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New York C. P. A. Examinations of June, 1912

BY PAUL-JOSEPH ESQUERRÉ, C.P.A.

UNIVERSITY OF THE STATE OF NEW YORK

33D ACCOUNTANT EXAMINATION

AUDITING

Wednesday, June 26, 1912—1:15 to 4:15 p. m., only

"The Regents of the University shall make rules for the examination of persons applying for certificates under this act, and may appoint a board of three examiners for the purpose. * * * " (Laws of 1896, ch. 312, sec. 2.)

Answer 10 questions but no more, selecting at least two questions from each group. Answers in excess of the number required will not be considered. Do not repeat questions but write answers only, designating by number as in question paper. Check (v) the number of each one of the questions you have answered. Each complete answer will receive 10 credits. Papers entitled to 75 or more credits will be accepted.

Group I

1. If you were sent to make the first audit of a concern what are the steps you would take?
2. What condition of office organization, above all others, leads to fraud and defalcation by bookkeepers and cashiers? Support your opinion.
3. In making an audit of a concern doing a mercantile business, what would you require to enable you to certify to the correctness of the inventory of merchandise that they had prepared?
4. What means would you employ to verify the usual cash receipts of the average social club?
5. Give at length your views on the "ethics" of accountancy.

Group II

6. Assuming that you are a certified public accountant and employed as auditor by a corporation, state what you would consider it your duty to do in order to safeguard your clients

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regarding the fire insurance that they carry on their stock of merchandise.

7. A foreign agent of a life insurance company sends monthly the following data: a report showing his receipts and disbursements, with dates; vouchers supporting the disbursements; list of overdue premiums; a statement of his daily cash balances in bank, supported by a certificate from his bank as to his closing balances. How would you audit his report?

8. A company has acquired, at \$90 per share, 100 shares of its own capital stock, of the par value of \$100 per share. Its balance sheet shows treasury stock \$9,000. Is this correct? If so why? If not state how you would adjust the books.

9. Describe briefly the way you carried out an audit which you planned and conducted personally.

10. In auditing the books of a corporation capitalized at \$250,000 you find that three years previously they acquired the business of a copartnership included in which was an asset called goodwill valued at that time at \$25,000, since which the same has not been written down. The average profits of the corporation for three years have been 9% on the capitalization. How would you treat the item goodwill? Give reasons.

Group III

11. What steps would you take to audit the Notes Receivable Purchased and the Notes Receivable on Commission held by a commercial paper house, to satisfy yourself that there had been no fraud by substitution?

12. The cashier of a concern is at the same time its book-keeper. During his absence on vacation slight irregularities are discovered and you are engaged to audit his books. He returns on the day you begin your audit and admits a defalcation of \$5,000. Knowing that his receipts were supposed to be deposited daily in the bank, state the steps that you would take to ascertain the truth of his admission.

13. The result of your count of the "cash on hand" at a large agency on January 1, 1912, discloses:

Bills	\$1,979.00
Coin	484.19
Cash items supported by properly signed vouchers:	
Jan. 14, 1908. Sub-agent Jones	\$200.00

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July 20, 1909.	Sub-agent Thomas	140.00	
Aug. 20, 1909.	Sub-agent Vincent	75.00	
Sept. 30, 1910.	Sug-agent Nelson	230.00	645.00
			<hr/>
	Cash balance as per general ledger	\$3,108.19	<hr/> <hr/>

Does this count complete your duty as an auditor? If you consider that further steps are necessary state what you would do.

14. What instructions would you give to a junior accountant to whom you had entrusted the audit of the account Investment in Bonds and mortgages appearing on the books of a trust company?

15. You find that a concern whose books you are auditing has capitalized the amount of royalties that it would have had to pay on the sales of a three years' period if it had not owned the patents. On the increase of surplus thus obtained the directors have declared a stock dividend. Would you consider yourself called on to criticize the action of the directors? If so state what would be the character of your criticism.

ANSWERS TO AUDITING QUESTIONS

Answer No. 1

Require the production of all books of account kept by the concern, and of all subsidiary records and memoranda pertaining thereto; make complete list of these documents, stating the titles borne by the books themselves, the names by which they are known to the persons in charge of them, and the technical terms given to them by accountants. List the names of the persons in charge of, and responsible for, each record, and earmark every document in such a manner as to insure absolute identification.

Become familiar with the general nature of the enterprise, its financial and business policy, its sources of income, its channels of disbursements, and its accounting methods, including the system in vogue in regard to making, posting and filing vouchers, invoices, receipts, and all other documents likely to have a bearing upon the audit.

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If the concern is a manufacturing one, obtain as much information as possible in regard to manufacturing processes, factory organization and management, and conditions prevailing in similar enterprises.

Answer No. 2

That species of cumulation of clerical functions which entrusts the cashier with the keeping of ledgers containing personal accounts, is the most obvious fault of office organization. It makes it possible for the "Bookkeeper-Cashier" to commit fraud not easily detected, by:

- a. Permitting him to substitute fictitious credits in connection with merchandise returned, allowances on defective goods, discounts, overcharges, etc., etc., for actual cash receipts, which he is thus enabled to appropriate.
- b. Making it easy for him to withhold cash receipts for indefinite periods before entering them in the cash record, while, at the same time, recording them to the credit of the customers in their ledger accounts.
- c. Enabling him to enter to the debit of impersonal accounts, cash disbursements which are properly chargeable to personal accounts. This practice permits the "Bookkeeper-Cashier" to secure the duplicate payment of creditor's accounts, and to divert to his own fraudulent use the funds first improperly charged to impersonal accounts.

Answer No. 3

1. Ascertain whether the inventory record produced is the original document, or a copy thereof.

If an original document, require the person under whose supervision it has been taken in each department, to certify in writing to the accuracy of the quantities recorded. If a copy, take or cause to be taken, such steps as will guaranty that it is a certified, thorough, and accurate transcript of the original document.

2. In either case: (a) investigate carefully the effect of all changes in quantities and in money values said to have been due to errors, and ascertain the legitimacy of the reasons given for the changes; (b) ascertain, by means of comparison with in-

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voices, whether or not the prices used for the computation of the inventorial values are not higher than cost.

3. Summarize the inventory by classes of merchandise, and, if possible, compare the results thus obtained, with the preceding inventories, to determine:

1. Whether or not unsaleable or obsolete goods are accumulating, and, if so, what provisions are made for depreciation.
2. Whether or not considerable fluctuations in prices have obtained during the period.
4. Check the footings of the entire inventory, and test the extensions.
5. Further steps depend upon the nature of and the conditions prevailing in the business, as well as upon the importance of the discrepancies which have developed during the audit.

Answer No. 4

Ascertain, from an authoritative and up-to-date list of members, and from the membership committee's minute book, that all initiation fees, dues and assessments, have been recorded in the members' ledger. Obtain, if possible, the original charge slips signed by the members for the different club privileges which they have enjoyed, and check them against the members' ledger. Check all receipts from members into the subsidiary ledger the accuracy of which has been ascertained as described above; verify further, if the filing system permits, by comparing the cash book with the duplicates, stubs or counterfoils, of the receipts issued to members upon settlement. Unless objectionable to the board of governors, send to each member a detail statement of his account, asking for confirmation thereof.

Answer No. 5

Mixing with all classes and all types of men, meeting his clients socially as well as in a business way, the accountant should be a man-of-the-world, a "gentleman," with all that the word implies. In order that he may uphold anywhere and in any medium whatsoever the dignity of his profession, the accountant must possess qualities which no training can give if he has not received them at birth, and qualifications which only the

broadest education and the hardest kind of work will secure for him.

He should place the ideals of his profession above personal ambition, and allow no consideration of the weakness and shortcomings of his brother accountants to alter his decision to remain faithful to the code of ethics which he has written for himself. To the crying demands of his materialistic self, he must oppose the aspirations of his professional mind; he must not advertise his willingness to demonstrate his ability, court the favor of the clients of a brother accountant, be a party to a fraud of any kind, shrink from telling the truth irrespective of consequences, and fear to lose a client by taking a stand which his conscience demands him to take. He must be serious, industrious, essentially honest, full of reverence for the noble precedents established by those who have preceded him in the arduous field of accountancy, alive to the dangers which besiege him at all hours of the day, and willing to sacrifice his welfare to his ideals, and to his love for his profession.

Answer No. 6

Compare the policies of insurance with the record thereof and examine each policy to ascertain: (a) that the stock of merchandise is described in precisely the same words in each policy, and that its location is likewise properly and concurrently described in each policy; (b) that the description of the merchandise, as found in the insurance contract, reflects fully, fairly and adequately, the merchandise which the policy is supposed to cover as shown by inventory; (c) that the co-insurance clause (if any) is concurrent in all the policies covering the same property; (d) that special privilege clauses are concurrently recorded on each policy; (e) that if a chattel mortgage exists against the merchandise, each policy bears evidence that the insurance company has been notified thereof and the mortgage clause duly attached.

2. Determine the amount of insurance carried during each month under audit, and compare the amount with the average merchandise stock during that month. This is to ascertain whether or not the insured was either over or under-insured,

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and if under-insured, to what extent he had become a co-insurer under the terms of the policies.

3. Generally speaking, ascertain that in all other respects the corporation is observing the terms of the contract of insurance as stated in the policies.

Answer No. 7

1. Analyze the agent's report in such a manner as to obtain, day by day, the amount of cash which he should have on hand; compare this analysis with the statement of daily balances furnished by the bank, note all differences, and ascertain how they originated. The importance of this procedure is indicated by the ease with which a foreign agent could report as overdue, premiums which in reality have been collected, and as disbursed in one given month, benefits under policies for which he would settle only in subsequent periods. In this manner, he could arrange to have in bank, on the last day of every month, an amount of cash corresponding exactly with the balance shown by his report, obtain a bank certificate therefor, and successfully cover shortages and misappropriations of funds.

2. Note all disbursement vouchers which are said to be missing, owing to the delay on the part of the policyholders, or to the time which it takes to communicate back and forth between foreign agencies and their sub-agencies; in subsequent audits, compare carefully the date of these documents with the dates at which they appear in the agent's reports of prior periods.

3. If it is found that in the particular agency from which the report comes, it is made to appear that the majority of the policyholders take advantage of the thirty or sixty days of grace which the payments of premiums carry, suggest that the company take some means of ascertaining whether or not the conditions shown by the agent's reports exist as a matter of fact.

4. If agents' commissions are involved in the agency disbursements, compare their rate with the data appearing in the book of agents' contracts kept at home office, and ascertain, by tests, whether or not the policies on which commissions are paid are still in force.

Answer No. 8

The balance sheet of the company is not correct, since it

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shows "Treasury Stock" which is an asset of the corporate entity, as worth \$9,000, while the company's stock liability therefor, to stockholders, is included at a value of \$10,000 in the liability account Capital Stock. The books should be adjusted as follows:

Treasury stock	\$1,000.00
To discount and premiums on treasury stock...	\$1,000.00

To increase the former asset account by the amount of the discount gained by the company at the time of the purchase of its own stock. The account discounts and premiums on treasury stock is to remain open until all the treasury stock has been sold, or otherwise disposed of. At that time, the net of the account will be applied according to the directions of the board of directors.

NOTE. The discounts and premiums could also be closed periodically into the profit and loss account.

Answer No. 9

It is believed that this question is far too good a test of the qualifications of the individual candidates to be answered even in an unofficial way. Since the C. P. A. certificate cannot be granted to one who has not had practical experience, it should not be possible for one not so equipped, to answer questions of this type.

Answer No. 10

It is often said that a common basis for the valuation of goodwill is as follows:

From the total of the average net profits for a certain number of years, deduct 7% on the capitalization, this being the return which the average business man expects to obtain from his invested wealth; the balance is goodwill.

The question as expressed here, does not, it is true, state the number of years of profits purchased by the corporation. But for the sake of argument, we may assume it to have been, say five years. On this basis, the ratio of profit for three years having averaged 9% on the capitalization, and 7% being deducted therefrom, there is left 2% a year earned through the investment

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of capital in goodwill. If we were to write down the value of goodwill within five years, the amount of the writing off would eliminate the very profits which the acquisition of the asset has made possible.

It is evident that, under the conditions the concern was justified in allowing goodwill to remain undisturbed.

Answer No. II

1. The production of all "Notes Receivable Purchased" and "Notes Receivable on Commission" still in the hands of the concern at the date of the audit, should be demanded. Two lists should then be made. One for each class of notes, stating in full all the information which may be of use to prove the accuracy of the books as well as the status of the assets. While the lists are being made, each individual note should be examined carefully, to determine its genuineness.

2. After the lists are completed, their money amounts should be compared with the balances of the general ledger controlling accounts "Notes Receivable Purchased" and "Notes Receivable on Commission."

3. An abstract of the subsidiary records containing the detail of the notes transactions of the period should then be taken in such a manner as to support in every respect the data furnished by the lists.

The importance of this latter step, lies in the fact that notes received on the day of the audit or after the closing of the books, may be submitted to the auditor in such a way as to support balances shown by the books, and, at the same time, cover the fraudulent use of notes received in prior periods. If, however, the abstract of the subsidiary records agrees with the lists in every respect, even as to names of customers whose notes have been purchased or accepted for ultimate disposition subject to commission, no substitution has taken place, and the books may be said to be correct. It might, however, be advisable to obtain confirmation from the makers of the notes, as to the genuineness of the instrument; but this proof is not always available, owing to the unwillingness of the clients to submit to a test which, they often claim, may be understood as an indication that the honesty of some one connected with the firm is involved.

Answer No. 12

1. Obtain from the bank a transcript of the account of the concern as a depositor, and compare this statement with the transactions reflected by the cash book, noting all differences in receipts deposited.

2. If possible, obtain direct from customers and creditors, with the approval of the client, a verification of all ledger balances. Investigate, prove and list any differences which may develop as a result of this test.

3. Scrutinize carefully all credits, other than cash, given to customers, as appearing in their accounts. List all such credits which are either unsupported by vouchers properly approved by the officers of the concern, or which have originated in the journal. Submit this list to the client, and ascertain whether or not he had knowledge of the transactions reflected thereon.

4. Vouch all cash disbursements as recorded, being careful to specially mark all vouchers, receipts, invoices, etc., at time of examination, to prevent their being produced twice.

5. Check footings of cash receipts and disbursements.

6. Require the defaulter to give full power of attorney to a trusted representative of the client, and, through him, obtain transcript of the defaulter's personal bank account. Connect, if possible, the deposits made by him in his own account, with the differences which the investigation has brought to the surface as revealing misappropriations of funds.

Answer No. 13

The auditor has not attended to his full duties in this respect, and the cash balance is not satisfactorily vouched. He should require up-to-date receipts for the funds held by the various sub-agents, to take the place of those stated by the question. The fact that \$200 was paid to Sub-Agent Jones in January, 1908, for instance, although attested by a properly executed voucher, is no evidence that Jones is still an agent, that the company has a claim against him, and that the money has not been refunded to the cashier in the intervening period. The auditor should require the sub-agents' funds to be carried in a separate account, subject to periodical accounting.

Answer No. 14

The audit of this kind of investment could hardly be entrusted

to a "junior" accountant, unless his training and education were such as to guarantee that he will be able to understand and follow the following instructions:

1. *General information which the subsidiary books or record should contain:* Name of mortgagor, amount of the loan, date of the mortgage, and maturity thereof; location and description of the premises; date and amount of appraisal of property, and by whom made; amount of fire insurance carried; name of insurance company, number of policy, date of issue and termination, amount of premiums and by whom payable; date and amount of interest payable under the mortgage, date and amount of payments; partial repayments of principal if the mortgage is repayable in installments.

2. *Information as to the asset.*

The bond is the instrument, the mortgage is the security therefor; the bond may be of an amount greater than the loan, but the only amount collectible by the mortgagee is the amount of his advances, including:

(a) the loan itself, (b) subsequent payments made by him for the security of the pledge, such as the payment of delinquent taxes and assessments which should have been paid by the mortgagor, and which, if allowed to remain unpaid, would have exposed the property to seizure; and the payment of fire insurance premiums also payable by the mortgagor, the non-payment of which invalidates the contract of insurance which is the security of the investor so far as destruction of the pledge by fire is concerned. The bond also covers interest defaulted, and all necessary expenses incurred by the mortgagee in case of foreclosure proceedings. The fee for recording the mortgage is held by courts to be incurred for the benefit of the mortgagee, and not to be chargeable to the mortgagor unless the indenture states that the latter will pay "All cost."

Note and report all cases when the mortgage is said to be "out for recording," so that in subsequent audits, their return may be ascertained.

3. *Accounting.*

The subsidiary mortgage books should be abstracted in such a manner as to show: (a) the cash advances for loans; (b) the cash advances for necessary expenses, and advances other than for loans; (c) the renewals at maturity of the mortgages; (d)

the repayment of principal; (e) the accrued interest not as yet collectible, the interest due and not collected; (f) the collection of interest.

This abstract is to be used to ascertain whether or not the transactions appearing in the subsidiary books is supported by the sundry books of original entry.

Answer No. 15

"Conservative" practice would dictate the periodical writing off of "Patents" during the life of the grant, even though renewal and extension may be possible. On the other hand, the capitalizing under the name "Patents" of an amount equal to the royalties which would have been paid on the sales had the patents not been owned, might well be defended by the directorate of a company whose asset "Patents" represents merely the cost of experiments leading to the patent, and the fees paid to obtain its legal recognition.

The progressive growth of the business resulting from the species of monopoly which patents afford, would naturally point out to the existence of a valuable capital asset, goodwill, whose effect on the prosperity of the company will be felt not only during the life of the patents, but long after they have expired. Hence, if instead of capitalizing goodwill due to patents, the directors of the company capitalize patents up to the amount which they would represent at fair market valuation, no objection would be offered. It would, however, be advisable to insert a footnote in the balance sheet, or a remark in the course of the comments on the audit, calling attention to the fact that the increased value of the asset patents was due to the capitalization of royalties charged to the cost of manufacture.