Woman C.P.A.

Volume 30 | Issue 1 Article 4

12-1967

Auditor's Approach to Cost Accounting

Pearl A. Scherer

Follow this and additional works at: https://egrove.olemiss.edu/wcpa

Digital Commons Network Logo

Part of the Accounting Commons, and the Women's Studies Commons

Recommended Citation

Scherer, Pearl A. (1967) "Auditor's Approach to Cost Accounting," *Woman C.P.A.*: Vol. 30 : Iss. 1 , Article 4.
Available at: https://egrove.olemiss.edu/wcpa/vol30/iss1/4

This Article is brought to you for free and open access by the Archival Digital Accounting Collection at eGrove. It has been accepted for inclusion in Woman C.P.A. by an authorized editor of eGrove. For more information, please contact egrove@olemiss.edu.

Make Figures Come to Life

The remainder of the annual report copy should attempt to explain the accountants' reports in layman's language and make the figures come to life. For example, a $5 million increase in revenues is converted into so many thousand new homes added to our lines, into new restaurants which have selected gas for their major energy requirements, and into new industries which have chosen to locate in our service area partially because of the availability of natural gas.

The increase in plant account is explained by the number of new customers and new services added and the miles of new main installed to reach new areas.

Payroll costs are converted into the number of employees involved. Their generous contributions to United Good Neighbors and the Red Cross Blood Bank, their acts of heroism and safe driving records, their active roles in local chambers of commerce and school boards—all are emphasized in a continuing effort to create the impression that the Company and its people are "good" citizens of the communities in which they live.

This same treatment is given taxes, capitalization and other financial data in an attempt to make them fully understandable and "real" to the reader. As an added fillip, we usually include a section on our outlook for the future. Here one's imagination can take over but only in a guarded way. Nothing can hurt a company's reputation more than undisciplined representation of its future prospects which may not, or cannot, ever be realized. The expression that "honesty is the best policy" never can be applied more aptly than to a company's corporate mouthpiece—its annual report.

And Finally

Finally, after weeks of galley proofs, page proofs, color separations and color proofs, Van Dykes and corrected Van Dykes, the show case for your statistical data is complete. I hope you will regard it as a fitting one in which to display your merchandise.

Now may I leave you with one last discouraging or fortifying thought depending upon your point of view. I have been told that only two people ever will read our masterpieces all the way through anyway, namely an assistant statistician in some brokerage firm and Old Man Smithers, age 83, who owns ten shares of stock. The latter also will attend the Annual Meeting and make his traditional speech criticizing the Company for the high salaries it pays its management people and the abysmally low dividends it pays its stockholders.

AN AUDITOR'S APPROACH TO COST ACCOUNTING

(continued from page 12)

ing anticipated costs at varying levels of sales, based on each unit of measure. A composite, variable cost can then be taken off for the flexible budget.

After completing the flexible budget, the projected break-even point, marginal income and margin of safety ratio can be computed for the estimated sales volume.

"Break-even point" is the volume of sales which will cover the total fixed costs plus that portion of the variable costs attributable to said volume of sales. In other words, the point at which the sales volume indicates neither profit nor loss to the company. "Marginal income" is the difference between total sales and total variable costs. The "margin of safety ratio" is that portion of sales, at any given volume, which is available to create profits for the firm.

Break-even Point

The results can usually be shown most clearly by the use of a break-even chart. There are many types of charts used, and the type chosen is largely dictated by the factors influencing the cost-volume-profit relationships. In Small Sales Co., Inc.'s projected expansion we have three of these factors at work: first, a change in the volume of sales; second, a change in the variable cost per dollar of sale; and, third, a change in total fixed costs. In my opinion, the most effective way to show the effects of these changes would be a line chart, with the base line representing sales and the verticle line revenue and costs. By a diagram representing the present figures, with the projected sales, fixed, and variable costs superimposed, the increase in gross sales required to make the expansion profitable is clearly shown. Even more important is the margin of safety ratio and the break-even point. Obviously, if this break-even point is higher than the maximum gross sales anticipated, the expansion cannot be profitable. And, even if it is within the anticipated sales range, if the margin of safety ratio is too small, loss probabilities far outweigh profit probabilities.

This conclusion is disappointing to everyone concerned, but it is not nearly as devastating as the results of the 'trial by error' method, which generally leaves a bankrupt company and stockholders with a total loss of their investment.

To me, putting accounting figures to work in order to assist management in making decisions is one of the most fascinating aspects of public accounting.

AN AUDITOR'S APPROACH TO COST ACCOUNTING

Pearl A. Scherer, CPA
Fountain Valley, California

Prior to going into public accounting, I had been employed for a number of years as a government accountant. I had become used to very complete and detailed records, kept in the same precise fashion whether my office was in California, the Philippine Islands, or Alaska.

It was quite a shock to me, therefore, when I first faced the task of trying to prepare even an unaudited report on a small retail firm. What I later came to recognize as a rather complete recording system, consisting of a general ledger, sales journal and cash disbursements ledger, appeared to me to be woefully inadequate. It wasn't until I faced the task of converting a box of miscellaneous receipts, cancelled checks, or invoices into one or more of these records that I reorganized my idea of what constituted "adequate" records.

One major difference between a public accountant and an industrial accountant is that the public accountant is only an accountant part-time. The rest of the time she (and by inference I include our male counterparts) is a salesman—selling herself, her knowledge and abilities to clients. One of the major tools she has for this selling job is cost control for small business.

To find out one way it is done, come with me while we visit Small Sales Co., Inc. The owner-manager of this small, retail firm has asked our firm to review his accounting records, prepare a report and his corporate tax returns for the current year. When asked if he wanted an audit, his rather irritable reply was, "Certainly not. I can't afford one."

So our job is now two-fold: first, to do what our firm was hired to do; and second, to sell Mr. Manager on our firm's ability to show him how to increase his net profit from the business more than enough to offset our audit costs. In the past few years we have heard much about how the Government, through its tax and regulatory functions, has extended the requirements of an annual audit to business. And it *has* helped, because showing a businessman how to reduce his income taxes is showing him how to increase his net profit, just as showing him how to cut his payroll or equipment cost would be.

But most businessmen are not familiar with income tax law, and it is often when the firm's income taxes become heavy that an auditor is first called in, as is the case with Small Sales Co., Inc. However, there are as many areas in which costs may be reduced as there are types of cost. A good auditor must be familiar with all of them, and scrutinize each area in every business audited.

Cost Control Tool—Comparisons

The basic tool of the auditor for cost control in small business is the comparative statement of income, presented in percentages of gross profit as well as in actual dollars. In the majority of audit reports this comparative income statement covers the current and the preceding period; but in many cases it will cover several periods—as many as the particular auditor thinks appropriate and informative. In a long form audit report you will usually also find a condensed comparative statement of income covering several prior periods, with appropriate comments. And, in every case, when discussing the audit report with management, the auditor should present this comparative information and comments so it will usually appear in any good set of working papers.

This brings us back to you, the on-the-job auditor of the Small Sales Co., Inc. In auditing a firm's records, and sometimes when preparing unaudited statements, a summary of the major items included in each expense account carried on the books is prepared as a regular part of the working papers. After the first few annual reviews, this may only indicate, "Same as prior period", but it should be there. By referring to the prior year's working papers while making her current review, the auditor can pick up changes in the classification of expenses, and radical increases or decreases in recurring expenses

---

PEARL A. SCHERER, CPA, Orange County Chapter, ASWA, has had a varied career in government and in public accounting practice. Among her 'firsts' are first woman CPA in Alaska, first woman to serve as president of a state society of CPAs, and first woman to serve on Council of American Institute of Certified Public Accountants. Mrs. Scherer presented this paper at a technical session during the course of the 27th Annual Meeting of AWSCPA-ASWA in Portland, Oregon in September.

(which are usually a "red flag", marking something that needs further investigation). Very often an alert auditor will pick up a hint that a new contract exists, or that a change has been made in the terms of a lease which have not been given her by management and which has not shown up in the balance sheet review.

Also, in auditing a closely-held business, the auditor must always be on the lookout for the tendency to "hide" personal expenditures by including them in business expense accounts. Time limitations do not permit an auditor to investigate every item of expense, so she must choose the ones she will scrutinize more closely by random selection, her knowledge of the attitudes and peccadilloes of management of the particular business, and a sort of sixth sense for trouble. This latter has absolutely nothing to do with women's intuition, but comes from experience and familiarity with various businesses.

In order to prepare an informed comparative statement of income, the major variations in costs from period to period must be fully catalogued and explained. So *all* expense accounts showing radical changes in total expenditures for the year must be investigated. One of the indelibly embarrassing moments in the early life of an in-charge senior auditor is to return from an out-of-town engagement, especially if the distance is considerable, prepare the draft of the report and have the reviewer ask why there is no explanation of a significant increase or decrease in the cost of a particular item.

Percentage Comparisons

Often what appears to be a minor change in the total cost of an account in the current as compared to the prior period will show up as a significant variation when expressed in percentages of gross profit for the two years. This is why the experienced auditor always prepares a draft balance sheet and statement of income in the field; and why the auditor busily computing percentages on a slide rule in a client's office used to be a common sight. In this day of magnificent machines, computing percentages is done more automatically, but it is done. And a second, or possibly even a third, look is then taken at all variances to insure inclusion in the working papers of a clear and concise explanation of what is included in the account in both periods, and to pinpoint the item or items that resulted in the increase or decrease. It is also advisable to go on into the period subsequent to the audit date, and determine the current status of such items.

With this type of information, it is easy to show the client how an increase in advertising costs, without a corresponding increase in sales, resulted in a decrease in net profit. However, a successful auditor will go further, and also show the client how a portion of this decrease is offset by the decrease in income taxes for the period; and, if possible, how the additional advertising is increasing sales in the period subsequent to the audit date. Everyone prefers to have his judgement vindicated, and it is a wise auditor who looks for all the ways to do this before telling a client that he has made a bad mistake.

By-Product Benefits

Several by-products result from this type of audit report presentation. First, the client and his staff soon become quite cost conscious. Perhaps not to the extent of setting up a cost control records system, but at least to the point of scrutinizing each proposed expenditure in relation to its effect on the business as a whole; and, usually, to requiring a comparative statement of income quarterly instead of just annually. Second, management generally is eager to report this type of cost information to stockholders when it reflects good management policies and so you have a better informed group of stockholders. This is important in a small corporation, because owning stock in Small Sales Co., Inc. is generally not the same thing as owning shares in General Motors. The stockholder in Small Sales Co., Inc. is vitally interested in the management of "his" corporation, its internal working, its expansion policies, and its net profit; and he usually does not hesitate to let management and/or the auditor know if it is not up to his expectations.

Projections—The Educated Guess

The next step in the cost accounting affairs of Small Sales Co., Inc., insofar as the auditor is concerned, usually occurs when a sizeable expansion is projected. This may be larger quarters for the present retail outlet, a branch in another locality, or a decision to expand the sales territory through salesmen in the field. Management is now used to running a tightly knit and profitable organization, and has become sufficiently versed in modern merchandising and accounting methods to realize that a continuation of its present policies might not result in continued profitability under changed and expanded conditions.

So the manager approaches our firm with the question, "How can we tell if this proposed expansion will really be profitable?" Of course, auditors do not guarantee results, and we must make this perfectly plain to the manager. However, the auditor and management together can work out an "educated guess"

(continued to page 12)

the sole proprietorship assets were sold to the corporation at a profit, which was reported as a capital gain. The Treasury Department attempted to tax part of the appreciation realized at ordinary income rates, on the theory that any amounts received in excess of the value of the tangible assets transferred represented a dividend to the taxpayer.

The Tax Court was satisfied that the amount paid by the corporation for the assets, including goodwill and other intangibles, represented the fair market value of the business transferred, and no dividend distribution was involved.

AN AUDITOR'S APPROACH TO COST ACCOUNTING

(continued from page 10)

through cost-volume-profit studies and break-even analyses.

Essentially these reports are a compound of future marketing information, and prior cost information. But the starting point, as in any study of cost and profit probabilities, is the estimation of costs at various levels of output, or sales. The first step is to determine which costs are fixed or constant and which are variable or change with output volume. Variable costs are also sometimes referred to as "controllable" costs for obvious reasons. In a retail outlet, such as our Small Sales Co., Inc., a fixed charge would be rent or depreciation of current premises, while a variable charge would be delivery costs. Some costs can be fixed in one set of circumstances, and variable in others. Normally utilities, for instance, are considered a fixed cost, because retail premises must be heated and lit regardless of whether the customers are few or many. However, if you are considering extending the hours of operation during which you heat and light the premises, then this cost becomes a semi-variable one, varying intermittently when the unit of measure, in this case, hours, reaches a certain level.

Once you have your costs indexed as to fixed, variable, or semi-variable, you can prepare a static budget, based on prior cost records, for a single volume of business activity. A budget for a retail outlet differs greatly from that of a manufacturing concern. It generally contains the information referred to in most discussions of budgeting as "selling and administrative" expense, plus direct materials cost. Since it eliminates manufacturing costs, these other items can be set forth in greater detail, and are often departmentalized into sales, warehousing, and administration expense. For our purpose, all costs must also be classified as fixed, variable or semi-variable.

From our prior years' audit statements we have percentage figures for cost of goods sold and gross profit at different sales volumes. Applying these percentages, modified for any changes in cost of goods sold due to volume buying or price changes, we can set up a fairly accurate flexible budget of gross profit to be derived from varying levels of sales. Of course, we rely heavily on the Company's marketing department, if there is one, or on management to determine the prospective sales volume and changes in cost of goods sold. Our job, as auditors, is to assist in the development and analysis of the financial data, arrange the figures in an acceptable manner, prepare the final reports, and use our knowledge of business enterprises in general, and this one in particular, to keep management's projections within the realm of possibilities. Our role requires us to be completely independent and objective in our thinking; and to look at the dark side of the picture rather than join wholeheartedly in management's enthusiasm. We are more management's adversary than its champion in the conferences during which future projections are put forth, analyzed, discussed, and, finally, established.

Flexible budgets are usually set up in variations of ten percentile points of the static budget, which is assumed to be 100% of present capacity. Thus, we might start at 70% of the static budget figures and go up to 150%, or whatever spread seems reasonable. The fixed costs will remain just that, fixed—regardless of changes in sales level. The variable costs will vary consistently, at the same rate as the increase or decrease in sales, so we simply apply the same percentages to compute each level of these costs.

The tricky computations concern the semi-variable costs, since each of these may vary according to a different unit of measure. For instance, the unit of measure of the utilities may be the hours of retail operation; of the salaries it may be the additional space to be covered by salesmen plus the additional hours of operation; while of the administrative travel the cost unit may be the number and duration of management's trips anticipated between the old and new locations.

Also, the unit of measure may be estimated rather than historical, so management and the auditor must work very closely together to arrive at realistic estimates and units of measure. For each of these costs, or group of costs, having more than one unit of measure, a separate schedule must be prepared, show-

(conclusion on page 8)