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American Institute of Accountants

Verification of Financial Statements

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VERIFICATION OF FINANCIAL STATEMENTS

(REVISED)

A METHOD OF PROCEDURE

SUBMITTED BY

THE FEDERAL RESERVE BOARD

WASHINGTON

FOR THE CONSIDERATION OF
BANKERS, MERCHANTS, MANUFACTURERS
AUDITORS, AND ACCOUNTANTS

A revision, by the American Institute of Accountants, of suggestions for the preparation of balance-sheet statements printed in the April, 1917, issue of the Federal Reserve Bulletin and reprinted in pamphlet form in 1918 for general distribution under the title "Approved Methods for the Preparation of Balance-Sheet Statements"

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CONTENTS

PREFACE

The following suggestions for the verification and preparation of balance sheets and profit-and-loss statements are a revision of suggestions which appeared in the April, 1917, issue of the Federal Reserve Bulletin and were reprinted for general distribution in 1918 under the title Approved Methods for the Preparation of Balance-sheet Statements.

The first edition was issued with the intention of standardizing the forms of statements submitted to bankers for credit purposes, and it provided a program for verification of items and uniform compilation of statements.

It was recognized that bankers have a vital interest in the subject, because the extension of credit is based largely upon statements presented by borrowers.

The subject is of interest to borrowers because their credit sometimes suffers on account of losses incurred by bankers through credits based on inaccurate statements.

Accountants have a professional as well as a practical interest in a standard of procedure. Statements which are misleading or actually false tend to discredit accountancy as a profession.

As a first step toward standardization the Federal Trade Commission in 1917 requested the American Institute of Accountants to prepare a memorandum on procedure. A memorandum was prepared and approved by the council of the Institute. After approval by the Federal Trade Commission the memorandum was placed before the Federal Reserve Board for consideration. The Federal Reserve Board, after conferences with representatives of the Federal Trade Commission and of the American Institute of Accountants, accepted the memorandum, gave it tentative indorsement, and submitted it to bankers and banking associations throughout the country for their consideration and criticism. The memorandum was subsequently published in pamphlet form and was reprinted several times.

The recommendations in the memorandum have been on trial more than 10 years, and various criticisms and suggestions for minor changes have been made. Some professional accountants regard the original program of procedure as more comprehensive than their conception of a so-called balance-sheet audit but not more than is required in the preparation of statements to be submitted by persons or companies seeking credit or loans of cash. Some accountants have felt that all the instructions were not as clear as they might be. Others have said that the procedure would not bring out all the desired information. The suggested form of certificate did not, perhaps, make it plain that the examination was not a complete audit of the accounts, and it was to that extent misleading.

After consideration of the desirability of a revision of the bulletin the American Institute of Accountants appointed a special committee to deal with this and certain other matters. The result of the labors of that committee is submitted in this revised edition, which represents what the Institute believes to be the best modern practice of the profession.

VERIFICATION OF FINANCIAL STATEMENTS

General Instructions

1. The scope of the work indicated in these instructions includes a verification of the assets and liabilities of a business enterprise at a given date, a verification of the profit-and-loss account for the period under review, and, incidentally, an examination of the accounting system for the purpose of ascertaining the effectiveness of the internal check. The procedure described is designed for the auditor's use primarily in the case of industrial and mercantile concerns, but it is also applicable in the case of most other business enterprises. The extent of the verification will be determined by the conditions in each concern. In some cases the auditor may find it necessary to verify a substantial portion or all of the transactions recorded upon the books. In others, where the system of internal check is good, tests only may suffice. The responsibility for the extent of the work required must be assumed by the auditor. This procedure will not necessarily disclose defalcations nor every understatement of assets concealed in the records of operating transactions or by manipulation of the accounts.

2. Trial balances after closing, both at the beginning and the end of the period under review, should be prepared in comparative form from the general ledger. All items in the trial balances should be traced into the balance sheets before the assets and liabilities are verified, to prove, among other things, that no "contra" asset or liability has been omitted from the accounts, that the assets and liabilities have been grouped in the same manner at the beginning and at the end of the period, and that the balance sheets are in accordance with the books. The disposition of any assets and liabilities that may have been scrapped, sold, written off, or liquidated during the period under review should be traced and noted in the working papers. Furthermore, there should be a scrutiny of the general ledger to see that any accounts opened after the beginning and closed before the end of the period have no bearing on the company's financial position at the close of the fiscal period.

3. The auditor should make a comparison of the balance sheets at the beginning and the end of the period under review, so that he may obtain a comprehensive view of changes which have occurred and prepare a statement of the disposition of resources.

4. In these instructions to the auditor the verifications of assets and liabilities will be considered generally in the order in which the items appear in the balance sheet printed at the conclusion of this program. This is a form suitable for credit purposes. A more condensed form of balance sheet is usually prepared for general distribution, but in no case should any essential feature be omitted.

Specific Instructions

CASH

5. The cash on hand, preferably, should be counted after banking hours on the last day of the fiscal period to be covered by the audit, and the amount, together with the cash stated to be in the bank, should be reconciled with the total shown in the cashbook. Cash, notes receivable, and investments must be examined on the same day, so as to render it impossible for a treasurer to make up a shortage in one asset by temporarily withdrawing negotiable funds from another.

6. When counting the cash on hand the auditor must see that all checks (other than those cashed) produced to him as part of the cash balance have been duly entered in the cashbook prior to the close of the period. He should note the dates and descriptions of such checks and of all advances made from cash but not recorded in the books. Advances to employees should be closely investigated. If any such advances are secured by personal checks the auditor should see that the checks are certified by the banks on which they are drawn.

7. The auditor should see that all cash funds have been cleared of incidental expenses at the date of the balance sheet.

8. The auditor must obtain personally or have mailed directly to himself certificates, as of the evening of the closing date, from all banks in which cash is deposited. The balances shown by the certificates must be reconciled with those shown on the cashbook, the check-book stubs, or bank registers, after taking into consideration the outstanding checks.

9. There is only one safe and satisfactory method of proving the accuracy of the list of outstanding checks—that is, to compare the credit side of the cashbook from the last day of the fiscal period backward, item by item, with the checks returned from the bank for whatever period may be necessary to account for all current outstanding items. If there are uncashed checks long outstanding, they should be made the subject of special inquiry. When the work is completed, a list of outstanding checks should be prepared, showing the dates of such checks, and this should be compared with the checks returned from the bank at a later date. If any checks are not returned, the reason should be ascertained. It is important to see that no checks for cash purposes are drawn at the close of the period and entered in the next period.

10. Where currency and bank transactions are kept together in the cashbook and the auditor does not count the cash until after the close of the period under review, he must verify the bank balances as of the date of the count of cash in addition to verifying them at the close of the period. This is essential because, although the cash on hand, which forms only part of the balance, may be correct at the date of the count, it does not follow that the total cash balance is correct.

11. When receipts, shown in the cashbook to have been deposited in the bank on the last day of the period, are included in the reconciliation statement because they were not deposited until the next day, the auditor must satisfy himself that such deposits have actually been made.

12. Deposits shown on the bank statements or pass books for the last two or three days of the period should be checked in detail to prove that they were composed of bona fide checks and that no check drawn by the company was deposited in a bank without being credited prior to the close of the period to the bank on which it was drawn.

13. The auditor should call for a number of deposit slips and compare them with the receipts shown by the cashbook for the days in which the corresponding deposits are made to satisfy himself that deposits are promptly made each day and that the checks deposited are the same as those received. To make such verification absolute the deposit slips should be obtained from the banks.

14. When it is the practice of a company to deposit all its cash receipts in bank, the total receipts should be reconciled with the total deposits shown by the bank statements, and the total disbursements should be reconciled with the total checks drawn. When it is the practice of a company not to deposit all its cash receipts in bank, all cashbook footings should be verified.

15. All checks outstanding at the beginning of the period must be traced into the cashbook.

NOTES RECEIVABLE

16. A list of notes receivable outstanding at the end of the period should be prepared. This should contain dates, makers' names, due dates, amounts, and interest. If notes have been discounted, verification should be obtained from the discounting banks.

17. Outstanding notes must be compared with the notes-receivable book and with the list prepared by or presented to the auditor. Due dates and dates of making the notes should be carefully checked. When notes have been renewed, special consideration should be given to their probable value. When notes have been paid since the close of the period the cash should be traced into the books of the company, and, when they are in the hands of attorneys or bankers for collection, certificates should be obtained from the holders.

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18. Notes (including installment-sales notes) maturing later than one year from the date of the balance sheet should appear separately on the balance sheet. This item on the balance sheets of businesses whose sales are based largely on installments should have more detailed classification.

19. When notes receivable are discounted the company usually has a contingent liability which should appear on the balance sheet as a footnote under the heading "Contingent liabilities." Lists of discounted notes not matured at the date of the examination should be obtained from the holders in order to verify the company's records.

20. The value of any collateral security for notes should be ascertained, as it frequently happens that notes are worth no more than the collateral.

21. Notes of officers and employees must always be stated separately. Notes arising from any transaction outside the ordinary business of the concern must also appear separately.

22. Notes of affiliated concerns must not be included as customers' notes, even though they may be received as a result of trading transactions. Affiliated companies' notes should be shown as a separate item of "current assets" or as "other assets," as the circumstances may require. They may be included properly in current assets if the debtor company has ample margin of current assets over its liabilities including such notes.

23. The best verification of notes receivable is an acknowledgment by the party named in each note as the payor that the note is a bona fide obligation. It is advisable to obtain a written confirmation for each note. When this method is followed the auditor should personally mail the letters of inquiry, inclosing for reply stamped envelopes addressed direct to himself.

ACCOUNTS RECEIVABLE

24. Lists of open balances at the end of the period, with the balances classified according to the age of the accounts, should be obtained. These lists must be footed and compared in detail with customers' accounts in the ledgers. Accounts paid since the close of the period should be noted on the lists before discussing past-due accounts with the credit department. Payment is clear proof that an account was good at the date of the audit.

25. The composition of outstanding balances should always be examined, as it frequently happens that, while a customer may be making regular payments on his current account, old items which have been in dispute for a long time are being carried forward. Disputed items and accounts which are past due should be discussed with the credit department or some responsible officer, and correspondence with the customers concerned should be examined, so that

the auditor may form an opinion of the worth of the accounts and satisfy himself that the reserve set up by the company for bad and doubtful accounts is sufficient.

26. Accounts (including installment-sales accounts) maturing later than one year from the date of the balance sheet should be separately shown on the balance sheet.

27. The totals of lists of outstanding accounts should agree with the controlling account in the general ledger, if separate ledgers are kept. When credit balances appear on customers' accounts they should be shown on the balance sheet as liabilities and should not be deducted from the total of debit balances. Debit balances on the accounts-payable ledgers should be treated correspondingly.

28. Trade discounts (and also so-called "cash discounts," if greater than 2 per cent) and freight allowed by the company should be investigated. If these items have been included in the accounts receivable, an appropriate reserve should be set up in the balance sheet. The auditor should review customers' claims for reduction in prices and for rebates and allowances on account of defective materials, so that he may satisfy himself that a sufficient reserve for such contingencies has been established.

29. If any of the accounts receivable have been hypothecated or assigned, the amount of such accounts must be shown in the balance sheet.

30. The auditor should satisfy himself that when bad debts have been written off the action has been approved by responsible authority.

31. Accounts receivable from directors, officers, and employees must not be included with trade accounts in the balance sheet. Such accounts must appear as distinct items. Deposits as security, guaranties, and any other extraordinary items must also be stated separately.

32. Accounts receivable from affiliated concerns must not be included as customers' accounts, even though they may be the result of trading transactions. Affiliated companies' accounts should be shown as a separate item of "current assets," or as "investments" or as "other assets," as the circumstances require. They may be included properly as "current assets" if the debtor company has ample margin of current assets over its liabilities including such accounts.

33. It is best to verify open balances by confirmation from customers. When this method is adopted the auditor should personally see the requests for confirmation mailed after comparing them with the lists of outstanding accounts. The envelopes for replies sent with the requests should be addressed direct to the auditor.

34. In large concerns the system of accounting is generally so arranged that it would be almost impossible for accounts to be paid

and not be correctly credited on the accounts-receivable ledgers; but in small concerns, with imperfect systems, such occurrences are quite possible.

SECURITIES

35. Under the caption "Securities" must be listed securities in which surplus funds of the company or firm have been temporarily invested and those which are considered available as "current assets," i. e., items which can be turned into money in time of need. Where stocks or bonds represent control of or a material interest in other enterprises, the ownership of which constitutes value to the holder aside from the dividend or interest return, they should be considered as permanent investments and be stated apart from current assets in the balance sheet.

36. Securities not readily marketable should be shown separately on the balance sheet and not included in the current assets.

37. A list of securities should be prepared, showing:

Dates of purchase.
Descriptions of securities.
Denomination of shares or bonds.
Number of shares or bonds owned.
Total capital stock of affiliated companies.
Amounts paid for securities.
Interest and dividends received.
Market values of securities.
Surplus or deficit shown by the balance sheets of the companies if no market quotations are available.
If securities are hypothecated, with whom and for what purpose.

38. This list must be compared with the ledger accounts concerned, and the total of amounts paid according to the list must agree with the balance of the investment account or accounts.

39. *The securities must be examined* by the auditor in person or he must obtain confirmation of their existence from the holders. The securities in possession of the company must be scrutinized and counted as soon as possible after the examination begins, and all of them must be submitted at once to the auditor. It is much more satisfactory to see the actual securities than to verify cash receipts and other evidences of possession after the examination has proceeded.

40. Ownership of certificates which have been sent out for transfer must be verified by communication with the transfer agents.

41. Where the total market value of marketable securities is less than the total book value, save where the difference is small, a reserve for loss in value must be set up on the balance sheet.

42. The auditor must see that bonds and stock certificates are made out in favor of the company, or that they are indorsed or accompanied by powers of attorney when they are in the names of individual persons.

43. Coupons on bonds must be examined to see that all those subsequent to the latest interest date are intact.

44. The schedule of securities must show that the total interest and total dividends receivable by the company have been duly received and recorded. Income from securities shown in the profit-and-loss account must be in accord with this schedule.

45. When market quotations for investments can not be obtained, the balance sheets of companies in which investments have been made should be examined, so that the auditor may form an opinion of their value.

46. In verification of the purchase price of securities listed on stock exchanges, brokers' advices must always be examined.

47. Deeds and mortgages must be examined, and it must be shown that all assessed taxes on property have been paid, that mortgages have been properly recorded, and that insurance policies are correctly made out to the owner.

48. When corporations have temporarily invested funds in the purchase of their own stocks and bonds, these securities technically should be deducted from the corporation's outstanding securities. Custom, however, has sanctioned the inclusion of such temporary holdings as investments; but where they are so held the fact should be clearly indicated on the balance sheet. Investments of this kind are not usually regarded as current assets.

49. If any securities owned by the company have been hypothecated, that fact and the book value of such securities must be stated on the balance sheet.

INVENTORIES

50. Only stocks of goods owned and under control of the owner should be included under the heading "Inventories." Stocks of merchandise are often hypothecated, and, if this has been done, that fact and the book value must be stated on the balance sheet.

51. Inasmuch as the accuracy of the profit-and-loss account is absolutely dependent upon the accuracy of the inventories of merchandise at the beginning and at the end of the period under review, this part of the verification should receive special attention. The auditor should satisfy himself that the inventories at the beginning and at the end of the period were taken on the same basis.

52. The auditor's responsibility with regard to inventories falls naturally into three main divisions—

(*a*) Clerical accuracy of computations, footings, and recapitulations.

(*b*) Basis of pricing.

(*c*) Quantities, quality, and condition.

53. The auditor's responsibility under the first two headings is clear. He must undertake sufficient investigation of the inventories

to satisfy himself that the clerical work has been accurately done and that the goods are valued in accordance with the usual commercial practice—that is, at cost or market price, whichever is lower.

54. With regard to the quantities, quality, and condition of stock, the auditor's duties and responsibilities vary with the circumstances of each case. The auditor is not a valuer and can not have intimate knowledge of many classes of business. He must generally rely for information as to quantities, quality, and condition upon the responsible officers and employees of his client, which he should supplement by such tests and confirmations as his skill and experience may indicate for the type of enterprise which he is examining. In the case of a business in which the verification of quantities, quality, and condition does not call for technical knowledge and presents no substantial difficulties, his responsibility is greater than it is in others where expert knowledge is essential to the correct determination of quantities, quality, and condition of the stock or where the volume is very large. The auditor must, however, use diligence in every case to convince himself that quantities, quality, and condition are correctly recorded.

55. The following program for examination of inventories is acceptable:

(*a*) The original stock sheets, if they are in existence, should be obtained, and the final inventory sheets should be carefully tested by comparison with the originals and with tickets, cards, or other memoranda which show the original count.

(*b*) The inventory sheets should be certified or initialed by the persons who inventoried the stock, made the calculations and footings and fixed the prices, and the auditor should satisfy himself that these persons are competent and responsible. If the accountant can come into contact with the situation before the stock taking, it is very desirable that he should take part in determining the methods to be followed or at least that he should understand them and have the opportunity to make any criticisms of them beforehand. A clear and detailed statement in writing as to the method followed in taking stock and pricing it and also a certificate from a responsible head as to the accuracy of the inventory as a whole should be obtained.

(*c*) A thorough test of the accuracy of the footings and extensions, especially of all large items, should be made.

(*d*) The inventories should be compared with the stores ledgers, work-in-progress ledgers, and finished-product records and stock records (if these are maintained) for verification of quantities, prices, and values. Any material discrepancy must be satisfactorily explained.

(*e*) If stock records are kept and no physical inventory is taken at the time of the examination, the auditor should ascertain when the last physical inventory was taken and should compare it with the book records. If no comparison with recent records is possible, a number of book items of importance should be compared with the actual stock on hand.

(*f*) When the cost system of a company does not form a part of the financial accounting plan, there is always a chance that orders may have been completed and billed but have not been taken out of the work-in-progress records. This is the case especially where such reliance is placed on work-in-progress records that a physical inventory is not taken at the end of the period to verify their accuracy. In such cases, sales for the month preceding the close of the fiscal period should be carefully compared with the orders in progress, shown by the inventory, to see that nothing which has been shipped is erroneously included in the inventory. Cost systems which are not coordinated with the financial accounts are untrustworthy and frequently misleading. Whenever and wherever a cost system is not adequately checked by the results of the financial acccounting the auditor should direct attention to the fact.

(*g*) The auditor should ascertain that purchase invoices for all stock included in the inventory have been entered on the books. He should look for post-dated invoices and should give special attention to goods in transit.

(*h*) The inventory must not include anything which is not owned but is on consignment from others. If goods consigned to others are included, they must be carried at cost prices, less a proper allowance for loss, damage, or expenses of possible subsequent return. This rule does not apply to goods at branches, as the valuing of such stocks will be governed by the principles which apply at the head office.

(*i*) The inventories must not include anything which has been sold and billed and is simply awaiting shipment.

(*j*) If duties, freight, insurance, and other direct charges have been added, the items should be tested to ascertain that no error has been made. Duties and transit charges are legitimate additions to the cost price of goods, but no other factors should be added except in extraordinary circumstances.

(*k*) As a check against carrying obsolete or damaged stock at an excessive valuation, the detailed records for stores, supplies, work in progress, finished products, and purchased stock-in-trade should be examined, and a list of inactive stocks should be prepared. This should be discussed with the company's officers and satisfactory explanations should be obtained.

(*l*) The auditor should satisfy himself that inventories are stated at cost or market prices, whichever are the lower at the date of the balance sheet. He must not approve an inventory in which goods have been marked up to market prices and a profit has been assumed that is not and may never be realized. If the market value is higher than cost, it is permissible to state that fact in a footnote on the balance sheet.

(*m*) It may be found that inventories are valued at the average prices of raw materials and supplies on hand at the end of the period. In such cases the averages should be compared with the most recent invoices to make sure that they are not in excess of the latest prices. The averages should be compared also with market quotations in trade papers to see that they are not in excess of market values.

(*n*) The auditor should make an independent inspection of the inventory sheets to determine whether the quantities are reasonable or not and if they are in accord, in particular instances, with the average consumption and average purchases over a fixed period. Abnormally large quantities of stock on hand may be the legitimate result of shrewd foresight in buying in a low market, but, on the other hand, they may arise from overbuying, overproduction, or serious errors in stock taking.

(*o*) The totals should always be checked by the "gross profit test" and the percentage of gross profit should be compared with that of previous years. In a business whose average gross profit has been fairly constant, this test is satisfactory because if the rate of gross profit apparently is not maintained and the discrepancy can not be explained by a rise or fall in the cost of production or of the selling price, the difference is usually due to errors in stock taking.

(*p*) A general examination and test of the cost system in force is the best means of verifying the prices at which the work in progress is included in the inventory. If there is a good cost system, little difficulty will be found in the distribution of raw materials, stores, and pay roll, but the distribution of factory overhead cost is one that should receive careful consideration. Two principal requirements must be kept in mind:

That no selling expenses, interest charges, or administrative expenses are included in the factory overhead cost.

That the factory overhead cost is distributed over the various departments, shops, and commodities on an equitable basis.

(*q*) No profits should be included in the price of finished products or stock-in-trade. The price list should be examined to see that the cost prices of stock are below the net selling prices. If they are not lower, an adequate reserve should be set up on the balance sheet. However, if the company immediately increases the selling price, the amount of this reserve may be limited to the loss on goods which have been sold prior to the date of discovery of the loss.

(*r*) In the case of companies manufacturing in fulfilment of large contracts it is frequently found necessary to make part shipments before completion of the entire order. The question then arises whether it is permissible to include the profits on these shipments in the profit-and-loss account. As a matter of fact, it is evident that actual cost can not be known until an order is completed. It may be estimated that a profit will ultimately be made; but unforeseen conditions such as strikes, delays in receiving material, etc., may arise to increase the anticipated cost. It is better not to include profits on part shipments, but information on this subject which may properly influence the banker in granting credit may be laid before him. Of course, an exception should be made if the profit on the part shipments largely exceeds the selling price of the balance of the order.

(*s*) The selling prices for contract work in progress should be ascertained from the contracts, and, if it is apparent that there will be a loss on the completed contract, a due proportion of the estimated loss should be charged to the period under audit by setting up a reserve for losses on contracts in progress.

(*t*) If a company has discontinued the manufacture of any of its products during the year, the inventory of such products should be carefully scrutinized and, if unsalable, the net amount of loss should be written off.

(*u*) The auditor should see that no machinery or other material which has been charged to plant or property account is included in the inventory.

(*v*) Deliveries received on account of purchase contracts for material, etc., should be verified by certificates from the contractors as to both quantities and prices.

(*w*) Advance payments on account of purchase contracts for future deliveries should never appear in an inventory. They should be shown on the balance sheet under a separate heading.

(*x*) Trade discounts should be deducted from inventory prices. It is not the general custom to deduct cash discounts, but they may be deducted if that is the practice of the trade.

(*y*) The auditor should ascertain the aggregate sales for the last preceding year. If the turnover has been below the normal rate, the fact may be due to a poor stock of goods as the result of an unwillingness to dispose of old or unseasonable stock at a sacrifice. The inventory and the sales should, therefore, be considered in their relation to each other.

(*z*) It may be well to reiterate that interest, selling expenses, and administrative expenses form no part of the cost of production: therefore they must not be included in the inventory.

FIXED PROPERTY

56. The auditor's working papers for the accounts grouped under the heading "Fixed property," such as real estate, buildings, plant, machinery, etc., must show balances at the beginning of the period,

additions to or deductions from the accounts during the period, and balances at the end of the period.

57. The total of the balances at the beginning of the period must agree with the cost of property stated in the balance sheet at that date, and the balances at the end of the period must agree with the amount shown in the balance sheet at the end of the period under review. The charges constituting additions to the value of fixed property must be verified. The following suggestions will assist the auditor to make the desired verification:

(*a*) Authorizations for expenditure made during the year should be examined, and if costs of additions to fixed property have exceeded the sums authorized, the reason must be clearly stated. Authorization should indicate the accounts to which expenditures are to be charged, the amounts, the approvals of the comptroller and manager, and the nature of the jobs. When authorizations do not specify that the work done is a repair, a replacement, or an actual addition to property, the property itself should be inspected, if that is practicable, to determine the account which should be charged.

(*b*) The auditor, before approving additions, should satisfy himself that they were made with the object of increasing the earning capacity of the plant and that they are not repairs or replacements of fixed property. Changes in the product and capacity of the plant should receive careful consideration.

(*c*) To verify pay roll, store, and supply charges to jobs, pay roll distribution reports and storehouse reports should be examined in detail in sufficient number to satisfy the auditor. If large purchases have been made from outside parties for capital construction work, the vouchers for the receipt of materials, prices, etc., should be examined, and the usual precautions should be taken to see that they are properly approved.

(*d*) Purchases of real estate should be verified by examination of title deeds and the vouchers for payments. The auditor should see that deeds have been properly recorded.

(*e*) While it may be considered permissible to make a charge to "additions to property" for factory overhead cost, e. g., time of superintendent and his clerical force employed on construction work, etc., such a charge can not be regarded as conservative business practice, inasmuch as it is probable that the overhead charges of a plant will not be decreased to any great extent when additions are not under way; consequently, the absorption of part of these charges in property accounts when additions are in progress reduces operating costs below those of periods in which no construction work is being done.

(*f*) Construction work in progress and construction material on hand at the end of the fiscal period should be shown on the balance sheet under the heading "Fixed assets" and not as part of the inventories. It is important to bear this in mind, because construction work is not an asset which can be quickly converted into money; whereas everything in the inventory is supposed to be realizable in cash within a reasonable time.

(*g*) The auditor should ascertain whether or not any installments are due on account of construction work in progress which is being carried on by outside parties; if so, the liabilities for these installments should be included on the balance sheet, as they may have a direct bearing on the amount of available cash on hand.

(*h*) When a company occupies leasehold properties, the leases should be examined and notes should be made of their terms so that improvements, etc., on such properties may be written off during the life of the leases.

(*i*) The auditor should satisfy himself that the reserves for depreciation of buildings, machinery, equipment, etc., are sufficient to meet the deterioration in value of fixed properties. If in his opinion the reserves shown on the balance sheet are insufficient he should refer to the fact in his certificate.

(*j*) The auditor must see that property destroyed by fire or otherwise prematurely put out of service is correctly recorded in the books. Any portion of the original charge for such property, which is not recoverable through insurance, salvage, or otherwise, and has not been provided for by depreciation allowance, should be written off.

58. It is to be observed that the foregoing notes are to be applied only to property costs incurred during the period under review. In addition, it is well to obtain information with regard to the composition of real estate, building, and machinery accounts, showing the principal property represented and how the accounts have been built up for years past, if not from the inception of the business. Such information will indicate the policy of the concern, the extent to which it invests undivided surplus in its own plant, etc. The banker who is asked for ordinary discounts or short-term loans is not interested in this kind of information, except in a general way. He looks more to the current assets for his security.

59. If the property valuation is stated on the basis of an appraisal at a given date, that fact should be mentioned on the balance sheet.

DEFERRED CHARGES TO OPERATIONS

60. Unexpired insurance, bond discounts applicable to a future period, prepaid royalties, experimental charges, etc., are grouped in the balance sheet under the heading, "Deferred charges." After the clerical accuracy of the deferred charges has been verified, the auditor should satisfy himself that they are properly carried forward to account of future operations.

61. Wherever possible, documentary proof in support of the items carried forward must be produced. For example, in case of unexpired insurance, the policies must be examined to verify dates of

expiration, amounts covered, and proportion of premiums carried forward. In the case of royalties, the agreements must be examined. Experimental charges must be supported by vouchers, and details of the work done must be investigated.

62. Any adjustments of premium for compensation insurance must be based upon the actual, not the estimated, pay roll.

63. Examination of the deferred charges will generally give the auditor valuable information with regard to the accounts of the company, for example:

(*a*) The experimental charges carried forward will supply information as to the future production and policy of the company.

(*b*) Royalty vouchers will offer a check on the production of mines on leased property.

(*c*) Examination of the insurance policies may show whether properties are mortgaged or covered by any other lien. This will afford an additional verification of the liability for mortgages on real estate, buildings, etc., shown on the balance sheet. The identity of assets specifically covered by insurance will be ascertained. If any omissions are discovered they should be mentioned.

NOTES PAYABLE

64. Notes payable and drafts accepted appear under the heading "Notes payable." A schedule should be prepared, with the following information under column captions:

- Dates of making the notes or drafts.
- Due dates.
- Names of creditors.
- Collateral hypothecated.
- Additional indorsers.
- Interest accrued to date of audit.
- Notations of renewals (information of this sort furnishes a guide to the state of the concern's credit).

65. The schedule must be compared with the notes-payable book, and the total must agree with the balance of the notes-payable account in the ledger.

66. Statements showing all notes and drafts discounted or sold for the benefit of the concern must be obtained from all bankers and brokers with whom the concern transacts business. These statements must be checked against the loans recorded on the concern's books and approved in the minutes of the company.

67. Inasmuch as a note is a negotiable instrument, the auditor should see that all notes recorded as paid during the period under review have been properly discharged. The canceled notes are the best evidence of this fact.

68. Confirmation of the existence of securities deposited as collateral for loans should be obtained from the holders. Hypothecation

of any of the concern's assets should be recorded on the balance sheet.

69. The auditor may properly suggest to the client the advisability of drawing notes payable on blanks bound in a book, like a check book, with a stub for each blank, blank and stub to bear identical numbers. The officer or officers signing the notes can then initial the stubs as a certificate to the amounts, payees, and terms of the notes issued. If this be done, the auditing of notes payable will be greatly facilitated.

ACCOUNTS PAYABLE

70. A list of balances payable on open accounts must be prepared and carefully checked with the ledger accounts. The auditor should see that no open account on the ledger has been omitted from the list. He should ascertain that the balances represent specific and recent items only. When an account appears to be irregular in any way, confirmation should be obtained from the creditor. If there are many accounts in dispute, and if they are large enough to affect substantially the total of current liabilities, the causes of disputes should be investigated and the reasons may be stated for consideration by the banker.

71. Where modern voucher systems are in operation, accounts payable are readily verified. The auditor must see that the liability for all goods received on the last day of the fiscal period, as shown by the receiving records, and for all goods which were in transit and belonged to the concern on that date are included as accounts payable, and that the corresponding assets are included in the inventories. This precaution is necessary because an increase in the accounts payable may have an important bearing on the financial position of the concern if the amount of cash on hand is small.

72. Monthly expenses outstanding can usually be estimated by comparing the expenses of the last month of the fiscal period with those of previous months and by comparing the expenses of the year with those of the previous year. But the voucher record for the months subsequent to the close of the fiscal year should be examined, as it may contain items applicable to the fiscal period under review.

73. Where a modern voucher system is not in operation, the auditor must exercise particular care to satisfy himself that all liabilities are included in the accounts, for example:

(*a*) Payments shown by the cashbook to have been made subsequent to the date of the balance sheet should be analyzed to ascertain whether any of them are applicable or not to the period under review.

(*b*) Bills on file not vouchered nor entered on the books should be examined to see whether or not any of them belong to the period under review.

(*c*) A study of the minutes of the company may assist the auditor in discovering liabilities.

74. When a company has large purchase commitments for future deliveries, the contracts should be examined. If the contract prices are higher than market prices and the purchase contracts are not protected or are only partly protected by firm sales orders, it may be necessary to set up a reserve for possible loss. Any debit balance on account of advance payments on such contracts or due to any other cause should be shown on the balance sheet under a separate heading.

75. If the business under examination is one in which it is possible that goods have been received on consignment and that part or all of these goods have been sold without record of a liability in the books, the auditor must be diligent to detect all such transactions. In many concerns consignment accounts are treated as memoranda only.

76. If inquiry reveals that goods have been received on consignment, all records relating to them should be demanded. If all the goods have been sold, the consignor's account should show the full amount paid or due, and if the debt is current the obligation will appear among accounts payable to trade creditors. If only a part of the goods has been sold, the net proceeds due to the consignors should be shown on the balance sheet under the caption, "Accounts payable, consignors."

77. As an additional precaution against the omission of liabilities a certificate should be obtained from the proper officer or member of the concern stating that all outstanding liabilities for purchases and expenses have been included in the accounts of the period under review or of former periods. In many cases it is advisable also to obtain a certificate from the president stating that all liabilities for legal claims, infringements of patents, claims for damages, bank loans, etc., have been included in the accounts, as he may be the only executive officer of the company who knows the extent of such obligations.

CONTINGENT LIABILITIES

78. It is not enough that a balance sheet show what must be paid—it should set forth with as much particularity as possible what may have to be paid. It is the duty of an auditor to discover and report upon liabilities of every description, not only definitely ascertained debts but possible debts. Contingent liabilities, other than those due to the specific hypothecation of current assets, should appear as footnotes on the liability side of the balance sheet. Contingent liabilities will usually be found in the following forms:

79. *Indorsements.*—The auditor should ascertain from officers or partners of the concern whether or not any indorsement of unrelated commercial paper has been made, and, if so, what security to protect the concern has been received. The inquiry should be especially strict if it is known that any of the officers or partners are interested in other enterprises.

80. *Guaranties.*—The auditor should investigate possible liability for guaranties as thoroughly as he should examine indorsements.

81. *Unfulfilled contracts.*—Agreements to accept delivery of goods for which contract was made before the end of the period may soon call for the payment of large sums of money. In the case of raw materials for a manufacturer, this may be a legitimate reason for seeking a temporary loan pending manufacture and sale; but in the case of a merchant whose balance sheet shows a large stock of goods on hand, it may indicate a real liability impending, with assets of a doubtful character to offset it. In every examination, therefore, the auditor should ask for copies of all orders for future delivery, and if those orders call for stock in excess of the current and reasonable prospective demand, the facts should be mentioned on the balance sheet and included in any report, the details to be governed by the circumstances of each particular case.

82. *Taxes.*—The possibility of unsettled Federal and other taxes for prior years should be investigated to determine whether or not there may be a liability for which provision has not been made.

83. *Damages.*—There may be claims or suits for damages not covered by insurance, and where the auditor finds any evidence which leads him to suspect the existence of a liability of this nature he should demand full information. He can then form an opinion as to the amount which should be set up as a contingent liability or, if the outcome is uncertain, as a reserve against possible loss.

84. *Liability for real-estate bonds and mortgages.*—If property is sold subject to a mortgage given by the vendor there may be a contingent liability under the bond unless the mortgage has been satisfied, the satisfaction recorded, and the bond canceled. The auditor should investigate the possibility of any liability through the sale of property made by the vendor subject to mortgage.

ACCRUED LIABILITIES

85. Interest, taxes, wages, etc., which have accrued to the end of the period under review, but are not due and payable until a later date, are grouped on the balance sheet under the heading, "accrued liabilities." These items can be accurately verified by the books and records. Special attention is directed to the following liabilities:

86. *Interest payable.*—Many of the liabilities which appear on a balance sheet carry interest. The interest obligation in the case of bonds and notes payable is obvious, but the auditor should consider the possibility that accounts also may bear interest. Many book accounts, when past due, do bear interest; and inquiry on this subject is justified. Loan accounts of partners and officers of corporations almost invariably bear interest. Judgments, overdue taxes, and other liens also require the payment of interest.

87. *Taxes.*—The amount of accrued Federal, State, and local taxes, other than income taxes, should be ascertained and shown on the balance sheet. In some cases it may be necessary to make inquiries of the proper taxing authorities as to the periods for which taxes accrue.

88. Under the Federal income-tax law and the laws of certain States a tax is imposed upon the net profits of a corporation, which must be paid even if the corporation is dissolved before the end of the year during which the tax is imposed. The tax is specifically based upon the net profits of a particular period, although payable some months later, and, if a net profit is disclosed upon the closing of the books during the year, a reserve for accrued taxes must be shown on the balance sheet.

89. If the concern under examination acts as a withholding agent of the government, either Federal or State, any liability for taxes withheld must be ascertained and stated on the balance sheet.

90. *Salaries and wages.*—If the date of the balance sheet does not coincide with the date to which the last pay roll of the period under review has been computed, the amount accrued to the date of the balance sheet must be ascertained and be entered as a liability, unless the amount is insignificant.

91. *Water rates, etc.*—If bills for expenses such as water, gas, etc., are not rendered monthly, the amount accrued to the date of the balance sheet must be ascertained and be entered as a liability.

92. *Traveling expenses and commissions.*—It is important to ascertain whether or not the accounts of all traveling salesmen have been received and entered before the books were closed. If any have not been entered, provision should be made for them.

93. Ample allowance should be made for all commissions eventually payable on sales which have been charged to customers. As commissions frequently are not payable to salesmen until payment has been received from customers, accrued commissions are often omitted from the books. They must, however, be paid out of the proceeds of the sales whose full profit has already been taken into the accounts, and they should be set up as an accrued liability.

94. *Legal expenses.*—Provision should be made for any accrued liability for legal expenses not already on the books.

95. *Damages.*—If the concern is insured against liability for damages to employees or the public, a proportion of the premiums paid in advance for the unexpired time covered by the insurance will appear in "deferred charges." But there may be claims or suits for damages not covered by insurance, and if the auditor finds any evidence which leads him to suspect a liability of this nature he should insist upon full information He can then form an opinion as to the amount that should be set up as an accrued liability or, if the outcome is uncertain, as a reserve against possible loss. The auditor should consider the

adequacy or inadequacy of the accrued liability for premiums on insurance carried to cover compensation for injury to employees.

BONDED AND MORTGAGE DEBT

96. Copies of all mortgages must be examined and the terms should be noted. The amount of bonds registered, issued, and in treasury, the rate of interest and the dates of maturity of the bonds should be shown on the face of the balance sheet. If there are serial bonds, the annual or periodical maturity date should be stated. The trustee should be asked to certify the amount of bonds outstanding, etc., as verification of the liability stated on the balance sheet. Interest on the bonds outstanding as shown on the balance sheet should be computed and be reconciled with the interest on bonds, as shown in the profit-and-loss account.

97. The auditor should investigate the sinking-fund requirements of mortgages and see that provision is made for them in the accounts of the company. If there has been any default it must be mentioned on the balance sheet.

98. Bonds redeemed during or prior to the period under review should be examined to see that they have been properly canceled, or, if they have been destroyed, a certificate to that effect should be obtained from the trustees.

99. Mortgages sometimes stipulate that current assets must be maintained at a certain amount in excess of current liabilities. The auditor must give consideration to this or any other stipulation with regard to accounts or audit which may be contained in the trust deed, and he must see that all requirements have been met.

100. *Mortgages.*—As a mortgage derives its chief value from the law that when it is registered it becomes a lien, the auditor may verify the existence of such obligations by inspecting the public records with reference, not only to liabilities which may be found on the company's books, but also to other obligations that may appear on the public records as unsatisfied. If the auditor lacks the necessary facilities for making a search he may make arrangements with a local lawyer or title company whereby, for a small fee, any mortgages or judgments entered against the concern under examination will be reported to him.

101. In any event the auditor must verify the amounts as shown in the books of account, the rates, the due dates, and the property covered by the mortgages. This may be accomplished by obtaining certificates from the mortgagees.

102. *Unpaid interest.*—The auditor must remember that interest unpaid is a lien as enforceable as unpaid principal.

103. *Judgments.*—Any liability for judgments against the concern may be discovered by searching the public records, either personally or with the aid of a local lawyer. Many business men will not permit

a judgment from which they propose to appeal to be entered in their accounts, and it is sometimes difficult for an auditor to find any evidence of such a liability. In such circumstances it may be necessary for the auditor to mention the facts in a footnote on the balance sheet.

CAPITAL STOCK

104. The auditor should see that capital stock is stated on the balance sheet as required by the statutes of the State under whose laws the corporation is organized, the articles of incorporation, and the company's minutes. He must remember that the laws of certain States provide for shares both with and without par value and for special treatment in the case of no-par-value shares.

105. If a trust company is the registrar of the capital stock for a corporation, it is sufficient, for verification purposes, to obtain from the registrar a certificate of the number of shares of capital stock outstanding.

106. In the case of companies which issue their own stock, the stock registers and stock-certificate books should be examined to ascertain the amount of capital stock outstanding.

107. On the balance sheet each class of stock must be stated, with the amount authorized, issued, and outstanding. If any stock of the corporation is held in the treasury it should be separately shown, either as a deduction from the outstanding capital stock or on the asset side of the balance sheet, as the circumstances may require.

108. When stock has been sold on the installment plan, the auditor should ascertain if any payments are in arrears. If special terms have been extended to any stockholder, the minutes of the board of directors should be examined to see that such terms have been approved.

109. If any stock has been sold during the period under review, the auditor should verify the receipt of payment.

110. In the case of companies having cumulative preferred stocks outstanding on which dividends have accrued but have not been declared, the facts must be mentioned on the balance sheet. All dividends declared but not paid at the date of the balance sheet should be included in the liabilities.

SURPLUS

111. The auditor should compare the surplus at the beginning of the period under review with the surplus shown on the balance sheet at the beginning of the period and with the ledger account, to see that they agree. He should investigate the entries made in the surplus account during the period covered by his examination. The nature of the surplus should be shown on the balance sheet by division into the principal classifications, such as

(*a*) Capital or paid-in surplus.
(*b*) Surplus arising from revaluation of capital assets.
(*c*) Earned surplus (or deficit).

While it may be legally proper in certain cases to charge a deficit from operations to paid-in or other capital-surplus account, such a deficit must always be disclosed.

112. Any credit reflecting appreciation based on an appraisal of assets should be shown, where possible, on the balance sheet above capital and surplus as "Unrealized appreciation resulting from revaluation of capital assets."

PROFIT-AND-LOSS STATEMENT

113. In order to certify the profit-and-loss statement for a given period the auditor must make such verification of the transactions during the period as will justify him in doing so. The extent of the verification will be determined by the conditions in each concern. In some cases he may find it necessary to verify a substantial portion or all of the transactions recorded upon the books. In others, where the system of internal check is good, tests only may suffice. The responsibility for the extent of the work required must be assumed by the auditor.

114. The statement should be prepared as indicated in the following paragraphs, so as to reveal the operating results for the period under review. Corresponding figures for one or more years prior to the period under review should be obtained from the books for purposes of comparison. These comparative figures will furnish valuable information to the auditor and to the banker who is asked to grant credit to the company. If unverified amounts are included in the comparison, that fact should be clearly stated.

115. A satisfactory form of profit-and-loss statement accompanies these instructions, but any other form giving generally similar information is acceptable. The following suggestions, however, must not be regarded as a program for verification of the profit-and-loss statement.

SALES

116. Whenever it is possible, the quantities of merchandise sold should be reconciled with the inventory on hand at the beginning of the period, plus the production or purchases during the period, less the inventory on hand at end of the period.

117. Where a good cost and accounting system is in force the sales records probably will be well kept, but the auditor should satisfy himself, by reference to the shipping records, that the sales books were closed on the last day of the period and that no goods shipped after that date are included in the record of the period. When an examination is being made for the first time, the auditor should make sure that the sales at the beginning of the period were recorded in accordance with the dates of shipment. This can be done by comparing the shipping memoranda with the invoices.

118. Allowances to customers for trade discounts, outward freights, reductions in price, etc., should be deducted from gross sales in the profit-and-loss statement.

119. The unfilled orders at the close of the year should be ascertained for comparison with the record of orders on hand at the corresponding dates of other years which will furnish an indication of the concern's condition and prospects. The auditor should give consideration to the concern's ability or inability to meet its sales-contract obligations.

COST OF SALES

120. The inventory at the beginning of the period, plus purchases or cost of goods produced during the period, less the inventory at the end of the period, indicates the cost of sales. The auditor must be careful to see that cost of sales does not include charges which should have been classified otherwise. Interdepartmental profits should be eliminated. Any intercompany relationships giving rise to profits or losses should be borne in mind when determining the cost of sales.

GROSS PROFIT ON SALES

121. Gross profit on sales is ascertained by deducting cost of sales from net sales. The ratio of gross profits to net sales should be computed and compared with like ratios of previous years.

SELLING, GENERAL, AND ADMINISTRATIVE EXPENSES

122. Selling, general, and administrative expenses, particularly the larger items, should be examined to ascertain that the amounts are proper charges to these accounts and that the credits do not arise from disposition of capital assets. Selling, general, and administrative expenses should be classified in the profit-and-loss statement so as to display the important features of each class. Expenses which do not fall into any of these three classes should appear separately on the statement.

NET PROFIT ON SALES

123. Net profit on sales is ascertained by deducting the aggregate of selling, general, and administrative expenses from gross profit on sales. The ratio of net profit to sales should be computed and compared with similar ratios of previous years.

OTHER INCOME

124. Income derived from sources other than sales, such as income from investments, interest, discounts, etc., should appear under the heading, "Other income." A schedule for each class of income should be prepared, and the auditor should assure himself of the propriety of including each item as income.

GROSS INCOME

125. "Other income" and "Net profit on sales" constitute gross income.

DEDUCTIONS FROM INCOME

126. Interest on bonded debt, interest on notes payable, taxes, depreciation for which no other provision is made, etc., should appear under the heading, "Deductions from income." Appropriate schedules should be prepared and the auditor should see that the entries are justified.

NET INCOME FOR THE PERIOD

127. Gross income less the deductions from income constitute the net income for the period.

SPECIAL CREDITS TO PROFIT AND LOSS—SPECIAL CHARGES TO PROFIT AND LOSS

128. Items of unusual profit or loss which are not the result of ordinary transactions of the concern and items which are due to operations of prior periods should be shown as special credits or special charges to profit and loss.

PROFIT AND LOSS FOR THE PERIOD

129. The profit and loss for the period is the result of adding special credits to and deducting special charges from net income for the period.

SURPLUS

130. Surplus is the result of adding or deducting profit or loss for the period to or from the surplus at the beginning of the period and deducting dividends paid or declared and other appropriations.

GENERAL

131. In some concerns certain details of procedure suggested in these instructions may be impracticable, and an effective system of internal check should make them unnecessary. In such cases tests only need be made, but the auditor must always be prepared to justify his departure from these instructions.

FORM OF AUDITOR'S CERTIFICATE

132. The auditor's certificate should be as concise as may be consistent with a correct statement of the facts. If qualifications are necessary, the auditor must state them clearly.

133. The balance sheet, the profit-and-loss statement, the auditor's certificate, and any report or memorandum containing reservations as to the auditor's responsibility, any qualifications as to the accounts, or any reference to facts materially affecting the financial position of the concern should be connected in such a way as to insure their use conjointly.

134. If the auditor is convinced that his examination has been adequate and in conformity with these general instructions, that the balance sheet and the profit-and-loss statement are correct, and that

any minor qualifications are fully stated, the following form of certificate may be used:

I have examined the accounts of................................company for the period from...................... to....................

I certify that the accompanying balance sheet and statement of profit and loss, in my opinion, set forth the financial condition of the company at........ ....and the results of operations for the period.

FORM OF BALANCE SHEET

Assets

Cash:
- On hand..
- In bank..

Notes and accounts receivable:
- Notes receivable, customers' (not past due)........
- Accounts receivable, customers' (not past due).....
- Notes receivable, customers' (past due)...........
- Accounts receivable, customers' (past due).........
- Less—
  - Reserve for bad debts.......................
  - Reserve for discounts, freight, allowances, etc...

Inventories:
- Raw material on hand..........................
- Goods in process..............................
- Uncompleted contracts.........................
- Less payment on account.......................
- Finished goods on hand........................

Other current assets:
- Marketable securities.........................
- Indebtedness of officers, stockholders, and employees.
- Indebtedness of affiliated companies (current)......
  - Total current assets........................

Investments:
- Securities of affiliated companies................
- Indebtedness of affiliated companies—not current..
- Other (state important items separately)..........

Fixed assets:
- Land used for plant...........................
- Buildings used for plant......................
- Machinery.....................................
- Tools and plant equipment.....................
- Patterns and drawings.........................
- Office furniture and fixtures..................
- Other fixed assets (describe fully)...............
- ....
  - Total fixed assets...........................
- Less—
  - Reserves for depreciation, depletion, etc. (describe fully)............................

Deferred charges:
- Prepaid expenses, interest, insurance, taxes, etc......

Other assets (describe fully)........................
- Total..

Liabilities

Notes and accounts payable:
- Secured liabilities—
  - Obligations secured by—
    - Customers' accounts assigned, to the amount of ________
    - Liens on inventories ________
    - Securities deposited as collateral ________
    - Other collateral ________
- Unsecured notes—
  - Acceptances made for merchandise or raw material purchases ________
  - Notes given for merchandise or raw material purchased ________
  - Notes given to banks for money borrowed ________
  - Notes sold through brokers ________
  - Notes given for machinery, additions to plant, etc. ________
  - Notes due to stockholders, officers or employees ________
- Unsecured accounts—
  - Accounts payable for purchases (not yet due) ________
  - Accounts payable for purchases (past due) ________
  - Accounts payable to stockholders, officers, or employees ________

Accrued liabilities (interest, taxes, wages, etc.) ________

Other current liabilities (describe fully) ________

____

Total current liabilities ________

Fixed liabilities:
- Obligations secured by—
  - Mortgage on plant (due date) ________
  - Mortgage on other real estate (due date) ________
  - Chattel mortgage on machinery or equipment (due date) ________
  - Other funded indebtedness (describe fully) ________
  - ________

Total liabilities ________

Net worth:
- If a corporation—
  - (*a*) Preferred stock (less stock in treasury) ________
  - (*b*) Common stock (less stock in treasury) ________
  - (*c*) Surplus:
    - Capital or paid in
    - Arising from revaluation of capital assets (see footnote) ________
    - Earned (or deficit) ________
- If a person or a partnership—
  - (*a*) Capital ________
  - (*b*) Undistributed profits or deficit ________
  - Total ________

Contingent liabilities—classify and explain.

NOTE.—See directions under paragraph 112.

When the balance sheet is that of a corporation, the State under whose laws it is organized should be indicated.

FORM OF PROFIT-AND-LOSS STATEMENT

Gross sales
Less outward freight, allowances and returns
    Net sales
Inventory beginning of year
Purchases, net (or cost of goods produced)
Less inventory end of year
    Cost of sales
    Gross profit on sales
Selling expenses (itemized to correspond with ledger accounts kept)
        Total selling expenses
General expenses (itemized to correspond with ledger accounts kept)
        Total general expenses
Administrative expenses (itemized to correspond with ledger accounts kept)
        Total administrative expenses
        Total expenses
        Net profit on sales
Other income:
    Income from investments
    Interest on notes receivable, etc
        Gross income
Deductions from income:
    Interest on bonded debt
    Interest on notes payable
    Taxes, depreciation, etc. (separately shown)
        Total deductions
Net income for the period
Add special credits to profit and loss (separately shown)
Deduct special charges to profit and loss (separately shown)
    Profit and loss for period
Surplus beginning of period
Add or deduct items in the surplus account attributable to prior periods
Dividends paid
        Earned surplus at end of period

If a profit-and-loss statement is prepared for more than one year it should be set up in comparative form.

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