Review Questions

16–1 Revenue accounts that are verified during the audit of balance sheet accounts are the following (only three required):

<table>
<thead>
<tr>
<th>Balance Sheet Item</th>
<th>Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
<td>Sales</td>
</tr>
<tr>
<td>Notes receivable</td>
<td>Interest</td>
</tr>
<tr>
<td>Securities and other investments</td>
<td>Interest, dividends, gains on sale, share of investee's income</td>
</tr>
<tr>
<td>Property, plant, and equipment</td>
<td>Rent, gains on sales</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>Royalties</td>
</tr>
</tbody>
</table>

16–2 Many analytical procedures are used in the verification of revenue. Typical are the following:

1. Comparison of this year's revenue to last year's.
2. Comparison of month-by-month revenue increments in the current year.
3. Comparison of revenue for each of the current year's months with the revenue of the prior year's comparable months.
4. Comparison of budgeted to actual revenue for each month of the current year.
5. Comparison of revenue to sales or production in units of product.

Any unusual variations developed in the above comparisons should be thoroughly investigated and the reasons therefore obtained.

16–3 Items often misclassified as miscellaneous revenue include the following (only three required):

1. Collections on previously written-off receivables; these should be credited to the allowance for doubtful accounts and notes receivable.

2. Write-offs of old outstanding checks or unclaimed wages; in states having unclaimed property laws these write-offs should be credited to a liability account.
(3) Proceeds from sale of scrap; these are generally applied to reduce cost of goods sold.

(4) Rebates or refunds of insurance premiums; these should be offset against the related insurance expense or unexpired insurance.

(5) Proceeds from sales of plant assets; these should be accounted for in the determination of gain or loss on the assets sold.

16–4 Expense accounts that are verified during the audit of balance sheet accounts are the following (only three required):

<table>
<thead>
<tr>
<th>Balance Sheet Item</th>
<th>Expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts and notes receivable</td>
<td>Uncollectible accounts and notes expense</td>
</tr>
<tr>
<td>Inventories</td>
<td>Purchases and cost of goods sold</td>
</tr>
<tr>
<td>Property, plant, and equipment</td>
<td>Depreciation, repairs and maintenance, and depletion</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>Amortization</td>
</tr>
<tr>
<td>Accrued liabilities</td>
<td>Related expenses, such as commissions, fees, bonuses, product warranty expenses, and others</td>
</tr>
<tr>
<td>Interest bearing debt</td>
<td>Interest</td>
</tr>
</tbody>
</table>

16–5 For income tax returns, the auditors should obtain or prepare analyses of officers' salaries and expenses, directors' fees, travel and entertainment, taxes, contributions, and casualty losses.

16–6 The department heads and other supervisors who direct operations and authorize expenditures should participate in the development of each year's budget and should receive frequent reports comparing actual revenue and cost data with the budget figures. When the budget is used in this way, it serves as a goal and as a measure of performance. The department head who helps set the budget figures for a department feels a personal responsibility for achieving the planned results. Regular reports keep the supervisor informed on variances between the budget and operating results and draw attention to matters requiring managerial attention.

16–7 The reasonableness of selling, general, and administrative expenses may be ascertained by obtaining or preparing comparative analyses of monthly expenses, including expenses expressed as percentages of net sales for both the current and preceding years. Study of the monthly and yearly relationship of individual expense accounts to net sales should reveal any material variation requiring detailed investigation.

16–8 Performing analytical procedures for expenses includes the following four steps:

- Develop an expectation of the amount of the expense balance by considering amounts such as budgeted amounts, prior year audited amounts, industry averages, and amounts developed by expected relationships among financial data or relevant nonfinancial data.

- Determine, based on materiality, the amount of the difference from expectations that can be accepted without investigation.

- Compare the amount of the expense to the expectations.

- Investigate any significant deviation from the expectation.
16–9 The functions of (1) employment (human resources), (2) timekeeping, (3) payroll preparation and recordkeeping, and (4) distribution of pay to employees should be lodged in separate departments to achieve maximum internal control over payroll.

16–10 If wages are paid in cash, it is particularly important that the person compiling the payroll not be responsible for filling the pay envelopes or distributing them to employees. Segregation of the functions of timekeeping, payroll preparation, and payroll distribution is essential to effective internal control.

16–11 Unclaimed wages should be deposited in the bank and credited to a special liability account. When the employee calls for unclaimed pay, a new check is drawn and a receipt obtained from the employee. If the paymaster or cashier is permitted to retain unclaimed wages, an incentive to payroll padding is created along with an opportunity for intermingling these with other funds and thus concealing shortages.

16–12 The "tests of controls over payroll transactions" includes tracing names and wage rates to human resources department records, tracing hours to time reports, tracing deductions to employee authorization forms, testing extensions and footings, comparing amounts to labor cost records, testing reconciliations of the payroll bank account, investigating the handling of unclaimed wages, and comparing of payroll data with payroll tax returns.

16–13 A complete review by the auditor of all correspondence in the client's files is usually out of the question. This would consume an enormous count of time and would yield only incidental benefits. The auditor's use of the correspondence files will usually be limited to a request for letters bearing on issues arising during the examination of other records. These are generally letters to banks and other financial institutions, attorneys, and governmental agencies.

16–14 Analytical procedures performed as a part of the overall review assist the auditors in assessing the validity of the conclusions reached, including the opinion to be issued. The final review may identify areas that need to be examined further as well as provide a consideration of the adequacy of the data gathered in response to unusual or unexpected relationships during the audit.

16–15 The audit procedures that are completed near the end of fieldwork include:
(1) Search for unrecorded liabilities.
(2) Review the minutes of meetings.
(3) Perform final analytical procedures.
(4) Perform procedures to identify loss contingencies.
(5) Perform the review for subsequent events.
(6) Obtain the representation letter.

16–16 Loss contingencies are possible losses, stemming from past events, which will be resolved as to existence and amount by some future event. Prior to the occurrence of the future event, uncertainty exists not only as to the amount of the loss, but also as to whether any loss has actually been sustained. Loss contingencies should be disclosed in notes to the financial statements whenever it is reasonably possible that a loss has been sustained (or when disclosure is warranted by tradition). If both (1) it is probable that a loss has been incurred and (2) the amount of the loss may be reasonably estimated, loss contingencies should be recognized as actual losses in the financial statements.

16–17 The usual procedure followed by the independent auditors in obtaining evidence regarding pending and threatened litigation against the client is a letter of inquiry (or lawyer's letter) sent to the client's legal counsel. The auditors obtain from management a list of such litigation and ask the client's attorney to
comment on this list, add any items to make it complete, and indicate any differences of opinion with management regarding the probable outcome.

16–18 An unasserted claim is a potential legal claim for which no claimant has demonstrated an intent to pursue legal remedies. Often, however, it is merely a matter of time before an unasserted claim becomes pending litigation. It is not the act of litigation being filed which creates a loss contingency for the defendant. Rather, it is having performed the acts which provide the basis for that litigation. To illustrate an unasserted claim involving the likelihood of loss, assume an airliner crashes in a populated area. For a short period of time, no claimant may exhibit intent to sue. In the long run, however, litigation is inevitable.

FASB ASC 450 requires disclosure of unasserted claims when it is (1) probable that a claim will be asserted and (2) reasonably possible that the outcome will be adverse. Unasserted claims not meeting these criteria need not be disclosed.

16–19 No. The status of the IRS's review is not generally disclosed in the notes to the financial statements. However, the auditors should review the prior year returns to make certain that any contingent liabilities for prior taxes are appropriately reflected in the financial statements.

16–20 The term commitment means a contractual obligation to carry out a transaction at a specified time in the future. Examples include commitments to sell merchandise at fixed prices, to buy goods at fixed prices, and to employ an executive at a stipulated salary for several years in the future. If commitments were a material factor in a company's operation, they should be disclosed in a note to the financial statements.

16–21 General risk contingencies are the many factors in the business environment of a particular entity that involve some risk of causing future loss. Examples include the risk of natural catastrophes, competition, strikes, and future raw material shortages. General risk contingencies should not be disclosed in financial statements. In the event that a loss actually occurs, that loss, of course, will be recognized in the financial statements.

16–22 "Subsequent events" are events occurring after the date of the balance sheet under audit but prior to completion of the audit and issuance of the report.

16–23 In evaluating their audit findings, the auditors consider (1) known misstatements, (2) projected misstatements, and (3) other estimated misstatements. By accumulating these types of misstatements, the auditors obtain an estimate of the total likely misstatement in the client's financial statements. If, based on this estimate of the total likely misstatement, the auditors conclude that there is an unacceptable high risk of material misstatement in the financial statements. They should then attempt to get the client to adjust their financial statements for the known misstatements, or perform additional tests to determine if the likely misstatements actually exist.

16–24 A disclosure checklist is a list of specific disclosures required by the FASB, the GASB, and the SEC. The purpose of the checklist is to assist the auditors in evaluating the adequacy of the disclosures contained in a set of financial statements.

16–25 Auditors read the other information and consider whether it is materially inconsistent with information appearing in the audited financial statements. If the other information is inconsistent, and the auditors conclude that neither the audited financial statements nor the audit report requires revision, they should request the client to revise the other information. If the client will not revise the information, the auditors should include an additional paragraph in their report indicating the inconsistency, or withdraw from the engagement. The auditors should also be alert for, and discuss with the client, other types of material misstatements included in the other information.
16–26 No. Because the supplemental information is considered unaudited, misstatement of it does not result in a qualified or adverse opinion. An emphasis-of-matter paragraph is added to the audit report.

**Questions Requiring Analysis**

16–27 The subsequent events evidence supports the removal of the account receivable from the bankrupt company from current assets, and its reclassification as a note receivable under the “Other Assets” classification. Any portion of the note due within the longer of one year or the client's next operating cycle should be classified under current assets. A note to the financial statements should describe the subsequent event. Auditors should use all available evidence—including evidence provided by subsequent events—to ascertain the fair presentation and disclosure of items in the client's financial statements.

16–28 Since the events or conditions that should be considered in the financial accounting for and reporting of litigation, claims, and assessments are matters within the direct knowledge, and often control of management of an entity, management is the primary source of information about such matters. Accordingly, the independent auditor's procedures with respect to the existence of loss contingencies arising from litigation, claims, and assessments should include the following:

1. Inquire of and discuss with management the controls adopted for identifying, evaluating, and accounting for litigation, claims, and assessments.

2. Obtain from management a description and evaluation of litigation, claims, and assessments that existed at the date of the balance sheet being reported on, and during the period from the balance sheet date to the date the information is furnished, including an identification of those matters referred to legal counsel. Wong also would obtain assurances from management, ordinarily in the form of a representation letter, that they have disclosed all such matters required to be disclosed by generally accepted accounting principles (FASB ASC 450).

3. Examine documents in the client's possession concerning litigation, claims, and assessments, including correspondence and invoices from lawyers.

4. Obtain assurance from management, ordinarily in the form of a client representation letter, that it has disclosed all unasserted claims that the lawyer has identified as probable of assertion and must be disclosed in accordance with generally accepted accounting principles (FASB ASC 450). In addition, the auditor, with the client's permission, should inform the lawyer that the client has given the auditor this assurance. This client representation may be communicated by the client in the inquiry letter or by the auditor in a separate letter. The auditor also should request the client's management to send a letter of inquiry to those lawyers with whom it consulted concerning litigation, claims, and assessments. Examples of other procedures undertaken for different purposes that might also disclose litigation, claims, and assessments are the following:

   a. Reading minutes of stockholders', directors', and appropriate committee meetings held during and subsequent to the period being examined.
   
   b. Reading contracts, loan agreements, leases, and correspondence from taxing or other governmental agencies.
   
   c. Reviewing correspondence with financial institution regarding guarantees and accommodation endorsements.
   
   d. Inspecting other documents for possible guarantees by the client.
16–29 No, the senior is in error. No loss has occurred. The senior auditor is concerned about the possibility of a future loss. All businesses face the risk of loss from numerous factors called general risk contingencies. A general risk contingency represents a loss that might occur in the future, as opposed to a loss contingency that may have occurred in the past. The risk of future loss is inherent in the business and is a general risk contingency rather than a loss contingency.

16–30 

\[ \begin{array}{|c|c|c|c|c|c|}
\hline
& \text{New Course Books} & \text{Used Course Books} & \text{General Books} & \text{School/Office Supplies} & \text{Insignia Apparel} \\
\hline
\text{Sales} & $543,400 & $234,100 & $45,500 & $63,400 & $45,300 \\
\text{Cost of sales} & 396,682 & 154,974 & 27,300 & 42,893 & 27,633 \\
\text{Gross margin} & 27.0\% & 33.8\% & 40.0\% & 32.3\% & 39.0\% \\
\hline
\end{array} \]

b. The answer to this question will depend on the statistics at the time the student accesses the National Association of College Stores’ homepage. However, the students should find that the following gross margins appear to be unusual:
- New Course Books
- General Books
- School/Office Supplies

16–31 

\[ \text{a.} \]

A "subsequent event" is an event or transaction that occurs subsequent to the balance sheet date, but prior to the issuance of the auditor's report. The subsequent event may have a material effect on the financial statements and therefore may require adjustments to or disclosure in, the financial statements.

The first type of subsequent event includes those events that provide additional evidence with respect to conditions that existed at the balance sheet date and affect the estimates inherent in the process of preparing financial statements. This type of subsequent event requires that the financial statements be adjusted for any changes in estimates resulting from such additional information.

The second type of subsequent events includes those events that provide evidence with respect to conditions coming into existence after the balance sheet date. These events should not result in adjustment to the financial statements, but may be of such a nature to require disclosure to prevent the financial statements from being misleading.

\[ \text{b.} \]

The specific auditing procedures that the auditors should apply at or near the completion of fieldwork to disclose subsequent events include:

(1) Review the latest available interim financial statements.
(2) Review the minutes of stockholders', directors', and appropriate committees' meetings through the date of the audit report.
(3) Make inquiries of appropriate client officials.
(4) Obtain a letter from the client's attorney describing any pending litigation, unasserted claims, or other loss contingencies.
(5) Obtain a letter of representations from the client concerning subsequent events. This letter should be dated as of the date of the audit report.

16–32 Neither alternative advanced by the controller is acceptable. No liability was created at the date of signing the agreements; Lane Company's obligation arises only as the ex-president fulfills his obligations under the agreements. In the case of the first agreement, the company is obligated to make the payments
only if the ex-president honors his agreement not to compete; in the second agreement, payments are required only if advisory services are provided. In effect, both agreements are commitments that should be fully described in a note to the financial statements.

16–33  

a. The two approaches to considering the effects of prior misstatements that were not corrected are the rollover approach and the iron curtain approach. The rollover approach considers only the amount of misstatement originating in the current income statement. It ignores the effect of misstatements that have accumulated in the balance sheet.

   The iron curtain approach considers the effect of correcting the entire amount of the misstatements in the current year regardless of when the misstatements originated.

b. SEC Staff Accounting Bulletin No. 108 requires the auditors to consider both approaches. If considering the misstatements under either approach results in financial statements that are material misstated the auditors should propose that the financial statements be corrected.

16–34  

Ward should immediately investigate the $170,000 liability for consulting services. If he determines that the liability existed at June 30, 20X0, he should request the controller of Dexter Company to immediately mail a notice to the 150 shareholders and to the creditors who received the company's June 30, 20X0, annual report. The notice should state that the financial statement and audit report are no longer to be relied upon. Since Dexter Company is not subject to the jurisdiction of the SEC, that agency need not be notified.

   If management of Dexter Company refuses the auditor's request, he should immediately notify all members of the company's board of directors of management's refusal. Ward should also inform the board that if the directors refuse to act, he will have to inform the state corporation regulatory authority. If possible, it would also be appropriate for Ward to notify all known shareholders and creditors who are presently relying upon Dexter's June 30, 20X0 annual report that his report on Dexter's financial statements can no longer be relied upon.

16–35  

a. Using the iron curtain approach, Tanner would consider whether $150,000 understatement of prepaid expenses (and related understatement of expenses) is material to the 20X5 financial statements.

b. Using the rollover approach, Tanner would consider whether only the $50,000 understatement of prepaid expenses (and related understatement of expenses) is material to the 20X5 financial statements.

c. SEC Staff Accounting Bulletin No. 108 requires the auditors to consider both approaches. If considering the misstatements under either approach results in financial statements that are material misstated the auditors should propose that the financial statements be corrected. Therefore, if the $150,000 or the $50,000 misstatement is considered material, an adjustment should be proposed.
Objective Questions

16–36 Multiple Choice Questions

a. (4) Testing whether employee time reports are approved by supervisors is an example of a test of a control, not a substantive procedure.

b. (3) The best procedure for the detection of a fictitious employee is a surprise observation of the distribution of paychecks. The fictitious employee’s paycheck will ordinarily not be picked up, and further audit procedures performed by the auditors may reveal that this is a fictitious employee.

c. (4) The purpose of analytical procedures is to locate potential misstatements in the financial statements. The auditors should investigate this significant fluctuation to determine whether it results from a financial statement misstatement.

d. (1) The three sections of a statement of cash flows relate to operations, financing, and investing. Capitalization is not one of the sections.

e. (3) The search for unrecorded liabilities should be completed as of the last day possible—ordinarily near the date of the audit report.

f. (1) The total likely misstatements composed of (a) known misstatements, (b) projected misstatements and (c) other misstatements.

g. (2) A loss contingency is a possible loss stemming from past events that will be resolved in the future.

h. (3) A Type 1 subsequent event relates to a condition that came into effect before year-end; Type 1 subsequent events result in an adjusting journal entry. In this situation, the customer’s check may be assumed to have been uncollectible at year-end, and therefore it would be considered to be a Type 1 subsequent event. The other three replies refer to events most ordinarily considered to be Type 2 events—the events came into existence after year-end.

i. (3) The representation letter should be dated as of the date the audit was completed.

j. (4) The performance of analytical procedures is a required part of the final review stage of an audit and is therefore most likely to be included in that stage of the audit.

k. (2) When the auditor becomes aware of facts existing at the report date that would have affected the report, s/he should next determine whether there are persons relying or likely to rely on the financial statements who would attach importance to the information. If such persons are believed to exist, the next step is to determine the best manner in which to disclose the information.

l. (3) The settlement of litigation is most likely to result in an adjusting entry (i.e., be a ”Type 1 subsequent event) because the cause of the litigation most likely occurred before 20X2.
16–37 Adapted AICPA Task-Based Simulation

a. (1) g. (2)
b. (7) h. (9)
c. (6) i. (3)
d. (8) j. (7)
e. (2) k. (4)
f. (9) l. (7)

16–38 Adapted AICPA Task-Based Simulation

a. Adjustment. The additional liability for the ore shipment would be handled by adjusting the financial statement amounts for purchases, ending raw material inventory, and accounts payable by the amount of the additional charge, $36,256.

b. Disclosure. The details of the agreement to purchase the treasurer's stock would be disclosed in a note because the use of company cash for the repurchase of stock and the change in the amount of stock held by stockholders might have a significant impact on subsequent years' financial statements. Usually, a management change, such as the treasurer's resignation, does not require disclosure in the financial statements. The details underlying the separation (personal disagreements and divorce) should not be disclosed because they are personal matters.

c. No disclosure. Disclosure of the reduced sales is not necessary.

d. Adjustment. The condition was in effect as of December 31, 20X3. Therefore an adjusting entry is appropriate.

e. No disclosure. Analysts’ reports are being issued frequently. One such as this will not ordinarily be disclosed.

16–39 Adapted AICPA Task-Based Simulation

a. Adjustment. The receipt of the shipment of raw materials by Flowmeter on January 3 provides additional evidence with respect to conditions that existed at the December 31 balance sheet date. The raw materials in transit at year-end with terms of FOB shipping point were the property of Flowmeter. Consequently, the financial statements should be adjusted to take into account this new information becoming available after the balance sheet date. The adjustment consists of an increase in inventories and the recording of a related liability.

b. Adjustment. Flowmeter's liability for the accident came into existence in March of 20X3 when the accident occurred. The reason that the liability had not been accrued in the accounts as of December 31, was merely that no reasonable estimate could be made of the dollar amount. The settlement of the litigation provides additional information permitting a reasonable estimate of the amount of the liability. Therefore, this additional information should be used to adjust the financial statements.

c. Disclosure. The purchase of a new business does not provide evidence with respect to conditions existing at the balance sheet date; thus, it is not necessary to adjust the financial statements. However, such an event would usually be of such importance that its disclosure would be required to keep the financial statements from being misleading. If the acquisition is significant enough, the auditor should consider requesting the client to supplement the primary financial
statements with pro-forma statements indicating the financial results if the two firms had been consolidated for the year ended December 31, 20X3.

d. Disclosure. Losses attributable to floods occurring after the balance sheet date do not provide evidence as to conditions existing at the balance sheet date; thus, the financial statements should not be adjusted. However, disclosure of the damage caused by the flood is necessary to prevent the financial statements from being misleading.

e. Disclosure. The sale of bonds or capital stock after the balance sheet date does not relate to conditions existing at the balance sheet date. However, such an event usually is significant enough that it should be disclosed to prevent the financial statements from being misleading.

16–40 Definitions

1. 
2. 
3. 
4. 
5. 
6. 
7. 
8.

Problems

16–41 SOLUTION: Maxwell Company (Estimated time: 20 minutes)

MAXWELL COMPANY
Proposed Adjusting Journal Entry
April 30, 20X2

Accumulated Depreciation: Machinery $ 8,000
Miscellaneous Revenue 15,424
Cost of Goods Sold 5,843
Unclaimed Checks 1,100
Allowance for Doubtful Accounts 4,381
Machinery 10,000
Gain on Sale of Machinery ($3,500 – $2,000) 1,500
Unexpired Insurance (11/12 × $600) 550
Insurance Expense (1/12 × $600) 50

To correct allocation of items erroneously credited to Miscellaneous Revenue.

16–42 SOLUTION: Traders Restaurant (Estimated time: 20 minutes)

The auditing procedures that would be employed to verify the total annual sales of Traders Restaurant include the following:

(1) Examine the lease to determine the exact terms defining the kinds of sales to be included in or exempt from the rental calculation.
(2) Obtain a copy of the restaurant's annual financial statements (or a trial balance of the general ledger) and trace significant amounts to the general ledger.

(3) Test the footing of the daily sales journal and compare with sales entries recorded in the general ledger. Foot the general ledger Sales account and compare the year's sales with the sales reported to the lessor. Scan the general ledger Sales account and investigate unusual entries.

(4) Test the sales figures entered in the daily sales journal by comparison with the source of the figures, which may be the cash register tapes, or the auditors' adding machine tapes of the restaurant checks.

(5) If the daily sales figures are obtained from a cumulative sales register in the cash register and if the register cannot be turned back to zero, ascertain whether the total sales for the year can be computed by comparing the register dial reading at the beginning of the year and at the end of the year. If the daily sales are summarized on a daily cash report before being entered in the daily sales journal, review these reports and compare them with daily sales. Inquire about any abnormal cash overages or shortages.

(6) Review the daily sales journal for deviations from sales patterns and obtain explanations for the deviations. On a test basis, for days showing such deviations, obtain all the restaurant checks and add the check totals to verify the total daily sales. In addition, determine that there was a proper cutoff of sales at year-end.

(7) Test the files of restaurant checks to determine that the checks are being used in numerical sequence and that all are accounted for. Review invoices from the supplier of restaurant checks to determine, if possible, that all checks purchased are accounted for. Inspect inventory of unused sales checkbooks.

(8) As an analytical test of sales, obtain the restaurant's bank statements. Reconcile the total cash deposits for the year, adjusted for miscellaneous cash disbursements such as freight charges, withdrawals, and so on, with total annual sales.

(9) As another overall analytical test, determine the restaurant's net cost of food for the year and apply a markup percentage to arrive at the approximate total annual sales. The net cost of food should be adjusted for meals furnished to employees.

(10) Compare the total sales reported to the lessor with sales reported on the restaurant's sales tax or gross receipts return, if any, and on its income tax returns.

16–43 SOLUTION: Internal Control, Tests of Controls, Substantive Procedures (Estimated time: 20 minutes)

a. (1) Separation of the human resources and approval functions is designed to prevent overpayment of payroll amounts or payments to fictitious employees.

   (2) If the same employees perform the functions of timekeeping and distribution, they have an opportunity to report the attendance of individuals who have resigned, and divert their payroll checks to their own use.

b. (1) and (2) Segregation of duties is tested by making inquiries as to which employees performed specific tasks throughout the year, and observing personnel performing those tasks. The auditors also should make inquiries as to who performs assigned tasks under unusual circumstances, such as prolonged illness of an employee.
c. (1) and (2) To test for fictitious payroll transactions, the auditors might observe the distribution of paychecks on a surprise basis. Analytical procedures applied to payroll expenses, such as comparisons of this year’s amounts to budgeted amounts or comparable amounts for prior years, might reveal a significant overstatement of payroll expenses.

16–44 SOLUTION: Olympia Company (Estimated time: 30 minutes)

<table>
<thead>
<tr>
<th>Possible Misstatements or Discrepancies</th>
<th>Control</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Step A</strong></td>
<td></td>
</tr>
<tr>
<td>(1) Time worked may be improperly reported by employees.</td>
<td>a. Timekeeping for payroll hours should be an independent function.</td>
</tr>
<tr>
<td></td>
<td>b. Time clocks should be used under the observation of timekeeping employees.</td>
</tr>
<tr>
<td></td>
<td>c. Strict rules should be enforced requiring employees to punch their own time cards.</td>
</tr>
<tr>
<td></td>
<td>d. Timekeeping personnel should make periodic floor checks of employees on duty.</td>
</tr>
<tr>
<td>(2) Payroll may be padded by timekeeper.</td>
<td>A procedure for authorization of overtime should be devised, and timekeeping personnel should determine that required authorizations are obtained.</td>
</tr>
<tr>
<td>(3) Employees may work unauthorized overtime hours.</td>
<td>A procedure for authorization of overtime should be devised, and timekeeping personnel should determine that required authorizations are obtained.</td>
</tr>
<tr>
<td><strong>Step B</strong></td>
<td></td>
</tr>
<tr>
<td>(4) Employees may not work effectively. Also, they may disguise inefficiencies by spreading excess hours to other jobs.</td>
<td>Employees should report hours by job, and preferably should use a time clock. Supervisors should review and approve time tickets, and timekeeping personnel should see that these approvals are obtained. Employees should be instructed to assign actual hours to jobs.</td>
</tr>
<tr>
<td>(5) Overtime work on a job may not be authorized, and the job may not be charged at the premium overtime rate.</td>
<td>Timekeeping personnel should verify required authorizations and appropriately note hours that should be charged at the premium rate.</td>
</tr>
</tbody>
</table>
**Step C**

(6) Job tickets and time cards may not be in balance. Absolute balancing may be impractical or unnecessary for cost accumulation, allocation, or control; appropriate authority should establish reasonable difference limits. Assuring that differences fall within established limits can be accomplished by having the timekeeper or computer balance hours per time card with job tickets and follow-up on any differences.

**Step D**

(7) Time cards and job tickets may be lost in transition from timekeeping to payroll audit and control.

a. Timekeeping should promptly forward time cards and job tickets accompanied by a transmittal slip denoting the number of employees for which time is being reported. Payroll audit and control should reconcile the number of employees reported with the master payroll record, considering employees on vacation, illness, and so on.

b. To assure that all time cards have been accounted for, timekeeping can prepare a hash total of employee numbers for both time cards and job tickets. These totals can be included in the transmittal slip described under (a) above.

(8) Payroll audit and control may total hours incorrectly in preparing the control total for the batch transmittal form. If this is a frequent error, payroll audit and control should recompute all control totals. If it is an infrequent occurrence, it can be handled as an exception printout from the computer.

**Step E**

(9) Time cards and job tickets may be lost in transit from payroll audit and control to data input. Payroll audit and control should batch time cards and related job tickets. A consecutively numbered transmittal sheet should accompany each batch and contain a control total, such as total hours. This control total should be compared to the total shown by the computer reports.

(10) Data input personnel may transcribe data incorrectly. Errors also should be detected through use of batch controls.

(11) The employee identification number may have been recorded or carried forward improperly. Employee identification numbers should contain a self-checking digit and the computer should be programmed to test the validity of each employee's number.
Time cards and job tickets may be lost in transit from data preparation to the computer. Supplementing the programmed computer checks, payroll audit and control should check the computer output hours against its input log.

Errors detected by programmed computer controls may not be reentered in the system. Payroll audit and control should maintain an error log.

16–45 SOLUTION: Rowe Manufacturing Company (Estimated time: 20 minutes)

To improve internal control for factory hiring practices and payroll procedures, Rowe Manufacturing Company should first make the following basic changes:

1. Appoint a current administrative employee as human resources administrator.
2. Install a time clock in the factory.
3. Transfer one of the two payroll clerks to the function of timekeeper.
4. Obtain a supply of prenumbered payroll checks.
5. Obtain a three-part preprinted form for initiating all new hires, terminations, and wage rate changes.

16–46 SOLUTION: Robertson Company (Estimated time: 10 minutes)

The major casualty of Thompson Corporation, a significant customer of Robertson Company, has an impact upon Robertson's financial statements at December 31, 200X. However, the casualty occurred subsequent to that date; consequently, it would be inappropriate for the auditors to recommend an increase in the December 31, 200X, allowance for uncollectible accounts. The casualty loss of Thompson Corporation should be disclosed in a note to Robertson Company's December 31, 200X, balance sheet.
In-Class Team Case

16–47  

a. KCN Total Likely Misstatement to Nearest Dollar (Estimated time: 45 minutes)

Keystone Computers & Networks, Inc.
Total Likely Misstatement
December 31, 20X5
Overstatement (Understatement)

<table>
<thead>
<tr>
<th>W/P ref.</th>
<th>Current Assets</th>
<th>Noncurrent Assets</th>
<th>Current Liabilities</th>
<th>Noncurrent Liabilities</th>
<th>Owners' Equity</th>
<th>Inc. Before Taxes</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Uncorrected Known Misstatements</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.</td>
<td>Unrecorded liabilities</td>
<td>(6,440)</td>
<td>1,610</td>
<td>6,440</td>
<td>6,440</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Projected Misstatements</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2.</td>
<td>Understatement of accounts receivable (confirmation results)</td>
<td>(2,042)</td>
<td>(511)</td>
<td>(2,042)</td>
<td>511</td>
<td>(2,042)</td>
</tr>
<tr>
<td>3.</td>
<td>Overstatement of inventory (price tests)</td>
<td>9,510</td>
<td>2,378</td>
<td>9,510</td>
<td>9,510</td>
<td>9,510</td>
</tr>
<tr>
<td></td>
<td>Other Estimated Misstatements</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4.</td>
<td>Understatement of allowance for uncollectible accounts</td>
<td>5,000</td>
<td>1,250</td>
<td>5,000</td>
<td>5,000</td>
<td>5,000</td>
</tr>
<tr>
<td></td>
<td>Total Likely Misstatements</td>
<td>$12,468</td>
<td>$1,713</td>
<td>$14,181</td>
<td>$18,908</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Amount Considered Material</td>
<td>$50,000</td>
<td>$75,000</td>
<td>$50,000</td>
<td>$75,000</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

b. The amount of total likely misstatements is low enough to result in a sufficiently low level of audit risk to justify our opinion.

Research and Discussion Case

16–48 SOLUTION: Interstate Land Development Corporation (Estimated time: 45 minutes)

a. In connection with registration audits, auditors may be liable for any losses to persons acquiring the security that are proximately caused by the auditors' ordinary negligence. This is a higher standard of liability than the gross negligence standard existing under common law (Ultramares approach) and under the Securities Exchange Act of 1934. In addition to being liable for losses attributable to ordinary negligence, a considerable portion of the burden of proof is transferred by the 1933 Act to the defendants. Thus, the auditors must prove "due diligence," rather than the plaintiffs having to prove negligence.
b. The IRS investigation constitutes a subsequent event—that is, information coming to the auditors' attention subsequent to the balance sheet date. As indicated in the text, the Securities Act of 1933 extends the auditors' attention to subsequent events to the effective date of the registration statement. Since this IRS investigation has come to light prior to that date, the auditors are responsible for proper financial statement presentation of these facts.

The $800,000 tax liability is a loss contingency, in that there exists some uncertainty as to whether or not the loss has actually occurred. FASB ASC 450, dealing with contingencies, establishes criteria for accruing, disclosing, or ignoring loss contingencies. If the loss is "probable" and can be "reasonably estimated," it should be accrued in the 20X4 financial statements. If either one of these criteria has not been met, but it is still at least "reasonably possible" that a loss has been incurred, disclosure is required. Only if the prospects of a loss having been incurred are "remote" can this contingency be ignored in the financial statements.

Thus, the auditors must make a judgmental decision as to whether it is appropriate to ignore, disclose, or accrue a loss relating to this matter in the 20X4 financial statements.

Prior to making this decision, the CPA firm should investigate the potential tax liability of Interstate, rather than merely relying upon Dunkirk's evaluation. The auditors should review Interstate's tax returns for the years in question. They should also review all correspondence between Interstate and the IRS in order to determine the areas under challenge and to judge the validity of the IRS's assessment. Furthermore, the CPAs should obtain Interstate's legal council's evaluation of the situation. In all probability, Marshal and Wyatt should at least insist upon complete disclosure of this situation in the financial statements; they may even need to insist upon accrual of a liability for some or all of the $800,000, depending upon the outcome of their investigation.

c. No. Although a minority of state courts apply the privileged communication rule to the CPA-client relationship, the federal courts do not follow this rule of evidence. Hence, the CPA firm had no choice but to honor the subpoena even though it did not prepare the client's tax returns.