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Management investment company of the open-end type; Case studies in auditing procedure no. 06

American Institute of Accountants. Committee on Auditing Procedure

NUMBER 6

CASE STUDIES

IN

AUDITING PROCEDURE

A MANAGEMENT INVESTMENT COMPANY OF THE OPEN-END TYPE

This is the sixth of a series of case studies prepared by individual members of the Committee on Auditing Procedure of the American Institute of Accountants to illustrate actual application of auditing procedures

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A MANAGEMENT INVESTMENT COMPANY OF THE OPEN-END TYPE

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FOREWORD

IN 1941, when the short form of auditors' report now in general use was recommended by the American Institute of Accountants, it incorporated for the first time two significant statements relative to the scope of the examination. These were (1) "Our examination was made in accordance with generally accepted auditing standards," and (2) The examination "included all procedures which we considered necessary." During recent years the Committee on Auditing Procedure of the American Institute of Accountants has given a great deal of consideration to the development of a more explicit statement of the meaning of generally accepted auditing standards. Comprehensive papers were presented by members of the Committee at the last annual meeting of the Institute and the Committee expects to publish a statement on the subject in the near future. The substance of the generally accepted standards tentatively adopted by the Committee may be summarized as follows:

General Standards

1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment an independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

Standards of Field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.
3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Standards of Reporting

1. The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.
2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

A consideration of the foregoing summary of standards will indicate that auditing procedures are the means by which the independent auditor attains or complies with the generally accepted auditing standards applicable to field work. Auditing procedures are so numerous and should be varied so greatly to meet particular circumstances that it is not possible to make an enumeration of procedures which would be applicable generally, or even widely. It is natural that this is the case because if the examination of accounts and financial statements could be reduced to a stereotyped check list of instructions, there would be no need for a public accounting profession. Experienced professional judgment determines the scope and nature of audit procedures to be followed in each individual engagement.

It is the view of the Committee on Auditing Procedure that the most satisfactory method of presenting auditing procedures is the preparation of a series of case studies illustrating the auditing procedures adopted and applied in actual examinations. Accordingly, each member of the Committee has been requested to submit a comprehensive description of audit work performed on a complete engagement. The following excerpt from the memorandum submitted for the guidance of the members of the Committee will indicate the general nature of the studies:

"It is believed that the case study material would be rendered more valuable, both to the practitioner and student, if an entire examination is covered. It is suggested therefore that each member of the Committee on Auditing Procedure should select a case within his own practice which he considers typical of current practices and procedures and that he should prepare a complete written audit program which will be fully descriptive of the work which actually took place. In this connection, it is important that actual procedures should be described even though the member may feel upon reconsideration and with the benefit of hindsight that certain modifications of the program should have been made. The principal purpose of the case study material is to illustrate typical current practices and not to set forth perfect or ideal models which might be misleading and perhaps even dangerous to hold out as representative of current practice. If rather complete information can be given as to the system of internal control and other pertinent circumstances the cases should bring out the importance of professional judgment in the selection and application of procedures as the principal means by which the independent accountant complies with generally accepted auditing standards."

The accompanying memorandum represents a case study submitted by one of the members of the Committee covering an examination of a management investment company of the open-end type. This case study is not a representation of the views of the Committee on Auditing Procedure; it has not been reviewed by the various members of the Committee. It represents the description of the auditing procedures which were actually followed in the particular case by one member of the Committee. The auditing procedures described may be applicable only due to particular circumstances surrounding this examination and, even in this case, alternative procedures might have been used to accomplish the general audit objectives.

The Committee hopes that the case study material will serve a useful purpose not only within the profession, but also in the various colleges and universities throughout the country which offer advanced instruction in accounting and auditing subjects.

Committee on Auditing Procedure.

September, 1947.

No. 6: A MANAGEMENT INVESTMENT COMPANY OF THE OPEN-END TYPE

NATURE OF BUSINESS

This study will cover the examination of the financial statements of an investment company which we will call The Atlantic Investment Fund, Inc. The Atlantic Investment Fund, Inc. is incorporated under the laws of the State of Delaware. It has the usual corporate organization with ten million shares of authorized capital stock of a par value of $1.00 per share. The affairs of the company are managed and its investments supervised under contract with Atlantic Management, Inc., for which services it pays to the management company an advisory service fee computed at the rate of ½ of 1% per annum of the average net assets of the company. In addition to furnishing investment advisory services, Atlantic Management, Inc. pays all officers' salaries and directors' fees of The Atlantic Investment Fund, Inc.

The Atlantic Investment Fund, Inc. is an investment company of the so-called "open-end" type. This means that its shares of capital stock are sold continuously at the then asset value of the stock plus a selling commission, and are redeemable at the then redemption price, which is equivalent to the net asset value at the time the shares are offered for redemption. The shares of the company's stock are offered for sale to the public through investment dealers throughout the country who place their orders with and receive the shares from the wholesale distributor, Atlantic Sponsors, Inc.

The offering price to the public is computed twice daily at twelve o'clock noon and again immediately upon the close of the New York Stock Exchange. The investment securities in the portfolio are valued at the closing market quotations on the New York Stock Exchange (New York Curb Exchange, over-the-counter markets, etc., with respect to securities not listed on the New York Stock Exchange). To the total value of investments thus arrived at is added the cash and receivables less liabilities. The resulting total net assets figure is then divided by the number of shares outstanding to arrive at the net asset value per share. To the per-share net asset value is added a selling commission of 9½% to determine the offering price to the public.

The investment portfolio of the company comprises a balanced list of securities, including common stocks, preferred stocks, and corporate bonds. In addition, temporary investments are made from time to time in United States Government obligations.

In view of the unusual characteristics of investment company accounting and financial statements, as contrasted with commercial and industrial accounting and financial statements, it is believed that some remarks concerning investment company accounting may be of assistance to the reader in obtaining a clearer comprehension of this case study. The remarks are applicable particularly to so-called "open-end" management investment companies, but may apply, with modifications, to other types of investment companies.

DISTINGUISHING CHARACTERISTICS OF INVESTMENT COMPANY ACCOUNTING

Inspection of the illustrative financial statements of The Atlantic Investment Fund, Inc., which are included in this study, indicates a wide variance between the accounting problems of investment companies and those of commercial and industrial companies. Such differences flow from the special characteristics of investment companies, the business activity of which, stated simply, consists of selling its own capital shares to the public, investing the proceeds for purposes other than control, collecting income from such investments, and distributing such income, less expenses, to its shareholders in dividends. In general, the investment company acts as a conduit, performing for its collective shareholders investment services which they might not be able to do as well for themselves. The significant aspects of the financial condition and operating results of such companies differ from those of commercial and industrial companies and, therefore, special type statements are used. That accounting practices which are generally accepted with respect to commercial and industrial companies do not necessarily apply to investment companies was recognized by the Committee on Accounting Procedure of the American Institute of Accountants which stated, in its initial research bulletin, that the general pronouncements of the Committee should not be regarded as necessarily applicable to such companies.

The following comments illustrate the manner in which the significant aspects of the financial condition of investment companies differ from those of commercial and industrial companies.

The major portion of the assets of investment companies consists of cash on demand deposit and readily marketable securities. Consequently, many ratios and analytical processes ordinarily applicable to commercial and industrial companies' statements do not apply to those of investment companies. Obviously, the commonly accepted procedure of segregating balance sheet accounts on the basis of current and non-current items is inapplicable in the case of investment companies.

Practically none of the problems involved in fixed asset or other prepaid costs are present in investment company accounting. As a consequence, the cost basis of stating accounts, so important from the point of view of commercial and industrial companies, loses most of its significance for investment company accounting. Actually, market value is unusually important for open-end investment companies. Such companies maintain a continuous market for the sale and repurchase of their own capital shares. The actual distribution of such shares is effected usually through another company acting as distributor under a distribution agreement. Under the common arrangements, the open-end investment company receives for each of its capital shares sold, an amount equal to the per-share net asset value of the shares already outstanding. The price to the public will be, however, such per-share net asset value plus usually from 7 to 9½ per cent thereof. This additional percentage, or "load" as it is generally called, represents the compensation of the distribution agents.

Capital shares are repurchased by the investment company from its shareholders at the option of the latter. Each share repurchased necessitates payment by the investment company of the proportionate equity of such share in the net assets of the company. The basic per-share price calculation is usually made twice each day, based on a value balance sheet, i.e., with investments based on market value. The importance of valuing investments at market and of stating net asset value per share is apparent. It might be mentioned at this point that investment company financial statements state securities either at value with cost stated parenthetically or vice versa. While the parenthetical statement of cost has been attacked as misleading to unsophisticated investors who might mistakenly deem differences between cost and market to be true indicators of managerial performance, it is felt that the weight of accepted accounting practice, plus the indication of the possibility of realizing security profits or losses militate strongly in favor of stating both cost and market value.

The importance of per-share net asset value, and the prevalent feeling that the general practice of stating surplus balances on balance sheets is of little significance with respect to investment companies, have resulted in the current practice of many such companies substituting a statement of net assets, supplemented by a statement of changes in net assets and certain historical information, in lieu of the usual balance sheet setting forth surplus balances segregated by type.

Another point worth noting with respect to investment company accounting is the sharp distinction drawn between ordinary income derived from dividends and interest, and income or loss arising from sales of portfolio securities. This distinction is important from a tax point of view, and also because of the general feeling that ordinary income constitutes the only true earnings of the investment company, and that security profits and losses represent an adjustment of the shareholders' investment.

An accounting practice peculiar to investment companies which frequently puzzles those unfamiliar with such companies is that which is sometimes known as "equalization." It is generally accepted, with respect to commercial and industrial companies, that proceeds received on the sale of capital stock in excess of the par or stated value thereof should be credited to paid-in or capital surplus. In order to maintain the per-share equity of the constantly fluctuating number of capital shares in the undistributed income account of the open-end investment company, proportionate amounts of proceeds from sales or cost of repurchases of capital shares are credited or charged to undistributed income account through the medium of an "equalization" account. Such credits or charges are sometimes referred to as equalization credits or debits. The result of this practice is that the per-share amount of undistributed income available for distribution remains the same irrespective of the number of shares sold or repurchased, and irrespective of the frequency of such transactions. Failure to follow this practice would, in a growing company, result in dilution of the per-share income available for distribution to stockholders.

It might be noted that accounting policies and practices of investment companies have attained a commendable degree of uniformity through the promulgation on November 27, 1946 by the Securities and Exchange Commission of the Revised Article 6 of Regulation S-X. The new rules issued thereunder became effective December 31, 1946. It was provided, however, that "such of the new rules as prescribe the accounting principles to be followed with respect to certain transactions or adjustments of the accounts will be applicable only as to transactions or adjustments falling in fiscal years beginning on or after December 31, 1946." The new rules were designed "to secure a reasonable degree of uniformity in the accounting practices . . ." of investment companies. The revised Article sets forth minimum standards of disclosure, and prescribes forms which will result in more uniform financial statements for investment companies. However, its provisions are neither rigid nor arbitrary and permit the exercise of judgment in matters where judgment is of paramount importance. It was promulgated by the Commission after careful study and conferences with representatives of the investment companies, accountants and other interested parties. It is generally regarded by those most concerned as a long step forward in investment company accounting.

PLANNING THE WORK

This study will cover the examination of financial statements for the year ended December 31, 1946. The auditing work involved in this examination covers the period from July 1 to December 31, 1946, since we had previously examined financial statements for the first six months of the year.

The year 1946 has been selected for study in order to give effect to the provisions of the Revised Article 6, referred to above, relating to the form and content of financial statements.

Plans for this engagement were made early in November in order to arrange staff assignments and undertake the audit early enough to permit as much as possible of the audit work to be completed prior to the end of the period. It had been determined from previous examinations that the work could be adequately handled by a senior accountant and one assistant. The work was to be started not later than December 15th so that all requests for confirmation of various accounts as at December 31, 1946 would be prepared and in the mail as early as possible.

The first step after scheduling the work and assigning the staff was to review the company's internal control procedures to determine what changes, if any, had been made to strengthen the procedures, and to ascertain that the procedures purported to be in effect were still being properly applied. After this review had been made, the audit program was prepared and adjusted to give effect to improvements or strengthening in the internal control which permitted changes in the scope of the audit work. This phase of the work will be commented upon more fully in the section under the caption, "Review of Internal Control."

MAJOR ACCOUNTING POLICIES

The major accounting policies of the company are summarized below.

Cost of Investment Securities

Cost of investment securities in the portfolio and net profits from sales of portfolio securities are determined for financial accounting purposes on the average cost basis. That is to say, when part of an issue of a particular security is sold, the cost of the securities sold for the purpose of computing profits and the cost of the securities retained are computed by averaging the various costs of all the certificates of that particular issue in the portfolio prior to the sale. The average cost per share thus arrived at is applied as the cost of the securities sold. This method of computing profits and losses from sales of securities is not acceptable to the United States Treasury Department for federal income tax purposes. For tax purposes, therefore, the company maintains a secondary investment ledger from which security profits or losses are computed by applying against the proceeds of a sale of securities the "identified cost" of the specific certificate delivered. In order to prevent wide fluctuation between net profit or loss from sales of securities for financial accounting purposes (average cost) and for tax purposes (identified cost) the company attempts, to the extent possible, to identify and deliver against a particular sale the specific shares having a cost nearest the average cost. As a result of this policy, the aggregate difference between the cost of securities in the portfolio on the two bases at December 31, 1946 was only approximately $10,000 on a portfolio having a market value of over $25,000,000, as shown on the accompanying statements.

Investment securities are set forth on the company's statement of assets and liabilities at value based on closing market quotations, with the average cost shown parenthetically in the investment caption. The unrealized appreciation (excess of value based on closing market quotations over cost) is set forth as a component part of the net asset value applicable to the shares of stock outstanding (see Exhibit A).

Net Profits from Sales of Securities

Net profits from sales of securities are computed as set forth above and are completely segregated in the accounts and in the financial statements from ordinary income. The balances of such net profits accumulated since the inception of the company, less distributions to stockholders made from time to time, are set forth in the statement of assets and liabilities as a component part of the net assets applicable to capital stock outstanding.

Ordinary Income

Ordinary income of the company comprises dividends and interest received on investment securities. The policies followed by the company in accounting for this income are as follows:

Dividend income

Dividends receivable are accrued on the record or ex-dividend date. This is generally considered to be the most logical date to accrue dividend income since it is the date on which the payor corporation generally provides the liability for the payment of the dividend in its accounts, and it is also the date on which the market price of the securities, as traded on stock exchanges, excludes the dividend. For tax purposes, however, under present regulations, dividends receivable are not included in income until the date of receipt. Cash dividends on common stocks are generally taken into income in their entirety unless they are extraordinary in nature, either because they represent an unusual and non-recurring dividend on the part of the payor company, or are not considered to properly represent income to the recipient for other reasons. For example, if an unusually large block of a particular security were purchased immediately prior to the ex-dividend date, consideration would be given to the propriety of including the dividend in income. This question will be discussed further under the caption, "Auditing Procedures."

Common stock dividends paid on common stock are not included in income. Adjustment is made in the security ledger to increase the number of shares owned without changing the cost of the total holding, thus reducing the per-share cost of the securities. Dividends in preferred stocks or in securities owned by the payor corporation are generally treated in the financial accounts on the same basis as they are treated for income tax purposes. The usual procedure is to record such dividends as income at their value on the date received. To the extent that dividends in preferred stock received on common stock do not represent taxable income, they are excluded from the income account.

Dividends received on preferred stocks, to the extent that they represent normal recurring dividends, present no particular problem and are taken into income on the ex-dividend date. If the company were to purchase a substantial block of preferred stock immediately prior to the dividend date, due consideration would be given to the propriety of including the dividend in income. Dividends received as payment of accumulated arrearages on cumulative preferred stocks present a different problem, however. Such dividends generally represent taxable income even though they may be substantial in relation to the value of the stock if a company decided to pay off several years' arrearages at one time. If the payments were made as part of a non-taxable reorganization, they would have a different tax effect.

An example of this is the case of General Cable Corporation 7% cumulative preferred, which, for many years, paid its current dividend but had accumulated arrearages of $52.50 per share. In August 1946, as part of an offer to exchange the stock for new preferred stock, General Cable Corporation paid $166.00 per share for the 7% stock offered for redemption. This amount represented $110.00 call price plus $52.50 cumulative dividends and $3.50 representing the current dividend. In spite of the fact that the payment included not only $52.50 of accumulated arrearages but also $3.50 of current dividend, the tax ruling was that the entire $166.00 per share represented proceeds from sales of securities rather than ordinary income.

The policy of The Atlantic Investment Fund, Inc. has been to include in income preferred stock dividends to the extent that they represented taxable income. In cases where such dividends included substantial amounts of payments of accumulated arrearages, the amount of such nonrecurring income has been separately disclosed in the financial statements (see Note 3 to financial statements). Starting January 1, 1947, in order to comply with the provisions of the Revised Article 6 of Regulation S-X, the policy of the company will be to exclude from income any payments received on preferred stock arrearages applicable to the period prior to the date the particular securities were acquired by the company. To the extent that such dividends, which are included in income in accordance with this practice, apply to a period prior to the current period but subsequent to the purchase of the securities by the company, they will be separately disclosed if material in amount.

Dividends received on shares of the company's own stock held in treasury are not included in income. In accordance with sound accounting, such dividends are netted against the charge for dividends paid, so that only the dividends applicable to shares in the hands of the public are charged to surplus.

Interest

The company's practice in recording interest income on bonds which are traded with accrued interest to the trade date added to the purchase price is as follows: When bonds are purchased, the interest accrued to the date of purchase is charged to interest receivable; when bonds are sold, accrued interest to the date of sale is credited to interest receivable. Interest accrued during the period the bonds are held is debited to interest receivable and credited to interest income. Coupons when collected are credited to interest receivable.

At the end of each month the interest receivable account is adjusted to the correct amount by calculating the accrued interest receivable on each bond position in the portfolio at that date. At the end of the first week of the following month, an equivalent proportion of the interest income for the previous month (adjusted for security transactions during the week) is charged to interest receivable and credited to interest income. This procedure is repeated each week throughout the month so that it is necessary at the end of the month to adjust the balance of interest receivable to the correct figure with an offsetting debit or credit to interest income account. Thus the interest income for the month is adjusted to the correct amount. Experience has shown that this method results in a sufficiently accurate accrual throughout the month.

It is not the practice of the company to amortize premium or discount on bonds in the portfolio. It is considered undesirable for investment companies to amortize discount on bonds since their portfolios usually include bonds purchased at substantial discounts and a distortion of income might easily arise if a policy of amortization were followed. Of course, this policy could be applied only to so-called money bonds, which generally sell at comparatively small discounts, but it is considered better practice to treat all bonds uniformly. While it would be conservative and probably acceptable accounting to amortize premiums and not discounts, the company and its accountants have agreed that a consistent treatment of not amortizing either would produce the best results.

Frequently, particularly in the past year, a number of corporations called outstanding bond issues for redemption either partially or wholly. Very often the redeeming corporation pays interest up to a date specified in the trust indenture but accepts the bonds and pays the cash a number of months prior to the date of redemption. The company's practice in cases of this sort is to record as income only that portion of the coupons collected which applies to the period up to the date the cash is received. Any amounts collected in respect of coupons applicable to the period between the date the cash is received and the final redemption date are considered as a redemption premium and are included in the proceeds from sales of securities.

Interest received on so-called "flat" bonds, representing payments on defaulted interest coupons for prior periods, presents a different problem. The company's practice in recording such receipts is in accordance with the Securities and Exchange Commission Accounting Series Release No. 36, promulgated November 6, 1942, which provides in essence that payments received on defaulted interest coupons applicable to a period prior to the date that the bonds were acquired should be applied as a reduction in the cost of the investment and not included in income. Similar treatment is accorded payments of contingent interest on income bonds.

Rule 6-04 1 (f) of the Revised Article 6 of Regulation S-X provides that:

"Due consideration shall be given to the propriety of treating as income, interest received on bonds which were in default when acquired. Any such interest which may be treated as income shall not be treated as ordinary interest income in an amount in excess of the amount arrived at by applying the stated interest rate to the period of report and any excess thereof shall be included under caption 1(a)(3) above (Other Income). The policy followed in accounting for such interest shall be stated in a footnote."

This rule seems to permit more flexibility than Accounting Series Release No. 36 and it is possible that the company's policy with respect to interest on defaulted bonds may be amended subsequent to December 31, 1946.

Expenses

The company's policy is to accrue once a week major expenses, such as advisory service fee, trustee's fees, and taxes. Experience has shown that the other expenses incurred by the company are of a stable and current nature, are billed frequently and periodically, and are immediately paid. Therefore, it is considered unnecessary to accrue such expenses and, in the interest of simplified bookkeeping, they are charged to expense accounts immediately upon payment.

Taxes

It is the policy of the company to qualify as a "regulated investment company" under the provisions of Section 361 of the Internal Revenue Code and to distribute to its stockholders annually in the form of taxable dividends substantially all of its net taxable income for each year. Through this procedure the company avoids liability for the payment of federal income tax or, at any rate, reduces to a minimum the federal income taxes to which it is subject. It distributes its net investment income, less expenses, quarterly to its stockholders and just before the end of each year it distributes substantially all of its net realized taxable gains on investments in the form of a special distribution. If the total distributions exceed the aggregate net taxable income, no tax is incurred. If the distributions are less than the aggregate taxable income, sufficient distributions are designated as capital gain dividends so that the net investment income will have been completely distributed and a tax of 25% will be incurred on the undistributed net capital gains. Because of the application of this procedure, it is neither necessary nor desirable to accrue federal income tax throughout the year since it is not determinable until the end of the year whether and to what extent a tax will be payable. At that time the tax liability, if any, is computed and provided for in the accounts. The federal income tax which may be determined to be due as of the end of the fiscal year is charged against net investment income or net realized gains on securities, depending upon which type of income results in a tax.

Other taxes to which the company is subject, other than minor items such as original issue and transfer stamp taxes, social security taxes, etc., are the New York State and Delaware franchise taxes and the New York City excise taxes. All three of these latter taxes are accrued periodically and are allocated to net investment income or net realized gains on securities, depending upon the extent to which these taxes are the result of such income.

Proceeds from Sales of Capital Stock

Proceeds from the sale of the company's own shares and cost of its own shares reacquired are treated on the books in the customary manner with one important exception. A portion of the proceeds from sales of shares is credited and a portion of the cost of shares reacquired is debited to a so-called "equalization account" in order to prevent the funds per share available for distribution from being diluted through the sale of additional shares. The amount thus credited or debited is equivalent per share to the amount of distributable funds available on the date of sale or reacquisition.

SURVEY OF INTERNAL CONTROL

The survey of internal control revealed that since the date of the previous examination, substantial changes had been made in the company's procedures with respect to the handling of cash and investment securities. As of the date of the last examination, the company's cash was on deposit in a checking account in a Jersey City trust company and the securities were maintained in a custody account with that institution. On July 1, 1946 the cash and securities were transferred to a trust account with one of the largest Wall Street trust companies acting as trustee for the company. The procedure followed by the company in handling cash and securities is as follows:

Investment Securities

Investment security transactions are originated by Atlantic Management, Inc. The transactions are recorded by the management company and reported to the Fund at or about the closing time of the New York Stock Exchange. On the following morning, brokers' confirmations are received by the company and compared with the information furnished by the management company. The company thereupon renders an officers' certificate to the trustee authorizing the trustee to receive and pay for the securities purchased, and to deliver and obtain cash for the securities sold. On the respective delivery dates the trustee delivers the securities sold and receives cash, and receives the securities purchased and pays cash.

Capital Stock Transactions

Entries covering transactions in the company's own stock are originated by the trading department of Atlantic Sponsors, Inc. Orders for shares are usually received by telephone, telegraph, or teletype at the prices in effect at the time of receipt of the order. Confirmations covering the trades are compared by the trading department, forwarded to the dealers, and summarized on blotters. Repurchases of shares of the company's capital stock are handled in a similar manner. A summary of each day's transactions is prepared and transmitted to the accounting department of the company, which then makes the proper entries on the books. Officers' certificates are prepared authorizing the trustee to issue the shares sold and to receive cash therefor, and to pay for and receive the shares repurchased. No securities are delivered by the trustee from its control until the cash receivable in payment therefor is received, and no checks covering repurchases are released until the shares repurchased are received.

Other Transactions

Officers' certificates authorizing the receipts and expenditures of cash are transmitted to the trustee so that all cash received and disbursed by the trustee is covered by authorizations signed by officers of the company, and supported by independent documentary evidence, such as copies of brokers' confirmations, expense vouchers, etc.

Interest coupons and dividends are collected by the trustee and credited to the company's cash account. These income items are, of course, checked by the company's accounting personnel and any income receivable which is not reported by the bank on the due date is immediately taken up with the trustee. For example, in connection with investment securities purchased prior to the "ex-dividend" date but not received and transferred until after such date, it is frequently necessary to make claims for dividends against brokers or others in whose names the securities were recorded on the record date.

Expense vouchers are paid by the trustee on the basis of certificates signed by officers of the company. The signing of these certificates by the officers is not a perfunctory matter and the certificates are signed only after careful review of vendors' invoices and of evidences that the supplies or services covered by the invoices were properly contracted for and actually received.

It can be seen from the foregoing that in spite of the fact that the company has relatively few employees, satisfactory internal control is effected in the operation of the company's affairs. This is particularly true because of the trustee arrangements. In order for any fraudulent or improper transactions to be undetected internally, collusion would have to exist among several of the following groups: (1) the officers of the company, (2) the accounting personnel of the company, (3) the employees of the management company and/or the sponsor (selling agent), and (4) employees of independent outsiders such as the trustee, brokers and vendors.

An additional safeguard results from the fact that income yields and expense ratios are very vital factors in the operation of investment companies. Both income and expenses are forecast from time to time for the purpose, among others, of dividend declarations (which must be made prior to the close of the fiscal year for tax reasons). Constant efforts are made to reduce expenses and to keep as low as possible the ratios of expenses to income and to net assets. These are competitive factors and management assiduously guards against the reduction of income or increase in expenses which would result from employee misappropriation of funds.

In spite of the foregoing safeguards and checks, however, it would be possible through collusive action on the part of management and employees to submit financial statements which misrepresented the financial condition of the company and the results of its operations. Our audit procedures, therefore, must be so designed as to assure us that no such collusive action has taken place.

FINANCIAL STATEMENTS

Before proceeding with a discussion of the auditing procedures applied in the examination under study, it is considered desirable to present the financial statements being examined. These statements were prepared to comply as to form and content with the provisions of the Revised Article

6 of Regulation S-X. They were prepared in the so-called "net assets" form which is permitted but not required by the Article.

In lieu of the conventional balance sheet and statement of surplus, there are submitted a statement of assets and liabilities, and a statement of changes in net assets. Statements in this form have been acceptable for periodic reports to stockholders since promulgation of the regulations issued by the Securities and Exchange Commission under the Investment Company Act of 1940, if accompanied by (1) a statement with respect to the period for which the report is made, and with respect to the three complete fiscal years next preceding the commencement of such period, of the net asset value per share of the reporting company's securities at the beginning and at the end of each such period, and (2) a statement of the dividends declared per share during each such period, together with the amount per share of such dividends declared out of sources other than net income for each such period, excluding from such net income profits or losses realized on the sale of securities or other property.

However, until the promulgation of the Revised Article 6, statements in this form were not acceptable for registration statements and annual reports filed with the Commission. It is to be noted that the "Special Statement in Lieu of Statement of Capital Stock and Surplus" included as part of the "Statement of Assets and Liabilities" (see Exhibit A) was originally promulgated by the Revised Article 6, and is not specifically required for periodic reports to stockholders under the regulations relating to the Investment Company Act of 1940.

The financial statements, together with brief descriptions thereof, are as follows:

Statement of Assets and Liabilities (Exhibit A)

This statement takes the place of the conventional balance sheet. In it total liabilities are deducted from total assets, the resulting figure representing the aggregate value of the net assets. Due to the unusual significance of this figure, the form is considered more informative than the usual form of balancing total assets with the sum of liabilities, capital stock and surplus.

The "Special Statement in Lieu of Statement of Capital Stock and Surplus" as its name implies takes the place of the conventional net worth section of the balance sheet. The first item represents the aggregate of amounts which generally would be included in capital stock and paid-in surplus. Any distributions to stockholders which may have been charged to paid-in surplus are required to be separately stated in this caption. The same is true of any other unusual charges to paid-in surplus.

It is believed that the other items in the "Special Statement" are self-explanatory and need no further elaboration. The Article requires that the number of shares of capital stock authorized and the number of shares and aggregate par value outstanding be stated in a footnote (see Note 2).

In the opinion of many, this form of statement of assets and liabilities has many advantages as compared with the traditional balance sheet. Among these advantages are:

(1) It stresses the very important aggregate total of the stockholders' equity in the company, and clearly reflects the items comprising such equity.

(2) It avoids the use of the word "surplus." Most accountants agree that the use of the term surplus is confusing to the reader, and has a tendency to mislead, particularly since it is applied to such widely different items as amounts paid in by stockholders, and accumulated undistributed earnings. The distinctions between paid-in and other types of capital surplus, and earned surplus are well understood by accountants and others experienced in financial and business matters, but there is grave doubt that they are understood by the average reader of financial statements.

(3) It avoids the purely legal separation of capital contributed by shareholders into the two items of capital stock and paid-in surplus. While the issuance of capital stock at per-share amounts in excess of par value may have legal and tax advantages which need not be sacrificed, there appears to be little accounting significance to the separation of the two elements of capital contributed.

Statement of Profit and Loss (Exhibit B)

It will be noted that this statement consists of three sections, each one separately totalled and each total separately carried over to the "Statement of Changes in Net Assets" (Exhibit C). This treatment carries out the principle of complete separation of ordinary income and capital gains.

The first section, "Income Account (exclusive of security profits and losses)," reflects the ordinary income from investments such as dividends and interest. Dividends other than cash dividends, to the extent included in income, are separately stated with the basis of valuation indicated. Non-taxable stock dividends are not included in income. As set forth in Note 3, cash dividends include dividends received in respect of arrearages on cumulative preferred stocks. As explained previously, under the accounting rules prescribed by the Revised Article 6 of Regulation S-X applicable subsequent to December 31, 1946, such dividends, to the extent they apply to a period prior to the acquisition of the particular securities by the company, will hereafter be excluded from income and treated as a reduction in the cost of investments. Interest on bonds, as shown in Exhibit B, includes interest received on income bonds and coupons in default only to the extent that such interest applies to the period the company has held the bonds. Any interest received applicable to periods prior thereto has been treated as a reduction in the cost of investments.

The second section of the statement sets forth the realized net profits from sales of securities during the year. Proceeds and cost of securities sold and cost of securities purchased (see Note 5) are set forth in order to indicate the extent of security turnover involved in the realization of the net profit reflected. Proceeds from sales of securities are net of brokerage commissions and transfer taxes, and cost of securities includes such items. It should be noted that the basis of determining cost of securities sold (average cost) is set forth.

The third section of the statement indicates the excess of the value of the securities based on closing market quotations over the cost thereof at the beginning and end of the year, and the change in such excess for the year. The importance of disclosing these results immediately under the realized net profits will be readily apparent. If it were indicated that the company realized $1,500,000 of security profits without indicating the extent to which the unrealized appreciation decreased, there might be an inference that market action during the year caused the value of the company's investments to increase by $1,500,000. Actually, such action caused a decrease of $1,500,000. Of the $3,000,000 of decrease in unrealized appreciation, $1,500,000 resulted from market action and $1,500,000 from the realization of security profits.

Statement of Changes in Net Assets (Exhibit C)

This statement supplants the conventional statements of surplus. The opening figure represents the net assets, with investments at value, at the beginning of the year to which are added or deducted the results of transactions during the year. The resulting figure represents the net assets at value at the end of the year, which agrees with the net assets set forth on the statement of assets and liabilities. The "net equalization credits" which are added to the net income before deducting dividends paid from net income have been described previously in this study.

Notes to the Financial Statements

The notes to the financial statements set forth additional information required by the provisions of the Revised Article 6 of Regulation S-X, or considered necessary to make the statements fully informative.

Investments (Schedule I)

This schedule sets forth both the cost and the value of the various securities comprising the investment portfolio, as is required in reports filed with the Securities and Exchange Commission. However, in periodic reports to stockholders it is usual practice to set forth only the value of the various securities.

The Revised Article 6 requires that any non-income-producing securities be separately indicated. Common stocks are to be considered non-income-producing if no dividends thereon were paid during the year preceding the date of report. Preferred stocks and bonds are to be considered non-income-producing if on the latest date on which dividends or interest were to be paid no dividends or interest were paid. Cases in which only partial payments were made should also be separately indicated. The Article also requires that the aggregate cost of investments for federal income tax purposes be disclosed. This cost is the "identified cost" since the average cost basis is not acceptable for tax purposes.

Exhibit A

THE ATLANTIC INVESTMENT FUND, INC.

STATEMENT OF ASSETS AND LIABILITIES
December 31, 1946

ASSETS:

Investments, at closing market quotations (average cost, $25,693,761.25)		$26,984,317.50
Cash on demand deposit		751,764.45
Receivable for interest and dividends		236,791.50
Receivable for investment securities sold		54,263.24
Receivable for capital stock sold		216,785.21
Total		$28,243,921.90

LIABILITIES:

Accounts payable and accrued expenses:		
Atlantic Management, Inc. (advisory service fee)	$ 12,651.25	
Atlantic Sponsors, Inc. (selling commissions)	19,819.41	
Other	10,216.52	
Accrued taxes (Note 1)	24,916.21	
Payable for investment securities purchased	197,345.60	
Payable for capital stock reacquired	8,738.42	273,687.41
NET ASSETS (Based on carrying investments at market quotations)		$27,970,234.49

The notes to the financial statements appearing on a separate page are an integral part of the above statement and should be read in conjunction therewith.

Exhibit A (Continued)

SPECIAL STATEMENT IN LIEU OF STATEMENT OF CAPITAL STOCK AND SURPLUS

Proceeds From Sales of Capital Stock (After deducting selling commissions (Note 7)), **Less Cost of Capital Stock Repurchased**		$26,643,827.76
Accumulated Realized Net Profit On Securities (Computed on the basis of average cost)	$6,915,986.32	
Deduct—Accumulated distributions of realized net profits	6,896,887.09	19,099.23
Undistributed Net Income (Exclusive of security profits and losses)		16,751.25
Total		$26,679,678.24
Unrealized Appreciation of Investments		1,290,556.25
Net assets applicable to outstanding capital stock—Equivalent to $8.95 per share on 3,125,166 shares of $1.00 par value capital stock outstanding (Note 2)		$27,970,234.49

The notes to the financial statements appearing on a separate page are an integral part of the above statement and should be read in conjunction therewith.

Exhibit B

THE ATLANTIC INVESTMENT FUND, INC.

STATEMENT OF PROFIT AND LOSS

For the year ended December 31, 1946

INCOME ACCOUNT (Exclusive of security profits and losses):		
Income:		
Cash dividends (Note 3)	$ 751,692.21	
Taxable stock rights, stock dividends and dividends in property (at market value on the dates received)	13,642.15	
Interest on bonds	232,461.25	$ 997,795.61
Expenses:		
Advisory service fee (Note 4)	$ 139,622.50	
Trustee's fees and expenses	35,724.15	
Reports to stockholders	18,752.15	
Legal and auditing fees	4,725.00	
State franchise and other taxes (other than portion applicable to security profits)	9,652.20	
Miscellaneous	5,273.26	213,749.26
Net income (exclusive of security profits and losses)		$ 784,046.35

NET PROFIT FROM SALES OF SECURITIES:	
Proceeds from sales of securities	$ 4,824,626.90
Cost of securities sold (computed on the basis of average cost)	3,303,252.98
Net profit from sales of securities before taxes	$ 1,521,373.92
Deduct—State franchise and City excise taxes	4,652.00
Net profit from sales of securities	$ 1,516,721.92
UNREALIZED APPRECIATION OF INVESTMENTS:	
Balance, December 31, 1945	$ 4,321,951.27
Balance, December 31, 1946	1,290,556.25
Decrease in unrealized appreciation	$ 3,031,395.02

The notes to the financial statements appearing on a separate page are an integral part of the above statement and should be read in conjunction therewith.

Exhibit C

THE ATLANTIC INVESTMENT FUND, INC.

STATEMENT OF CHANGES IN NET ASSETS

For the year ended December 31, 1946

NET ASSETS, December 31, 1945		$29,239,597.96
INCOME (Exclusive of security profits and losses):		
Net income, per statement of income	$ 784,046.35	
Net equalization credits included in price of shares sold and repurchased (Note 6)	7,216.21	
Total	$ 791,262.56	
Deduct—Cash dividends paid (four quarterly dividends aggregating $.26 a share)	789,326.42	1,936.14
SECURITY PROFITS AND LOSSES (Average cost basis):		
Net profit from sales of securities (after deducting taxes) (Note 5)	$1,516,721.92	
Deduct—Cash dividend of $.50 a share paid	1,512,224.00	
Remainder	$ 4,497.92	
Decrease in unrealized appreciation	3,031,395.02	
Net (decrease)		(3,026,897.10)
CAPITAL STOCK ISSUED AND REPURCHASED (Exclusive of equalization credits and debits):		
Amounts received for subscriptions to 224,315 shares of capital stock issued (after deducting selling commissions (Note 7))	$2,028,516.25	
Less—Amounts paid for 60,420 shares of capital stock repurchased	272,918.76	
Net increase		1,755,597.49
NET ASSETS, December 31, 1946		$27,970,234.49

The notes to the financial statements appearing on a separate page are an integral part of the above statement and should be read in conjunction therewith.

THE ATLANTIC INVESTMENT FUND, INC.

NOTES TO THE FINANCIAL STATEMENTS

(1) No provision has been made for federal income tax on net income, realized capital gains or unrealized appreciation in investments, since it is the policy of the Company to distribute all of its taxable income for each year in taxable dividends (including capital gain dividends) and to qualify as a "regulated investment company" under Section 361 of the Internal Revenue Code.

(2) At December 31, 1946 there were authorized 10,000,000 shares of capital stock of a par value of $1.00 each, of which 3,125,166 shares having an aggregate par value of $3,125,166.00 were outstanding. Reference is made to the accompanying statement of changes in net assets.

(3) Cash dividends include $15,261.50 of non-recurring income consisting of dividends in arrears on various preferred stocks.

(4) Atlantic Management, Inc. received fees during the year pursuant to contract (at the rate of ½ of 1% per annum of the average of the daily net assets) aggregating $139,622.50. Certain officers and directors of the Company are also officers, directors or stockholders of Atlantic Management, Inc.

(5) Cost of investment securities purchased during the year amounted to $6,592,821.60.

(6) Equalization credits and debits represent, respectively, portions of amounts received for capital stock issued or portions of amounts paid for capital stock reacquired included in distributable funds, in order to equalize the per-share amounts thereof at dates of sales and repurchases of capital stock.

(7) Atlantic Sponsors, Inc. received $192,938.16 representing payment of gross selling commissions on sales of capital stock of the Company during the year. Certain officers and directors of the Company are also officers, directors or stockholders of Atlantic Sponsors, Inc.

Schedule I

THE ATLANTIC INVESTMENT FUND, INC.

INVESTMENTS

December 31, 1946

SECURITY	SHARES	AVERAGE COST	MARKET VALUE
COMMON STOCKS:			
Allied Chemical & Dye Corporation	5,000	$ 807,425.88	$ 855,000.00
Allied Stores Corporation	15,000	601,810.72	532,500.00
American Gas and Electric Company	9,000	304,778.87	388,125.00
The Atchison, Topeka and Santa Fe Railway	7,000	600,458.90	686,000.00
Bethlehem Steel Corporation	6,000	496,810.60	546,000.00
Chrysler Corporation	8,000	619,410.48	732,000.00
Deere & Company	10,000	401,810.40	362,500.00
The Flintkote Company	12,000	492,610.50	448,500.00
General Motors Corporation	15,000	711,517.99	787,500.00
The B. F. Goodrich Company	10,000	519,794.11	640,000.00
International Harvester Company	12,000	719,428.37	864,000.00
International Nickel Company of Canada, Ltd.	17,000	684,486.19	603,500.00
Johns-Manville Corporation	6,000	642,894.46	820,500.00
Kennecott Copper Corporation	15,000	802,948.54	791,250.00
Montgomery Ward & Co., Incorporated	12,000	794,628.40	721,500.00
National Cash Register Company	5,000	201,287.22	196,875.00
North American Company	14,000	469,777.88	441,000.00
Pennsylvania Railroad Company	16,000	568,920.11	408,000.00
Republic Steel Corporation	18,000	362,586.44	500,130.00
R. J. Reynolds Tobacco Company, Class B	12,000	719,486.19	600,000.00
Sears, Roebuck and Co.	17,000	665,468.42	648,125.00
Socony-Vacuum Oil Company, Incorporated	25,000	412,916.80	368,750.00
Standard Oil Company (New Jersey)	12,000	688,942.05	831,000.00
Union Carbide and Carbon Corporation	8,000	648,480.62	774,000.00
Union Pacific Railroad Company	5,000	559,864.44	650,625.00
United Fruit Company	12,000	684,877.77	616,500.00
United States Gypsum Company	6,000	501,817.17	632,250.00
United States Steel Corporation	8,000	519,810.60	574,000.00
F. W. Woolworth Co.	10,000	495,894.69	465,000.00
Total (forwarded)		$16,700,944.81	$17,485,130.00

Schedule I (Continued)

Security	Shares	Average Cost	Market Value
Total (brought forward)		$16,700,944.81	$17,485,130.00
PREFERRED STOCKS:			
American & Foreign Power Company, $7.00 cumulative preferred	5,000	$ 558,689.10	$ 576,250.00
Armour & Company (Illinois), $6.00 cumulative convertible prior preferred	4,000	459,684.10	518,000.00
Commonwealth & Southern Corporation, $6.00 cumulative preferred	6,000	700,968.50	735,000.00
Electric Power & Light Corporation, $7.00 cumulative preferred	5,000	658,684.80	760,000.00
Jones & Laughlin Steel Corporation, 5% cumulative preferred, Series A	6,000	754,810.87	594,000.00
Minneapolis-Moline Power Implement Company, convertible $6.50 cumulative preferred	5,500	506,201.04	591,250.00
The New York, Chicago and St. Louis Railroad Company, 6% cumulative preferred, Series A	6,000	512,595.59	552,000.00
Public Service Corporation of New Jersey, 8% cumulative preferred	4,000	541,848.14	516,000.00
Standard Gas and Electric Company, $7.00 cumulative prior preferred (Note 2)	4,000	445,270.30	482,000.00
Total		$ 5,138,752.44	$ 5,324,500.00
Total stocks		$21,839,697.25	$22,809,630.00
	Principal Amount		
BONDS:			
American & Foreign Power Company, Inc., Gold Debentures, 5's 2030	$ 500,000	$ 462,684.50	$ 542,500.00
The Baltimore and Ohio Railroad Company, Refunding and General Mortgage Bonds, Series A, 5's 1995 (Note 3)	400,000	220,612.00	260,000.00
Buffalo, Rochester and Pittsburgh Railway Company, Consolidated Mortgage Bonds, 4½'s 1957 (Note 3)	400,000	198,417.50	270,000.00
Total (forwarded)		$ 881,714.00	$ 1,072,500.00
Total stocks (forwarded)		$21,839,697.25	$22,809,630.00

Schedule I (Continued)

Security	Principal Amount	Average Cost	Market Value
Total stocks (brought forward)		$21,839,697.25	$22,809,630.00
BONDS:			
Total (brought forward)		$ 881,714.00	$ 1,072,500.00
Chicago, Great Western Railway Company, First Mortgage Bonds, Series A, 4's 1988	$ 300,000	245,000.00	261,000.00
Gulf, Mobile and Ohio Railroad Company, General Mortgage Income Bonds, Series A, 5's 2015	300,000	239,425.50	253,500.00
Missouri Pacific Railroad Company, First and Refunding Mortgage Gold Bonds, Series F, 5's 1977	200,000	165,418.00	167,000.00
The New York Central Railroad Company, Refunding and Improvement Mortgage Bonds, Series A, 4½'s 2013	200,000	151,812.50	151,500.00
Northern Pacific Railway Company, Collateral Trust Bonds, 4½'s 1975	500,000	455,877.50	502,500.00
Southern Railway Company, Development and General Mortgage Gold Bonds, Series A, 6½'s 1956	400,000	459,817.50	480,000.00
Western Union Telegraph Company, 25-Year Gold Bonds, 5's 1951	300,000	254,999.00	257,625.00
United States of America Treasury Bonds, 2½'s 1967-72 (December)	1,000,000	1,000,000.00	1,029,062.50
Total bonds		$ 3,854,064.00	$ 4,174,687.50
Total securities (Note 1)		$25,693,761.25	$26,984,317.50

NOTES:

(1) Aggregate cost for federal income tax purposes $25,682,452.90.

(2) Non-income-producing securities.

(3) Only partial interest is being received on these bonds on the semi-annual interest dates. In addition, the Company received during the year 1946 contingent interest on these bonds for 1945. A portion of the interest, which is applicable to a period prior to the dates on which such bonds were acquired, has been applied as a reduction of their cost.

DESCRIPTION OF AUDITING PROCEDURES

The problems in connection with the audit of a company of this type fall into the following principal classifications:

(1) Investment Securities and Income Received Thereon
(2) Transactions in the Company's Own Capital Stock
(3) Cash Transactions
(4) Verification of Other Assets and Liabilities at the Balance Sheet Date
(5) Expenses
(6) Taxes
(7) Permanent File and Miscellaneous

The audit program followed and the auditing procedures applied in the examination of the financial statements of The Atlantic Investment Fund, Inc. as at December 31, 1946 will be described under the seven general classifications set forth above.

Investment Securities and Income Received Thereon

Shortly after undertaking the engagement the preparation of the investment schedule for the working papers was started, as set forth below.

The investment schedule was prepared on broad analysis paper setting up the following headings (across the page):

Col.	
1	Description of securities
	Balance, June 30, 1946:
2	Number of shares (or face amount of bonds)
3	Average cost
4	Identified cost
	Purchases:
5	Number of shares (or face amount of bonds)
6	Cost
	Sales:
7	Number of shares (or face amount of bonds)
8	Average cost
9	Identified cost
10	Proceeds
	Profit or loss:
11	Average cost basis
12	Identified cost basis
	Balance, December 31, 1946:
13	Number of shares (or face amount of bonds)
14	Average cost
15	Identified cost

Col.	
	Market value:
16	Price
17	Amount
	Dividends:
18	Receivable, June 30, 1946
	Declared during period:
19	"Ex-dividend" date
20	Record date
21	Payable date
22	Rate
23	Number of shares owned on "ex-dividend" date
	Allocation of dividends:
24	Income
25	Return of investment
26	Cash receipts
27	Receivable, December 31, 1946
	Interest:
28	Receivable, June 30, 1946
29	Purchased
	Accrued during period:
30	Income
31	Return of investment
32	Sold
	Coupons collected:
33	Face amount of bonds owned on coupon date
34	Cash receipts
35	Receivable, December 31, 1946

Bonds are listed on sheets separate from stocks so that either columns 18 to 27 or columns 28 to 35 are applicable.

Work relating to the above investment schedule can be started before the end of the period under review and adjusted after the balance sheet date for transactions occurring subsequent to the start of the work. The investment securities on hand at the beginning of the period were listed on the schedule from the previous working papers and the number of shares or principal amount of bonds and the average and identified cost of each holding inserted in the proper columns. The next operation was to ascertain the dividends declared on stocks selling "ex-dividend" during the period. This information was obtained by reference to independent published dividend records and inserted in the proper columns on the schedule.

A 100% check of purchases and sales of securities during the period was made as follows:

1. All brokers' confirmations reflecting transactions during the period were obtained and sorted by securities, taking the first security on the list.
2. The purchases and sales, as reflected by the brokers' confirmations, were checked in detail to the company's investment ledger and the total cost of securities purchased and the proceeds of securities sold were entered on the schedule.
3. Dates, number of shares, and amounts shown on the confirmations were checked to the investment ledger and the average cost of sales was computed simultaneously.
4. At the same time, and before releasing the investment ledger, the "long" position of the particular security on the "ex-dividend" date or the coupon date was entered on the schedule in column 23 or 33, to be used in computing income on the particular security.
5. At the same time, the opening balances of shares and both the average and identified cost thereof were checked from the schedule to the security ledger.

Care was taken that all of this work for each particular security was done at the same time in order to prevent any changes in the dates of transactions subsequent to the checking operation and before the calculation of dividend income. For example, if 100 shares of a particular security were purchased prior to the ex-dividend date and the dividend on this particular 100 shares diverted, and not included in income, it could be covered up by changing the date of the transaction if the verification of dividend income was not made simultaneously with the verification of purchases and sales of securities. In examining brokers' confirmations with respect to bonds, interest purchased and sold was entered in the appropriate columns on the schedule from the brokers' confirmation. By reference to interest tables, a 50% test check of the computation of such interest was made.

After the balance sheet date, any additional purchases and sales of securities during the last few days of the period were checked in the same manner as outlined in the preceding paragraphs and the number of shares or principal amount of bonds and the average and identified cost of the holdings at the balance sheet date were entered on the investment schedule by crossfooting the columns. Such balances were checked to the investment ledger.

Dividend income was verified by multiplying the number of shares owned on the respective "ex-dividend" dates by the dividend rates. The dividends were reviewed for the purpose of determining whether or not any portion thereof should be considered a return of investment rather than income. The principles followed in making this determination are set forth in the section of this study entitled "Major Accounting Policies." Dividends received on preferred stocks representing payments on arrearages were segregated for disclosure in the report. Dividends received during the period were entered in column 26. The dividends receivable at the end of the period were computed by crossfooting columns 18 to 26, the result being entered in column 27.

Coupons collected on bonds were computed from bond descriptions (or independent reporting services in respect of income bonds or bonds in default) and entered in column 34. In connection with bonds which sell plus accrued interest, the interest receivable at December 31, 1946 was computed by reference to interest tables. The interest income for the period was then verified by crossfooting columns 28 to 35.

Income bonds and bonds on which coupons are in default are generally traded "flat." In other words, accrued interest is not added to the price. Any interest collected on such bonds was verified by reference to independent reporting services. To the extent that such interest was determined to be applicable to a period prior to the purchase of the bonds by the company, it was considered to represent a return of investment and was inserted in column 31. The remainder of such interest was considered to represent income and was inserted in column 30.

As mentioned above, the average cost of securities sold was verified at the time of sale and was checked 100%. With respect to securities of which only a portion was sold, a test check of the identified cost of 50% of the securities sold was made. The identified cost of securities completely sold out was, of course, the remaining cost of the securities on hand prior to the sale.

As of the audit date, the value of the securities, based on closing market quotations, was independently computed by reference to published quotations in the newspapers or to other price quoting services in cases where prices were not obtainable from newspaper quotations. The price used was the last sale price in respect of securities on which a trade occurred on that date. The mean between the closing bid and asked price was used in respect of securities not traded on the balance sheet date.

An independent confirmation was obtained from the trustee listing the securities held by it on the balance sheet date. Securities purchased but not received on the balance sheet date or sold and not delivered on the balance sheet date were verified by independent confirmations obtained from brokers, as explained below.

At the time of the previous examination as of June 30, 1946, the investment securities owned were physically inspected and counted by our representatives, in addition to being confirmed to us by the custodian. As mentioned in the section under the caption "Survey of Internal Control," the securities at that time were held in custody by a Jersey City bank. Inasmuch as they subsequently were transferred to a large New York City trust company and at December 31, 1946 were held by such company, as trustee, it was considered that it was unnecessary to inspect and count the securities. Confirmation of the securities by the trustee was considered sufficient independent verification under the circumstances. It might be noted that this procedure is in accordance with the Rules and Regulations of the Securities and Exchange Commission which require the physical inspection and counting of investment securities of investment companies by independent public accountants only when the securities are maintained in the custody of officers or employees of the company.

The completion of the procedures described above resulted in the verification of the following accounts:

(1) Investment securities owned
(2) Dividends receivable
(3) Interest receivable
(4) Dividend income
(5) Interest income
(6) Net profit from sales of securities

The various totals on the investment schedule were crosschecked to the summary of cash transactions and other working papers as follows:

Investment Schedule Column No.	*Account to Which Cross-checked*
6	Investment securities purchased but not received
10	Receivable for investment securities sold but not delivered
11	Profit or loss on sale of investment securities
12	Memorandum account—Profit or loss on sale of investment securities for federal income tax purposes
14	Investments at average cost
15	Memorandum account—Investments at identified cost
17	Investments at market value (the difference between the totals in columns 14 and 17 are crosschecked to a valuation reserve for unrealized appreciation or depreciation on investment securities. This valuation reserve appears in the net worth section of the audit working balance sheet.).
24	Dividend income
26	Summary of cash transactions

Investment Schedule Column No.	*Account to Which Cross-checked*
27	Dividends receivable
29	Investment securities purchased but not received (at the time of purchase, such interest is debited to interest receivable account).
30	Interest income
32	Receivable for investment securities sold but not delivered (at the time of sale, such interest is credited to interest receivable account).
34	Summary of cash transactions
35	Interest receivable

An additional test check of prices at which investment securities were purchased or sold was made as follows:

The prices shown on approximately 25% of the brokers' confirmations were checked to published newspaper prices for the day of the particular transactions and it was ascertained that the prices were within the range of the highest and lowest prices quoted for the day.

A further test check was made whereby approximately 25% of the brokers' confirmations were compared with the related bank advices reflecting receipt or delivery of the securities.

Transactions in the Company's Own Capital Stock

Sales and repurchases of the company's own shares were verified in the following manner:

The company's monthly summaries of the daily totals from the blotters were test checked approximately 10% each month to the respective blotters and the summaries were footed. The totals were abstracted on a schedule by months under the following headings:

Sales:
- Number of shares
- Gross amount at offering prices
- Dealers' concessions
- Amounts billed to dealers
- Atlantic Sponsors, Inc. commissions
- Net asset value
- Capital stock
- Paid-in surplus
- Equalization credits

Purchases:
- Number of shares
- Asset value
- Capital stock
- Paid-in surplus
- Equalization debits

The totals from this schedule will reflect the changes in the capital stock and surplus accounts for the period.

A test check was made of the prices at which the shares were purchased or sold during the period. Only a limited test check was deemed necessary, since more extensive checks in previous examinations and the degree of internal control exercised by the company in computing these prices had given reasonable assurance that the prices were honestly and accurately computed. A test check was, therefore, limited to checking two days each month throughout the period selected at random, with some emphasis on the days when the largest number of shares were sold or repurchased.

The procedure followed in checking the prices was as follows:

1. The long positions of investment securities owned, as shown on the company's price make-up sheet, were checked to the investment ledger, the quoted market prices were checked to independent published quotations, and the extensions were verified.
2. Other assets and liabilities were checked to the books.
3. The number of shares of capital stock outstanding was ascertained by reference to the capital stock account and the blotters.
4. The price was then verified by dividing the total net assets thus arrived at by the number of shares outstanding.
5. This price was multiplied by the number of shares sold and repurchased and the total receivable and payable checked to the totals of the blotters for the particular day.

This test check of net assets was also employed in the verification of the management fee, as described below. In addition, the amounts debited or credited to the "equalization account" were test checked on the days selected for checking prices.

An independent confirmation was obtained from the trustee (which also acts as transfer agent for the company) setting forth the number of shares of capital stock authorized and the number of shares outstanding on the audit date. The number of shares outstanding as reported by the trustee was reconciled with the number of shares shown by the capital stock account on the company's books. The reconciling items represent shares issuable or in process of issue to new subscribers and shares repurchased but not yet received.

Commissions payable to Atlantic Sponsors, Inc. are not paid until the transactions in respect of which the commissions are payable have cleared or, in other words, until the proceeds from the sale of capital stock have been collected by the company. A confirmation of the balance of commissions remaining unpaid at December 31, 1946 was obtained from Atlantic Sponsors, Inc.

Cash Transactions

As outlined under the section "Survey of Internal Control," all cash transactions are effected by the trustee upon receipt of officers' certificates. The trustee furnishes the company daily with advices describing the transactions effected. The advices are summarized daily and entered in the cash book, from which postings are made to the general ledger.

The audit work consisted of the following:

1. A monthly summary of cash transactions was made and the monthly total of receipts and disbursements was reconciled with the bank statements.

2. The totals of this schedule were summarized and cross-checked to the working papers relating to other accounts as follows:

Cash Receipts:
- Dividends received (as shown on the investment schedule above)
- Interest received (as shown on the investment schedule above)
- Receivable for investment securities sold but not delivered
- Receivable for capital stock sold

Cash Disbursements:
- Investment securities purchased but not received
- Payable for capital stock repurchased but not received
- Dividends payable
- Various expense accounts or accruals

3. Bank advices for one month were examined in detail, checked to the summary and followed through to the cash book, which was totalled and abstracted on the schedule described above. Independent confirmation was obtained from the trustee showing the balance of cash on deposit on the audit date.

At the time of the previous examination the cash on deposit was held by the bank in Jersey City in an ordinary checking account subject to withdrawal by check. At that time it was necessary to reconcile the bank account in the usual manner. Also under that arrangement it was considered necessary to examine cancelled checks, foot the cashbook, and check cash receipts to the bank statements for three months during the period. In addition, it was considered necessary to obtain a cut-off bank statement at a date subsequent to the audit date and to reconcile the transactions and balance shown thereon with those recorded on the books. As set forth hereinbefore, during the six months ended December 31, 1946 cash has been handled by the Trust Company in New York as trustee. Since cash account entries are made on the books from bank advices, the account on the company's books is always in agreement with the bank statement and no reconciliation is necessary. In addition, in view of the improved control afforded by having the trustee receive and disburse cash, a test check of details for only one month was considered sufficient. Thus it can be seen that the strengthening of internal control simplified the auditing procedures and permitted a reduction in the extent of test checking considered necessary.

Verification of Other Assets and Liabilities at the Audit Date

Receivable for capital stock sold

Transactions in this account were summarized from the general ledger account and cross-checked with other accounts as follows:

Balance, beginning of period	$ 185,659.94
Add—Sales of capital stock during the period (cross-checked to schedule of sales and repurchases of capital stock)	2,095,321.56
Total	$2,280,981.50
Deduct—Cash receipts (cross-checked to the summary of cash transactions)	2,064,196.29
Balance, end of period (cross-checked to audit working balance sheet)	$ 216,785.21

Requests for confirmation were sent to dealers in respect of the open balances in the account at the audit date. Second requests were sent to those dealers who failed to respond to the first request. In cases where no reply was received to either request, the records were examined to determine that the transaction was cleared subsequent to the audit date.

Receivable for investment securities sold but not delivered

Transactions in this account, as shown by the general ledger for the period, were summarized and cross-checked to other accounts as follows:

Balance, beginning of period		$ 271,633.15
Add:		
Proceeds from sales of securities during the period (cross-checked to the investment schedule)	$4,824,626.90	
Interest sold (cross-checked to the investment schedule)	10,781.36	4,835,408.26
Total		$5,107,041.41
Deduct—Cash received (cross-checked to the summary of cash transactions)		5,052,778.17
Balance, end of period (cross-checked to audit working balance sheet)		$ 54,263.24

Independent confirmation, showing the shares and amounts in respect of transactions open at the audit date, was requested from brokers. In addition, it was determined that the trustee confirmed that it was holding the particular securities sold but not delivered in addition to the securities in the investment account.

Payable for capital stock repurchased but not received

Transactions in this account were summarized from the general ledger and underlying records and cross-checked to other accounts as follows:

Balance, beginning of period	$ 21,568.42
Add—Capital stock repurchased during the period (cross-checked to the schedule of sales and repurchases of capital stock)	272,918.76
Total	$ 294,487.18
Deduct—Cash disbursements (cross-checked to the summary of cash transactions)	285,748.76
Balance, end of period (cross-checked to audit working balance sheet)	$ 8,738.42

Open items on the audit date were verified by independent confirmation from the dealers in the same manner as was followed with respect to securities sold but not delivered.

Investment securities purchased but not received

Transactions in this account were summarized and cross-checked to other accounts as follows:

Balance, beginning of period		$ 319,489.80
Add:		
Cost of securities purchased during the period (cross-checked to the investment schedule)	$6,592,821.60	
Interest purchased (cross-checked to the investment schedule)	18,402.57	6,611,224.17
Total		$6,930,713.97
Deduct—Cash disbursements (cross-checked to the summary of cash transactions)		6,733,368.37
Balance, end of period (cross-checked to audit working balance sheet)		$ 197,345.60

The open items in this account at the audit date were verified by independent confirmation and by applying the same procedures as were followed in respect of securities sold but not delivered.

Expenses

The principal item of expense incurred by the company is the management fee paid to Atlantic Management, Inc. which, as previously noted, is computed at the rate of ½ of 1% per annum of the daily average of the net assets of the company. The computation of this fee was verified by determining the average of such net assets, as shown on the company's daily price make-up sheets. It will be recalled that the accuracy of the price make-up sheets was test checked in connection with verifying the prices at which the company's securities were sold and repurchased. An adding machine tape was run of the daily net assets as shown by the price make-up sheets and the total thus arrived at was multiplied by 1/730 of 1% to determine the fee. The balance of the management fee payable at December 31, 1946 was confirmed to us by the management company.

The second expense in size is the trustee's fee, which is established by contract, and varies depending upon the number of security transactions, aggregate total assets, and other factors. The computation of the fee was checked by reference to the contract and the invoices submitted by the trustee were examined. The balance of the trustee's fee payable at December 31, 1946 was verified by independent confirmation obtained from the trustee.

All other expenses were verified by examination of vendor's invoices and payment was established by reference to the relative bank advices. Confirmations were obtained from the attorneys for the company and others to the effect that there were no unpaid bills at December 31, 1946 for legal services, printing, dividend disbursing charges, etc.

Taxes

New York State franchise, Delaware franchise, New York City excise, and miscellaneous other minor taxes were verified by examination of tax returns, and by computation of taxes accrued for the period since the date to which returns had been filed.

As previously mentioned herein, the company has elected to be taxed as a "regulated investment company" under Supplement Q of the Internal Revenue Code. It was, therefore, necessary to determine that the company met the requirements necessary for qualification under such Supplement, and did not incur any federal income tax for 1946. In order to accomplish this, a review was made to ascertain that

(1) At least 90% of the gross income of the company was derived from dividends, interest and gains from the sale or other disposition of stock or securities. (Actually 100% of its gross income was derived from those sources.)

(2) Less than 30% of the gross income of the company was derived from the sale or other disposition of stock or securities held for less than three months. (Only 5% of the gross income of the company was derived from such source.)

(3) At the close of each quarter of the taxable year (a) at least 50% of the total assets of the company was represented by cash, receivables, government securities, securities of other regulated investment companies, and other securities limited in respect of any one issuer to an amount not greater than 5% of the value of the total assets of the company and to not more than 10% of the outstanding voting securities of the issuer and (b) not more than 25% of the value of the total assets of the com-

pany was invested in the securities of any one issuer. (The distribution of the assets of the company were well within the limits of these requirements at the end of each quarter during 1946.)

(4) The company had filed an election in a prior year to be a regulated investment company. (If 1946 had been the first year of operations, it would be necessary to file such an election with the return for that year.)

(5) The company distributed during the taxable year all of its investment income and net realized gains in the form of taxable dividends. In order to qualify as a regulated investment company, it is necessary that at least 90% of the investment income be so distributed, but by distributing 100% of the investment income plus 100% of the net capital gains, the company avoided the incurrence of any federal income tax. (The review of this particular phase of the company's operations was made on a preliminary basis and based on estimates at a date prior to the declaration of the final dividend paid during the year. This was done for the purpose of assisting the company in determining the amount of its final dividend.) A subsequent review based on actual figures was made after December 31, 1946.

(6) The company had complied with all the rules and regulations of the Commissioner of Internal Revenue for the purpose of ascertaining the actual ownership of its outstanding capital stock. In addition to determining by the foregoing procedures that the tax liability of the company for 1946 was correctly reflected on the books, and in the financial statements, a review was made of our tax file for the purpose of determining that no liability existed in respect of prior years' taxes. It was disclosed that federal income tax returns had been examined and accepted as filed by representatives of the Bureau of Internal Revenue for all years through 1944. While the return for 1945 was still subject to examination, there was no reason to believe that any tax liability for that year existed. Correspondence with the taxing authorities of New York State, Delaware and New York City indicated that all questions raised in respect of returns filed with those authorities had been satisfactorily explained.

Permanent File and Miscellaneous

On each engagement a permanent file is maintained which is carried forward from one examination to the next. The permanent file is brought up to date as early as possible in the course of the work. Our permanent file on this engagement consists of the following:

Survey of internal control

As previously pointed out, the survey of internal control was reviewed and brought up to date immediately upon undertaking the work.

Certificate of incorporation, by-laws, and contracts

Copies of the certificate of incorporation, by-laws, and contracts with the trustee, the sponsor and the management company are maintained in this section of the file. Copies of any amendments to these documents during the period were obtained, compared with the originals and inserted in the file. Payment of trustee's fees, management fees and commissions were verified by reference to the contracts.

Minutes of stockholders' and directors' meetings

Copies of minutes of meetings of stockholders and directors were mailed to our office throughout the period by the company. These copies were checked to the original signed minutes. Amendments to contracts, declarations of dividends, investment changes, etc., were checked from the working papers to the minutes where applicable.

Approved list of investments

The company's investments are made from an approved list of companies. Additions to the list are approved by the board of directors before purchase. Stockholders are advised within three months of additions to the list. An up-to-date approved list is maintained in our files from which changes were checked to the minutes of directors' meetings and notices to stockholders. The investments were reviewed to determine that no securities were purchased which were not on the approved list.

Notices and reports to stockholders

A complete file of notices and reports to stockholders is maintained in our file. All figures appearing in such notices were checked to the records. Printer's proofs were checked in connection with notices relating to the sources of dividends paid, which notices accompanied dividend checks. Proofs were also checked in connection with periodic reports to stockholders which contained financial statements and our reports relating thereto.

Cumulative financial information

Cumulative analysis of capital stock and surplus accounts are maintained in the permanent file. (These schedules were brought up to December 31, 1946.)

Letter of representation

A letter was obtained signed by officers of the company representing to us that:

(a) Copies of minutes of all meetings of stockholders and directors had been submitted to us (The dates of the various meetings were listed in the letter.);

(b) The company had no unrecorded or contingent assets of material amount at December 31, 1946;

(c) All known or ascertainable liabilities of the company of material amount at December 31, 1946 had been recorded on the books as of that date;

(d) The company had no contingent liabilities of any nature at December 31, 1946;

(e) No extraordinary or non-recurring items of income or expense of material amount were included in the income account, except dividends in arrears on preferred stocks;

(f) The accounting principles and policies followed during the six months ended December 31, 1946 were consistent with those followed during the preceding period.

Report

A standard short form report was prepared setting forth the scope and results of our examination and our opinion with respect to the financial statements. No exceptions or qualifications were necessary either as to the scope of our examination, the accounting procedures of the company, or the financial statements.