

## AUDIT METHODS AND TECHNIQUES

### Introduction to Auditing Procedures

The audit of the Clerk of Courts is compromised of both a financial audit and compliance audit.

#### I. Financial and Compliance Audit

- A. Financial auditing basically consists of a systematic examination and evaluation of the financial systems, transactions, and accounts of an organization, in order to offer an opinion on the “fairness” or reliability of its financial statements.
- B. The compliance aspect of auditing is to ensure that an organization is following the laws and ordinances that govern the handling of its general finances, such as those pertaining to tax levies, spending, investing, and borrowing. A compliance audit can also focus primarily on regulations that apply to specified funds, such as intergovernmental grants.

#### II. Conducting the Audit (In Line With Standards)

- A. The first step in conducting the audit begins with a definite audit plan. This involves the audit team familiarizing themselves with the auditee’s operations through review of the permanent file maintained at the district headquarters. Such files include prior working papers, audit reports, newspaper clippings, etc. After completing this review, the field supervisor plans the audit and prepares a detailed set of instructions for the staff.

#### B. Study and Evaluation of Internal Control

- 1. Through the use of questionnaires, flow charts and narrative memorandums, the audit process effectively evaluates and auditee’s existing internal controls. Internal control is a system under which employees duties, records, and procedures are designed to make it possible to exercise effective control over assets, liabilities, revenues, and expenditures. The primary objectives for the auditee to establish such a system are to (a) prevent fraud and waste; (b) ensure accuracy of the accounting and other operating data; (c) promote adherence to stated policies; (d) further the efficiency of operations; and (e) ensure conformance with applicable laws.
- 2. Systems devised to achieve the above objectives are usually segregated into two major areas:

A. Accounting Controls (Achieve first two objectives—the means of keeping track of resources)

1. Segregation of duties
2. Procedural Control—Documentation and Internal Auditors
3. Physical Inventories
4. Accounting Function
  - a. Collections
  - b. Disbursements
  - c. Custody
  - d. Detail Accounting
  - e. Bank Reconciliation
  - f. Approval of Investments
  - g. Imprest System for Petty Cash and Charge Funds

B. Administrative Controls (Achieve remaining objectives—the means of using resources)

1. Budgetary Process
2. Organizational Chart—Lines of Responsibility
3. Job Description
4. Staffing Levels and Competence
5. Written Procedure Policy
6. Minute Record

3. The examiner's conclusions about the existing controls in use, determine

- a. the kinds and extent of tests to be conducted
- b. the potential for undetected abuse within accounting system
- c. whether management is diligently exercising its responsibility

C. Validation – Test of Transactions

1. Established systems and procedures for internal control are statements of good intentions; their achievements must be verified by systematic examination of records and other evidence. There are two types of examinations conducted in a financial and compliance audit: legal compliance tests and verification of financial records. Compliance tests involve a review of records to see whether a specified body of laws is being adhered to. Financial verification steps are devised to determine the accuracy of the information on which the financial statements are based. For example, a compliance test might consist of examining the budgeting practices to see whether local officials have (a) authorized appropriations within the amount certified by the budget commission in the "official certificate of estimated resources" and (b) restricted expenditures plus outstanding encumbrances to amounts appropriated by the board for such purpose, as required by Ohio law, while a financial verification step might entail writing letters to vendors to confirm the

balance of payables outstanding. If the tests show serious exceptions, the amount of testing may be increased.

2. For the sake of time and efficiency the examiners will use sample testing techniques as a means of validations. Such sampling techniques will vary depending upon the internal control evaluation and results of prior tests. These techniques allow the examiners to review a limited number of records as a representative to the whole. In essence, the more testing required due to lack of internal control and lack of accuracy in the accounting records takes additional audit time therefore increases the cost of the audit.
3. There are certain validating procedures and auditing techniques that are performed by State Examiners on every examination. The following methods or techniques are not meant to be all inclusive, but will give the State Examiner the basic techniques that will assist in complying with GAAS.
  1. Determine the accuracy of arithmetical calculations by Recompilation. (Footing and Crossfooting)
  2. Verification of entries in booked of record by examining the original documentation upon which they are based. (Vouching)
  3. Reconciliation and account analysis.
  4. Confirmation
  5. Scanning and review.
  6. Physical examination and count.

### RECOMPUTATION

LPA's maintain many columnar books of original entry that are totaled, carried forward, balanced or posted to a ledger or financial statement of some kind. Whenever there is an arithmetical computation, there is a possibility of an error. Thus, the great number of calculations, postings, etc. performed by the auditee, represents to the State examiner, the potential of a great number of mistakes which he must address himself to if he is to satisfy himself that no material error exists.

This procedure is applied on a test basis. Depending on the system of internal control, a determination must be made as to how many months out of the audit period is to be footed. Also, it is not sufficient to accept the auditee's adding machine tape as evidence of the footings. Incorrect footings are one of the easiest means of covering a shortage, or making the facts appear other than what actually exists. This same rule applies to listings and totals by mechanical or computer accounting equipment. Remember, until

you have tested results, you are not entitled to rely on their results. Types of recomputation verification can be classified as either absolute or approximate. Absolute recomputation is required for all funds in the general ledger. In other words, sometime during the examination, all fund balances and general ledger balances must be proved. However, in testing inventory extensions it is not necessary to prove to the penny. It is unlikely that all chance of error can be eliminated anyway; all the State Examiner can do is satisfy himself that no material error exists at arriving at the final figure.

## CONFIRMING

To confirm means to obtain a written statement, usually from someone outside the auditee's operation, on some fact of importance to the State Examiner, and on which that person is qualified to make a statement. The confirmation procedure has wide usefulness, and is generally considered to be an extremely reliable method of verification.

## CONFIRMATION CONTROL

The importance of confirmation control cannot be overemphasized. If at any time there is an opportunity for the confirmation to come under the control of anyone who might falsify a reply, destroy a confirmation that indicated information not in agreement with the books, or in any way manipulate the confirmation replies, the procedure has failed. Remember, if the documentation provided by the confirmation is to be reliable, no tampering with the results may be permitted.

Confirmations are obtained in reply to a request. Normally, the request for confirmation of some fact should come from the auditee. Realistically, there is no reason why anyone receiving a confirmation should reply to anyone other than the auditee. Therefore, it will be standard practice in the Bureau of Inspection to have the auditee prepare and sign confirmation requests. This will make confirmation control very difficult. Therefore, the State Examiner, in order to maintain adequate control must take the following steps:

1. After preparation and signing of confirmation requests, they must be returned to the State Examiner for final review and mailing. It is at this time that all confirmations are to be accounted for.
2. The State Examiner, after he has assured himself as to the propriety of the confirmation, must place them in the envelope, seal, and place them in the U.S. Post Office receptacle. Under no condition should the auditee gain control for mailing, nor should the requests be processed through the auditee's mail procedure.

3. The envelopes in which the requests are mailed must contain the State Examiner's address as the return address so that he may learn of non-delivery. The return address should be the district office or post office box for the Auditor of State.

If these precautions are not taken, then the State Examiner cannot rely on the reply. All these precautions are applicable regardless of whether the confirmation is for bank balances, accounts receivable, loans, or any other data that the State Examiner may be seeking independent verifications.

### RECONCILIATION

The technique of reconciliation is basic to all auditing but it is even more basic to management accountability. Reconciliations, whether of bank accounts. Daily receipts, expenditures or inventories should be a routine part of management's system of control and accountability for the purpose of preventing or detecting errors. Remember the reconciliation process is not complete until all items are traced to their proper disposition; in-transit transactions and recording of adjustment.

### ACCOUNT ANALYSIS

Account analysis means to break down and summarize the details of an account in a way that is meaningful for the intended purpose. There are two basic types of account analysis. One is an analysis of the activity, and the other is an analysis of the composition of the balance in which the major items or categories of items are identified.

### PHYSICAL INSPECTION

Physical inspection of the items represented in the accounts is a significant validation procedure. Although often time consuming, an accurate identification of the items being inspected is sometimes difficult, there is no better way to substantiate an account balance. Also, physical inspection is an accountability procedure, and should be employed by management with the State Examiner participating or observing.

Physical inspection of documents or assets is done by the State Examiner as an auditor, not as an appraiser, handwriting analyst, lawyer, or other kind of expert. The State Examiner is entitled to ask for reasonable assurance that the documents, material or any other items being inspected is what it is represented to be, and he should exercise common sense in evaluating that assurance.

## TERMINOLOGY OF AUDITING

In order to be consistent in our application of auditing techniques, the use of audit programs, working papers, and that reports may be clearly understood, the following auditing terms are defined.

FOOTING	The process of proving totals of vertical columns of figures.
CROSSFOOTING	The proving of totals of figures appearing in horizontal rows.
VOUCHING	The process of establishing the accuracy and authenticity of entries in accounts, funds, or other records by examining such supporting evidence of the transactions as invoices, paid checks, and other original papers.
VOUCHER	A term used to describe any document supporting a transaction.
TESTING	The selecting and examining of a representative sample from a large number of similar items.
ANALYZE	The process of identifying and classifying, for further study the debit and credit entries contained in a fund or ledger account. Funds or accounts are analyzed in order to ascertain the nature of all the elements compromising the balance.
CONFIRM	The process of proving the authenticity and accuracy of account balance by direct communication with the debtor, creditor, or other party to a transaction.
RECONCILE	To establish agreement between two sets of independently maintained, but related, records.
VERIFY	To prove the validity and accuracy of records, or to establish the existence and ownership of assets.
COMPARE	The process of observing the similarity or variations of particular items in financial statements from one period to the next. The term can also be used to mean ascertaining the agreement, or lack of agreement, between related documents such as a purchase order and an invoice.

## RECEIPT

When monies are received by the Clerk of Courts, or by any Deputy on behalf of the Clerk, a receipt must be prepared properly signed by the individual receiving payment. The original copy should be given to the person(s) making the payment while the duplicate should remain in the binding. Receipts should be numbered consecutively when purchased from the printer. The receipt should be carefully prepared as the duplicate is the posting source of entry for the Cash Journal. It is recommended that the fund(s) and line-item(s) receipt identification(s) be shown on the prepared receipt, and indicate whether cash or a check was received.

It is further recommended that when preparing a deposit receipt for the banking of moneys received, all receipt numbers going into making up the deposit be reflected on the deposit slip. Instead of listing cash receipt number the numbers may be listed as a group, i.e., 100 through 195. In the instance that there is a problem in the reconciliation to the depository, this will provide a ready method of checking.

If it is found necessary for the Clerk to make a refund or correction, the payee should return the original copy of the receipt to the Clerk of the Court for posting and auditing purposes. The copy as well as the duplicate retained copy should be marked void. Should the entry necessitate a new (corrected) receipt to be issued, the new (corrected) receipt should be cross referenced back to the receipt that was voided. A reversing entry on the cash journal should be made only in the "debit receipts" column in the cash control and the "credit receipts" column in the affected fund. Similarly the entry should be reflected on the receipts Ledger(s).

## RECEIPTS LEDGER

The annual budget is based on anticipated receipts from various sources.

The proper procedure in setting up the Receipts Ledger is to post the amounts anticipated, upon which the budget was predicted, to each source as follows. (See Exhibit D-1)

Date:	January 1.
Vendor:	Estimated Amount
Balance:	Amount estimated

An example of receipts falling short of estimates is provided in Exhibit D-2. It is clear from a glance at the entries that actual receipts are falling short of anticipated receipts, requiring that the court curtail incurring obligations. Similarly, from a glance at exhibit D-3, it should be apparent that actual receipts are exceeding estimated receipts, and

additional or supplementary appropriations may be made after acquiring and Amended Official Certificate of Estimated Resources, reflecting the increased receipts.

NOTE: THE EXHIBITS REFERRED TO ON THIS PAGE ARE NOT AVAILABLE AT THIS TIME AND THEREFORE CANNOT BE MADE A PART OF THIS MANUAL.

## THE INVESTMENT RECORD

A properly maintained investment record shows how each investment was made and the return of each investment to the active funds of the Court.

The investment should be posted as follows:

Date: Date on which transaction occurred.

Description: The type of investment and interest amount.

Number: Certificate of Deposit Number. (If the investment is in treasury bills, post the bill numbers as well as the Custody Receipt number.)

Credit Column: Amount of the Certificate or the cost of the Treasury Bills.

Balance: To show immediately the total amount of funds invested. The "Balance" column is increased by the amount of each investment.

When a Certificate of Deposit is redeemed, or treasury bills sold the record should be posted with the same information as shown above; except that the redemption amount or purchase price of the bills whichever is applicable, is posted in the "Debit Column" and the "Balance Column" is decreased accordingly.

A check mark is placed in the "check" column on the line showing the original investment and the line showing the redemption of the investment to indicate that the investment has been redeemed.

All entries in the "Credit" column which are not preceded by a check mark are unredeemed certificates of unsold treasury bills and should always equal the total amount invested.

## DEPOSITORY REGULATIONS

Summary of discussion topics:

“NOW” accounts – effective Nov. 5, 1981 (Amended House Bill 255) :

- (A) Permits public funds of governmental units to be placed in “NOW” account in “NOW” Accounts (negotiable orders of withdrawal) in banks and savings loans and such funds are to be awarded as active deposits.
  - (B) “NOW” accounts are either interest-bearing savings accounts against which checks may be written or are checking accounts on which interest may be paid. In either case these accounts are active for Depository Act purpose.
  - (C) Maximum interest rates permitted for “NOW” accounts at banks and savings and loans is 5 ¼%
  - (D) Under Federal Regulations, financial institutions are not authorized to issue “NOW” accounts to villages, municipalities, townships and counties, as issue of these accounts is restricted to public schools, public libraries, public hospitals, and public housing authorities.
2. Minimum period of maturity of certificates of deposit representing interim funds – Effective November 5, 1981 (Amended House Bill 255):
- (A) Removed minimum period of maturity for certificates of deposit into which interim funds may be deposited.
  - (B) Before November 5, 1981, interim deposits were evidenced by interest-bearing certificates of deposit maturing in thirty or more days but not more than one year from date of deposit (§135.09 and 135.13) .
  - (C) After November 4, 1981, the minimum maturity of thirty days was completely removed so that interim deposits may now be evidenced by interest-bearing certificates of deposit maturing not more than one year from the date of deposit (§135.09 and 135.12) .
  - (D) Banks and savings loans, however, since November 1, 1980 have been authorized under Federal Regulations to issue certificates of deposit bearing interest maturities of not less than fourteen days.
  - (E) Interaction of Ohio Law and Federal Regulations is resolved in a requirement that limits maturities to not less than fourteen days nor more than one year for interim funds placed in interest-bearing certificates of deposit.

3. Pooling of securities pledge as collateral security for repayment of deposited public funds – effective March 15, 1982, (Amended Sub. House Bill 230) (new §135.181).
- (A) Allows financial institutions, at its option, to secure public deposits it holds with a single pool of eligible securities, rather than individually assigning specific securities to each treasurer depositing public funds in the depository institution. This applies to public funds of the state, a county, or any other political subdivision thereof.
  - (B) Before this change in the law, a depository institution was required to pledge specific eligible securities exclusively with each treasurer as collateral against the appertential loss of any deposited public funds at time of repayment of such deposits.
  - (C) Because new law offers the pooling method of pledging securities as an alternative to and not a replacement for the individual assignment method, rather than pooling method.
  - (D) Under the pooling method, a depository institution, at its option, may pledge a single pool of eligible securities to secure the repayment of all public funds deposited and not otherwise secured pursuant to law (individual assignment method) provided that at all times the total value of securities so pooled and pledged is at least equal to 110% of the total amount of all public deposits to be secured by pooled securities including securities.
  - (E) Each depository institution is required by the new law to carry in its accounting records at all times a gernerl ledger account showing the total amount of all public deposits to be secured by the pool of securities as determined at the beginning of each business day and the total value of all securities pledged to secure such deposits.
  - (F) The State and each subdivision has an undivided security interest in the pool of securities pledged by a depository institution in the proportion that the total amount of each subdivision's respective deposited public funds bears to the total amount of all public deposits so secured by the pooled securities.
  - (G) The depository institution at any time may substitute, exchange or release eligible securities deposited with a qualified Trustee Provided that each substitution, exchange or release does not reduce the total value of securities in the pool to an amount that is less than 110% of the total amount of deposited public funds collateralized by such pooled securities.
4. Maximum interest rates permitted for public fund deposits: For public fund deposits of governmental units of less than \$100,000.00 the maximum interest rate bank may pay is 8%. For non-governmental units the maximum rates are: 5 ¼% for maturities of 30 to 89 days; 5 ¾% for ninety days to one year; and 6% for one year.

5. Penalties for early withdrawals form certificates of deposits.

(A) Effective July 1, 1979, Federal Regulations as revised June 2, 1980, required the following penalties for prematurity withdrawals form certificates of deposit:

- (1) Penalties apply only to the actual amounts withdrawn prior to maturity provided the certificate is not reduced below the minimum amount required to qualify for a particular rate (below \$10,000.00 for the six-month money market certificate of below \$100,000.00 for large certificates which carry no interest rate limitations). No restrictions on amount of interest paid on CD over \$100,000.00.
- (2) Deposits bearing original maturities of less than three months: Forfeiture of total interest that could have been earned at contracted rate on the amount withdrawn had such amount remained on deposit until maturity.
- (3) Deposits bearing original maturities of three months interest on amount withdrawn at the contract rate without regard to the length of time the funds withdrawn had actually been on deposit. Calculate interest on amount withdrawn at the contract rate from date of deposit to date of withdrawal – deduct any amount of interest actually paid and also deduct interest for three months at contract rate on amount withdrawn. Positive answer is net amount due to depositor. Negative answer is net amount due form the depositor which amount is deducted from amount of requested early withdrawal.
- (4) Deposits bearing original maturities of more than one year: Forfeiture of six months of interest on amount withdrawn at the contract rate without regard to the length of time the funds withdrawn had actually been on deposit. Calculation as described in (3) except that there is a deduction of interest for six months instead of three months at the contract rate on the amount withdrawn.

(B) The six-month penalty provision only applies to Inactive Deposits of public funds as these deposits are the only funds which may be placed in certificates bearing maturities of more than one year.

The three month penalty provision applies to Interim Deposits of public funds which may be placed in certificates with maturities of fourteen days or more to and including one year.

7. Increased FIDC deposit insurance coverage on public funds:

(A) Effective March 31, 1980, Federal Deposit Insurance Corporation Deposit insurance coverage of public funds was increased:

- (1) Active deposit (aggregated demand deposits) are separately insured up to \$100,000.00 (previously this was, up to \$40,000.00).

(2) Combined interim and inactive deposits (aggregated certificates of deposit) are separately issues up to \$100,000.00 (no change from before March 31, 1980).

(B) In some cases this increased issuance coverage could result in reduced amounts, if not the elimination of collateral securities required to be pledged. (135.18 (A).)