* In 1954, the committee issued a revised report on auditing standards under the title, *Generally Accepted Auditing Standards,* in which the substance of Statement No. 23 (Revised) was added to the previous summary of auditing standards. The revised summary is as follows:

*General Standards*

1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment an independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

*Standards of Field Work*

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.
3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

*Standards of Reporting*

1. The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.
2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an over-all opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

## Auditing Procedures

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

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

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

. . . .

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

. . . .

"The case studies so far issued have described the audits in considerable detail. There has been some feeling among committee members, however, that a large proportion of that detail could well be reduced in future case studies by omitting detailed descriptions of procedures which are pretty much the same in all audits and by concentrating instead upon the phases of the audit which, in the author's opinion, are somewhat distinctive to the particular engagement."

The accompanying case study describes the auditing procedures which were actually followed by a practitioner in a particular instance. The procedures used may be applicable only due to particular circumstances surrounding the examination; furthermore, alternative procedures might conceivably have been used to accomplish the general audit objectives. This case study has not been reviewed by the various members of the committee and is not intended as a representation of the views of the committee on auditing procedure.

The committee hopes that the case study material will serve a useful purpose not only within the profession, but also in the various colleges and universities throughout the country which offer advanced instruction in accounting and auditing subjects.

*Committee on Auditing Procedure*

*March, 1956*

# NO. 10: A SMALLER COMMERCIAL FINANCE COMPANY

## INTRODUCTION

Commercial finance companies lend money (usually secured by specific assets) to business ventures. They satisfy a definite need in the business community through flexibility in meeting the requirements of a varied group of borrowers. A recent article in *The New York Times* (June 12, 1955) characterized the commercial finance company as the middleman of credit who walks profitably where banks fear to tread. It specializes in giving a financial lifeline to struggling entrepreneurs as well as to established concerns hard-pressed for working capital. It has been estimated that the financing volume of the 4500 commercial finance companies in the United States exceeded $32,000,000,000 in 1954.

This study will describe the operations of a particular commercial finance company and outline the auditing procedures applied in its examination.

## DESCRIPTION OF THE BUSINESS

Primarily, this company grants loans secured by a pledge of accounts receivable which are created by the borrower in the normal course of business. The company operates on a non-notification basis, which means that the debtors of the borrower are not notified that their accounts have been assigned. The borrower is permitted to collect the accounts but he is required to turn over such collections, in the original form, to the finance company. None of the credit risks pertaining to the assigned accounts are assumed by this finance company and the borrower is fully liable for the repayment of the loan even though his accounts receivable may prove uncollectible.

The assigned accounts of each borrower are controlled in total as well as in detail by individual debtors. In the case of a borrower who assigns all of his accounts, the finance company's collateral records are identical to the borrower's accounts receivable records.

The assigned accounts are continually examined and appraised. Large accounts are rated and delinquent accounts are investigated and returned to the borrower with a request to substitute current accounts. In addition, the internal auditors of the finance company periodically examine the records of the borrowing company. Their audit program includes the following steps:

1. Comparison of collateral records with the borrower's accounts receivable records.
2. Determination that all accounts assigned are conspicuously noted on the ledger sheets.
3. Inspection of sales invoices and shipping documents for selected charges to accounts receivable.
4. Tracing of returns and allowances to the accounts receivable records.
5. Comparison and mailing of monthly statements.
6. Confirmation, in the name of the borrower, of selected accounts.
7. Preparation of bank reconciliations.
8. Scrutiny of cash receipts and disbursements.
9. Determination of the status of accounts payable and tax liabilities.
10. Review of such business trends as sales, returns and allowances and gross profit percentage.

In the event of bankruptcy or other financial difficulty of a borrower, the finance company usually notifies the debtors of the borrower that their accounts have been assigned and that payments must be made directly to the finance company. In these circumstances, where the finance company must look to its security, collateral which has been properly controlled, examined and appraised will usually liquidate an otherwise uncollectible loan.

The advance percentage (ratio of loan to collateral) varies between 70 and 90% depending upon the nature of the borrower's business and his financial strength. Selling terms, trend of bad debt losses, returns and allowances and net worth are some of the guides used by the finance company in fixing the advance percentage for individual borrowers.

Since the borrower is usually short of capital, the lender must constantly be alert to detect attempted or actual fraud. Some of the common types of borrower frauds encountered in connection with accounts receivable financing are:

1. Assignment of fictitious accounts.
2. Assignment of the same account to more than one finance company.
3. Withholding collections on assigned accounts.

While adequate control of collateral can usually be relied upon to disclose such fraudulent practices, sad experience has taught that considerable damage can be done within a short period of time. Therefore, as additional protection, this company is insured against losses up to $150,000 arising from customers' frauds, to the extent of 85% of the losses in excess of $20,000 per annum. This policy is written on a deposit premium basis and the annual cost approximates ¾ of 1% of the average amount of outstanding loans.

The company limits its risk and avoids concentration by permitting other finance companies to participate with it, on a percentage basis, in certain of the larger loans.

The finance charge for an accounts receivable loan is based upon a daily rate of interest applied to the balance of the loan at the end of each day. Since statements are rendered monthly, a practical equivalent is obtained by applying the daily interest rate to the total of the thirty daily balances of the loan outstanding during the month. In some cases, collateral balances, or a combination of loan and collateral balances, are used as the basis for computing the charge.

Because of the greater risk and additional bookkeeping and supervision involved, accounts receivable financing cannot profitably be conducted at bank rates of interest. This company's charges, converted to annual effective rates, vary between 12 and 20%. However, in contrast to bank loans, it should be noted that accounts receivable loans vary from day to day and require no compensating balances. Since the factors of time and amount are equally significant to rate in determining the cost of money, a loan which is fully utilized and which is never more than the requirements of the borrower, may not be as costly as indicated by the rate.

This company also makes mortgage loans secured by machinery, plant equipment and real estate, as well as loans secured by inventory or marketable securities. In connection with its mortgage loans, the company, in many cases, receives an advance discount. These advance discounts are included in the principal amount of the mortgage loans and are credited to income monthly over the term of the loan.

This finance company serves approximately 100 borrowers with an average loan of approximately $30,000. However, loans of $5,000 are not uncommon and the company has also granted loans of $200,000.

Consistent with the practice in prior years, interest on mortgage loans is not accrued but is included in income only when collected. The amount of interest thus excluded from the financial statements is not significant in relation to total assets.

## FINANCIAL STATEMENTS

The following financial statements are submitted primarily to illustrate the presentation of the items which are distinctive to a commercial finance company. While the figures are indicative of the size of the company under review, they are not actual figures and conclusions should not be drawn therefrom.

## ORGANIZATION OF THE BUSINESS

The company is organized as a partnership consisting of two active partners and several special (limited) partners. Twelve employees control customers' accounts and perform the necessary bookkeeping, auditing and clerical work. The organization chart on page 16 indicates the responsibilities of the functional divisions of the company.

ABC FINANCE CO. (Partnership)

## CONDENSED STATEMENT OF INCOME AND EXPENSES

**For the Year Ended....................**

| | |
|---|---|
| Income from charges and interest | $800,000 |
| Salaries and other operating expenses | 400,000 |
| Balance | $400,000 |
| Interest on bank loans | 125,000 |
| Profit before provision for losses | $275,000 |
| Provision for possible losses on loans | 25,000 |
| NET PROFIT BEFORE PARTNERS' DRAWINGS | $250,000 |
| Due partners at beginning of year | 125,000 |
| Total | $375,000 |
| Partners' net withdrawals | 275,000 |
| DUE PARTNERS AT END OF YEAR (TO BALANCE SHEET) | $100,000 |

## ABC FINANCE CO. (Partnership)

## BALANCE SHEET AS AT ......................

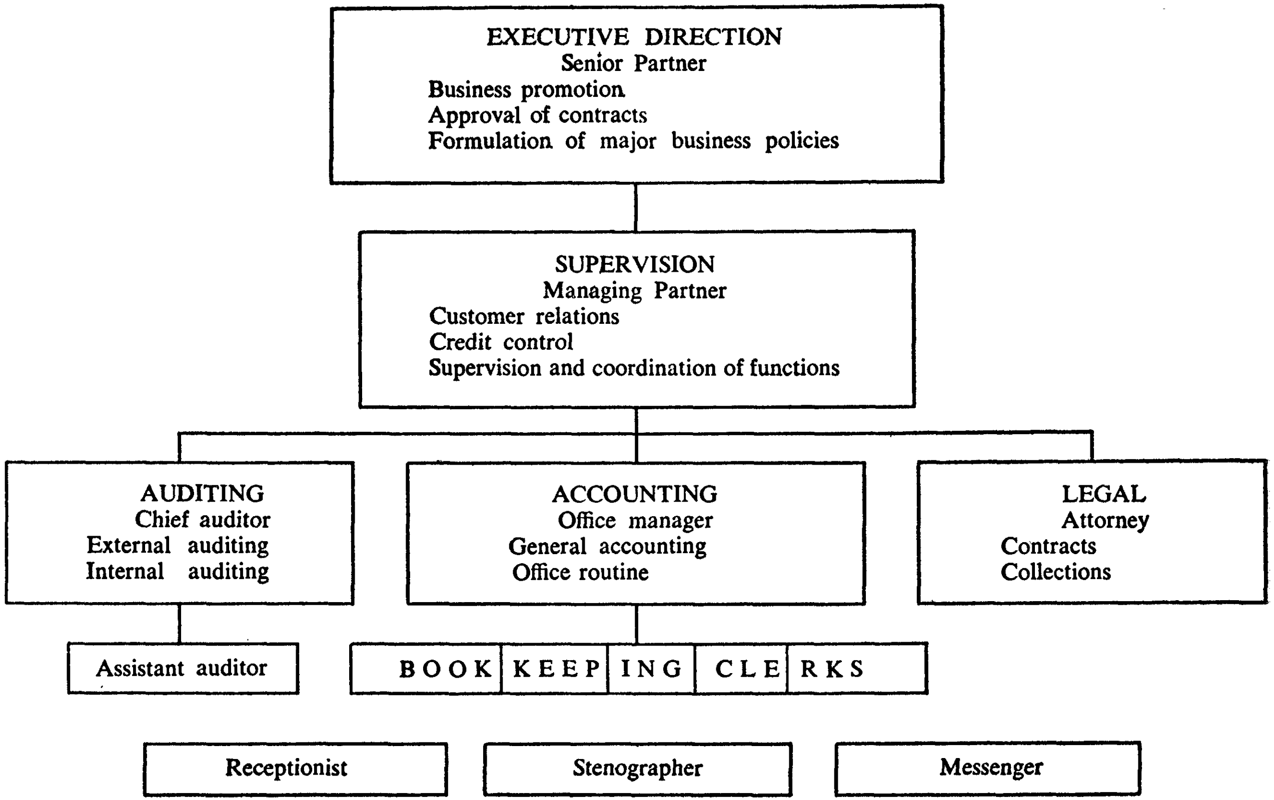
### ASSETS

| | | | |
|---|---|---|---|
| Cash | | | $ 800,000 |
| Loans receivable: | | | |
| Collateralized by assigned accounts receivable | | $2,000,000 | |
| Mortgage loans (chattel and realty) | $800,000 | | |
| Less deferred discounts | 75,000 | 725,000 | |
| Collateralized by merchandise | | 200,000 | |
| Collateralized by marketable securities | | 100,000 | |
| Unsecured | | 50,000 | |
| Total | | $3,075,000 | |
| Less allowance for possible losses | | 250,000 | 2,825,000 |
| Prepaid expenses | | | 25,000 |
| Furniture and equipment (net of depreciation) | | | 10,000 |
| TOTAL | | | $3,660,000 |

## LIABILITIES AND CAPITAL

| | |
|---|---|
| Current liabilities: | |
| Notes payable to banks | $2,000,000 |
| Accrued taxes and expenses | 60,000 |
| Due to partners | 100,000 |
| Total current liabilities | $2,160,000 |
| Partners' capital (no change during year) | 1,500,000 |
| TOTAL | $3,660,000 |

## ORGANIZATION CHART



## BOOKS OF ACCOUNT

The accounting records of the company include the following books of account:

Journals

1. Cash receipts book
2. Summary cash disbursements book (loans)
    a. Duplicate check binders (loans)
3. Cash disbursements book (expenses)
4. Income register
5. Payroll book
6. General journal

Ledgers

1. General ledger
2. Subsidiary ledgers
    a. Accounts receivable loans ledger
    b. Collateral accounts receivable ledger
    c. Mortgage and other loans ledger

The cash receipts book and the mortgage and other loans subsidiary ledger are prepared simultaneously on a bookkeeping machine.

Duplicates of checks, issued in connection with loans, furnish the details for the summary cash disbursements book, which is manually operated and posted weekly.

Expense checks are drawn on a separate bank account and posted to a standard manually operated multi-distribution column journal.

The income register is used to record the monthly charges to accounts receivable loan customers. Figure 1 illustrates the form of this journal.

The payroll book, general journal and general ledger are standard and manually operated.

The subsidiary accounts receivable loans ledger is maintained on cards and is prepared as a separate run on the bookkeeping machine. Two ledger cards (cash and collateral) are prepared for each customer. Each card has a snap-off statement which is detached and sent to the customer at the end of the month. New ledger cards are prepared every month. Figures 2 and 3 on pages 19 and 20 illustrate the form of these cards. The final entry in the accumulated balance column of these forms serves as the basis for computing the monthly charge.

## INCOME REGISTER

| | CHARGES | | |
|---|---|---|---|
| Customer's Name | January | February | March |
| | | | |
| Total Charges | | | |

Figure 1

## ACCOUNTS RECEIVABLE LOAN LEDGER CARD—CASH

| | | CASH | | | | |
|---|---|---|---|---|---|---|
| Schedule # | Folio | Date | Advances | Net Remittances | Balance | Accumulated Balance |
| | | | | | | |

Figure 2

## ACCOUNTS RECEIVABLE LOAN LEDGER CARD—COLLATERAL

| | | COLLATERAL | | | | |
|---|---|---|---|---|---|---|
| Schedule # | Folio | Date | Collateral Received | Collateral Reduced | Collateral Balance | Accumulated Balance |
| | | | | | | |

Figure 3

*Flow of cash receipts*

Mortgage and other loans are evidenced by notes. All notes maturing in a particular month are sent to one of the company's banks at the end of the preceding month. The company is advised of collection by bank credit advice.

Payments in reduction of accounts receivable loans are received by mail. The customer forwards the checks of his debtors together with a remittance report, the form of which is supplied by the finance company. Figure 4 on page 22 illustrates this form. Payments in currency are rare.

The mail is opened and examined by the partners. A bookkeeping clerk foots and crossfoots the remittance reports and compares the checks to the items listed thereon. This same clerk prepares the deposit and the cash receipts journal. A second clerk posts cash and collateral reductions to the subsidiary accounts receivable loans ledger. The remittance reports are then divided among three other clerks who post the details to the collateral accounts receivable ledger.

*Flow of cash disbursements*

The partners and the office manager are authorized to sign checks individually on all banks. As a general rule, however, this function is performed by the managing partner, and the office manager signs checks only in the absence of the partners. The bank statements are opened and reconciled by the auditing department, and the chief auditor submits all checks signed by the office manager to the senior partner for approval.

A typist prepares all checks from a detailed check requisition prepared by the partners or the office manager. In connection with mortgage and other loans the amount of the check is determined by reference to a specific contract. The amount of the check issued to an accounts receivable loan customer is determined by reference to the schedule of assigned accounts submitted by the customer and the provisions of his contract with the finance company. The customer's request for an advance (usually presented by messenger) is accompanied by the schedule of assigned accounts (Form illustrated in Figure 5 on page 24.) and appropriate duplicate sales invoices and shipping documents. Since speed is an essential feature of the finance company's service, these documents are only cursorily examined by the partners or the office manager before the check is issued. Prior to the

## REMITTANCE REPORT

(Customer's Name)

Date ____________________

| Invoice Date | Remitted by | Amount of Check | Returns & Allowances | Discounts | Gross Amount of Invoice |
|---|---|---|---|---|---|
| | | | | | |
| | Totals | | | | |

Remittance Report #

Figure 4

close of banking hours of the same day the documents are audited as follows:

1. The schedule of assigned accounts is footed.
2. The duplicate sales invoices and shipping documents are examined and compared to the schedule.
3. Large accounts on the schedule are rated.

If the audit of the documents discloses a serious discrepancy, the check issued in connection with them is stopped.

The check requisitions and the schedule of assigned accounts furnish the details for posting to the subsidiary ledgers by the clerks whose functions are described under the "flow of cash receipts" caption.

## INTERNAL CONTROL

The company's accounting system and internal control procedures are reviewed by the CPAs annually. The report prepared by the senior accountant in charge of the engagement is summarized as follows:

### *Books of Account*

1. The journals and ledgers are neatly maintained and the bookkeeping work is kept up-to-date. Postings to the subsidiary accounts receivable loans ledger and collateral accounts receivable ledger are completed one to two days after date of origin. The subsidiary mortgage and other loans ledger is kept current daily. Customers' statements are mailed promptly. Overtime pay is negligible.

2. A general ledger trial balance and subsidiary schedules are taken off and balanced every month.

3. The general ledger accounts are in balance sheet order and are sufficiently numerous to provide an adequate trial balance.

4. Distribution columns in the cash books are adequate to provide for the recurring items.

### *Collections*

1. Virtually all collections are in the form of checks and bank credit advices. Collections in currency are rare. Checks are deposited intact, daily.

2. While the mail is opened and receipts examined by the partners and office manager, a listing of the checks is not prepared before they are turned over to a bookkeeping clerk for processing and deposit.

## SCHEDULE OF ASSIGNED ACCOUNTS

(Customer's Name)

Date ______________________

| Invoice Date | Name and Address of Debtor | Amount of Invoice | Terms |
|---|---|---|---|
| | | | |

Schedule #

Figure 5

This procedure has not been recommended in this case since its only purpose would be to insure against collections being lost rather than abstracted. The incidence of lost checks is uncommon.

3. The fact that the same bookkeeping clerk prepares the daily deposit and the cash receipts journal and posts to the mortgage and other loans subsidiary ledger does not constitute a major breech in control. Mortgage loan installment payments are usually evidenced by bank credit advice and delinquencies are investigated immediately.

### Checks

1. The partners and the office manager are authorized to sign checks individually. While countersigned checks would be desirable, this procedure would limit the activities of the partners and impede customer service. The office manager signs checks only in the absence of the partners and checks thus signed are subsequently examined by the senior partner.
2. Advances to customers are never made payable to "cash" and expense checks are generally supported by bills and vouchers which are marked with the check number and date of payment.
3. All checks are pre-numbered and voided checks are defaced and retained.
4. Bank statements are opened and reconciled by the auditing department.

### Petty Cash

1. The managing partner controls the imprest petty cash fund which is reimbursed weekly by summary voucher.
2. The fund and expenditures therefrom are small.

### Payroll

1. The weekly payroll is constant as to amount, paid in cash and prepared by the auditing department.
2. Increases are authorized by the senior partner.
3. Payroll records comply with Federal and State regulations.

### General

1. All employees are bonded.
2. All employees take a vacation annually and their work is then performed by other employees.
3. Postage is controlled by the use of a postage machine.

4. Valuable papers and collateral securities are kept in a safe deposit box, access to which is available to either partner.

### *Conclusion*

The system of internal control of the company is adequate as one of the bases for the expression of an opinion in connection with its financial statements.

## SCOPE OF ENGAGEMENT

The engagement is recurring and calls for a semi-annual examination of the accounts.

The report includes an unqualified opinion and a copy is prepared for each partner and each of the company's banks. The report contains comments relating to the balance sheet items and operating results, an outline of the confirmation procedures applied in the examination, a balance sheet, operating statement, analysis of loans and analysis of partners' accounts.

Because of lack of time on the part of this client's staff, computation of certain of the accruals, prepayments and other adjustments in connection with the closing of the books is done by the accounting firm, as is the preparation of the detailed semi-annual financial statements.

Except for the various payroll tax returns which are prepared by the client's auditing staff, Federal, State and local tax returns are also prepared by the accounting firm.

Certain of the additional detail audit work is performed at the client's request, in connection with receivables, interest and discount computations and expense analysis, which may not be required in the usual similar situation in order to render an opinion on the financial statements.

The audit is assigned to a senior accountant who is assisted in the field work by two accountants of junior grade and a comptometer operator. Time estimates for each semi-annual audit are as follows:

| | *Total Man Days* |
|---|---|
| Senior accountant | 15 |
| Junior accountants | 25 |
| Comptometer operator | 4 |

The work papers, report and tax returns, prepared by the senior accountant, are reviewed by the tax and reviewing staffs and finally approved by a partner of the accounting firm.

## PREPARATORY WORK

The examination is commenced approximately one week to ten days after the close of the period to be reviewed, at which time a trial balance and subsidiary schedules are available. On the last business day of the period under review, the senior accountant in charge performs the following steps:

1. Examines the marketable securities held by the finance company as collateral for loans granted thereon.
2. Prepares and mails the following confirmations and letters:

   Banks:
   a. Standard bank confirmations.
   b. Requests for cut-off statements and duplicate deposit slips.
   c. Requests for confirmation of notes held for collection.

   Attorney:
   a. Request for information concerning any suits, judgments or other legal matters affecting the company.

   Insurance brokers:
   a. Confirmation of the insurance coverage.

Prior experience has shown that loan confirmations and the other requests for information, as indicated in the detailed audit program, are best prepared and mailed while the audit is in progress.

## AUDIT PROGRAM

### *Foreword*

The program for the initial examination of this company included the following steps:

1. Obtain a copy of the articles of copartnership and retain in the permanent file.
2. Analyze the following accounts from their origin:
   a. Partners' capital
   b. Partners' loans

c. Furniture and equipment and accumulated depreciation
d. Allowance for losses

3. Abstract loan contracts in force
(The abstract of loan contracts is prepared and maintained primarily as an aid in testing the accuracy of the reported income. There are approximately 50-75 loan contracts in force at audit dates (exclusive of mortgage loans). The percentage rate charged and the bases to which they are applied are sufficiently varied so that computation of the monthly charges is not a routine clerical job. In the circumstances, a test of income based upon all the accounts for one or more months is more conclusive than one based upon selected accounts for all or random months. Since loan contracts are basically uniform, the abstract of loan contracts consists of several columnar sheets with appropriate headings for date, name, advance percentage, charge rates and bases to which charge rates apply. Each contract is summarized on a single line. The test of income from charges to accounts receivable loan customers, as outlined in this study, requires approximately two to three days of junior accountant's time and is performed at the client's request. A lesser amount of testing would otherwise be adequate.)

The working papers developed in connection with the above items have been carried forward and brought up-to-date at each succeeding audit; the current audit program therefore includes procedures applicable only to the period under review.

### Cash in Banks and on Hand

I. For each of the eight bank accounts maintained by the company, prepare and mail the following:
   A. Standard bank confirmation (Request information as at the close of the period under review.)
   B. Request for a cut-off bank statement (inclusive dates to include the first day of the subsequent period and a sufficient number of days thereafter to allow for clearance of the current period's outstanding items) (Ten days is usually sufficient.)
   C. Request for several days' (about five) duplicate deposit slips (Select heavy deposit days and include the first two business days in the period subsequent to the period under review.)

II. To the bank used by the company for collection of notes, prepare and mail a confirmation request of notes held for collection (Request information as at the close of the period under review.)
(Each of the above letters request the bank to mail its reply directly to the accountant.)

III. For each of the company's banks prepare or obtain a bank reconciliation as at the close of the period under review and in connection therewith perform the following:
   A. Check the accuracy of the client's bank reconciliation for the month prior to the close.
      a. Check the bank statement and general ledger balances.
      b. Check the outstanding deposits and checks to the current month's bank statement and returned checks.
      c. Check the arithmetic.
   B. For the last month of the period under audit:
      a. Compare the deposits and dates thereof reflected on the bank statement to the cash receipts book.
      b. Vouch the returned checks and debit memos to the duplicate check binder, noting:
         1. Date
         2. Payee
         3. Amount
         4. Signature
         5. Endorsement
      c. Foot and crossfoot the cash receipts book.
      d. Foot the duplicate check binder and trace the total to the summary cash disbursements book.
      e. Foot and crossfoot the summary cash disbursements book.

IV. For each of the company's banks prepare a bank reconciliation as at the close of the short period covered by the requested cut-off bank statement. Perform the same procedures outlined in III B. Investigate and discuss with the client's senior partner all outstanding items appearing in the reconciliation for the period under review which have not cleared by the close of the cut-off period.

V. Compare the details on the requested duplicate deposit slips to the details on the customers' remittance reports. Compare the total remittance from each customer to the entry in the cash receipts book. For remittances affecting mortgage and other loans, trace the amounts thereof from the duplicate deposit slip to the subsidiary ledger and thence to the cash receipts book. (Irregularities disclosed by this procedure may be an indication of manipulation on the part of employees or customers.) Investigate and discuss with the senior partner all unsatisfactorily explained differences.

VI. Schedule all bank transfers occurring during the current month and the subsequent cut-off period and be certain that debits and credits to cash correspond as to amount and date within the same month. (Irregularities disclosed by this procedure may be an indication of theft or padding of cash.)

VII. For all months of the period under review and the cut-off period, examine the initialled approval by the senior partner of all checks signed by the office manager.

VIII. For three months of each year check the analysis of the general ledger columns in the cash receipts and disbursements books.

IX. For one month of each semi-annual period check the postings from the cash and other journals to the general ledger.

X. Count the petty cash imprest fund and on a test basis examine summary vouchers approved by the managing partner supporting reimbursements thereto.

XI. Review the receipts and disbursements of the month subsequent to the period under review for accruals and other items applicable to the period under review.

### Loans Receivable

*Loans Collateralized by Assigned Accounts Receivable*

I. As at the close of the period under review, prepare or obtain a detailed schedule of the outstanding loans and collateral and compare the total thereof to the controlling account in the general ledger. The columnar headings of this schedule are:

1. Name of borrower
2. Total cash advanced
3. Amount of participation by other finance companies
4. Net loan
5. Total assigned accounts receivable held as collateral
6. Ageing of total cash advanced:
   a. 30 days

b. 60 days
c. 90 days
d. more than 90 days

7. Amount of loan and collateral confirmed by direct correspondence with the borrower
8. Amount of participation of other finance companies confirmed by direct correspondence with participants

II. A. As at the close of the period under review, prepare and mail direct positive-type confirmation requests as follows:

a. All borrowers:
1. Total indebtedness
2. Total assigned accounts receivable held as collateral

b. All participants:
1. Amount of participation
2. Type of loan
3. Name of account to which participation is applicable

B. Approximately ten days after the initial confirmation requests have been mailed, follow-up selected unconfirmed accounts with second requests for confirmation. (Select loans in excess of $10,000.)

(In response to initial and second confirmation requests, approximately 90% of the total dollar volume of such loans were confirmed.)

III. A. For each loan, determine that the total collateral and assigned accounts exceeds the total cash advanced. If the total cash advanced exceeds the total collateral, examine additional collateral retained, if any, and reclassify the excess advance accordingly. If excess advances have been made against future shipments, reclassify such excess advances as unsecured loans.

B. On a test basis, audit selected schedules of assigned accounts and remittance reports as follows (The total of assignment schedules and remittance reports processed by the bookkeeping department of this finance company aggregates many thousands during a semi-annual period. The test of relatively few of these documents is intended to determine the efficiency of the system of accounting control as it relates to customers' accounts.):

a. Schedule of assigned accounts:
1. Determine that the date of the assignment falls

within the period under review.
2. Foot.
3. Vouch the total thereof to the subsidiary accounts receivable loans ledger.
4. Vouch the individual items thereon to the subsidiary collateral accounts receivable ledger.
5. Vouch the cash advanced to the duplicate check binder.
6. Examine the duplicate sales invoices and shipping documents supporting the individual items on the schedule and determine that they are not dated subsequent to the date of assignment.

b. Remittance report:
1. Foot.
2. Vouch the total thereon to the subsidiary accounts receivable loans ledger.
3. Vouch the individual items thereon to the subsidiary collateral accounts receivable ledger.
4. Vouch the total cash received to the cash receipts book.

(Select several schedules and reports dated during the current month for approximately ten active customers. One of the schedules for each customer should be the last one of the current month.)

IV. For several active customers (about five) prepare an aged schedule of the collateral accounts receivable and compare the total thereof to the subsidiary accounts receivable loans ledger. Determine that the assigned accounts are sufficiently current in accordance with the selling terms of the borrower to provide adequate security for the cash advanced.

V. In connection with the ageing of the total cash advanced, investigate and discuss with the client's senior partner all accounts which indicate advances 90 days and older. Since the turnover in accounts receivable loans is generally not more than 60 days, old advances may be an indication of a bad account, uncollectible collateral or fraud. Depending upon the results of the investigation, which should include examination of subsequent month's collections, make necessary adjustments, reclassifications or write-offs.

VI. For the current month, examine and compare to subsidiary records the confirmation replies received by the finance company in response to its test verification (in the name of the borrower) of assigned accounts receivable. (As previously noted, the company operates on a non-notification basis and it is therefore not practicable for the CPAs to confirm the collateral by direct correspondence.)

VII. Review the adequacy of the audit program used by the finance company's auditing department in connection with its periodic examination of borrowers' records and determine that all accounts are audited regularly.

*Mortgage and Other Loans*

I. As at the close of the period under review, prepare or obtain a detailed schedule of the outstanding loans and compare the total thereof to the controlling account in the general ledger. The columnar headings of this schedule are:

1. Name of borrower
2. Total loan
3. Amount of participation by other finance companies
4. Net loan
5. Loan classifications:
    a. Chattel mortgage
    b. Real estate mortgage
    c. Real estate and chattel mortgage
    d. Marketable securities
    e. Inventory
    f. Unsecured
6. Date of notes evidencing loan
7. Interest rate
8. Approximate accrued interest at the audit date
9. Ageing by due dates of notes:
    a. Past due
    b. Due on demand
    c. Due 1 month after audit date
    d. to n. Due 2 to 12 months after audit date
    o. Due 13 to 15 months after audit date
    p. Due 16 to 18 months after audit date
    q. Due 19 to 21 months after audit date
    r. Due 22 to 24 months after audit date
    s. Due after 2 years of audit date
10. Subsequent month's collections
11. Amount of loan confirmed by direct correspondence with the borrower

12. Amount of participation of other finance companies confirmed by direct correspondence with participants

II. A. As at the close of the period under review, prepare and mail direct positive-type confirmation requests as follows:
   a. All borrowers:
      1. Total indebtedness
      2. Description of collateral held
   b. All participants:
      1. Amount of participation
      2. Type of loan
      3. Name of account to which participation is applicable

B. Follow-up unconfirmed accounts in the same manner as for accounts receivable loans.
(Confirmation results approximated those for accounts receivable loans.)

III. A. Mortgage loans:
   a. Examine the following in connection with selected loans. (There are approximately 30 mortgage loans outstanding at the audit date. The larger items should be examined):
      1. Mortgage
      2. Filing receipt
      3. Insurance policies covering the mortgaged property and naming the finance company as the insured
      4. Notes aggregating the unpaid balance of the loan

The company employs an attorney who checks title to the property before each loan is made.

While the notes maturing in the month subsequent to the date of the audit are not available for inspection they are confirmed by direct correspondence as being held by one of the company's banks.

(As previously indicated, interest on mortgage and other loans is not accrued but is included in income only when collected. However, the amount of interest thus excluded from the financial statements is estimated as at the audit date and the amount thereof is included in the report comment section.)

B. Loans secured by marketable securities:
   a. On the last business day of the audit period, examine

all marketable securities (see that they are endorsed in blank) retained by the finance company as collateral for loans granted thereon.

b. Obtain market quotations for all securities, as at the audit date.

c. Determine that the market value of the collateral as at the audit date, applicable to each of the loans, is equal to or in excess of the balance of the loan granted. (In any case where the collateral value is less than the amount of the loan, transfer the item to a "partially secured" or "unsecured" caption in the report.)

C. Loans secured by inventory:

a. Examine the warehouse and trust receipts in the name of the finance company covering the merchandise securing each loan.

b. As at the audit date, confirm by direct correspondence with the warehouses the physical quantities of the merchandise indicated on the warehouse receipts.

c. For large inventory loans obtain permission to physically inspect the merchandise indicated on the warehouse receipts.

d. Estimate by reference to the borrower's purchase invoices or sales invoices, depending upon the nature of the inventory, the market value of the merchandise and determine that the amount thereof exceeds the balance of the loan granted. (Reclassify any loans in excess of market value of collateral as "partially" or "unsecured" loans in the report.)

IV. Investigate and discuss with the client's senior partner all past due notes, and obtain current valuations from the company's retained appraisers of the properties securing delinquent loans. Depending upon the results of the investigation, which should include examination of subsequent month's collections, make necessary adjustments, reclassifications or write-offs.

***Allowance for Losses***

I. Analyze the entries in the allowance for losses account and determine their propriety.

II. Discuss the adequacy of the balance in the account with the senior partner, giving ample consideration to the following:

a. Total loans

b. Condition of the loans
c. Company's prior experience

III. Determine that the allowance for losses, as finally adjusted, is reasonably adequate under present conditions.

### *Deferred Discounts*

As previously described, the company in many cases receives an advance discount in connection with its mortgage loans. These advance discounts are included in the principal amount of the mortgage loans and are credited to income monthly, on a straight line basis, over the term of the loan.

I. Prepare or obtain a detailed schedule of the discounts on mortgage loans as follows:
   a. Name of borrower
   b. Unamortized balance of discount received in prior periods
   c. Discount received in current period
   d. Total of columns b and c
   e. Term of the mortgage loan
   f. Amount of monthly credit to income
   g. Total amount credited to income—current period
   h. Unamortized balance of discount—close of current period
   i. Amount of the unamortized balance of discount—close of the current period, to be credited to income during the next twelve months.

II. The unamortized balances of discounts received in prior periods are carried forward from the schedule prepared at the close of the prior period. Examine selected mortgage loan contracts executed in the current period and the duplicate checks drawn in connection therewith to obtain the necessary information required to complete the foregoing schedule.

III. Compare the total unamortized balances of discounts at the close of the current period, to the deferred discounts account in the general ledger.

IV. Vouch the total amount credited to income during the current period to the sum of the monthly journal entries picking up income from this source.
   (The balance of deferred discounts as at the close of the period is shown as a reduction of the mortgage loans in the financial statements and the portion thereof to be credited to income during the subsequent year is the subject of a comment in the report.)

### *Fixed Assets*

The fixed assets of the company consist of office furniture and equipment and an automobile. The accounts in which they are recorded together with appropriate accumulated depreciation accounts were analyzed from inception at a prior audit and the working papers developed have been carried forward and brought up to date at each succeeding audit.

I. Vouch additions to fixed assets acquired in the current period, to invoices.

II. A. Physically inspect major additions.
    B. In connection with the automobile, examine the registration certificate indicating the company as the owner.

III. Compute and record depreciation for the current period.

IV. Bring schedules up-to-date and tie-in to the general ledger accounts.

### *Insurance*

The company's insurance coverage is as follows:

1. Customers' fraud bond
2. Employees' blanket position bond
3. Fire—office furniture and equipment
4. General liability
5. Workmen's compensation
6. Employees' disability
7. Automobile
    a. Public liability and property damage
    b. Fire, theft and collision

I. Prepare or obtain a detailed schedule of insurance coverage as follows:
    1. Policy #
    2. Carrier
    3. Broker
    4. Type of coverage
    5. Amount of coverage
    6. Term of coverage
    7. Premium
        a. Deposit
        b. Fixed
    8. Unexpired premium as at the beginning of period
    9. Unexpired premium as at the end of the period

II. Vouch additions and renewals in the current period to brokers' invoices.
III. Examine all policies.
IV. Confirm the details of coverage as at the close of the period by direct correspondence with the brokers.
V. Review the coverage for adequacy.
VI. Compute the unexpired premiums as at the close of the period and adjust the general ledger account accordingly.
VII. In connection with deposit premium coverage (customers' fraud bond, general liability and workmen's compensation) check the accuracy of the computation of the earned premiums, and estimate and accrue the earned premiums to the close of the period.

### *Notes Payable—Banks*

The company has an active line of credit at each of the eight banks in which it has an account. Loans are evidenced by unsecured company notes for periods of 30 to 90 days; the banks deduct discount in advance. (In connection with these loans, the banks have not imposed any restriction as to operations or capital. However, partners have advised the banks that their capital account is fixed and will not be reduced.)

I. For each bank prepare a detailed schedule of all notes discounted during the period as follows:
   1. Amount of note
   2. Date discounted
   3. Date paid
   4. Unmatured notes at the close of the period
   5. Interest rate
   6. Term of note
   7. Amount of bank discount
   8. Prepaid interest at the close of the period
II. By reference to bank credit and debit advices, abstract pertinent information to complete the above schedule.
III. Check the computation of discounts.
IV. Confirm the balances of outstanding notes payable by direct correspondence with the banks. (Standard Bank Confirmation Form)
V. Compare the total of the unmatured notes at the close of the period to the notes payable account in the general ledger.
VI. Compare the total of the bank discounts to the interest expense account in the general ledger.

VII. Compute the prepaid interest on unmatured notes as at the close of the period and adjust the interest expense account accordingly.

### Contingent Liabilities

I. As at the close of the period under review, prepare and mail a direct confirmation request to the company's attorneys for information concerning any suits, judgments and other legal matters affecting the company. Discuss the information and opinions contained in the attorney's reply with the client's senior partner and, if necessary, accrue adequately for foreseeable costs or expenses.
II. Prepare and have the client's managing partner and one other partner sign an accounts receivable and liability certificate.

### Partners' Accounts

The articles of copartnership provide for a fixed capital account; profits and drawings are channeled through the "due to partners" account, which is subject to withdrawal and is shown in the liability section of the balance sheet. Changes in the capital account are supported by amendments to the articles of copartnership.

The partners' capital and due to partners accounts were analyzed from inception at a prior audit and the working papers developed have been carried forward and brought up-to-date at each succeeding audit.

I. Analyze the capital and due to partners accounts for the period under review, vouching additions and reductions to the cash journals, cancelled checks, articles of copartnership and other data.
II. Bring the working papers schedules up-to-date and tie-in to the general ledger accounts.
III. Obtain a copy of any amendments to the articles of copartnership and retain in the permanent file.
IV. Compute the partners' distributive shares of the net profit in accordance with the provisions of the articles of copartnership and transfer the amounts thereof to the "due to partners" account.

### Income

The income of the company falls into three general categories as follows:

1. Income from charges to accounts receivable loan customers.

2. Interest income on mortgage and other loans.
3. Amortization of deferred discounts on mortgage and other loans.

Finance charges on accounts receivable loans are billed to customers at the end of each month and the charges are recorded in the income register; from this journal they are posted in total to the income account in the general ledger.

As previously described, the finance charge on an accounts receivable loan is based upon a daily rate of interest applied to the balance of the loan at the end of each day. Since statements are rendered monthly, a practical equivalent is obtained by applying the daily interest rate to the total of the thirty daily balances of the loan outstanding during the month. In some cases collateral balances, or a combination of loan and collateral balances are used as the basis for computing the charge. Referring to the illustrations in figures 2 and 3 (on pages 19 and 20), it is evident that the final entries in the accumulated balance columns are the bases for computing the monthly charge. In any particular case, if either cash or collateral accumulated balances are not required for the computation of the charge, the column is left blank by the bookkeeping machine operator.

Interest income on mortgage and other loans is recorded directly in the cash receipts book when received. As previously described, interest on mortgage and other loans is not accrued as at the close of the period under review and the amount of accruable interest thus excluded from the financial statements is not significant in relation to total assets.

Credits to income resulting from the amortization of deferred discounts on mortgage and other loans are recorded at the end of each month by summary entry in the general journal.

I. Income from charges to accounts receivable loan customers.
   A. As previously described, the working papers include a schedule of the details of accounts receivable loan contracts in force. Examine the company's loan contract file and bring the contract schedule up-to-date.
   B. For two months of the period under review, foot the income register and trace the totals to the income account in the general ledger.
   C. Select two test months, one of which should be the last month of the period under review and perform the following:
      1. Check the accuracy of the final entry in the accumulated balance column of the ledger cards in the subsidiary accounts receivable loans ledger. (cash and/or collateral

where applicable as determined by the loan contract)

2. Referring to the schedule of loan contracts in force for applicable finance charge rates, check the accuracy of the computation of the monthly charge to each customer and trace it to the income register.
3. Determine that all customers have been charged for the month and that the charge has been recorded in the income register.

II. Interest income on mortgage and other loans.

A. For two months of the period under review, scan the entries in the interest income column of the cash receipts book. The names of the payors should be familiar as being mortgage and other loans customers. Investigate the sources of interest from unfamiliar names.

B. On a test basis for several entries in each month, check the accuracy of the amount of the interest. Approximately 50 items should be tested for the period under review.

III. Amortization of deferred discounts on mortgage and other loans. The audit procedures covering "Deferred Discounts" account for the income from this source in detail for the period under review.

IV. Prepare a summary schedule of income by months from the above sources and compare the sum of the totals to the income account in the general ledger.

### Expenses

*Office Salaries*

A. For the period under review obtain the detailed analysis of office salaries by month and employee and compare the total thereof to the expense account in the general ledger. (The weekly payroll check is drawn to "cash." This step is requested by the managing partner.)

B. Prepare or obtain a schedule of employees' salary rates indicating the following:

1. Name
2. Position
3. Weekly salary—beginning of the period
4. Weekly salary—close of the period
5. Bonus—prior year
6. Bonus—current year

C. Submit the schedule to the senior partner for approval and determine that the rates are in accordance with those actually paid.
D. Determine that rates, overtime payments and records comply with Federal, State and workmen's compensation insurance regulations.
E. On a test basis (two months of the period under review) foot and crossfoot the payroll journal and determine that the net pay column is equal to the check drawn therefor.
F. Accrue salaries and bonuses to the close of the period under review.

*Payroll Taxes*

A. Analyze Federal and State payroll tax expense accounts in detail for the period under review.
B. Reconcile Federal and State payroll tax returns filed for the period under review.
C. Determine that payroll tax returns are filed on time and that interim payments are deposited in accordance with regulations.
D. Determine that there is a signed W-4 form for each employee.
E. On a test basis, using the latest payroll period available, determine that social security and withholding tax deductions are proper.
F. Check the accuracy of the W-2 forms filed for each employee.
G. Check the accuracy of the computation of the company's State unemployment insurance experience rate.
H. Accrue payroll taxes to the close of the period under review.

*Other Taxes*

Except for payroll tax returns, the various Federal, State and local tax returns are prepared by the accounting firm.

A. For the period under review, analyze the "other taxes" expense account in detail vouching the amounts thereof to duplicate copies of the tax returns and cancelled checks.
B. Accrue the various taxes to the close of the period under review.

*Rent*

A. Check the total rent paid during the period under review to the abstract of the lease in the permanent file of the working papers.

*Other Expenses*

A. Analyze the following expense accounts in detail, vouching all items to bills, cancelled checks or other available data:
    1. Professional fees
    2. Contributions
    3. Insurance

B. On a test basis (items $50. and over) analyze the following expense accounts, vouching test items to bills, cancelled checks or other available data:
1. Commissions
2. Repairs and maintenance
3. Travel and entertainment
4. Stationery, printing and postage
5. Dues and subscriptions
6. General expenses

Expenses applicable to the period under review which were not paid at the audit date, are determined and accrued by examination of the subsequent month's cash books as outlined in the procedures for cash. Prior experience and the nature of the expenses of this company have shown that the method used to determine expense accruals is adequate to reflect the liability therefor in the financial statements. Direct correspondence with expense creditors is deemed unnecessary for this engagement.

### *Other Procedures*

I. Compare the opening balances in the general ledger accounts to our workpaper copy of the adjusted trial balance at the close of the prior year.
II. Foot the general ledger. (Done by comptometer operator.)
III. Vouch all entries in the general journal. (There are very few general journal entries.)
IV. Discuss pencil copy of report and financial statements with client's senior partner.
V. Write separate letter covering recommendations regarding system, internal control, etc.