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Confirmation of public utility accounts receivable; Statements on auditing procedure, No. 14

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Statements on Auditing Procedure

No. 14

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Committee on Auditing Procedure,
American Institute of Accountants,
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Confirmation of Public Utility Accounts Receivable

Query: The XYZ Corporation is a utility with a satisfactory system of internal control and has approximately 50,000 residential, commercial, rural, industrial, and other customers. Is it practicable and reasonable to communicate directly with these customers as a matter of regular procedure in the examination of its financial statements, and if so, how extensive should the confirmation be?

ON OCTOBER 18, 1939, the special committee on auditing procedure of the American Institute of Accountants recommended that, wherever practicable and reasonable, confirmation of accounts receivable by direct communication with the debtors shall be regarded as generally accepted auditing procedure in the examination of the accounts of a concern whose financial statements are accompanied by an independent certified public accountant's report; and that the method, extent and time of confirming receivables in each engagement, and whether of all receivables or a part thereof, be determined by the independent certified public accountant as in other phases of procedure requiring the exercise of his judgment.

The aggregate balance of all receivables of utilities usually averages 2 per cent of all assets and about 10 per cent of annual revenues. Accumulations of receivables materially beyond these percentages result from unusual conditions and would invoke inquiry, apart from the question of confirmation. The average account balance for all accounts receivable of utilities seldom averages more than \$10 per customer.

In dealing with the specific question, it is desirable to discuss it in relation to the receivables under two general categories, namely:

- I. The large accounts — Municipal, other utilities, industrial and miscellaneous accounts receivable
- II. The "mass" accounts—Residential, commercial, rural and merchandise accounts receivable

Statements on Auditing Procedure

Experience indicates that on the average a little less than one-half of the aggregate electric utility receivables is represented by the first group of accounts, consisting of industrial and other large accounts, and that for utilities other than electric the proportion is usually lower.

It is recognized that many utilities do not maintain general ledger control accounts classifying receivables into these two categories; however, most utilities ordinarily maintain sufficient subdivisions in the detail records to permit such a classification.

I. THE LARGE ACCOUNTS—MUNICIPAL, OTHER UTILITIES, INDUSTRIAL AND MISCELLANEOUS ACCOUNTS RECEIVABLE

These large accounts are with organizations which maintain complete accounts and, accordingly, are in a position to express an informed opinion on the correctness of charges made against them. The methods of computation for service rendered to these customers are often very technical, complicated, and difficult to test-check. While internal control is important and must be considered in connection with these accounts, it cannot be relied upon as greatly by the auditor to serve his purposes as in the case of "mass" accounts discussed later. Furthermore, because of the size of individual accounts it is possible for irregularities, if any should exist, to be confined to relatively few accounts. The committee accordingly believes that the extent of confirmation of these accounts receivable should be similar to that of the accounts of an industrial enterprise where comparable conditions prevail.

II. THE "MASS" ACCOUNTS—RESIDENTIAL, COMMERCIAL, RURAL AND MERCHANDISE ACCOUNTS

There are many factors which distinguish this class of accounts from those of the first group. The average number of "mass" accounts of a utility is very large in relation to the gross revenues. The number of these accounts varies from a few thousand for a small public utility to hundreds of thousands in the larger utilities. The individual balances average a few dollars each; even including merchandise instalment accounts an average of \$5.00 per customer is ordinary. Utilities follow the policy of disconnecting service if the "mass" accounts are not promptly paid and in many cases also grant more than ordinary discounts for prompt payment, with the result that the aggregate amount of utility service receivable balances not derived from the current month's billings is generally not significant.

Confirmation of Public Utility Accounts Receivable

The characteristics of these accounts create a large volume of small and simple repetitive operations which require special skill and efficiency for economical performance. As a result these operations are ordinarily assigned to separate employees or departments which operate independently of each other. In the particular case under consideration it was found that the more important separation of duties among employees and departments was as follows:

- (a) Installation and removal of meters or stations
- (b) Meter reading
- (c) Billing and maintenance of receivable ledgers
- (d) Receiving payment on accounts
- (e) Investigation and collection of delinquent accounts

In addition to the above segregation of major duties among independent departments or employees, further secondary checks were employed; for example, rotation of meter readers among routes, checking of new accounts against those previously written off, maintenance of control accounts by employees other than those assigned to detail accounts, requirements that vacations be taken by cashiers, and approval of discounts forfeited.

These segregations of duties among dissociated employees create an internal control which prevents any particular employees from controlling a sufficient number of the operations to conceal material irregularities. Consequently, only relatively petty irregularities are experienced in these accounts and these are ordinarily detected in the normal operation of the system of internal control. It is believed in this case that a sufficient separation of duties exists to assure substantial accuracy and to avoid significant irregularities in the maintenance of the "mass" accounts. In reviewing such systems, the presence or absence of a particular feature of the system should not be stressed unduly unless it is likely to be the source of a fundamental weakness. It is the effectiveness of the system as a whole which is important and which justifies reliance upon the resulting accounts.

In all essential respects, where applicable, controls comparable with the foregoing are also maintained over merchandise accounts receivable. The company collects merchandise instalments as part of its monthly bill for service and, in addition to disconnecting service if the monthly bill is not paid, it follows the practice of repossessing the merchandise after an instalment is thirty days overdue. As a result the amount of overdue accounts is negligible.

Experience gained from reviews and certain test checks, where applicable, of systems of internal control such as the one described indicates that the "mass" accounts receivable balances maintained by

Statements on Auditing Procedure

most utilities are reliable for financial statement purposes, and that, where the system in operation is good, test confirmation is not necessary for the purpose of checking the credibility of the company's representations as to their authenticity.

Where the conclusion is reached for a specific utility that the system in operation is good, experience has nevertheless indicated the desirability of making a small sample or test circularization as an additional check upon the functioning of the internal control. In the case of the XYZ Corporation, which has a satisfactory system of control and approximately 50,000 "mass" accounts receivable with customers and approximately one-half that number of accounts having unpaid balances, it is believed that a confirmation of a few hundred accounts would be fully adequate for this purpose; and that, in view of the purpose of the test, namely, to provide an additional check upon the functioning of the internal control, such a test confirmation is desirable even in cases in which test confirmations may be made by internal auditors employed by the utility.

The division of duties comprising internal control will vary among utilities according to type of utility and concentration of activities. and it should be borne in mind that where a satisfactory system of internal control does not exist, a larger portion of the accounts should be confirmed, the extent thereof being dependent upon the circumstances of the particular situation.

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