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FINANCIAL EXAMINATIONS

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FINANCIAL EXAMINATIONS

F. W. THORNTON

FINANCIAL EXAMINATIONS

By

F. W. THORNTON

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EDITOR'S NOTE

In 1917 the Federal Trade Commission approached the American Institute of Accountants and suggested the preparation of a brief but authoritative exposition of what was then understood as the duty of an auditor in making what was called a balance-sheet audit. A special committee of the American Institute of Accountants labored for some months in the preparation of such a work and the matter, when in complete form, was handed to the Federal Trade Commission with the recommendations of the American Institute of Accountants. The commission felt that this manual was of great importance and brought it to the attention of the Federal Reserve Board which in turn adopted it tentatively and recommended it to the favorable consideration of bankers throughout the country.

In 1926, it was suggested that the pamphlet should be revised by the Institute, and another special committee undertook the labor of rewriting and adding to the original document. It required two or three years of earnest effort to complete the revision. Nothing was done without careful consideration and various schools of thought were represented in the revising

committee. The final result was published by the Federal Reserve Board in 1929 under the title *Verification of Financial Statements.*

Since that time the contents of the report have been translated into foreign languages and the English text has become a handbook for bankers, accountants and corporate officers throughout the United States.

The text was necessarily condensed to the utmost possible degree and it was felt at the time it did not constitute a complete guide. Many of the important functions of the auditor were dismissed with a few words. There has been much demand for an exposition of the meaning of the manual and for the addition of instructions which would act as a guide to accountants engaged in the audit of companies, particularly those of medium size. This work could be done only by a competent practising accountant; Mr. Thornton, who has now completed his task, is well qualified to expand the outline in the Federal Reserve *Bulletin* and to make of it a book of instruction and suggestion that should be helpful to practitioners everywhere. He has had the advantage of assistance of many of his co-workers in the profession and the text which is here presented is really the result of conference, deliberation, writing and rewriting until it has actually become an expression of the most modern opinion of accountants as to what should be done in most of the important problems which arise in practice.

A. P. RICHARDSON, *Editor.*

New York, September, 1933.

PREFACE

For some years there was a demand by bankers, accountants and others, for an accepted audit procedure, so that a certificate might be read with assurance that certain definite steps had been taken in verification of the accounts certified.

The Federal Trade Commission, recognizing this demand, requested the American Institute of Accountants to formulate a program. This was published by the Federal Reserve Board with a tentative approval, in April 1917, and was given a title *Approved Methods for the Preparation of Balance-sheet Statements.* It applied primarily to the accounts of industrial companies and contained a statement of the important steps required in an audit for the certification of financial statements.

A revision by a committee of the American Institute of Accountants was later undertaken, completed in 1929, and published by the Federal Reserve Board with the title *Verification of Financial Statements.* It is submitted in full as an appendix to this book.

It is not possible to prescribe an exact procedure to be followed in auditing widely differing kinds of

business organizations. It is recognized by the accounting profession that the Federal Reserve Board bulletins do contain an acceptable outline of procedure in an audit for credit purposes and in many respects for certified annual reports to stockholders.

The American Institute of Accountants has received requests for an amplification of the skeleton of procedure contained in the bulletin. This book is written in part to serve this purpose, to supply in a brief text some explanation of the reasons for the steps in the verification program of the bulletin and to set forth more in detail other steps which may suggest what might be included in the audit of a medium or smaller sized company.

Business organizations vary so widely in character and methods and changes take place so rapidly that the procedure outlined here can be only suggestive.

No attempt has been made to deal with special questions relating to partnerships or individual proprietorships, nor with problems arising only in consolidations, except here and there as illustrations.

To a number of associates I am indebted for help in the preparation of this book. The best accountants are generally willing to give unselfishly of their time to help other accountants; the associates to whom I refer are of this kind.

F. W. Thornton.

CONTENTS

PAGE

EDITOR'S NOTE v

PREFACE vii

CHAPTER

I. SCOPE OF THE EXAMINATION 1

II. GENERAL CONSIDERATIONS AT THE COMMENCEMENT OF THE EXAMINATION . . 8

III. CASH AND CONTROL OF SECURITIES . . . 15

IV. ACCOUNTS AND NOTES RECEIVABLE . . . 30

V. INVENTORIES 47

VI. INVESTMENTS AND ADVANCES 79

VII. FIXED ASSETS 93

VIII. DEPRECIATION AND DEPLETION 112

IX. DEFERRED CHARGES 125

X. CURRENT LIABILITIES 130

XI. LONG-TERM LIABILITIES 142

XII. CONTINGENT LIABILITIES 155

XIII. DEFERRED CREDITS AND RESERVES . . . 162

XIV. CAPITAL STOCK AND SURPLUS 169

XV. PROFIT-AND-LOSS ACCOUNT 184

CHAPTER PAGE

XVI. INTERNAL CHECK 206

XVII. AUDITOR'S CERTIFICATE 211

APPENDIX: FEDERAL RESERVE BOARD BULLETIN, *Verification of Financial Statements* 217

INDEX 275

FINANCIAL EXAMINATIONS

·I·

SCOPE OF THE EXAMINATION

THE Federal Reserve *Bulletin* deals primarily with the audit procedure and preparation of statements for credit purposes. The phrase "balance-sheet audit" was used by the Federal Reserve Board in its earlier bulletin to distinguish an audit of one kind from another described as a "detailed audit"; the latter involves a much more exhaustive examination of the details of the records and transactions. It is necessary to consider the difference between the two types of audit and the conditions in which each is commonly used.

The earliest type of audit was a detailed verification of all transactions, examination of all disbursements, checking of all postings to the ledgers, checking of all footings and preparation of trial balances. It was a "detailed audit," designed to satisfy the owner of the business that all the transactions were in order and properly recorded.

With modern methods and corporate organization, owners and creditors of a business may be widely scattered; large-scale operations result in expansion and

departmentalization of bookkeeping procedure. Systems of "internal check" have been devised whereby the work of one employee is checked by the work of others.

Internal auditors are also employed to make continuous or periodical examinations of the details of transactions, to see that the procedure is correctly followed and to introduce improvements when possible. Such auditors, from their knowledge of the specific merchandise and of the character of the staff, become peculiarly well qualified to deal with the smaller details of the work. It has become unnecessary in the case of many of the larger companies for the outside auditor to check in detail the great mass of routine entries; the volume of business would render the cost of detailed independent verifications almost prohibitive.

This development is not uniform in all business; there are smaller concerns, with a few employees engaged in accounting, among whom full separation of duties and division of responsibility is difficult or impossible. There are also some old-fashioned systems still in operation in larger concerns. It has become a practice for public accountants at the beginning of an examination to review the system of accounts and the internal check to see whether they can adequately perform their duties without the expense of making a "detailed audit."

The amount of reliance to be placed upon the inter-

nal check is a matter of judgment. In chapter XVI will be found a list of some of the principal things that an auditor may consider with profit in reference to internal check. If previous audits have been made and the system is more or less familiar these questions will need less attention.

The Federal Reserve *Bulletin* is restricted to the procedure for a so-called balance-sheet audit, not a detailed audit. There is as yet no general agreement as to the best designations of the several types of audit, the phrase "balance-sheet audit" being unsatisfactory. The title is relatively unimportant if it be understood that the audit described by the Federal Reserve *Bulletin* and discussed in this book is directed toward the "verification of the financial statement" and not toward the verification of the correctness of each of the detailed transactions. Detection of defalcations is not the purpose of this type of audit.

It may be desired that some verification or test-check of detailed transactions be made beyond that needed for certification of financial statements. This should be discussed with the client and the extent of the auditor's responsibility should be clearly defined, both to the client and in the mind of the auditor.

The work of the public accountant is not restricted to conventional types of audit and, even when an audit of conventional type is to be made, there may be some feature, perhaps a minor one, to which special attention is to be given. There are investigations into

costs of production, verifications of royalties, of other kinds of income, of overhead expenses, examinations for purchase of a going business and many more kinds of work.

The client as well as the accountant should understand that accounting is not an exact science; very seldom does an audit program for one company apply exactly to another, even if it be in the same kind of business. As an audit proceeds complications may develop and tests of records not originally expected may be found necessary.

There is usually a maximum and minimum audit that can be made in every case, and the expense that the client is willing to incur has an important bearing on the scope of the examination. In an address before the Society of Certified Public Accountants of the State of New Jersey in 1926 Geo. O. May stated the position as follows:

"An audit is a safeguard; the maintenance of this safeguard entails an expense; and this expense can be justified only if the value of the safeguard is found to be fully commensurate with its cost. The cost of an audit so extensive as to be a complete safeguard would be enormous and far beyond any value to be derived from it. A superficial audit is dangerous because of the sense of false security which it creates. Between the two extremes there lies a mean, at which the audit abundantly justifies its cost.

"The problem is to determine this happy mean, to en-

sure that the auditor does not fall short of a reasonable discharge of his duties, and that the investor or lender does not attribute to the audit a greater significance than it can as a practical matter possess. And it must be recognized that skilled dishonesty, especially collusive dishonesty, may at times and for a time deceive even the auditor who conducts what is regarded as a reasonable audit, and that this should be so is not to be regarded as a defect of the system, since as I have said audit procedure represents a balancing of the consideration of risks on the one side and cost on the other. As a matter of fact, investors and lenders need protection against deliberate dishonesty less than protection against unsound practices and undue optimism. In the experience of my firm, and probably it is also the experience of other firms, cases of deliberate dishonesty are trivial in number in comparison with cases where misrepresentations have been made on the basis of excessive hopes or as the result of unwillingness to face unpleasant facts or through an incorrect treatment of facts which there was no attempt to conceal or the ordinary procedure of an audit would readily disclose."

The large failures of the recent past call for no modification of this statement. In most of those failures the disastrous fall in values was the main contributing cause. In some instances, such as the collapse of some of the inverted pyramids created in the public-utility field the effect was heightened by previous unsound treatment of items (*e.g.*, stock dividends) which was clearly disclosed on the face of the

accounts. In the most spectacular case of all, the Kreuger failure, the final report of the accountants who investigated the group of companies makes it clear that any honest audit even though only moderately extensive would, if it had included all the companies, have disclosed the irregularities long before they reached the proportions which they ultimately attained.

There is no room for doubt that in the great majority of cases an audit extensive enough to be really valuable can be carried out at an expense that is not burdensome. The essential difficulty in formulating a program for such a verification is to outline a procedure which will be adequate in the great majority of cases without being unnecessarily extensive in a large proportion of them.

The discussion which follows is predicated on the assumption that such usefulness as this book may have will be in relation to the audit or verification of the accounts of corporations of medium or small size and not in relation to the largest companies whose systems of internal check are apt to be highly developed.

The extent of the verification requisite must depend upon the circumstances of each case. It should be understood, therefore, that throughout this work the word "should" and its equivalents are employed as indicating what in a large number of cases will be

found to be desirable, with the understanding that the procedure outlined will not be applicable in all cases and that the omission of any particular steps will not necessarily constitute a dereliction of duty on the part of the auditor in a given case.

· II ·

GENERAL CONSIDERATIONS AT THE COMMENCEMENT OF THE EXAMINATION

At the commencement of every audit, in addition to reviewing the accounting system and internal check, the accountant should acquaint himself with the general organization and business of his client. He should obtain the names and duties of the officers with whom he will come in contact. He should ask for copies of the published reports and important internal reports both for the current year and for several prior years, if he does not already have them in his working papers. In a first audit, it is well for him to inquire into the manufacturing processes, the methods of distribution—whether through wholesalers, jobbers or retailers—and other important facts about the business of his client. The accountant in charge can assign his assistants at once to the detailed work of the audit, but he should first familiarize himself with the general situation, outline an audit program and determine the essential features of the audit which are to

be stressed. The importance of such preliminary work is readily apparent. The value of the audit is increased and time saved by obtaining a thorough understanding of each assignment at the outset.

In the case of recurring audits it is customary to keep a so-called "permanent" or "continuous" file containing all the more essential facts with respect to the business, the names and duties of the officers and employees with whom the auditor comes in contact, a running analysis of the surplus account and a digest of the minutes from the beginning. This file should be reviewed by the auditor each year before commencing the examination. He should also review his correspondence files for special points or specific instructions.

Trial balances in comparative form at the beginning and end of the period or periods under review should be prepared and checked to the ledgers. Space should be provided on the working schedules for adjustments to the ending balances and also the beginning balances, if these have not been previously verified. If the books have been closed before the auditor commences his examination, trial balances after closing can be used, but they will reflect only the balance-sheet accounts. Analysis of the profit-and-loss account and closing entries will then be necessary. In addition to analyzing the important accounts in the trial balance, the auditor should scrutinize the general ledger, private ledger and journal to ascertain what

accounts have been opened and closed during the period and do not appear in the opening and closing trial balances. If there are loose-leaf general ledgers, the transfer binders should be examined and the monthly trial balance book reviewed to disclose any accounts that may have been removed from the current ledgers.

As soon as tentative balance-sheet figures and results of operations are available, the accountant in charge should obtain and study them. It is always advisable for him to be able to discuss the figures with the executives of the company or with his superiors in his own office before the audit is completed. This may prevent the management from giving prematurely to the press figures which the auditor subsequently determines should be adjusted. The officers are, naturally, reluctant to correct figures already published, particularly if the statements, as revised, present a less favorable view of the financial condition or operations of the company.

"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" (Paragraph 3 of the *Bulletin*).

The statement of "disposition of resources" is a condensed statement setting forth the important

changes in financial position during the year as the result of operations and other transactions. To prepare it, the balance-sheets at the beginning and end of the year are compared and the changes are briefly explained. The auditor will often find it desirable to prepare such a statement as early as possible in the audit or as soon as comparative balance-sheets are obtained. At the completion of the audit, this statement should be modified in order to summarize as clearly as possible what are then considered to be the most important changes during the period.

Inasmuch as the statement of "disposition of resources" or "changes in financial position," is not used as frequently as its importance would justify, an example will be given. Let it be assumed that the following comparative balance-sheets are available shortly after the commencement of the audit:

Comparative balance-sheets (in round figures)

Assets	At beginning	At end	Increase *Decrease*
Current assets:			
Cash	$ 150,000	$ 50,000	*$100,000*
Accounts receivable	300,000	500,000	200,000
Inventories	400,000	350,000	*50,000*
	$ 850,000	$ 900,000	$ 50,000
Investment in and advances to affiliated company	100,000	200,000	100,000
Fixed assets	500,000	550,000	50,000
Depreciation reserve	*120,000*	*150,000*	*30,000*
Total assets	$1,330,000	$1,500,000	$170,000

Liabilities	At beginning	At end	Increase *Decrease*
Current liabilities:			
Notes payable—banks ...	$ 100,000	$ ...	*$100,000*
Accounts payable	150,000	200,000	50,000
	$ 250,000	$ 200,000	*$ 50,000*
Funded debt outstanding....	300,000	250,000	*50,000*
Capital stock	500,000	750,000	250,000
Surplus	280,000	300,000	20,000
Total liabilities ...	$1,330,000	$1,500,000	$170,000

These figures may be expressed in the form of a statement of "disposition of resources" as follows:

Resources provided by:		
Issue of additional capital stock......		$250,000
Increase in surplus for the year......		20,000
		$270,000
Applied as follows:		
Increase in net working capital......	$100,000	
Increase in investments.............	100,000	
Additions to fixed assets (net).......	20,000	
Reduction in funded debt...........	50,000	
Total as above...............		$270,000

During the audit it is found that the profits for the period amounted to $160,000, after charging off depreciation of $80,000; that fixed assets with a book value of $140,000, on which depreciation of $50,000 had been previously provided, were scrapped, and the loss of $90,000 was charged against surplus; that dividends

of $50,000 have been paid; and that $300,000 sales had been made at large profit but on long-term credit to foreign customers. At the close of the audit, therefore, it may well be decided to revise the statement of disposition of resources to bring out what are now known to be the most important factors as follows:

Resources provided by:			
Issue of additional capital stock			$250,000
Net profits from operations before deducting depreciation provision of $80,000 and loss on disposition of capital assets of $90,000			240,000
			$490,000
Applied as follows:			
Additions to fixed assets		$190,000	
Increase in investment in affiliated company		100,000	
Reduction in funded debt		50,000	
Dividends paid		50,000	390,000
Difference, representing increase in net current assets as explained below			$100,000
Increase in foreign accounts receivable		$300,000	
Liquidation of bank loans		100,000	
		$400,000	
Less:			
Reductions in:			
Cash	$100,000		
Domestic accounts receivable	100,000		
Inventories	50,000		
Increase in accounts payable	50,000	300,000	
Increase in net current assets		$100,000	

There are other possibilities of variation in such a statement, but the emphasis should always be placed on the most significant changes in financial position during the year. This form of statement will usually be of interest to the client and by its preparation the auditor is helped to visualize the most important points requiring attention during his examination.

· III ·

CASH AND CONTROL OF SECURITIES

Verification of cash on hand, bank balances, notes receivable, and securities should be made simultaneously, since they are mutually complementary or convertible: a shortage in one may be made up out of another if verifications are made at different times. The verification of all of them should be made at an early stage of an audit.

CASH ON HAND

If a surprise examination is required, the cash, securities and notes must be counted without delay. In ordinary examinations it is best to count them after banking hours on the date of closing the fiscal period because verification of cash at that date is desirable. It is not unusual for the client's staff to expect such a count at that time and to arrange the records accordingly. All cash held by the cashier and his assistants should be counted at the same time as the cash shown by the cashbook and ledger even though it include funds not carried on the general books; thus, un-

claimed wages, Christmas club money, money of athletic associations and other similar funds may be held. The amount that should be on hand for each fund is to be verified from the records or by certificates, if the records are kept elsewhere.

The count should be made in the presence and under the inspection of a representative of the client, preferably the cashier. At its conclusion the cashier or other representative of the client should be asked to approve and initial the working sheet, especially if any differences have been found.

If any differences seem to exist the cashier or other custodian should be informed at once and given full opportunity to explain. The auditor may not have understood fully the circumstances. At least the custodian has the right to justify conditions if they are justifiable.

The auditor's schedule of cash counted should show separately amount of currency, gold coin, other coin, customers' cheques, coupons, employees' cheques and I.O.U.s. Dates and signatures of cheques and I.O.U.s should be noted.

Vouchers for disbursements not yet entered on the books may appear as part of the cash or petty-cash funds. The amount of detail of such items to be transcribed into the auditor's record must be left to his discretion.

If any moneys have been lent to directors, officers or stockholders of the client company and are repre-

sented by cheques, I.O.U.s or notes carried as part of the cash on hand, full detail must be transcribed and the approval of the treasurer or some other officer obtained. In no case may amounts other than petty sums be passed as proper without the authority of some high officer, and even so they can not be left in the account as part of the cash. If salaries are paid by cheque and the cashier has cashed cheques thus given to employees it is not necessarily objectionable: such cheques may properly be counted as part of the cash on hand.

Undeposited customers' cheques are to be listed and the list compared with cashbook entries and traced to bank deposits. Postdated or antedated cheques should not ordinarily be included. If they are, satisfactory explanation should be obtained.

At the end of a fiscal period cash should be relieved of all non-cash items, and this is generally done. If, however, postdated cheques have been entered as cash received, their amount should be deducted from the cash balances and transferred to accounts receivable, if they are ultimately collectible, or written off, if not collectible.

Clients may not engage the auditor until some time after the end of the fiscal period to be examined; it is then impossible to count cash on the closing date. In such cases the auditor may make two cash counts, one immediately upon beginning work, reconciling his count with current records, and a second more rigid

count at a date when the bank accounts may simultaneously be closed and canceled cheques returned. Besides examining the canceled cheques for the last month of the audited period and making a reconcilement at the closing date, the transactions between the end of the fiscal period and the date of the second count are to be checked as thoroughly as though the date of the second count were the date of closing the books, a reconciliation statement being prepared, showing balance at end of fiscal period and receipts and payments up to the date of the second count.

If the interval elapsing between the date of beginning the audit and the date on which the bank statements and canceled cheques are obtained is short it is permissible to make only the last of the two counts which are referred to above. The first count is of value principally as a surprise check made before the cashier has opportunity to improve the appearance of his accounts.

CASH IN BANK

The procedure for verifying bank accounts prescribed in paragraphs 8 and 9 of the Federal Reserve *Bulletin* is the minimum permissible. If more extended verification is desired the following procedure is suggested:

The client's reconcilement of his bank accounts at the end of the preceding month and the canceled cheques for the month to the date of closing are ob-

tained; the canceled cheques are compared, first, with the list of outstanding cheques prepared by the client as of the beginning of the final month of the audited period; then with the cashbook entries for the last month. Amounts, names of payees and bank endorsements are to be examined. The endorsements of the payees can not be known to the auditor, but responsibility rests on the banks through which cheque has been passed and for that reason the auditor should see that each cheque bears the endorsement of some bank. The items in the list of outstanding cheques at the beginning of the month and the cashbook entries for the month not covered by canceled cheques are the outstanding cheques at the end of the month.

Then, total deposits shown on the bank statement should be reconciled with the total receipts entered in the cashbook, and for the last few days the bank deposit should be compared in detail with the entries of daily receipts as shown in the cashbook and with the duplicate deposit slips. If irregularities are suspected, the original slips may be inspected at the bank.

A reconciliation statement for each bank is to be prepared substantially as follows:

Balance per bank statement		xxxxxx
Add:		
Deposits forwarded to bank but entered on a later date:		
Date entered	xxxxxx	
do do	xxxxxx	
Bank charges not in cashbook.........	xxxxxx	xxxxxx
		xxxxxx

Deduct:

Outstanding cheques per list	xxxxxx	
Interest credited but taken on the books next month	xxxxxx	
		xxxxxx
Balance per cashbook		xxxxxx

If there are several banks, the total of all balances after reconcilement should agree with the ledger account "Cash in banks." If the bank charges are known in time it is preferable to take them on the books, not to use them in the bank reconcilement.

If of several bank accounts one is overdrawn, either the overdraft is deducted from the balances in the other banks or it is shown as a separate liability, according to circumstances. If the overdraft be due to error or carelessness, if there are ample funds available to be transferred to the overdrawn account, and if the overdrawn condition has been promptly rectified, the first course is permissible; if the overdraft is in a foreign bank, if it be in the bank of a subsidiary or if there be insufficient funds in other banks readily available for transfer to cover the overdraft, then it should be shown as a separate liability.

If an audit is commenced after the nominal date of closing and is completed before the end of the following month it is not necessary to wait until the end of the month to obtain a bank statement and canceled

cheques; banks will furnish them on a few days' notice and they should be obtained at a date toward the end of the audit, when the cash, bank accounts and security accounts may be simultaneously verified. In any case the canceled cheques for the last month of the audited period should absolutely agree with the cashbook entries.

Charge slips, accompanying bank statements, showing failure of the bank to collect on cheques, drafts, notes, etc., affect not alone the cash balance but also the standing of the corresponding accounts receivable. Full details of such charge slips should be noted.

Outstanding cheques not returned within a reasonable time should be investigated; very old outstanding items should be traced, if possible, to the original cashbook entries and an effort should be made to have them transferred from the bank account to a ledger account, or written off if there seems to be no possibility that they ever will be presented.

All bank transactions for a few days before and a few days after closing the books should be reconciled exactly with book entries; if there be several bank accounts "kited" cheques may cover a shortage for a day or two but their use necessarily causes bank deposits and bank payments to differ from the cashbook detail. While the primary duty of an auditor in making an examination of this kind is not the detection of fraud, he is not relieved of the duty of detecting

fraud so far as it would be detected by the faithful observance of the procedure prescribed for a balance-sheet audit.

Paragraph 14 of the Federal Reserve *Bulletin* says that the total receipts of clients depositing all cash receipts in bank "should be reconciled with the total deposits shown by the bank statements and the total disbursements should be reconciled with the total cheques drawn." "When it is the practice for a company not to deposit all its cash receipts in bank all cashbook footings should be verified."

The period over which such verification is to be made is not stated, but it is a practice of auditors to restrict it to the last month of the audit period in case of an examination only for the purpose of verification of a financial statement which does not include full examination of all cash transactions. It is better practice to make some test of another part of the audit period in addition to the test of the last month, because adherence to the practice of examining only the last month may lead employees to dress up the last month's accounts.

Bank certificates should be obtained as of the date of closing and also as of the date of the count of cash and securities.

BRANCH OFFICE CASH

Cash at branch offices may include imprest funds, part of which may be in bank and part on hand, and

collected cash which should be deposited intact in bank. The branch offices of film distributors have both kinds of cash.

If the client has an adequate staff of traveling auditors, the imprest funds as certified by branch managers may usually be accepted as correct, the bank balance being confirmed by bank certificates. Collected moneys should be deposited in an account from which withdrawals can be made only on the cheque or draft of the head office; the verification of such accounts is, therefore, part of the verification of the head-office bank accounts.

If there are numerous branches the working papers may contain a schedule showing for each office:

Imprest fund:

1. Actual cash on hand
2. Cash in bank
3. Cash in transit (reimbursing cheques in the mail)
4. Branch vouchers, to be reimbursed by head office
5. Branch vouchers, not to be reimbursed

   Total, established balance of fund.

Collections from customers:

1. Collections not deposited or deposited and not yet credited by the bank
2. Collections deposited and credited by banks

   Total, equal to all collections made.

Item 3 should be verified as being in agreement with outstanding cheques in the head-office bank.

Item 4 represents payments actually made which at the moment may not have been taken up by the head office but are shown as part of the branch cash. The total of vouchers for all branches should be deducted from cash and charged to the proper expense or other accounts. It is not sufficient that the client set these amounts up as liabilities, charging the proper expense and other accounts; they are not accounts payable but have been paid and, while for bookkeeping convenience, it is permissible to set them up on the books as accounts payable the adjustment should be made in the statement of assets and liabilities.

Item 5 may be deposits, advances to salesmen or other refundable advances. If material in amount the auditor may have to classify them as assets other than cash, according to their character.

Branch reports and vouchers for a short time after the date of closing should be examined for expenses that should have been taken up before closing, and if necessary the liability should be set up with a corresponding charge to operations.

If branches are not too numerous and widely scattered, it may be well for the outside auditor to visit them; if cash and bank balances are relatively large such visits are even more desirable. Upon making such a visit the work to be done is similar to that done in verifying the bank and cash balances at the head office.

SPECIAL FUNDS

Payroll and dividend accounts should be examined, even though the books may show no balance. If funds for payment of dividends and payrolls are entrusted to the cashier and are carried in separate bank accounts, those accounts should be verified with canceled cheques and bank certificates as in the case of other bank accounts. It is not sufficient to check dividend accounts for the last month since there may not have been any dividends paid; the test should cover at least the last dividend payment on each class of stock.

If dividend moneys or amounts for payment of interest on funded debt are deposited with a bank or trust company as trustee the certificate of such trustee as to the condition of the fund and amount of cash in bank will suffice.

Unclaimed payroll items are treated variously; several methods are considered proper. If all payments are by cheque, the books will probably show the entire payroll as having been paid, with the unclaimed items as outstanding cheques. If some or all payments are made in cash and there are unclaimed items it is proper to return the cash to the regular cash funds, setting up a liability for the amount so returned as "unclaimed payroll." Again, it is not unusual for the cashier to hold unclaimed wages in envelopes recording them in a record outside the regular books; in this case the system relies entirely on the integrity of the

cashier. Unless employees sign for their wages and salaries the auditor can do little to check the cashier where wages are paid in cash. Payroll unclaimed for three months is seldom paid at all.

Some clients keep their cashbooks open after the closing date, obtaining and paying expense and other bills and dating the cheques as of the date of closing the books. By this device accounts payable may be made to appear smaller in amount or may even disappear altogether. The practice is wrong; it distorts the balance-sheet so that it does not present fairly conditions as they exist. Adjustments increasing cash and accounts payable should be made so that they appear as they really were at the date of the balance-sheet. Similarly, the cashbook may be kept open so that receipts after the date of closing are recorded as having been on hand at the closing date; this will clearly appear in making the bank reconciliation and must be corrected before a fair presentation can be made.

Although not strictly to be classified as cash or securities, postage and revenue stamps need consideration when cash is counted. Postage stamps may amount to a large sum where wide advertising is done; revenue stamps are of large amount in brokers' accounts; and if sales taxes payable by affixing stamps become more general such stamps may absorb a large amount of capital. Stamps, therefore, should be considered as having a close connection with cash and should be counted at the same time.

In all cash matters the adequacy of internal check has great weight. Apart from collusion there is little danger of continued losses from defalcation if there be a thorough internal check.

CONTROL OF SECURITIES

If the client furnish a complete list of all securities, notes, warehouse receipts and other negotiable instruments, whether owned or held as collateral, it will expedite the auditor's count. If the list can not be obtained from the client, all such assets should be counted, listed with sufficient detail for positive identification and checked to the records without delay. If many such documents are owned it is desirable, when arranging for the audit, to ask the client to prepare the list in advance; best results are obtained when the count, as it progresses, can be checked to a list which the client admits to be a list of all he claims to have.

When any securities have been counted and listed they should be held under the seal of the auditor or otherwise under his control, but in the physical possession of the client, until the count is complete and the quantities have been reconciled with the records or with a list furnished by the client. That list afterward should be checked to the records.

The work of verifying securities must be done as quickly as possible, so that the staff of the client may not be inconvenienced. Counts of cash or of securities

should be made only in the presence of the client or of his authorized representative. If possible his approval of the quantities should be obtained and noted on the working schedule.

Stock certificates and registered bonds should be in the name of the client or accompanied by sufficient power of attorney or assignment. Unmatured coupons should be attached to bearer bonds.

Securities owned but not actually on hand, because they are pledged as collateral, out for transfer, or deposited for collection, should be verified by confirmations from the holders, the confirmations specifying any liens against them.

If the count of securities can not be made on the date of closing, it is best made on the same date as the bank and cash verification. In those circumstances the dates of issue of stock certificates should be noted —those dates, of course, should be earlier than the closing date, if the securities were owned at the closing date. Endorsements, that might indicate that securities had been pledged, should be noted. A test of serial numbers of bonds may be made if there is suspicion of substitution.

These instructions are applicable to counts of securities in ordinary commercial enterprises; they are quite inadequate for the verification of securities in banks, brokers' offices and the offices of dealers in investment securities. The procedure necessary for

these enterprises differs from that needed in any commercial office and is the subject of special treatises.

If hypothecation of securities is suspected the auditor should remember that securities can be hypothecated by means of attached powers of attorney and without any endorsement on the securities themselves; freedom from endorsement does not prove that securities have not been pledged. When they are improperly pledged the pledgor is likely to use a device that leaves no record on the securities except the pinholes where powers were attached.

· IV ·

ACCOUNTS AND NOTES RECEIVABLE

As a preliminary to the actual verification of accounts and notes receivable the internal check on customers' accounts should be reviewed. If persons in charge of customers' ledgers are entirely independent of the billing and credit department, do not have access to incoming mail and do not themselves list and mail the monthly statements of customers' accounts, the possibility of defalcation without collusion is much reduced. Without such a separation of duties it becomes possible, without collusion, to conceal defalcation by fictitious entries in the customers' ledgers and by suppression or falsification of customers' statements, which might go undiscovered in the absence of a complete circularization of the accounts or a detailed check of all postings. Such a complete check of all postings is seldom practicable; the amount of time required to make it for a large enterprise would make the cost prohibitive. If the internal check be good the validity of the accounts may generally be sufficiently confirmed by comprehensive tests.

After reviewing the internal accounting methods it

is well also to review the methods of billing and handling the invoices, the terms extended to customers, the extent to which the terms are enforced and the procedure followed to collect overdue accounts. Time is not lost in making these reviews; they will simplify the work of audit and prevent spending time in unnecessary detail work.

In verifying notes and accounts receivable the auditor must be satisfied: 1. that they represent valid claims against bona-fide debtors and 2. that they are collectible. The first point is most thoroughly covered by an examination of the books and a complete circularization of debtors' accounts. The second point rests on the judgment of the auditor, having in view the internal check, the credit terms, the aging of the accounts, the experience of the company in prior years and general business conditions.

If circularization of customers is not possible, the next best check is to compare monthly statements of customers' accounts with the customers' ledger trial balance, and then to have them mailed either by the auditor or by an employee of the client company who does not have access to the customers' ledgers.

The audit procedure in the examination of accounts receivable may be as follows:

VALIDITY

1. Check trial balance of customers' accounts to detail ledgers and reconcile with general ledger control.

2. Check monthly statements to trial balance and mail the statements without allowing them to pass through other hands.
3. Determine by tests of postings from original records or by circularization that fictitious accounts are absent.
4. Ascertain whether or not there are any liens against accounts receivable.
5. Test-check to see that the accounts arose from sales made prior to the balance-sheet date and that the goods sold were excluded from the inventory.

COLLECTIBILITY

1. "Age" the accounts, ascertaining what amounts are past due under the terms allowed.
2. Discuss overdue accounts with credit manager and examine collection files.
3. Provide reserves for losses in collection, rebates, allowances, discount and any other deductions that will be made on payment.
4. Classify accounts, separating trade accounts, intercompany accounts, amount due from officers and employees, loans, special deposits, sundry debtors.

COMPARISON WITH BOOKS

It is necessary to have a trial balance of customers' accounts, leaving open columns for the purpose of "aging"; this is to be compared with the customers' ledger, the individual accounts are to be aged, and the total reconciled with the control. If the internal

check be excellent, if there is a large number of relatively small accounts and several controls by sections, it may be sufficient to check in detail only two or three sections. In subsequent audits the other sections may be checked in rotation so that all sections will be checked within two or three years.

CIRCULARIZATION

The most thorough method of verifying customers' accounts is to send to all customers with open balances statements of their accounts with requests for confirmation, the replies to be mailed direct to the auditor at his own address, not in care of the client. Before mailing such statements the auditor should check them to the trial balances and then personally mail them, enclosing return envelopes addressed to him. If confirmations are addressed to the client it becomes possible for employees to intercept either replies from customers whose accounts are known to have been manipulated, or returned statements sent to fictitious addresses.

The purpose of the confirmations should be explained to the customers with a comment that they are not to be interpreted as a request for payment.

Not all confirmations will be returned; small business men and storekeepers and private persons are most often guilty of neglecting to reply, but these people will reply as quickly as anyone if the statements sent to them are not found correct. Failure to

object to statements is not equivalent to confirmation but it is some indication that the statemens are correct. In extreme cases it may be necessary to send a second request for confirmation, especially of large or overdue accounts. In the absence of serious objection to any of the statements, if two thirds in number and in amount be confirmed the general confirmation may be regarded as fairly good. Special attention is to be paid to accounts the statements for which are withheld from the mail at the request of the client or his staff.

In some organizations statements are prepared as carbon copies of the ledger entries, compared with the trial balances by an employee not handling cash nor making entries in the customers' ledgers and then mailed without permitting the ledger clerks again to have access to them; this is, in effect, a circularization by the client's staff.

It is not entirely necessary that the date of the statements circularized should be the date of the balance-sheet to be prepared; if the audit be begun some time later than the date of the balance-sheet to be prepared the statements confirmed should be brought up to the end of the latest possible month.

OTHER TESTS OF VALIDITY

In the absence of circularization, close inspection of customers' ledgers becomes necessary, with a good test of postings from sales and cash records. Particularly

sales and collections for the last few days of the period under examination should be checked to the ledger; they may contain special additions or changes, padding of sales, and other doubtful entries. All postings to the control account should be checked and any journal entries affecting the control should be explained and justified. Balances of important accounts and of the total amount of all accounts outstanding should be compared with corresponding amounts at earlier dates including the amounts at the opening of the period. Any material change in the ratio of sales to the total of unpaid balances should be explained.

LIENS

Accounts receivable may have been sold or pledged. Such accounts usually are and always should be distinguished from free accounts, either by segregation in a separate binder or by memoranda on the ledger sheets. If there are such accounts not directly distinguishable from free accounts in one of the ways indicated, they must be segregated in the audit working papers; this may be done by the client's staff, checked as far as possible from the records, and verified by confirmations from the creditors who have liens on the accounts.

DATE OF SALES

Shipping records immediately before and immediately after the closing date may be examined to see

that shipments to customers up to the balance-sheet date were duly charged to them and, conversely, that goods charged out before the balance-sheet date were actually shipped or at least excluded from the inventory. Similarly, goods received from suppliers may be compared with purchase entries when the shipping records are under review.

Postdating of invoices may be in effect an extension of normal credit terms or it may indicate that goods have been billed on memorandum and are subject to return or to adjustment of price. In the first case the charges to customers' accounts may properly be included in accounts receivable, but in the second the goods should be included in the inventory and the charge to the customer eliminated. Rights of customers to return goods irrespective of defects or to have prices revised in case of a general price decline should be investigated. A reserve may be needed.

AGING

Upon comparing the customers' trial balances with the ledgers the accounts should be classified as to age. Certain credit terms, differing for each business, are normal; accounts that are due or overdue under these terms should be set out in separate columns on the audit working schedule and so classified that the total of accounts overdue, say, one, three, six and more than six months will be obtained. These periods are illustrative only; the significant periods vary widely

with different kinds of business and even among individual companies in the same business.

If accounts are numerous it will not be practicable for the auditor to examine the financial standing of each; the total of aged accounts considered with the collections and losses on similar aged accounts in the past affords a reasonably good base for an estimate of bad-debt reserve needed.

Of course, if any accounts in arrear at the balance-sheet date have been paid since, that is clear proof that the account was good at the date of audit. It will not do, however, to assume that accounts receivable that have been balanced off have necessarily been paid. They may have been closed out by credits for allowances, or for notes given, with or without some cash payment.

In aging accounts it is not to be assumed that the open balances represent the most recent sales; they may be the amount of old and disputed items, or of older items paid, the remittances having gone astray. If the amounts paid are really for the oldest items the ledger could be checked or ruled off to the last item paid. If there should appear a cash credit in the open section of a customer's account it can be aged only when it is ascertained what items were intended to be covered by the cash payment.

Some accounts are settled by periodical payments of round sums on account; these reduce the balance but never extinguish it to any definite point. Such

accounts can be verified only by confirmation by the debtor, although it is of some value to see whether the balance unpaid is increasing or decreasing in comparison with amount of sales.

In examination of ledger accounts of customers, certain entries should be watched; they may indicate manipulation. Some of them are journal credits to customers, credit memorandums, amounts carried to bad-debt account, credits subsequently recharged, reversal of previous sales entries at the beginning of a period, exceptionally large sales at the end of a period, credits subsequent to the date of closing, notations on ledger sheets as to requests for payment, disputes, reference to collection agents, etc.

SLOW ACCOUNTS

After aging the accounts receivable an estimate of the amount of required bad-debt provision is in order. The general condition of the accounts as shown by aged totals will be the principal base of estimate if the accounts are small and numerous. If there are any large accounts in arrear the credit rating of each, the client's previous experience with the customers, the period of delinquency and the pressure exerted to obtain payment will be factors in deciding upon the reserve needed.

Before making any recommendation to the management the auditor needs all the light that can be thrown on the accounts by the credit manager or

others of the client's staff. If any matters seem to need further inquiry it should be made; mere compliance with any set of fixed rules will hardly suffice to relieve the auditor of all moral responsibility for the approximate correctness of his estimate of the realizable value of accounts receivable.

Balances due from customers in bankruptcy are seldom of any appreciable value. If possible, information as to probable recovery should be obtained, but in its absence it is sound practice to consider such accounts as worthless and to treat any recoveries as an offset to bad-debt expense in the period in which recovered.

Correspondence files relating to large old or questionable accounts should be reviewed; they inform the auditor of the causes of delay, disputes, claims or financial trouble. Then, having figures showing the ratio of losses to sales in the past and considering prevailing business conditions a general idea of the amount of loss that should be attributable to the period is obtained. This is to be compared with the amount of loss from bad debts as computed from the amounts charged off during the year and the reserve needed at the end of the year as estimated for the individual accounts receivable.

The percentage of losses to sales in a merchandising concern may be remarkably constant from year to year in normal times but while that percentage will throw some light on the probability of loss on accounts not in arrear it is not a percentage to apply to

all outstanding accounts receivable because the ledger usually contains a larger proportion of doubtful accounts than the proportion of such accounts contained in average sales. Doubtful accounts accumulate.

RESERVES

After the work described has been done the auditor may proceed to compute the needed reserve. With the advice and, if possible, the consent of the credit manager collectible values should be established for each large account in arrear; small and numerous accounts may be provided for by a percentage of the total amount in arrear for the several segregated periods; for those not in arrear the reserve may properly be an amount equal to the average amount of loss on an equivalent amount of average sales. Accounts not in arrear may fairly be considered to represent average sales.

In addition to loss from customers' inability to pay, accounts may be subject to reduction for discount, returned merchandise, rebates, freight allowances and adjustments to conform to general price changes. Many enterprises treat ordinary cash discount as an expense of the period in which allowed and treat cash discount on purchases as income or reduction of cost of merchandise; others provide reserves for such discounts, which is theoretically more correct. Discounts of more than two per cent are "trade" discounts and are really reductions from list prices allowed, whether

cash discount is taken or not. If they have not been deducted from invoices but have been included in the total of sales, their amount should be provided for by deduction from gross sales and either reserved for or deducted from accounts receivable.

The reserve needed for returns, discounts and allowances may be determined with some approach to accuracy if the audit is made so long after closing date that most or all of the accounts have been liquidated. If this is not possible one must rely upon a review of accounts that have been closed out and of previous experience.

The auditor should ascertain that bad debts written off during the period have been examined and the charges to bad-debt expense approved by responsible officers. This is especially needed where the client has only a small accounting force. He should also inquire what record is kept of accounts written off, whether they are transferred to a suspense ledger which is controlled by a general ledger and followed up or whether the bad accounts are willingly forgotten.

The working papers should show who has authorized any loans to stockholders, officers or directors. Inquiry as to responsibility of these debtors and as to the probable time of repayment should be made. Accounts representing amounts due from officers or stockholders for the purchase of stock of the corporation should not exist; in some states such loans are prohibited unless upon adequate collateral—and stock

of the company is not adequate collateral. In all states such loans are frowned upon and generally carry with them a heavy liability on assenting officers and directors; sometimes the liability even includes imprisonment for assenting directors.

CLASSIFICATION

Accounts receivable, as their total appears in the control account, will include, beside trade debtors, customers' credit balances, accounts with officers or stockholders, accounts with employees and miscellaneous debtors' accounts. The credit balances will affect the control account which shows the net balance of the ledger; they must be separated and added to the accounts payable, increasing the total of accounts receivable in like amount. Accounts with officers or stockholders must also be separated, unless they are for insignificant amounts or have arisen from sales of merchandise in the ordinary course of business.

Other debit balances if of large amount and of a character differing from usual trade accounts, should be separated as "sundry debtors" or "miscellaneous accounts receivable."

Accounts with subsidiary or affiliated companies, even though they have their origin in sales of merchandise by the parent company, can not be classified as trade accounts receivable. They may be, in effect, advances of working capital and should be shown as part of the investment in subsidiaries. If the "debtor

company has ample margin of current assets over its liabilities including such accounts" they may be shown as a separate item of current assets.

Accounts due from subsidiaries are best verified by examination of their books; if this be impossible recent balance-sheets and operating accounts should be seen.

Other debit balances which should be excluded from trade accounts receivable are deposits, guaranties, prepayments on purchase contracts, claims of all kinds, advances to contractors and others. Unless they will be realized in money within about a year they can not be classified as current assets.

Accounts for instalment sales and for other sales not to be paid for within a year are not ordinarily classified as current assets. The valuation of instalment accounts is difficult; they may be conditional sales, the goods remaining technically the property of the seller until full payment is made. The values assigned to the balances uncollected should be such that if the goods were repossessed there would be no loss on resale after paying costs of repossession, reconditioning and resale. Profit taken on instalment sales should not exceed the proportion of total profit corresponding to the proportion of the sale price actually collected. A reserve for unrealized profit is necessary and is almost always to be found on the books. (See under DEFERRED CREDITS.)

Long-term credit may have been granted to foreign

buyers; their accounts may be payable in foreign currency; trade conditions in the foreign country, current rates of exchange and possible high collection costs all affect the amount of reserve needed.

NOTES RECEIVABLE

When notes are inspected the working papers should ordinarily show:

Date of note
Due date
Maker
Amount
Interest rate and dates payable
Collateral
Endorsements
Payments on principal
Payments of interest and amount accrued and unpaid.

If notes are not too numerous, it will be well to make an analysis of the note account for the entire period. Such an examination may disclose unpaid notes of doubtful value transferred back to accounts receivable, repeated renewals, discounted notes on which there is a contingent liability and other matter affecting the collectibility of the notes. In any case a thorough test, preferably of the last part of the period under audit, is needed.

The procedure in the case of instalment paper houses and companies having hundreds or thousands of notes is somewhat different.

Confirmation by the debtors is the best verification of the validity of notes. It can be made only with the approval of the client, confirmations being returned directly to the auditor.

The amount of reserve needed will be estimated from a consideration of the amount of renewals, amount overdue, promptness of interest payments and amount of notes in the hands of collection agencies. The credit manager should be consulted, as in the case of accounts receivable. If collateral is held it should be examined and valued.

Instalment notes, long-term notes, notes from subsidiaries, notes of officers and employees and notes not arising from ordinary trading may not be shown as part of the asset "trade notes receivable." Notes not due within a year are not considered current assets.

CERTIFICATES

A certificate should be obtained from the treasurer or other officer responsible for the accounts and notes receivable. A suggested form follows:

I certify that to the best of my knowledge and belief the accounts and notes receivable summarized below are valid claims against customers and are not subject to any rebates, allowances or other deductions which are not provided for in the accounts; that the reserves for doubtful notes and accounts, amounting to $.......... are adequate to cover possible losses in collection; that the notes and accounts are the property of the company and

are not hypothecated or pledged except as noted below; and that all other relevant facts have been disclosed.

(Insert summary and exceptions)

Signed:

....

Treasurer (or as the case may be)

Such a certificate does not relieve the auditor of the responsibility of conducting a careful independent examination of the notes and accounts and of exercising such reasonable diligence and care as the circumstances may require. Its primary purpose is to impress upon the management the importance of disclosing all relevant information to the auditor and to obtain from the officer responsible a signed statement that the accounts, notes and reserves are properly stated.

·V·

INVENTORIES

PARAGRAPH 51 of the Federal Reserve *Bulletin* says, "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." The balance-sheet is also seriously affected by the valuation of the inventories. Paragraph 52 of the *Bulletin* says that the responsibility of the auditor "falls naturally into three main divisions, (a) clerical accuracy of computations, footings and recapitulations; (b) basis of pricing; and (c) quantities, quality and condition."

The order of this might well be reversed; the auditor's first work is to satisfy himself that the inventories, if physical, have been properly taken or, if based on book inventory quantities, are sufficiently trustworthy to be accepted without physical test. If possible it is well for the auditor to be consulted in advance, so that he may coöperate to the end that the work of stocktaking shall be well organized and stocks so arranged that they may be taken with the minimum of labor, time and risk of error.

It has been suggested that the accountant take full responsibility for quantities and a few accountants have accepted such responsibility in special cases. As a general rule it is impracticable for several reasons: 1. the impossibility of opening and inspecting packaged goods; 2. the technical knowledge required for identification and valuation of merchandise; 3. the lack of trained accountants in sufficient numbers to count stock on inventory dates, particularly December 31st; 4. the increased cost to the client; 5. the impossibility of distinguishing between goods belonging to the client and goods in its storehouse not owned. "The auditor is not a valuer and can not have intimate knowledge of many classes of business." It is possible by tests such as those outlined in succeeding pages to determine that the quantities, quality and condition of the merchandise is "correctly recorded." Inventories of securities in the hands of brokers are exceptional; there the auditor does take and value the inventory and does not accept the client's valuation if it differs from his own.

The responsibility of the auditor for clerical accuracy and basis of pricing is more definite. "He must undertake sufficient investigation of the inventories to satisfy himself that the clerical work has been accurately done." This is within the field of his experience and capability. He must also satisfy himself that the basis of pricing is a reasonable one, producing a proper valuation of the inventory. This proper valua-

tion is to be proper with respect to the profit account as well as to the balance-sheet, which implies that the basis should not change from time to time but should be consistent from year to year. The most generally used basis is "the lower of cost or market," which complies with the sound accounting principle that expected losses should be provided for but that unrealized profit should not be taken up in the accounts.

In the balance-sheet and accompanying statements the basis of inventory valuation should be clearly stated. In the profit account, at least, there should be an unmistakable notice if the method of valuing the inventory has changed materially between the beginning and end of the period. On the balance-sheet raw materials, goods in process and finished goods may be shown together or separately, according to circumstances, but supplies are better classified separately. "Only stocks of goods owned and under the control of the owner should be included." Merchandise held on consignment is, of course, excluded; it does not belong to the consignee and no liability to pay for it exists or appears on the books.

Pledged inventories should be so shown; they are not free and clear for the satisfaction of all debts of the business.

Summarizing, the duty of the auditor is to see:

1. That the quantities are the result of a proper physical stocktaking or are based on trustworthy book

records and that the quality and condition of the merchandise are as represented.

2. That the basis of valuation is sound.
3. That the basis of valuation is the same at the beginning and at the end of the period.
4. That the clerical computations are correct.
5. That the financial statements disclose the significant facts concerning the inventories and their valuation.

QUANTITY VERIFICATION

If the auditor has been consulted before the stocktaking it will be to his advantage to review the book records and to determine how frequently stock on hand has been wholly or partly checked physically and ascertain what differences were found when physical counts were made. Then, after a visit to the warehouse, factory or storerooms in which the merchandise is kept, he may make such suggestions as he thinks will be in the interest of better arrangement of the stock and of more effective stocktaking.

A method of taking the count that has had wide approval consists in counting and marking the stock in advance with attached tags, each tag sealed within an envelope that carries on its face provision for a second count exactly like the first. One clerk counts stock and attaches the envelope containing the tag; a second counts the goods again and registers the count on the envelope; the auditor takes the envelopes, opens them, compares the tags with the envelopes and if a discrepancy appears has a third count made.

Sometimes these tags and envelopes provide for pricing and extending the values; that, of course, is not done before the tags are collected. There are other methods in use that are satisfactory.

If the auditor have not been consulted in advance he should ascertain how the quantities were determined, the nature of the goods, their location and the way in which they are handled, physically and on the books. If he is dissatisfied with the method of stocktaking he must consider the advisability and practicability of again taking the stock in whole or in part.

If the internal check is inadequate, shortages of merchandise can be covered up and quantities altered by interested employees. Thorough testing of inventories is all that can be done by the auditor under these conditions and if he has been unable to obtain what he thinks is a satisfactory verification he must protect himself and those who read the statements by qualification of the certificate.

In examining physical inventory quantities the facts to be established are:

That the stocktaking was properly organized and supervised.

That the merchandise was so arranged that it could be counted properly.

That the persons taking the stock were familiar with the merchandise and generally capable of making a satisfactory count.

That the quantities were rechecked or at least reviewed by a responsible employee who could determine if there were any obvious duplications or omissions.

That the quantities were correctly transferred from the original tags or stock-sheets to the final summary.

That the figures were not changed later by anyone.

The original records of the count should be signed by the persons making and recording the count, and they should be checked by the auditor to the final inventory sheets. If a second count has been made, the two sets of figures should be compared. The competence of the persons making estimates of quantities of materials in bulk should be investigated; if possible two independent estimates should be obtained.

After checking the physical inventory quantities they should be compared with any available stock records. The extent of tests to be made will be governed by the size and value of the inventory, the care with which the stock inventory was taken and the discrepancies that may appear between book and physical inventories. Any large discrepancies will need explanation.

Where inventories are based only on book quantities, the records must be reviewed in detail and the adequacy of the system determined. Such a system should be supported by the records of physical inventories taken from time to time when stock had become low in the tested classes; if differences have been small and if correction of the books for such differences as

have appeared have been made and if such other tests as are prescribed here are carried out, the inventory may be accepted. If, however, the auditor can not satisfy himself that the inventory has been properly taken or that the permanent inventory records are correct, it may be necessary to have substantial tests made of the physical quantities. Book inventories, when properly kept and tested periodically throughout the year, may be quite as accurate and satisfactory as a complete physical inventory taken on one date.

All records affecting the inventories, whether on the detail or the financial books, should be closed at the same point. Goods billed to customers up to the closing date must be excluded from inventory if the sales have been entered, whether the goods have been shipped or not, and any goods shipped but not properly chargeable to customers must be excluded from sales and included in the inventory. Ordinarily goods are invoiced as shipped, but if it is the client's practice to hold billed goods awaiting delivery instructions it is necessary to determine whether the goods have been definitely sold or the customer's order is subject to cancellation.

The client, if he does an instalment business, may have merchandise in the hands of customers, partly paid for, nominally the property of the seller until fully paid for—such merchandise is not treated as part of the inventory but the balance due on it is treated as instalment accounts receivable.

The merchandise in the inventory must be either merchandise purchased, for which liabilities have been taken into the accounts, or merchandise manufactured for which the manufacturing cost has been taken into the books.

Incoming goods in transit for which the liability has been taken up must be included in the inventory, although not yet physically received. No goods may be included although actually received unless the corresponding liability has been taken up.

Invoices dated prior to the date of closing but not entered upon the books until the succeeding period should be compared with the receiving record and with the inventory to ascertain whether they should have been taken up as a purchase and included in the inventory and whether they have actually been taken into the inventory although not included in the purchases.

Besides goods in transit there must be included in the inventory any goods in storage or on consignment. Warehouse receipts and confirmations from warehousemen are used to verify goods in storage and any liens against them. The client's records will show what merchandise is or should be in the hands of consignees. Verification is to be obtained from the consignee.

The quantities of some of the larger items in the closing inventory may be compared with the corre-

sponding quantities at the beginning of the period and in other prior inventories and with the quantities sold during the audited period. If quantities unsold have increased disproportionately to sales, inquiry as to the correctness of the count and as to the salability of the merchandise is in order.

Increase in inventory of raw material or other goods does not necessarily indicate accumulation of undesirable stock; it may be the result of buying policies or of speculation as to the course of market prices.

Examination of the invoices for cost prices may be so made as to serve also for test-checking of quantities to the permanent inventory record.

Proper balance of inventories has weight in their valuation. Suitable amounts of raw material, work in process and finished goods are needed, not alone as to total inventory but also for each principal product. A proper distribution of quantities may be deduced from an examination of opening and closing inventories and quantities consumed during the audited period.

An unbalanced inventory is a danger signal indicating that condition and salability of stock is to be looked upon with doubt until satisfactory evidence is obtained that the inventory is really good and salable.

The comparison of opening and closing inventories is often most useful if applied to the opening and closing inventories each month. Such a comparison

shows the course of business producing the final result and defines and restricts the necessary field of inquiry if explanations of changes are required.

The gross profit test is particularly applicable to those businesses whose trade is in goods sold at relatively stable prices. The theory is that if fluctuations in cost are reflected in corresponding fluctuations of selling price the ratio of gross profit to sales should be reasonably constant. This test, too, is most valuable if applied to monthly transactions, rather than to a whole year, since an irregularity that might be buried in the transactions of a year would be distinct if only the transactions of a month were affected. A misstatement of inventory or an error in crediting sales to a wrong period would affect the apparent gross profit for the last month so greatly that it probably could not be overlooked. If applied to the transactions of a year it might not be noticed; indeed it might even bring the year's ratio into better agreement with those of prior years. If the accounts are so kept that the test may be applied monthly to each principal product or group of products, there should be little chance that any material error will remain hidden. Of course, unless a monthly inventory is available the monthly comparison can not be made.

It is worth while to compare inventories as prepared by the client for his balance-sheet with the corresponding inventories shown on federal, state and other tax returns. It usually happens that it is to the

interest of a taxpayer to state his inventory at as low a figure as possible in his return, while an inclination to overvalue it for balance-sheet purposes may at times exist.

BASIS OF VALUATION

For commercial and manufacturing enterprises the bases most commonly used are (a) cost and (b) the lower of cost or market. Both are acceptable for income-tax returns if used consistently, but the latter is generally accepted as the better practice.

Another base (c), market price, is also in use. It is allowed by the bureau of internal revenue if it is adopted as a permanent policy. It is suitable for use in valuing inventories of securities, of meat products in the packing industry, and of wholesale quantities of primary products, such as cotton, wheat, copper, coffee, etc., which have officially recognized grades and a freely quoted public market in which wholesale quantities can be disposed of at the quoted prices.

Whatever base be used the value obtained should be compared with cost and with probable realizable value. Gross understatements of value as well as overstatements are to be avoided; they lead to untrustworthy statements of earnings.

(a) *Cost basis*

Cost, in most cases, can be checked with reasonable accuracy. Although reductions to market value are

correct in a balance-sheet there may be a distinct advantage in preparing the profit-and-loss statement on the basis of opening and closing inventories at cost with a final adjustment to bring the net result to the basis of the lower of cost or market or to a strict market basis, as the case may be.

If sales prices are based on cost, as in "cost plus" contracts or other firm contracts for future delivery, and the merchandise has been purchased to fill the contracts, the cost basis is the correct one in any case. This is so common in the accounts of raw silk importers and other dealers in foreign merchandise that their inventories may properly contain many lots of exactly similar merchandise, bought to fill firm orders, at varying cost prices, notwithstanding that their inventories of merchandise not contracted for sale are valued at the lower of cost or market.

(b) *The lower of cost or market*

The lower of cost or market is not always capable of exact determination. There may be a lack of information or differences of opinion as to what was the "market" price at the date of the balance-sheet. Quoted prices can be accepted for inventory purposes only after considering:

The volume of the products sold at the quoted price.
Whether or not a free public market existed.
The quantities included in the inventory and the quantities which the client usually purchased at one time.

The time necessary for delivery and shipping costs from the locality where the price was quoted.

The "cost or market" basis most closely approximates fair values both for the balance-sheet and for the earnings statement of the following period. A perfectly balanced inventory is rare; the following period will necessarily be burdened with some portion of the inventory that is not exactly suitable for the demand either in character or in quantity; it should not also be burdened with inventory at a price higher than that at which it could be purchased at the balance-sheet date.

This base is especially suitable if losses have been sustained as the result of speculative purchases in advance or in excess of normal requirements or if there has been a substantial fall in the general price level of commodities. Effect should be given to such losses as soon as they occur.

In using the base "the lower of cost or market," it is usual to apply it to each item in the inventory, although some companies have computed for the whole inventory a cost value and a market value, using the smaller total. This produces a value higher than that produced by taking the lower of cost or market for each item. If the lower totals only are used it is preferable to indicate that fact in the caption.

Market for raw material is properly the market price that would have to be paid to replace it in the

quantities usually purchased by the client. For finished and partly finished goods there is not often any definite market price. The retail selling price is not a proper market price to apply to an inventory. For such goods "market" is interpreted to mean selling price less cost of completion and less the usual percentage of gross profit, or raw material at current market plus cost of work done on it. Market for finished goods is usually net selling price less a percentage to cover cost of selling and general expenses. This is fully explained later.

(c) *Market price*

In certain industries it is not possible to determine and allocate to all products the true cost. This is true of farm products and live stock. There are published quotations for these products, and the stock is ordinarily valued at market prices less cost of marketing. If it be held that profit is made when goods are sold, this implies that profit is taken in advance; but the profit on farm products can reasonably be held to accrue, largely if not wholly, as the products mature, and the valuation of inventory of this nature at sale price less cost of marketing, called "farm-price method," is accepted by the treasury as a proper base for the purpose of taxation. Under this method it is necessary to see that the product is really marketable and that the prices used are applicable to the quantities in the inventory. Allowance for the cost of mar-

keting may include discount, freight, selling expense and a reasonable proportion of general and administrative expenses.

A somewhat similar method of valuing inventories of leather is used in the tanning industry. From a given class of skins it is not possible to tell in advance just how many skins will turn out of first or other grades; the several grades are sold during the year for varying prices and the unsold leather at the end of the year is valued at selling prices with a deduction, not of cost of selling but, instead, of an amount corresponding to the ratio of gross profit made on that class of goods during the year.

Where numbers of products are necessarily the output of a given process, or where several grades or sizes are produced, not from choice but as a result of a manufacturing process, the whole cost is allocated to the several products, grades or sizes in proportion to their selling value. Such a valuation is, of course, a valuation at cost, unless an arbitrary deduction be made to bring the total value to a hypothetical market value.

Department and chain stores have such a large variety of goods that to search out the cost of each would be too laborious. Instead, inventories are valued at selling prices, which are readily obtained, and the totals of each class of merchandise, or of the merchandise in each department, subjected to a deduction equal to the average rate of gross profit for each class

or department. This plan has also the merit of taking into account the markdowns to which merchandise may have been subjected; the sale prices are those current after all markdowns.

Each of the larger and more representative items of the inventory should be separately checked as to the basis of pricing.

PRICE VERIFICATION; COST OF GOODS PURCHASED

Cost of goods purchased is cost delivered at the client's plant or warehouse. It includes invoice price, freight and cartage, duty, brokerage and commission. Trade discounts, allowances and rebates should be deducted, but when the rebates are "quantity discounts," based on the volume of purchases during a specified period, and it is impracticable immediately to adjust the cost of the materials, the amount of the rebates when ascertained may be taken as a deduction from cost of sales; if any stock to which the rebates apply be on hand its inventory value should be reduced to a value equaling cost less rebate.

The practice with respect to cash discount is not uniform. Frequently cash discount received or paid is treated as a miscellaneous item of profit or loss. Convenience, not theory, is the justification for this practice.

For inventory purposes cost should ordinarily be the cost of the most recent purchases covering the quantities on hand. The stock records should show

the dates of purchases and the names of the suppliers; a number of invoices should be obtained and examined, noting the length of time that the goods have been in stock. If this period seem unreasonably long further inquiry into the salability of the stock is indicated. If any of the goods in the inventory have been carried forward from a preceding year the price at which they were last taken should be treated as cost.

Unit prices used in valuing an inventory may represent average costs, changes in which will lag behind changes in current market prices. Many companies adopt standard rather than actual costs in order to eliminate the effect of minor market fluctuations and to simplify the records. Such prices should be compared with the costs of the most recent purchases or the cost of manufacture, both recent and average for the year. Wide differences from present costs can not be allowed to remain in the inventory.

Another method of pricing bulk materials, such as wool and cotton, in identifiable bales is to use the cost of the identical bales on hand. This may produce uneven results if the goods are not used in the order in which the lots are purchased; the method has little to recommend it and if used must not be allowed to produce a value that is materially greater than current cost.

COST OF PROCESSED AND FINISHED GOODS

Cost of finished goods should be considered on a

unit basis. Material costs will have the same verification as that mentioned under "cost of goods purchased." Direct labor charges are easy to verify if the cost accounts are satisfactory. They may be largely piecework, which is the most accurately apportionable.

Burden charges are not so easy to verify. The method of allocation must be reviewed to see that the items charged to cost of manufacture are those, and only those, that are directly attributable to carrying on the manufacture. The following list indicates the character of expenses that should not be charged to cost of manufacture:

General and administrative expenses
Selling expenses
Interest on investment
Depreciation, taxes, insurance and other carrying charges on excess plant facilities not in operation nor necessary to normal operation throughout the year.

Interest on investment is considered by a few accountants to be a proper element of cost, but this view is not generally accepted. It may be useful for statistical purposes, but the inclusion of interest as a part of cost of unsold inventory is not permitted by the regulations of the bureau of internal revenue for income-tax purposes and is condemned by accountants and bankers generally.

A reasonable provision for depreciation of plant and equipment is part of manufacturing overhead.

In industrial plants the amounts charged to operations should absorb, during their actual life, the value or the original cost of the machinery, buildings and equipment.

If a plant has capacity definitely in excess of requirements, carrying charges on the unused plant should not be included in the unit costs for inventory purposes. This situation arises in plants originally constructed in excess of requirements and with plants wholly or partly closed as a result of consolidations. If plant to meet seasonal or peak loads is a requirement of the normal business activities, a necessary protection for ordinary trade, its maintenance is a proper part of the charge to ordinary output; but it should be spread on a unit basis over the whole output of the period.

MARKET PRICES

The definition of "market" as applied to inventory prices is stated clearly and concisely in the income-tax regulations, as follows:

> "Under ordinary circumstances and for normal goods in an inventory, 'market' means the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which usually purchased by the taxpayer."

This applies primarily to raw materials and supplies, but to some extent its application may be extended

to goods in process and finished merchandise. Market prices are determined as of the date of the balance-sheet, but the effect of changes in price levels immediately following the closing date can not be ignored.

The usual sources from which market prices are obtained are published quotations and contracts made just prior or just after the date of the balance-sheet. In using published quotations it is necessary to employ quoted prices for quantities comparable with those usually bought at one time by the client. Market values for goods not specifically quoted may be approximated if there be quotations of goods differing only slightly from the merchandise to be valued. Values derived from small transactions are not trustworthy. Special needs either of buyer or seller may induce a small transaction at a price that is not fairly representative of current values. Market prices for standard quantities at a date somewhat later are to be preferred to prices as of the date of closing for small lots only.

If important declines occur between the statement date and the completion of the audit, the advisability of making a special reserve needs consideration by the auditor in conference with the representatives of the client. If no reserves are made, it becomes the duty of the auditor to disclose the situation by footnote or mention in the certificate.

Market quotations for raw materials can ordinarily be obtained; but they are not often available for man-

ufactured products, unless those products are a raw material for the buyer. So soon as processing has begun, materials are no longer salable except after finishing; it is therefore necessary to obtain the realizable value of the finished articles and to deduct therefrom the cost of finishing, plus the normal percentage of gross profit, or to value them at the market price of the material entering into them plus the amount already spent on their elaboration. The second of these alternatives is to be preferred if the product is salable at a profit.

Income-tax regulations approve the use of a reproduction market value for finished goods if followed consistently from year to year. This reproduction value is the sum of the cost of materials, the labor at current rates and current burden. If labor and material rates have decreased at the date of the statement it may be desirable to price the inventory at cost or reproduction value, whichever is lower.

REALIZABLE VALUES

Valuation on the basis of realization values is used in the following cases:

- Goods, such as farm products, for which actual cost can not be determined
- By-products, of which the cost is not known and would be unimportant if known
- Obsolete or damaged merchandise
- Finished products and goods in process where realiz-

able value is less than cost and there is no open market price

Goods owned by enterprises in liquidation.

Scrap and minor by-products are valued always at net realizable value; they could not have any definite cost unless their recovery caused some increase of cost of the main product of which they are the by-product.

Correct valuation of obsolete, damaged and slow moving stock is difficult even for an expert in a business and is almost impossible for an auditor, unless there be some similar sales that may be used as a guide. Little can be done beyond taking the opinion of as many of the client's employees as possible and the addition of some of the auditor's common sense. If the inventories contain large quantities of such goods, which may well be the case with companies manufacturing specialties subject to fashion changes, the quantity to be disposed of affects materially the prices that are apt to be obtained, so that a small sale of such goods can not be accepted as proof that the same price can be obtained for a larger quantity.

Even when the realizable value is obtained its application to inventory implies that the future sale will be conducted without profit.

There is some difference of opinion among accountants as to how large a deduction should be made from gross realizable value for selling and administrative

expenses; it is certain that some allowance must be made for expenses and discounts and it is obviously improper to value inventory so that all net profit on sale is anticipated. Realizable value, therefore, should never exceed cost if that can be ascertained.

Reliance must be placed upon the opinion of the client's managers and sales executives as to marketability. To assign a fair value to an inventory of finished goods, an intimate knowledge of business conditions, customers' requirements, style trend and future supply and demand is needed. If values already assigned are substantially below cost, the previous inventories will be consulted to see how long the goods have been on hand and what the previous inventory prices were. From all these reviews the auditor should be able to form a reasonable judgment as to the values assigned by the client company. Such values are never more than estimates.

In industries such as contracting and shipbuilding, work for customers will be undertaken for a fixed price. The auditor will check the cost to the date of the balance-sheet for the larger jobs, the degree of completion, generally certified by an architect or inspector; and by comparison with the contract price he will determine whether reserves are needed to cover probable losses on completion of the contract or present progress justifies taking up a part profit on the work done. On long contracts, as in the case of a

ship taking two or three years to build, it is permissible to take some profit before the end of the work proves what total profit will be made.

INTERDEPARTMENTAL PROFITS

Interdepartmental profits are a business convenience, often met, and they must be eliminated in the statement of profit and loss, although not necessarily in the statement of profit by departments. In valuing the inventory the amount of interdepartmental profit on goods remaining unsold must be computed and deducted. It should be ascertained that the corresponding interdepartmental profit was eliminated from the accounts at the beginning of the period under audit.

SAME BASE OF VALUATION AT BEGINNING AND END OF PERIOD

If a profit-and-loss account is submitted or the profit of the period be shown on the balance-sheet it will not be sufficient that the inventory at the date of the balance-sheet is correct. To reflect correctly the profit for the period it is essential that the inventory be valued on the same basis at the beginning and at the end of the period—if a change of basis has been adopted during the period under examination the profit-and-loss account should be prepared with opening and closing inventories on the finally accepted basis, and afterward an adjustment should be made to the net profit or loss absorbing the change of result

due to the change of base. That adjustment has no reference to the actual profit for the period, but it is in effect a change of surplus involving a correction of prior years' accounts.

If the base be "cost or market, whichever is lower," it may happen that cost will be lower in one year and market lower in another. This is not to be interpreted as a change of basis of valuation.

CLERICAL ACCURACY

Verification of clerical accuracy involves proving extensions, footings and summarization of inventories.

In checking extensions it is first in order to see that the prices are given for the same units as those in which quantities are expressed. If quantities are in dozens and prices are per thousand, quantities in tons and prices per pound, errors are apt to occur and to be overlooked. Such illogical pricing does occur and the accountant needs to be on watch. A sufficient detailed check of extensions should be made to determine the substantial correctness of the inventory—the number and kind of errors found will indicate how far the detailed checking must go. It may even be necessary to check all extensions. In any case not only the larger items need checking, but a fair proportion of the smaller items should be tested. Undervaluation as well as overvaluation is to be avoided.

An adequate test is to be made of footings of inven-

tory sheets, and in addition all sheets should be checked "by sight" to see that there is no large error. Besides the rigid test of extensions, a sight check of all sheets will serve to avoid serious clerical error in extensions.

The most common errors in inventory calculation are those made in adjustments of prices and extensions, adjustments for goods not billed, on consignment or in transit and in the omission or duplication of totals of sections of the inventory. These errors the auditor must not overlook, for his work should cover all these matters in detail.

PRESENTATION OF INVENTORY FIGURES IN FINANCIAL STATEMENTS

Much of the work of verification is wasted by improper presentation of the salient features brought out in the examination. The basis of valuation and classification of inventories, any liens existing against them, commitments in excess of normal requirements and the reserves to adjust values or to provide for future possibilities should all be made evident.

If the basis be stated as "cost," the "lower of cost or market" or in any similar definite way, any person with ordinary business experience should understand the general character of the valuation. If, in any case, a basis is adopted that produces a valuation materially in excess of current market, that fact should be stated. If inventories are undervalued on any basis to such an

extent that a substantial secret reserve is created, that fact also should be made clear. If any definite basis of valuation be given and the auditor take no exception, the reader of the financial statement has a right to assume that the inventories are fairly valued on the given basis and that the values so determined do not depart materially from a fair current value.

Classification of inventory sections may be useful; raw materials, work in process and goods finished for sale may well be separately stated; supplies chargeable in a subsequent period to expense. Advances for purchase of materials, machinery parts, or work in process eventually to be transferred to fixed assets should not be merged with the trade inventories but transferred to a proper classification or shown separately.

In presenting a full analysis of inventory accounts the auditor may find that the client objects to the publication of details that may be of use to competitors. Proper consideration must be given to such objection. If much detail is given it may well appear in an attached exhibit, not on the face of either the balance-sheet or the operating account.

LIENS AGAINST INVENTORY

Liens against inventory should appear in the regular verifications of liabilities. They are not often found except where banks hold liens on merchandise shipped from abroad, when the merchandise may be held in warehouse subject to release on "trust re-

ceipt." This condition should be fully disclosed by the ledger accounts, and confirmation can be obtained from warehousemen.

Other liens occur, especially when companies are financially embarrassed, and should be looked for in audits of such companies.

Warehouse receipts are not always to be trusted as evidence of ownership; they should always be confirmed by certificate from the warehousemen showing what liens are held against the merchandise. Confirmation of the liens by the banks holding them should also be obtained. Such liens on merchandise will be shown on the balance-sheet in a note with respect to the secured liability. Other liens are better disclosed in the description of the pledged asset, as the liability may be a part of the current account with a regular creditor.

COMMITMENTS IN EXCESS OF REQUIREMENTS

If there be commitments for purchase of merchandise at prices above present market prices, provision for the apparent loss should be made. In any case if very large and unusual commitments exist, irrespective of any possible losses, mention should be made of their existence.

INVENTORY RESERVES

Reserves may be set up to provide for obsolete stock or reduction in market price; this serves the purpose of correcting the valuation while leaving the merchan-

dise in the stock records at cost prices. The inventory should be shown in the financial statement at the net value after deducting reserves of this kind, for they are simple devices to adjust the inventory to definitely estimated values. If reserves are provided out of excessive caution or to provide for possible but not actual decline in prices, set up against the inventory as a whole and not applicable to any specific price, and without positive knowledge that they are needed, they are best shown as contingent inventory reserves, on the liability side of the balance-sheet. In any case the amount of such reserves should be shown.

CERTIFICATES

After making his own verification of the inventory the auditor should obtain from responsible officers of the client company a certificate, similar to the specimen shown below:

A. B. CHASE COMPANY
NEW YORK

January 20, 1933

Messrs. Auditor & Co.
New York.

Certificate

With reference to the inventories of this company at January 1, 1933, we summarize them as follows:

Raw materials	$500,000
Work in process	350,000
Finished goods	700,000
Manufacturing supplies	75,000
	$1,625,000

We certify that to the best of our knowledge and belief:

The above inventories represent only goods for which liabilities had been taken up at Dec. 31, 1932.

The inventories of raw materials and manufacturing supplies represent book inventories of quantities, which have been periodically adjusted to physical count and are believed to be accurate; such physical quantities are verified at least twice a year. Other inventory quantities were determined by actual weight, count or measurement by competent employees of the company. Quantities so determined were priced at the lower of cost or market values for the materials, with a reasonable addition for the cost of manufacturing but not in excess of realizable values. Damaged, obsolete or other depreciated merchandise has been valued at approximate realizable value.

Bankers' acceptances amounting to $ were secured by trust and warehouse receipts against raw materials valued at $. There were no other liens against merchandise in the inventory.

Provision has been made on the books for all purchase commitments at prices in excess of current market and for all sales commitments at prices below inventory values. There were no commitments in excess of current requirements.

Signed:

A. B. Chase, president
L. D. Chase, treasurer
C. B. Adams, chief accountant

Such certificates establish the fact that the representations made to the auditor, which properly have

had weight in fixing values, are the considered opinions of the official representatives of the client company and not merely the opinions of those members of the staff from whom the information was first directly received. The certificate, unsigned, should be left with the officers before signature for a time sufficient for them to satisfy themselves that the statements contained in it are correct. It is preferable to leave the filling in of the figures to the officers. The figures should be those finally determined by the client, not necessarily those considered correct by the auditor.

CONCLUSION

The steps in verification which have been outlined are suggestive only and are primarily applicable to industrial companies of moderate size. Conditions in each audit will govern procedure to some extent.

Upon completion of the work the auditor may not be able to concur exactly with the client as to what are fair values. In differences depending upon such uncertain factors as prospective markets, or changing fashions, or upon technical questions such as recoverable ore content, heat equivalents of fuel or output of hides in process of tanning due consideration should be given to the opinions of the client, founded upon his intimate and technical knowledge of the business. But, after taking all things into consideration, if the auditor feels that the inventory valuation misrepre-

sents substantially the best attainable estimate of fair value, he must disclaim in his report responsibility for the value assigned. Such a qualification is undesirable and to be made only as a last resort if the auditor is unable to persuade the client to revise the values or description or to provide a reasonable reserve.

·VI·

INVESTMENTS AND ADVANCES

For balance-sheet purposes investments are separable into readily marketable securities (temporary investments of funds to be liquidated as required and classified as current assets) and other investments not capable of ready liquidation and not to be classified as current assets. In the second class of investments there may be investments in and advances to subsidiary companies, securities held for business reasons and other investments not readily marketable, long-term notes, company's own securities held in the treasury for definite purposes, not intended for retirement and not deducted from the corresponding liability, sinking-fund assets, insurance policies on the lives of officers and loans or advances to officers or employees.

The verification of securities has been described in the section on cash and bank verifications. The schedules in the working papers should be similar to the following specimen, or if in other form they should give all the information that is contained in this sample.

Kind and quantity of security	Cost	Sold during period	Income	Profit or loss on sale	Balance on hand at Cost	Balance on hand at Market	Accrued interest
Owned at beginning of period							
BONDS (classify)							
Government							
100M Liberty 4¼	xxxxx	xx	xxxx	xxxx	xxxxxx	xxxxxxx	xxxx
Industrial							
42M U. S. Steel 5	xxxxx	xxx	....	xxxxx	....	....	
Railway							
30M C. C. C. & St. Louis							
STOCKS (classify)							

Other proper classifications may be U. S. government, municipal, public utility, foreign government, all bonds, and industrial, public utility, foreign and miscellaneous stocks.

Names of brokers, dates of purchase, and serial numbers of certificates may be added if the transactions are not too numerous. Of course, the total of the first column, less the total of the second column, and plus or minus the total profit or loss on sale should equal the total of the balance on hand.

Unless the quantity of bonds owned is quite large it is not the custom in commercial enterprises to take up accrued but unmatured interest but to take up as income the amount of coupons as they mature. In no case should income be taken up on account of undeclared dividends, even on guaranteed or preferred stocks.

Securities must be described in sufficient detail to permit of positive identification. Interest rates on bonds should be given, and for bonds of companies having more than one issue the maturity date is required.

Purchases and sales of securities should be vouched with brokers' advices and compared with published quotations at the date of purchase or sale; the authorization of directors may also be inspected. Interest and dividends received will be readily verified if the working schedule conforms to the specimen given above.

The published market price of quoted securities and the latest available estimate of the value of securities not quoted should be compared with book values. Income-tax regulations compel commercial and indus-

trial companies to report their incomes on the basis of securities at cost; if the cost or book values differ widely from current fair values it will be necessary either to make a reserve for any deficiency of value or to note on the face of the balance-sheet the difference between current market and stated values. It is sufficient to compare the values as a whole; if one lot show a gain and another an equal loss no note is needed.

Brokers and dealers in securities are not governed by the same rule as other enterprises; for them the securities are inventory, to be valued in the same way as other inventories. The "lower of cost or market" is used by some brokers and strict market value by others.

Investment trusts are not now considered to be dealers in securities and therefore use cost values in their books, with or without reserves to bring the net value to market prices. The ruling of the bureau of internal revenue in this case has produced some undesirable results. The extraordinary fall in the prices of securities has caused balance-sheets carrying the assets at cost to be meaningless.

At present investment trusts are not permitted to take as cost of securities sold the average cost of all those owned; they must either take the cost of the earliest purchases or the cost of the specific certificates delivered. This defeats the intention of the regulations and enables an investment trust to select and sell such

of the securities as will produce the result most desired by the company. The auditor can see that the balance-sheet shows securities at fair current value. Future taxes will be affected by the retention of higher or lower cost securities but this can not be provided for in advance.

Values for securities not covered by published prices may be confirmed by balance-sheets and operating statements of the issuing companies, not necessarily as of the exact date of the audit but as of as recent a date as possible. Brokers who are specialists in unlisted securities can sometimes give useful information. The auditor must use all available means to determine the fair values.

MARKETABLE SECURITIES

Marketable securities, when classified as current assets, may be valued at the lower of cost or market or, preferably, at strict market prices, showing which value has been used, and providing on the books, but not in the financial statement, a reserve to adjust book value to fair value. When market value is higher than cost the difference should be credited to a reserve and not to current profits. It is also satisfactory, when market value is higher than cost, to show securities at cost with a note of market value in parentheses.

OTHER INVESTMENTS AND ADVANCES

Other investments and advances are placed in the

balance-sheet between current and fixed assets. They should be stated at cost, but if cost differ widely from fair value, that value should be stated, or a reserve may be set up to adjust the net figure to fair value.

AFFILIATED COMPANIES

Balance-sheets and income statements of all subsidiary and affiliated companies, of recent date, are needed, whether the interest amounts to control or not. They furnish the principal information on the basis of which the auditor can value the securities. Consideration may then be given to the propriety of consolidation. If the accounts are not consolidated, the investments must be properly valued in the financial statement of the parent company. The usual basis for affiliates not fully controlled is cost, less any dividends that may have exceeded the earnings since the acquisition of the securities. When the subsidiaries are fully owned, controlled and consolidated, it is usual and proper for the parent to take up on its books the results of the subsidiary whether declared as dividends or not. If the subsidiaries are majority-owned, controlled and consolidated the proportional interest of the parent company in the operating results may also be reflected in the parent's books.

If subsidiaries not consolidated have accumulated substantial amounts of undistributed surplus since the acquisition of their stock by the parent company, it is proper and desirable to show as a note, on the

balance-sheet, profit-and-loss account or in the report, the amount of such equity accruing to the parent company, but the surplus of the parent company and its profit-and-loss account should not take up as income any more than the declared dividends from any subsidiary not consolidated. If a subsidiary not consolidated have made a loss since the date of the acquisition of its stock the parent should provide in its accounts for its share of the loss.

Stock exchanges, particularly that of New York, are pressing for more complete information as to the affairs of subsidiary companies. While there is no change in the attitude of accountants in this matter, they are succeeding more and more in obtaining acceptance of the theory that parent company statements should include reference to everything of major importance that there may be in the accounts of controlled subsidiaries. With this in mind the auditor will be able to deal with each case as it arises.

When subsidiaries are not consolidated, it is undesirable for the parent company to take up income in respect of profits not declared as dividends, but a note of the parent's equity in subsidiary profits not declared in dividends may properly appear on the statements of account.

Advances to affiliated companies may be combined with the investment in securities of these companies if they represent permanent or long-term advances of capital. Trade accounts and notes receivable from such

companies, which can not be repaid currently, should also be treated as long-term advances. Profits of subsidiaries, the common stock of which is owned by a parent company, will be transferred to the parent; hence accumulation of profit is not a source from which repayments can eventually be made. Unless the financial position of a subsidiary is such that it could immediately pay its debts to the parent without leaving itself short of working capital, no part of the indebtedness is to be placed among the current assets.

Intercompany advances and other transactions between parent and subsidiary and between subsidiaries should be reviewed. Transfers of real estate or other fixed assets or of securities should not result in a profit nor in an increase of valuation within the combined companies whether a consolidated statement is made or not.

It is impossible to set unvarying rules as to the conditions in which consolidation of accounts should be made. It may be indicated if there be 75% ownership of companies engaged in the same or closely allied business with much intercompany trading or when nearly 100% of the voting stock is owned, although the federal tax regulations require 95% ownership for consolidation of tax returns.

Notwithstanding even 95% ownership, consolidation of companies in domestic trade with companies in foreign trade is of doubtful value, and the consolidation of companies engaged in such incongruous

kinds of business as banking and manufacturing is undesirable, even though the same people own the entire capital stock. The combination of the assets of a bank with those of a manufacturer would give no information as to the financial status of either.

Even when consolidated statements are prepared, it is good practice to submit with the statements of the accounts of the parent company supporting schedules of the more important items of the balance-sheet showing the origin by companies and by localities. When consolidated statements are not prepared, separate statements of important subsidiaries should be submitted.

The consolidated earned surplus in the consolidated balance-sheet should include earned surplus of the parent company plus surplus of subsidiaries earned since the date of the acquisition of their stock by the parent. In the consolidated operating accounts, intercompany transactions should be eliminated. Interest to outside creditors and proportion of profit accruing to outside stockholders should be deducted before representing profits of subsidiaries as available for the payment of interest on the liabilities of the parent company or dividends to its stockholders.

OTHER SECURITIES

Securities owned and held for business reasons and not intended to be sold, even though they have a ready market, and securities which have not a ready

market are classified as investments, not as current assets. If they are not currently quoted, statements of their financial position and of their earnings, obtained from trustworthy sources, will afford evidence of their fair value. Such investments are usually carried at cost, with reserves to cover any losses in value since purchase; it is not always necessary to reduce book values to any outside quotations if the actual value to the owning company as a going concern be equal to book value. Quotations for inactive or privately held securities are seldom conclusive proof of value.

LONG-TERM NOTES AND ACCOUNTS

Amounts receivable from abroad, if of a non-current character, and instalment accounts extending over a year or more should be excluded from current assets. Their verification is similar to that of current accounts and notes. If mortgage notes be held full proof of their validity may be had by examination of public records. Paid tax bills and insurance policies should be on file with the mortgage notes. If questions of title have been raised the accountant may find it desirable to consult an attorney.

TREASURY SECURITIES; COMPANY'S OWN STOCKS AND BONDS

Securities of a company's own issue, held temporarily in the treasury for a specific purpose, may be shown as investments, if their character is disclosed. If held for retirement or without any definite inten-

tion of reissue they should ordinarily be deducted from the amounts outstanding as liabilities on the financial statement. The number of shares and face value of bonds should be shown with the value assigned to them, if carried as investments. If deducted from the amounts outstanding on the liabilities side of the statement there should be applied against the capital-stock liability the par value or stated value of the shares, any apparent gain being absorbed in capital surplus and any apparent loss either in earned or capital surplus, according to circumstances. And from the liability on bonds there should be deducted the face value of the treasury bonds, any difference being absorbed in earned surplus. If there be carried as an asset any discount on stock or bonds and any part of such stock or bonds be treated as described above, a proportionate part of the discount must also be written off against earned surplus or capital surplus as the case may be.

The corporation laws of the several states vary much as to the treatment of gains arising from dealings of a company in its own capital stock. In some states profit on purchase and sale of a company's own stock may be added to surplus available for dividends. The foregoing comment is based not on the maximum latitude permitted under any state statute but on conservative accounting practice. If a client insist upon taking advantage of any provision of the statutes of the state in which it is incorporated the auditor can

not dispute the right to do so, provided that there is full disclosure of what has been done.

If securities owned be contracted for sale to stockholders, employees, or others, they may not be carried at a price higher than the contracted sale price.

SINKING-FUND ASSETS

Securities or cash deposited under sinking-fund or retirement provisions should be confirmed by the trustee. Although such assets may be cash or readily marketable securities, they are not current assets. Income on securities so held should be verified and credited either to the sinking fund or to current income, according to the provisions of the governing indenture.

LIFE-INSURANCE POLICIES

When a corporation is the beneficiary and pays the premiums on the life of one of its officers, the cash surrender value of the policy may be treated as an asset. It is not a current asset if there is no intention of surrendering the policy, but is best treated as an investment. The auditor should have the surrender value confirmed by the insuring company if the amount is significant.

ADVANCES TO OFFICERS AND EMPLOYEES

Amounts due from officers and employees should

not be included under current assets unless both insignificant in amount and strictly temporary in character. For any loans or advances the auditor should see the authority and inspect the collateral, if any has been deposited. In the accounts a reserve to cover probable loss in collection will be needed.

Loans to officers are generally objectionable and in many states illegal; they need rigid scrutiny by the auditor.

Employees' subscriptions to unissued capital stock are sometimes treated as outright sales on an instalment basis. This may be done entirely for bookkeeping convenience, but in the financial statement it is improper to show the whole of such stock as an outstanding liability concurrently with accounts receivable in the amount of the unpaid subscriptions. The amount actually paid in should appear on the liability side, with the regularly issued capital stock, as "paid in on subscriptions to capital stock."

In many states the issue of capital stock certificates before the stock is fully paid is illegal; it is always improper to issue certificates showing stock as fully paid and not assessable if in fact it be not so paid.

If capital stock that has been already acquired and is in the treasury be sold to officers or employees to be paid for on an instalment basis, it is not unusual for the stock to be eliminated from the asset "treasury stock" and the unpaid balance set up as an account

receivable from the officers or employees involved. This is acceptable where the statute governing the incorporation does not forbid it. In some states, New York for example, the statute explicitly provides for this treatment.

· VII ·

FIXED ASSETS

An auditor making a first examination can not confine his verification to transactions of the fixed-asset accounts during the period under audit. He must make some examination of the origin of the assets on the books at the beginning of the period. The extent of this verification depends in part upon the relative importance of fixed assets in the affairs of the client company and the past provisions for depreciation and retirement. So far as the records allow, the auditor should satisfy himself that the fixed-asset accounts do not contain expenditures improperly capitalized, that the basis of valuation is actual cost unless otherwise stated on the balance-sheet, that items disposed of have been eliminated from the accounts and that sufficient provision has been made for depreciation, depletion, repairs and maintenance.

First the auditor should review the available books and records to determine upon what basis fixed assets are stated. Unless an appraisal valuation has been approved and accepted by the directors for use in the

accounts the working papers should contain summaries of the several fixed-asset accounts showing when and how the principal items were acquired.

It may be that fixed assets were acquired from a predecessor company; particulars will be obtained from minutes, bills of sale and journal entries recording the transaction. If fixed assets were acquired by the payment of a single consideration for an aggregate of items the auditor should ascertain from the records or otherwise how the total consideration was allocated between the assets acquired, whether by an arbitrary valuation by the purchaser, an outside appraisal or on the basis of original cost to the first owner, modified or not by accrued depreciation.

Fixed assets may be tangible or intangible; in the first group are land, mineral deposits, buildings, machinery and equipment; in the second are patents, franchises, goodwill, trademarks, copyrights, etc.

TANGIBLE FIXED ASSETS

Expenditures charged as additions to fixed-asset accounts should be only for additional equipment increasing the productive capacity or efficiency of plant, and not for simple maintenance, repair or replacement of existing property. Whether any given expenditures are for simple replacement or for maintenance can not always be decided by an auditor, and in this case much reliance must be placed upon the good faith and judgment of the client.

Additions to land and land values offer little trouble, new buildings and improvements to old ones may generally be classified with confidence. But changes in machinery and plant are most difficult. No fixed rules can be applied uniformly; thus if a ship-owning company replace derricks aboard a ship the expenditure is to be classified as expense, since the original equipment was part of the ship and depreciated with the ship, and the renewal does not prolong the ship's life and is of no value when the ship goes out of service; if the same derrick replaced one in the yards of the company the old derrick would be charged against depreciation reserve and the new one capitalized.

In all cases the chief accountant or the controller should approve the capitalization of all expenditures and all extraordinary charges to maintenance and to depreciation reserves.

The mechanism of booking replacements varies; some companies capitalize the new and charge off the cost of the retired items to depreciation reserve or in part to operations; others leave the original cost undisturbed, charging part of the replacement to depreciation and capitalizing only that portion of the new which represents estimated increase in capacity or useful value. The difference in method is of little consequence; the results are almost identical. In any case the cost of the retired unit is to be charged against depreciation reserve to the extent that reserve has al-

ready been provided for it. Any difference is charged to profit and loss as "cost of discarded plant."

Detailed property ledgers may be kept, with separate records for each large item or group of items alike in kind and installed at one time. In the absence of such records the entries made upon discarding any item can be checked against original cost and the percentage and number of years during which depreciation reserve has been provided. The auditor continually is required to use his judgment concerning depreciation provisions.

Simple replacements are often called improvements. Reshingling a roof, for example, is not necessarily an improvement, but if a wooden shingled roof be replaced with a slate roof the net result may properly be the capitalization of the difference between the original cost of the wooden shingled roof and the cost of the slate roof. Even so, any work that does not prolong the useful life of a building is not a desirable addition to its capitalized value.

Such a transaction might appear as follows:

A building 15 years old with a life of 50 years and depreciation at two per cent annually has a shingle roof costing $1,500 and replaces it with a slate roof costing $3,500. The journal entries follow:

Dr. Reserve for depreciation	$ 450	
Profit and loss	$1,050	
Cr. property account (old roof removed)		$1,500

Dr. Property account $3,500
Cr. cash (or account payable) $3,500
Cost of a new slate roof, to be written off within the remaining life of the building—35 years—at $100 per annum.

A more difficult problem arises upon the installation of new machinery; ostensibly it may be intended to add to the capacity of a plant, and it may really do so, but at the same time it may take the place of existing plant which has become somewhat obsolete but is retained to meet emergencies or peak loads. The fact that the old machines have not been moved, are still in operating condition and even are occasionally used may make it difficult to determine what disposition should be made of the cost of the old plant on the books. If the old machines have been so long in use that their net book value—cost less depreciation—is quite small there may be no need to anticipate full retirement.

WORKING PAPERS

To assist in the examination of fixed-asset accounts there should be prepared a summary schedule showing for each ledger classification the amount at the beginning of the audit period, purchases, sales, retirements during the period of audit, interplant, interdepartmental and intercompany transfers and amount at the end of the period. Transfers between plants are

segregated so as to bring out the totals of actual purchases, sales and retirements.

A similar summary should show the changes in the reserve for depreciation with the rates used for the audit period. It is convenient to have the summaries on the same sheets so that the reserve for each kind of asset may readily be compared with the asset for which it is set up.

Transfers of fixed assets from one plant to another should be at original cost with accompanying transfer of the depreciation reserve accumulated in respect of the transferred assets, increased if necessary by the amount of any deficiency of reserve provided by the first plant.

Upon making a first examination, the working papers should contain a brief history and description of the plant accounts and the depreciation reserve.

VERIFICATION OF ADDITIONS DURING THE AUDIT PERIOD

Additions to property accounts are verified by listing them from the ledger record and vouching them in detail with vouchers, contracts, bills of sale and directors' minutes. The ledger entries may be monthly entries of totals, and then the books of original entry must be referred to for the details to be vouched. Some of the smaller items should be compared with original bills; they will indicate the extent to which the company includes items on the borderline between maintenance and new assets. All of the larger items should

be vouched and enough detail transcribed on the working papers to indicate the character of the assets.

Cost of removing and reinstalling machinery and plant is chargeable, at least partly, to operations since the original installation cost was capitalized; but as the original cost of installation has been partly covered by depreciation reserve the amount so provided should be credited against the cost of moving and reinstallation. It then becomes necessary for the depreciation rate on the reinstalled machines to be so adjusted as to absorb the reinstallation cost during the useful life of the machines in their new situation. This is fair, because the reinstallation would not have been made, the company having knowledge of its cost, unless there were expectation that additional profit resulting from the change would absorb its cost.

AUTHORIZATIONS

In well regulated corporations authorization for new construction and additions to fixed plant are issued by a central authority. Such authorizations should be examined and compared with actual additions. If costs exceed estimates contained in authorizations supplementary authorizations should be issued; if this is not done and the excess is large reference to the past should be made in the credit report.

In the case of unfinished work the working papers should contain information as to authorization number, amount authorized, amount expended to date,

estimate of plant engineer of cost of completion, and estimated difference between total final cost and original estimates.

The board of directors should approve in advance construction work of unusual importance; the minutes should be examined for such approval. If construction be by outside contractors the contracts should be seen.

REAL ESTATE

Purchases of real estate are verified by examination of vouchers for payment and contracts and authorizations for purchase. If absolute legal proof of ownership is required it may be obtained only by a search of title carried out at the office where deeds are recorded; this is work rather for a lawyer than for a layman.

Title deeds and tax bills, in the absence of a search, may be examined, but they are not proof of ownership. A search of title also serves to show what liens are registered against the property.

When the deeds covering purchases of real estate are examined it is well to make rough sketches for the permanent file, indicating locations, street numbers and intersections, townships, etc. They help to show whether or not all taxes have been paid and serve other purposes.

Assessments for sidewalks, paving, sewers and other public improvements are properly classified as capital

expenditures; for tax purposes such classification is mandatory. The cost of demolishing old structures existing on purchased sites to prepare for the erection of new structures is properly to be capitalized as cost of land. Land bearing old and worthless buildings sells for less and is worth less than the bare unencumbered site would be. Any sale of old materials removed from the land is to be credited against the cost of the land.

If a bond and mortgage be assumed when real estate is purchased or if a mortgage be given by the purchaser, the asset should appear in the balance-sheet at its total value with the bond stated as a liability; in these circumstances the buyer is liable for any deficiency in the amount of the mortgage upon foreclosure if the property be sold for less than the amount of the bond. If, however, the property be acquired in such a way that while the mortgage is a lien on the property the buyer is not liable for a deficiency upon foreclosure, the amount of the mortgage may be shown as a deduction from the amount of the asset and not be stated as a direct liability.

This condition is often brought about by carrying the property in the name of a subsidiary having no assets other than the bare property and incorporated for the sole purpose of carrying the property in its name.

Most companies maintain a fixed-asset register showing the cost, date of acquirement, betterments

made and depreciation rates applied to each large item. Such a register is of value in tracing the details of assets long in service.

CONSTRUCTION BY COMPANY'S OWN STAFF

In auditing construction work for a company's own use by the company's own employees, verification of payrolls, purchases of construction materials and requisitions from stores for materials and supplies are to be checked in the same way and to the same extent as outside purchases of any fixed assets. Capitalized cost of buildings, machines and other equipment constructed in this way contains all the usual elements of cost—material, labor and overhead—but no margin of profit may be added. If work of construction is done concurrently with ordinary operation it is not good practice to capitalize such an amount of factory overhead that the manufacturing costs of the ordinary product are reduced below the normal amount per unit in periods in which no construction is done.

During construction it is permissible to capitalize a proportion of the salaries and wages of such officers and employees as are engaged partly or wholly in planning and supervising the work. This might include part of the time of the general manager, and payroll of timekeepers, engineers and clerks directly engaged on the construction work and its records. Other proper charges to construction incurred during

the period of construction and not otherwise are interest actually paid on money borrowed to buy the site and to finance construction, real estate taxes and insurance.

So soon as the work is completed capitalization of overhead ceases; it ceases also as soon as operation begins, whether the construction work is then complete or not.

CONSTRUCTION IN PROGRESS

Work done on any construction that will eventually be charged to fixed-asset account is to be stated in the balance-sheet, not as ordinary work in progress, but as part of fixed assets, and materials for construction of this kind are also to be stated as part of fixed assets, not as inventory or supplies.

During the progress of construction by contractors, payments are made periodically, usually 80% to 90% of the amount of work already done, the final 10 to 20 per cent being retained until the satisfactory completion of the work. Contractors should furnish monthly statements, certified by supervising engineers or architects. The entire amount invoiced by contractors should be taken up whether due for immediate payment or not. If the commitment for uncompleted work be large it may have a material relation to the balance-sheet and should be noted on it. Money raised specifically for new construction can not be

stated as free cash but should be shown among the non-current assets as cash held for construction purposes.

INSTALMENT PURCHASES

Machinery and equipment are often bought on an instalment or hire-purchase system. The total contract price should be taken up in the books and unpaid instalments set up as a liability, or if the hire-purchase contract permit, the whole amount paid may be treated as a payment of rent for the machines and no asset need be set up. Instalment contracts stipulate that title shall remain in the seller until all instalments are paid; but, if the instalments are not charged to operations as rent of machinery, depreciation reserve should be set up from the time when the equipment enters into use. The capitalized value should not exceed the price on outright purchase; any excess over that price is an expense either as financing expense or "hire of machinery."

IMPROVEMENTS TO LEASED PROPERTY

Leases should be inspected and their terms noted. In cities large hotels, office buildings and other structures are erected on land held on long-term leases, say from fifty to one hundred years. These leases are generally considered as practical equivalents for freeholds. If a lease be for a period of one hundred years the application of the sinking-fund method of amorti-

zation is indicated; the difference between the present value of a lease for one hundred and of one for ninety-nine years is less than one thirtieth of one per cent, computing the amortization at 5 per cent, and it is even more insignificant if a higher interest rate is used.

For practical purposes, therefore, amortization of a leasehold may be deferred until the unexpired term is thirty to forty years; this is the more justified by the expectation that in the ordinary course the annual value will increase as years pass.

Improvements to leased property should be amortized over the life of the improvements or over the remaining life of the lease, whichever is the shorter time.

FIXED ASSETS RETIRED FROM SERVICE

If assets have been destroyed, sold or otherwise disposed of, both the asset account and the depreciation reserve must be cleared. That portion of the original property not recovered by salvage, insurance or otherwise and not covered by the depreciation reserve already provided for it should be charged against profit and loss.

When one unit is retired out of many for which depreciation is provided at a composite rate, it may be proper to charge it against the reserve, on the theory that the law of averages operates effectively on the whole account. If the estimated life of many units

be, say, ten years it is not to be expected that each item will last exactly ten years; one may last eight, another twelve, the average ten.

The law of averages does not apply to obsolescence; units retired for this cause are to be charged to depreciation reserve only to the extent that reserve has been provided for them. The rest of the gross book value is charged to operations—"cost of retired plant."

Fixed assets should be retired only on the authorization of the works manager or the controller. Some recognized routine generally exists to inform the accounting staff of fixed assets retired. The auditor should ascertain what it is and if it appears inadequate make further investigation to be sure that the fixed-asset accounts do not contain values for retired items.

APPRAISALS AND REVALUATIONS

Gross values of fixed assets may best be their cost; if no particulars of the basis of valuation be given in the balance-sheet caption it will be presumed that it is cost. If assets are shown at appraised value or at a value determined by a board of directors, that fact, with the name of the appraisers and date of appraisal or other basis for the determination of value must be clearly stated. This statement should appear, not only on the first balance sheet issued after the appraisal, but in subsequent statements, until the assets are retired, with a further statement of the basis of valuation of assets acquired since appraisal.

Even if an appraisal as of the date of audit is to appear in the accounts the fixed-asset accounts for the audited period should be examined as though no appraisal had been made. If ordinary repairs have been capitalized or items properly to be capitalized have been charged to operations, corrections should be made, not so much on account of the balance-sheet as to correct the operating account. Such errors would not change the balance-sheet valuations of fixed assets but they would cause a change in the earned and in the appraisal surplus.

A credit arising from true revaluation of fixed assets does not represent a profit; it has no place in earned surplus, and should be shown as surplus arising from revaluation; but if a credit arise from correction of excessive depreciation in the past it may properly be restored to earned surplus.

WASTING ASSETS

Even in industrial accounts, to which this book is primarily applicable, wasting assets such as timber lands, mineral deposits and some others may be found. They are owned for the purpose of assuring future supplies of needed materials. The expenditures for their acquisition are to be verified in the same way and to the same extent as any other capital expenditures, but there must be provision for depletion, rather than depreciation. Development and prospecting work are properly to be capitalized. Within limitations such

charges as interest on money borrowed to finance the purchase and taxes may be capitalized, but only up to the date when the properties are put into condition to begin production. The preferred method is to charge off interest and taxes as paid.

Development work on mining properties consists of stripping ore bodies, making roads, placing shafts and other work necessary to give access to minerals. This cost, after being capitalized, is to be written off against the product of that portion of the total deposit rendered accessible.

PRESENTATION ON THE BALANCE-SHEET

Fixed assets should be so classified on the balance-sheet as to show their general character, the amount of assets that from their nature are subject to depreciation and the depreciation reserve already provided for them. The subdivision may be land (not depreciable), buildings (depreciable but at low rates), and machinery and equipment (depreciable at higher rate). If the allowance for each class of assets be shown separately either on the financial statement or on an exhibit, the statement of values will gain in clarity. Allowances for depreciation should be deducted from the gross asset value, not shown on the liability side as separate liabilities.

INTANGIBLE FIXED ASSETS

The more common varieties of intangible fixed as-

sets are leaseholds, franchises, licences, copyrights, trademarks, royalty rights and goodwill. They are not specifically discussed in the Federal Reserve *Bulletin* but their verification follows the general procedure prescribed in that bulletin for other fixed assets, including verification of the cost or other basis of valuation set up on the books and determination whether proper provision has or has not been made to amortize the book values of assets having a definite limited life.

BASIS OF VALUATION

There are no other assets to be met with having such widely varying bases of valuation as some intangible assets, especially goodwill. Upon acquisition of a prosperous concern, either for cash or for stock, a price may be paid exceeding the value of the tangible assets acquired. The tangible assets are then valued and taken up as the values so assigned, and goodwill is set up, not on the basis of a specific valuation, but at the amount of difference between the value of the tangible assets and the total price paid. If the assets are acquired for capital stock, the stock so issued carries with it a share of any surplus that may exist; consequently the amount of total consideration may exceed, even largely exceed, the face amount of stock issued.

In other cases goodwill may be purchased for cash at a price definitely fixed. As a balance-sheet asset

goodwill varies from the most profitable of all assets to a mere worthless space filler.

It is necessary therefore for the auditor to ascertain the origin of the goodwill or other intangible-asset accounts and vouch any additions there may be. The number of transactions is so small that a review of the account from the beginning is generally practicable without spending much time.

The existence of corporations with worthless goodwill accounts has led many stable, prosperous corporations to write down, sometimes to the nominal sum of one dollar, all intangible assets, and to charge the amounts to surplus, capital (either paid in or appraisal) or to earned surplus. One can not object to this if the transaction be fully disclosed.

The working papers for intangible assets should contain not alone the figures but also some historical comment giving the origin of the goodwill or other intangible asset, the present use made of patents, the rate of profit on products made under patents and the amount of sale of copyrighted books.

AMORTIZATION

Such assets as patents, licences and franchises, having a limited life, should be amortized over their useful life. They may have statutory lives but their value does not necessarily extend over the whole of their legal existence. For example, the patent on a toy, a sweetmeat, a new radio set, can have only a short

profitable life. The spreading of the cost of copyright of a fashionable novel over the twenty-eight years of legal life would be absurd. All intangible assets with limited lives should be charged off against the profits they produce, and it becomes necessary to make a forecast of probable usefulness.

DISCLOSURE IN THE BALANCE-SHEET

It is essential to separate tangible from intangible assets in any statement of financial condition. If a mixed aggregate of tangible and intangible assets be acquired for a single consideration it is now considered unsound to state the joint value in a single figure.

· VIII ·

DEPRECIATION AND DEPLETION

VERIFICATION of allowances for the depreciation of buildings, machinery and equipment is referred to in paragraph 57 (i) of the Federal Reserve *Bulletin*. It should include the verification of allowances for depletion where wasting assets are owned.

Article 202 of Treasury *Regulations No.* 77 contains the following statement:

> "The necessity for a depreciation allowance arises from the fact that certain property used in the business gradually approaches a point where its usefulness is exhausted. The allowance should be confined to property of this nature. In the case of tangible property it applies to that which is subject to wear and tear, to decay or decline from natural causes, to exhaustion and to obsolescence due to the normal progress of the art, as where machinery or other property must be replaced by a new invention, or due to the inadequacy of the property to the growing needs of the business."

In the broader sense depreciation includes, beside ordinary wear, deterioration due to natural decay, nor-

mal progress of the arts, special discoveries and inventions, tariffs and changes in fashions and in economic conditions. In verifying reserves it is necessary to distinguish between these several elements causing loss of value; some can not be foreseen and provided for in advance.

Provision for depreciation is generally provided for by an allowance set up periodically at predetermined rates. The life of a depreciable asset can be estimated with only a limited degree of certainty and the provision to be made should absorb cost of the asset over its estimated life or over the estimated units of its total production. There is greater risk of error in estimating the production of a machine than in estimating its life in years and its loss in useful value occurring through the passage of time as well as from operation. It is customary, therefore, to use an annual rate for the computation of depreciation, although, if it were possible correctly to forecast the total production there would be advantages in using that method.

Before beginning the verification of the annual rates applied to the fixed assets of any corporation the accepted rates generally applied to similar assets and the effect on those rates of the corporation's policy relative to maintenance and repairs should be considered. Current provisions for accruing depreciation and expenditures for maintenance and repair are to some extent interdependent. Some machinery resembles the old family carving knife that has had

seven new blades and three new handles. A relatively low rate of depreciation may be sufficient if a liberal policy of repair and maintenance be followed, while a higher rate may be inadequate where ordinary repairs are neglected.

To determine the adequacy of current provisions investigation should be made of the policy of the corporation as to maintenance, its practice in dealing with renewals and replacements, the effect of obsolescence and the results of the policy followed as it appears from the sufficiency or insufficiency of accumulated reserves when units have been retired in the past.

The rates dictated by experience for many kinds of property have been studied and to some extent standardized. Such standards will be found in *Accountants' Index,* Income-tax Regulations, *Bulletin F,* of the Bureau of Internal Revenue and in reference works. Except in industries in which it is necessary to operate continuously, the rates are based on operation for about eight hours daily.

Such rates are not indiscriminately applicable; conditions vary too much. A blast furnace operating with poor ore, high blower pressure and making much slag will need relining oftener and wear out sooner than a similar furnace using cleaner ore and worked under less pressure. The standard rates are useful as indices only.

When plant is worked overtime some additional

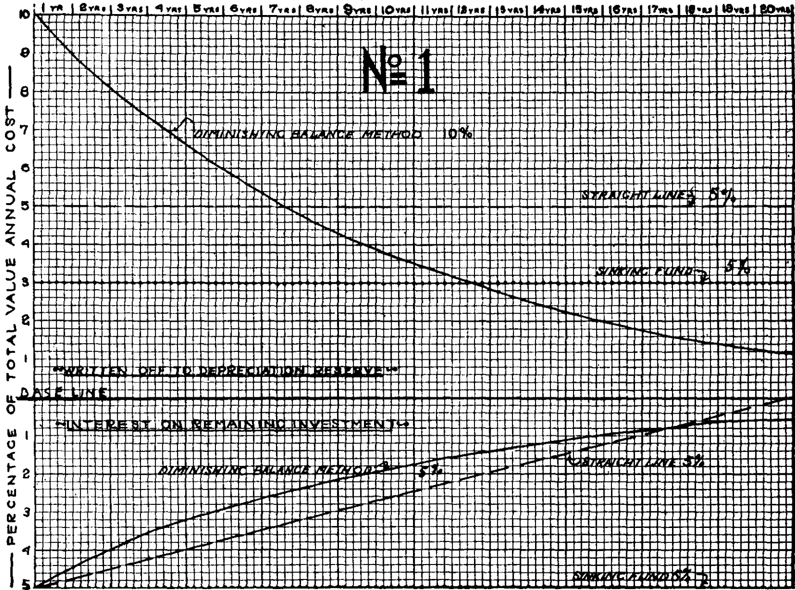
depreciation provision is required but not in direct proportion to the hours worked. The increased allowance is to be based entirely on increased physical wear. Obsolescence of any kind is not increased. Tables showing suitable differentials are given in *Accountants' Index.*

When plant is idle it may be permissible to reduce but not to suspend the ordinary provision; wear may be absent but depreciation from other causes continues. Some kinds of plant suffer from lack of use and no reduction is allowable. It is probable that almost all buildings when unoccupied suffer undiminished deterioration, if, indeed, deterioration is not accelerated.

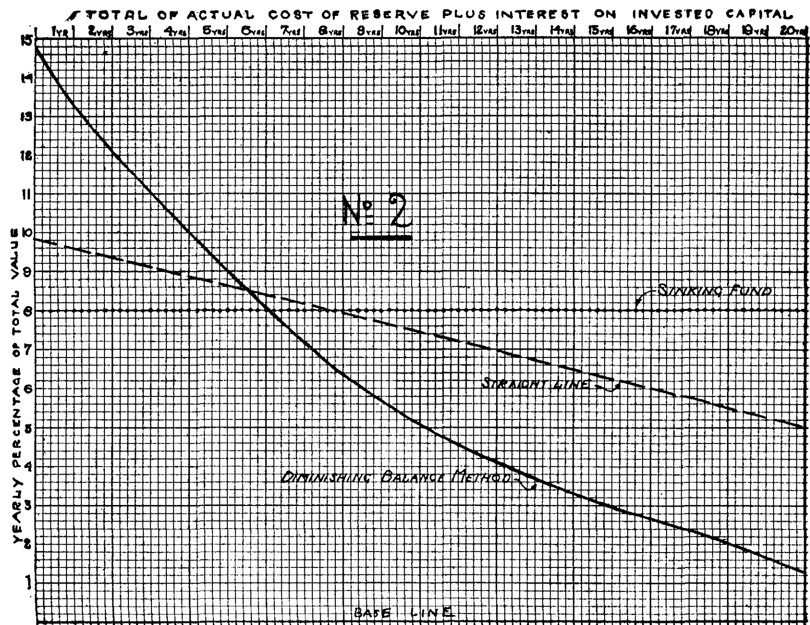
EXPLANATION OF GRAPHS

No. 1. The curves above the base line represent the amounts explicitly charged to operations for depreciation allowance; for instance in the tenth year there is charged by the sinking-fund plan approximately 3 per cent of the cost; by this plan the charge is the same in every year. By the straight-line plan the charge for the same year is 5 per cent; by this plan the charge is the same every year. By the diminishing-balance plan the charge for the tenth year is approximately 3½ per cent of cost, and varies during the 20 years from 10 per cent to about 1 per cent.

In the lower half of the diagram is shown the cost of interest, not specifically shown in the accounts but actually a part of cost. The quicker depreciation is applied the quicker the interest on invested capital decreases. In the sinking-fund method it is contemplated that the money shall actually be set aside and not used in the business but that it shall earn interest to be added to the fund. Accordingly there is no return of capital to the business and the cost of capital does not decrease as the years pass. In this case it is constant at 5 per cent of cost. In the straight-line method the depreciation is a book transaction only and in effect the amount of cost



№ 1
PERCENTAGE OF TOTAL VALUE ANNUAL COST
1 YR
2 YRS
3 YRS
4 YRS
5 YRS
6 YRS
7 YRS
8 YRS
9 YRS
10 YRS
11 YRS
12 YRS
13 YRS
14 YRS
15 YRS
16 YRS
17 YRS
18 YRS
19 YRS
20 YRS
DIMINISHING BALANCE METHOD 10%
STRAIGHT LINE 5%
SINKING FUND 5%
"WRITTEN OFF TO DEPRECIATION RESERVE"
BASE LINE
"INTEREST ON REMAINING INVESTMENT"
DIMINISHING BALANCE METHOD 5%
STRAIGHT LINE 5%
SINKING FUND 5%


TOTAL OF ACTUAL COST OF RESERVE PLUS INTEREST ON INVESTED CAPITAL
1 YR
2 YRS
3 YRS
4 YRS
5 YRS
6 YRS
7 YRS
8 YRS
9 YRS
10 YRS
11 YRS
12 YRS
13 YRS
14 YRS
15 YRS
16 YRS
17 YRS
18 YRS
19 YRS
20 YRS
YEARLY PERCENTAGE OF TOTAL VALUE
15
14
13
12
11
10
9
8
7
6
5
4
3
2
1
No. 2
SINKING FUND
STRAIGHT LINE
DIMINISHING BALANCE METHOD
BASE LINE

that is absorbed by depreciation is returned to the business, leaving a smaller investment to bear interest. Accordingly the interest on investment varies in a straight line from 5 per cent to nothing at the end. In the plan called the diminishing-balance method the cost of invested capital decreases most rapidly, varying from 5 per cent to a figure decreasing in logarithmic ratio but theoretically never extinguished.

No. 2. This graph shows the total of the two kinds of cost for each year. It represents the true total cost to the business. It will be seen that the sinking-fund method is the only straight-line method; that the diminishing-balance method takes up the depreciation far faster than either of the others; and that the so-called straight-line method is intermediate in its incidence.

The amount of annual depreciation is not the only figure that is affected by the method of applying the provision; the remaining unabsorbed investment is also of major importance, especially to corporations such as public utilities, whose rates of charge for gas, current, water, transportation and other service are regulated by public authorities in a manner intended to allow them a reasonable return on the capital value of plant in use. It happens that corporations of this kind have the greater part of their capital invested in extremely long-lived assets, and for that and other reasons they, almost without exception, have claimed the sinking-fund method as best representing the equities of their case. Reference to chart No. 2, for example, shows that at the end of 15 years the total charges to operations to provide the annual increment to the sinking fund would be 15 times 3 per cent, or 45 per cent of original cost, leaving the capitalized remaining value 55 per cent of original cost, while the straight-line method at the same point would have reduced capitalized cost by 15 times 5 per cent, or 75 per cent, leaving only 25 per cent unabsorbed. The diminishing-balance method would leave a still smaller capitalized value at the same date.

METHODS OF COMPUTING DEPRECIATION

The methods generally used are the "straight-line" or fixed-percentage method computed on original

cost, the "straight-line-diminishing-value" method the "sinking-fund" method and a method based upon output. The term "straight line" is applied to those methods in which a straight percentage of the book value of assets is charged to depreciation at certain periods of time, although the resulting total charge to operations and interest on invested capital is by no means a straight line.

It is to be noted that the shorter the term of life the less the difference of effect between these varying methods. Obviously for an asset with one year of life there is no difference, while for an asset with a life of one hundred years the difference is enormous. This fact is a major consideration in deciding upon the plan to be adopted.

The straight-line method is most commonly used by industrial enterprises; the cost of an asset is divided by the number of years of expected life, the quotient being the amount of annual provision. Salvage value is sometimes stressed but is not often of importance. Old platinum vessels from chemical works may bring more than half the original cost; old copper brewing kettles have a value; retired buildings may possibly furnish old material sufficient to pay for the removal of the structures.

The diminishing-value method is applied by deducting from book value a fixed percentage, as in the ordinary straight-line method, but the percentage is applied not to the original cost but to the cost diminished

by all previous provisions. A reserve is not set up. Assuming a constant flow of additions and retirements the nominal rate should be twice the rate used when it is applied to original cost.

The sinking-fund method, which is a true straight-line method, although not generally so recognized, is a plan whereby there is annually set aside such a sum as will amount, with interest, to the value or cost of the corresponding asset at the end of its expected life.

The real cost of the use of any asset is made up of two factors: the actual amount needed in an allowance for replacement and the cost of the capital absorbed in the asset. The graphs on pages 116 and 117 illustrate the differences in the time distribution of the total cost by the three principal methods in use. The sinking-fund method allocates the smallest cost to the earliest years and the diminishing-balance method the most. The cost of capital plus actual depreciation provision in the sinking-fund plan is constant throughout the life of the asset, while each of the other plans involves greater charges and costs in the early years.

The diminishing-value method needing no reserve is applied to mixed aggregates such as those classified as furniture, fixtures, office equipment and small tools. It avoids the work of following up the history of a multiplicity of small items and setting a retirement date for each. Under this plan failure to provide a rate sufficiently high can not result in in-

definite inflation; if the rate be 7½ per cent where 10 per cent is proper the amount of depreciation provision needed will be reached when the asset is valued at one third more than its proper value. This plan is also suitable where the earlier years of service of any asset are more productive or more efficient than later years.

The sinking-fund method is most adaptable to assets such as a bridge, where efficiency is constant, life long and part replacements not required. There is always in such cases a surplus of actual cash not needed for operation and arising from the depreciation allowance and not from profits after providing for eventual retirement. In these circumstances the sinking-fund provision may be set aside in actual cash or its equivalent or, better, invested in the bonds issued to finance construction.

When sinking funds are prescribed in the terms of an indenture the segregation and separate investment of the fund is compulsory; when the choice of methods is at the election of a corporation and the sinking-fund method is chosen the funds may be returned to the business, not set aside in a separate fund. The annual provision then is the basic annual allowance plus interest on sinking-fund moneys accumulated and returned to the business.

The production method is applied by estimating the total output of a machine or other asset and charg-

ing against output such an amount per unit as will wipe out the cost against the entire production of the asset during its life.

SMALL TOOLS

It is satisfactory where small tools are concerned if no specific rate of depreciation be applied but instead a physical inventory be taken and valued at each accounting date and the books be adjusted to the value so obtained. No reserve is set up; the loss of value is written off directly against the asset account.

Another satisfactory plan of dealing with such assets as small tools is sometimes used. A fair value, considering depreciation and obsolescence, is fixed for a normal stock of tools or other small but numerous assets. That value is allowed to remain on the ledger continuously, and all replacements are written off as expense. From time to time the stated value of the tool stock is verified by an inventory and valuation. No depreciation allowance is made directly.

SPECIAL ORDERS, PATTERNS, DIES, ETC.

Machinery and apparatus constructed or purchased for special work should be written off directly against the work for which it was acquired. No value should be retained except such as the asset might have for ordinary use. Dies, patterns and assets of that kind are not to be depreciated over their possible physical life but over their probable period of usefulness. Assets

of this type should be reviewed periodically by the staff of the client and their book value should be adjusted. If such assets are subjected blindly to any set scheme of depreciation for a long period without adjustment by observation of their actual condition and use, their book value will probably differ widely from the correct amount.

OBSOLESCENCE

There is a certain normal obsolescence due to ordinary progress of manufacture which may result in supersession of plant before the expiration of its otherwise useful life. Provision for this kind of obsolescence is included, perhaps unconsciously, in the regular provision for depreciation. It should be.

Obsolescence from sudden changes in processes or loss of public demand can not be foreseen and must be provided for when the losses occur. The auditor can and should see that provision be made for changes that have already arrived; thus, patterns and moulds for old style tires, for old pattern automobile bodies, radiators, etc., became worthless within a year or two. An increase in the total book value of such assets is matter for investigation.

DEPLETION

Provision for depletion of wasting assets must be made, and it is usually provided by the straight-line method with cost as a base. The straight line is not

applied to the time factor but the total expected output is estimated and the cost or other value divided by the units of output. The quotient is the amount to be charged against each unit produced.

If the wasting asset be carried at an appraised value—which is quite common—depletion must be computed on that basis. Appraisal values are the more used because in the hands of original discoverers the cost of mineral deposits has no relation whatever to value but is the result of accident.

From time to time, as production progresses, corrected estimates of production can be made and the unit charge for depletion adjusted if necessary. The adjustment may be either an increase or a decrease in the unit charge.

Dividends are declared by companies exploiting wasting assets "out of depletion reserve." Such dividends are distributions of capital and are quite proper if full disclosure of the source of the money is made.

The Internal Revenue Bureau and Treasury *Regulations* permit depletion for tax purposes to be based upon "discovery value," a recognition that cost may not represent anything approaching actual value. The result is a deduction for tax purposes differing from the depletion charge on the books and in the financial statements.

Allowances for depletion of timber, articles 240 to 248, of the *Regulations* are in accord with accepted accounting practice.

·IX·

DEFERRED CHARGES

Deferred charges, in the balance-sheet, are those expenses that are incurred for the benefit of future operations. If a three-year insurance premium be paid at July 1st, the amount chargeable to the year ending December 31st will be one sixth of the total premium. The remaining five sixths of the premium serve to insure the property for the following thirty months, and it is to be absorbed in that period. This is a typical deferred charge.

Verification consists of determining whether the deferred amount is of a character properly to be deferred and in ascertaining whether the proportion of the total that is deferred is truly the portion that will be of benefit to future operation.

Discount on interest-bearing obligations is perhaps the largest single item of deferred charges, and the amount to be allocated as discount is not always clear. If bonds are sold with stock, for a single consideration without separation of the amounts paid respectively for stock and for bonds, the fair value of the stock

must be determined before the discount on bonds can be known.

The effective interest rate is affected also by sinking-fund provisions, premiums payable on bonds compulsorily to be retired and by varying dates of maturity of serial bonds.

Upon the whole, it is considered correct accounting practice to spread discount evenly over the life of bonds. If there are serial bonds this treatment demands the spreading of the discount in such a way that the amount charged off in each year will be proportionate to the amount of bonds outstanding in that year.

In addition to discount it is permissible to defer and amortize over the life of bonds expenses of their issue. These may include legal and accounting services, cost of engraving and printing, charges for original registration and authentication, taxes on issue and original listing fees.

Prepaid insurance premiums are verified by examination of policies and of the computations of unexpired proportions of premiums. If policies are small and numerous and controlled by a well kept insurance register the test of a large section may suffice.

If any of the policies be with mutual companies the probability of dividends should be ascertained and allowance be made for them. Compensation-insurance premiums are first fixed on the basis of estimated payrolls and a deposit is paid, adjustable afterwards by

actual payroll. The deferred portion is therefore the excess of the deposit over the amount corresponding to the actual payroll to the date of the financial statement. The actual payroll may exceed the estimate and the whole of the deposit be absorbed and a further liability incurred.

It is not undesirable for the auditor to summarize the coverage so as to be able to compare it with the assets insured. Any material deficiency of cover may be discussed with the client.

Periodic expenses paid in advance, such as rent and taxes, are usually prorated over the period to which they apply. Local tax dates vary: state excise and franchise taxes are almost always applicable to a calendar year. All taxes except income taxes may properly be applied to the period in which they become due and payable; this is the plan prescribed in income-tax *Regulations*. Income taxes, however, are liens against the income on which they are assessed and should be charged against that income.

In some states, notably New York, the equivalent of an income tax is assessed as a franchise tax. Thus in 1933 a corporation must pay a franchise tax computed on its income in New York during 1932, but the tax so payable is strictly a tax giving the right to operate during 1933 and is not payable if the taxpayer does not operate in 1933. The income of one year is a measure of the franchise tax to be assessed in the following year.

Some other states have true income taxes assessable against corporations. When this occurs the allocation of the expense is the same as in the case of the federal income tax.

Advances to salesmen for traveling expenses and commission are deferred charges to the extent that the money has not been spent nor earned during the audited period. The asset can not be admitted until all expenses incurred or commissions earned have been deducted from the amount of advance or have been taken up as a liability.

Deferred advertising, development expense other than development of natural resources, experiment cost and organization expenses can be set up as assets only on the ground that they will be of value to future periods. A nation-wide advertising campaign may be expected to affect future sales and if the amount deferred is reasonable and approved by proper authority it may be accepted. Advertising paid for before it is actually printed and circulated is obviously a proper deferred charge. Expense of developing a new product may also be a proper deferred charge if there is a prospect of success. The period over which such charges are spread should be short.

Experimental costs that have remained without material change for many months are to be regarded with doubt. In all such matters the facts of each case will govern.

Advertising and office supplies may be classified as

deferred charges. The inventories should be reviewed and values assigned should be within the limit of useful value.

The correctness of deferred charges may affect closely the operating results; their understatement may be as undesirable as overstatement. If bond discount be charged directly to surplus, the effective rate of interest on borrowed capital is understated, a misstatement that affects directly the prospect of future profit as well as the profit of the current period. The Federal Reserve *Bulletin* mentions the necessity of obtaining, if possible, documentary confirmation of deferred charges.

·X·

CURRENT LIABILITIES

THE auditor is to verify and classify the liabilities already on the books and to use all available means to discover omissions of liabilities that should appear.

The classification of liabilities is generally into a group called "current" liabilities, consisting of liabilities payable at an early date, and groups of liabilities of longer term, such as "funded debt" and other liabilities not payable within about a year.

There is no sharp line of demarcation between the liabilities to be included in current liabilities and those otherwise classified, but by common consent amounts due within about a year are current liabilities and those definitely maturing at a date more than a year ahead are not so classified.

Each kind of liability should be given a clearly descriptive name—notes payable should not be merged with accounts payable; secured notes and accounts should be distinguished from liabilities not secured; the collateral should be mentioned; subordination of some liabilities to others should be disclosed.

The order of arrangement in the financial statement depends somewhat on the business and the purpose for which the statement is to be used. In some statements the order is by maturity, past-due accounts being shown separately. If solvency is questioned the legal order of priority may be the rule. General practice for manufacturing and commercial corporations is to show current liabilities first in the relative position on the balance-sheet that the current assets occupy on the other side. The Federal Reserve *Bulletin* suggests the order:

NOTES AND ACCOUNTS PAYABLE:

- Secured liabilities
- Unsecured notes
- Unsecured accounts

Accrued liabilities
Other current liabilities.

Each of these headings may be further subdivided.

NOTES PAYABLE

The balance-sheet heading "Notes payable" or "Bills payable" covers all promissory notes, acceptances or other forms of drafts drawn on or accepted by a corporation.

As a preliminary to verification of notes payable an analysis of the note accounts is to be made, most conveniently in columnar form, to show all changes and the maximum and minimum amount outstanding

at any time during the period. Totals of notes outstanding at the beginning of the period, issues of notes both new and renewals, retirements and balance at the end of the period should appear on this schedule.

In addition to analysis of the account the working papers should contain a schedule showing notes finally outstanding with details as follows:

Date of issue and maturity
Name of payee
Endorser of guarantor
Interest rate and due dates
Amount of note
Amounts paid on principal
Collateral
Disposition of notes maturing after statement date but before completion of audit.

The same schedule may show amount of interest payable during the period under audit, the total to be reconciled with the interest account. Notes not recorded may sometimes be found in this way.

Confirmations may be obtained directly from payees unless they have disposed of the notes. Requests for confirmations of notes and of collateral for them should be obtained from banks with which the client company has done business.

The audit work will include examination of paid notes and a comparison of them with the working

schedules. Part payments on account should be checked to the cashbook.

Officers of corporations can sign notes only when authorized by directors or stockholders. Evidence of authority should be seen. Failure to note that unauthorized persons had incurred corporate obligation would subject the auditor to severe criticism.

Notes receivable discounted may be shown either as contingent liabilities or the notes may be shown as full liabilities and their amount included in the asset "notes receivable."

ACCOUNTS PAYABLE

The general title "accounts payable" should cover liabilities other than notes to trade creditors and bills for current expenses. Such accounts are generally unsecured. Accruals of wages, interest, taxes and other regular periodical expenses are current liabilities set forth as "accrued liabilities." Bills for capital expenditures, if currently payable, may be included as general accounts payable. It is their relation to the current financial position, not their origin, that is to be considered. It is good practice however, to separate trade accounts payable that have arisen in the ordinary conduct of the business.

The working papers should contain a full list of unpaid bills, prepared either from the open items in the voucher register or from a creditors' ledger or register if one be kept. If accounts are extremely numerous an

adding machine strip may serve. The total should, of course, agree with the controlling account.

Amounts long outstanding should have attention; it may be that payment has been withheld pending settlement of disputes and that there is some additional liability.

In the balance-sheet attached to the Federal Reserve *Bulletin* there is a separation between accounts payable "not yet due" and those "past due." Separation is not always needed; the facts of each case will govern. In order to determine as far as possible that all existing liabilities are taken up in the accounts, invoices received since the date of the balance-sheet, but before the audit is completed, should be examined to discover any charges applicable to the period under audit and omitted from the books. Receiving records may be used to help make clear the status of any merchandise at the date of audit. Payments shown by the cash-book since the date of closing may be scrutinized for similar reasons. If a record of orders placed and executed is kept that may be of some use.

Liabilities of other kinds may sometimes be disclosed when the minutes of the directors are reviewed.

Dates of shipment and of invoice are significant but not conclusive. It is common in some industries to date invoices forward for the purpose of extending credit terms on special lots, while apparently keeping to the fixed terms. If merchandise has actually been received and placed in stock for sale it should be

taken into the inventory and the purchase taken up as a liability irrespective of the date of invoice. If any part has been sold the propriety of taking up the purchase becomes indisputable.

Merchandise may be received in advance of the date at which it is expected to be needed. It may be alleged that it was accepted only at the request of the shipper to allow him to clear his warehouse, that it is stored for the convenience of the shipper and that it should be excluded from the inventory. If such goods are returnable this claim can not well be disputed; but if the goods are in execution of firm orders and must eventually be accepted and paid for they should be included in the inventory and the liability should be taken up.

Monthly statements of the larger creditors as of the date of audit should be compared with the books and differences should be explained. If such statements are not available, direct confirmation by creditors may be required. Monthly statements are generally furnished and should be obtained by the client, irrespective of audit.

Examination of purchase contracts, monthly expense bills and commitments may serve to indicate existing liabilities. Claims for price adjustments not yet approved by the creditors involved should appear on the balance-sheet as claims receivable, not as deductions from the liabilities.

Trade discounts—that is—those deducted without

reference to time of payment—should be deducted from the purchase price when the purchases are entered on the books and the accounts should appear net after deduction. Strictly cash discounts are sometimes deducted from the total of outstanding liabilities and the practice can not be opposed if followed consistently both in respect to accounts payable and to accounts receivable and if the financial position is such that cash discounts have consistently been taken.

If consigned merchandise be held for sale, all sales of such goods must be accompanied either by payment for them or by credit given to the consignor. A statement of merchandise unsold and of the ledger balance with the consignor should be sent to and confirmed by him. Such statements and confirmations are generally exchanged at short intervals for aid of the client, even if no audit be made.

Accounts due to officers and employees should be shown separately, and large amounts should be confirmed directly by the creditors. Some corporations accept savings deposits from employees and pay interest on such deposits, which when payable on demand are current liabilities. Payments by employees for subscriptions to capital stock should be shown next to capital stock as "paid-in subscriptions to capital stock." It is improper to take up the stock as though it were issued and to carry the unpaid balance of the subscriptions as an account receivable.

ACCRUED LIABILITIES

Expenses accrued at the date of the balance-sheet but not payable until a later date are classified in the Federal Reserve *Bulletin* as "accrued liabilities," a subdivision of current liabilities. They may include salaries and wages, officers' commissions and bonuses, interest, royalties, rentals and taxes, legal services, compensation insurance, pensions, traveling expenses and salesmen's commissions and other items.

If the last payroll does not coincide with the date of closing, the amounts accrued will be determinable by piece-work records and by the payrolls for other salaries and wages. The amount of accrual should be checked; all except piece work should be allocated in proportion to the working hours.

Bonuses and additional compensation can usually be verified from the directors' minutes; a statement of such bonuses or additional compensation should be furnished by the treasurer.

Interest accrued but unpaid is easily checked from the verified schedules of interest-bearing debt. The liability for royalties should be verified by reference to contracts and records of production or sales. Where royalties are payable on net profit from the rights conferred by the royalty agreement, the definition of profit contained in the agreement must be followed, as it may differ from what an accountant would call net

profit. Rentals accrued may be checked to the last rent receipt; such receipts always show to what date rent has been paid and are almost conclusive evidence that there are no arrears, except as noted on or indicated by the receipt. If rentals are adjustable to conform to amount of business done in the rented premises the liability must be checked accordingly.

Legal bills, as a class, are presented late; such bills to date or a memorandum of charges including work done to date should be requested.

Full provision for federal taxes up to the date of the balance-sheet should be made on the basis of book income plus an additional amount if necessary to cover deductions not allowed for tax purposes, such as depreciation in excess of the government rate. Provision should be made for any proposed assessment for prior years that probably can not be resisted.

Pension liabilities can be determined only with the assistance of the client. There is generally a large degree of discretion and volition left to the pensioning corporation.

Commissions are often computed on the results after all other closing entries. This liability should not be omitted.

Liability for taxes is discussed under "deferred charges." Disputed income and other taxes must be provided for either directly or as contingent liabilities. If a corporation attempts to apply taxes against the period to which they technically apply, reference to

local tax laws is necessary, because the allocation of local taxes to nominal periods by the taxing authority is made by changing and inconsistent methods. Except for true income taxes it is most satisfactory to take up as expense all taxes becoming due and payable within the accounting year.

Other recurring expenses—water, gas, electric current, power, freight, telephones, cables, dues, wire rent and others—are billed soon after the end of each month; if bills are not received in time for closing the accounts an estimated amount of liability for overlapping accounts is to be set up.

DIVIDENDS

Dividends declared but not paid before the end of the period under audit are a separate item under current liabilities. Cumulative preferred dividends are sometimes provided for in advance of declaration and may be included among the liabilities, although this is not necessary. If cumulative dividends are in arrear, whether declared or not, the amount of arrear is not a direct liability but only a preference as between the several classes of stock and is shown generally in a note under the capital stock classification.

Unclaimed dividends are a current liability for a statutory period; after that time they should be returned to surplus unless they revert to the state in which the corporation is organized.

Dividends of subsidiary or associated companies or of companies whose facilities are used by the client company may be guaranteed; there may be a contingent or actual liability in this respect.

GUARANTIES

Deposits required from customers are repayable on demand, repayable at the expiration of a term of service or to be liquidated only by service to be rendered. The first two are current liabilities; the third (which is of large amount in the accounts of some film distributors) is not a current liability but occupies an intermediate position between current liabilities and long-term debt. It is usually stated on the balance-sheet by itself, without classification as between current and non-current liabilities.

CERTIFICATE

The positive discovery of all outstanding liabilities is beyond the power of any investigator. The auditor, having taken all the steps described should then obtain from president, treasurer or controller, or from two or all of them, a certificate to the effect that all liabilities known to them have been disclosed. The form of the certificate may be similar to the specimen which follows.

A. B. CHASE COMPANY

NEW YORK

Date.

To Auditor & Co.

In connection with your audit of the accounts of this company as of (date) we certify that to the best of our knowledge and belief all liabilities of the company had been recorded on the books as at that date whether in respect of purchases, expenses, bank loans, lawsuits, claims for damages or other claims either actual or contingent, except as follows:

(Particulars if there are exceptions.)

Signed

President
Treasurer
Controller

·XI·

LONG-TERM LIABILITIES

For present purposes long-term liabilities are those payable more than a year after the date of the financial statement. Bonded debt and mortgages are the principal liabilities of this kind; their existence becomes readily apparent in the examination of the books. The auditor's verification consists chiefly of examining relative indentures, seeing that the provisions have been observed, confirming the amount authenticated by the trustee, accounting for the proceeds and presenting correctly the outstanding liability in the balance-sheet.

Upon a first examination and upon sale of a new issue the minutes authorizing the issue, the indenture, the agreement with the underwriting bank or syndicate and the listing application should be examined, the price obtained verified, the proceeds traced to the cashbook or journal and the treatment of any discount investigated.

All changes in bond accounts during the period audited should be verified and scheduled in the work-

ing papers. The auditor should see that all new issues have been approved and the bonds duly authenticated. Bonds retired should be inspected to see that they have been effectively canceled or that they are covered by cremation certificates.

Treasury securities of a corporation's own issue should have been counted with other securities and cash. Working papers may contain a schedule as of the balance-sheet date showing for each issue the amount authorized, amount authenticated, treasury securities, classified as between those deposited with trustees, pledged as collateral, held for specific purposes, held for retirement and held for sinking fund, intercompany holdings and balance in the hands of the public.

If there be only one or two issues outstanding they may be shown separately on the balance-sheet but if there are many issues a detailed supporting schedule is more convenient.

Bonds reacquired by an issuing company should be shown in the balance-sheet, preferably as a deduction from the amount of bonds issued, with an adjustment of bond discount, so that no deferred charge in respect of the bonds reacquired shall remain.

If bonds be held alive by trustees in accordance with sinking-fund provisions they are to be shown on the balance-sheet among the sinking-fund assets at face value. Interest on them is usually collected and added to the sinking fund by the trustee.

Bonds authenticated but unsold should not be

shown as an asset; if such bonds have been pledged as collateral the facts should be stated clearly, but neither an asset nor a direct liability should appear in the statement.

Funds on deposit with a trustee in accordance with sinking-fund or other requirement should be described and shown separately on the balance-sheet; cash and marketable securities so deposited are not current assets, and not free for general corporate uses. The auditor should obtain from sinking-fund and other trustees holding corporate funds statements of changes during the audit period and compare it with the books.

Interest on sinking-fund moneys is added to the sinking fund unless the indenture provides otherwise. If the charge to operations be only the annual sinking-fund provision, such interest is not to be credited to operations. Income from other moneys and securities deposited with trustees generally is a part of ordinary corporate income. The indentures prescribe the disposition of such income.

Accrued interest on bonds and other interest-bearing liabilities at the date of the audit should be checked and the amount charged to profit and loss for the period should be reconciled with the amount computed from the interest rates and the amount outstanding during the period. Accrued interest is a current liability, not following the bonds on which it is computed. Intercompany holdings of interest-bearing

securities will produce credits in the accounts of one company exactly offset by interest charges in the accounts of the other. Both will disappear on consolidation.

Funds deposited with a trustee to pay interest on interest dates are generally treated as full discharge of the liability. This is correct, but control records should be kept and the auditor should verify their correctness by direct correspondence with the trustee.

BOND INDENTURES

Bond indentures are usually comprehensive and extremely technical in language. The working papers for any bond issue should show, with index notes to the corresponding sections of the indenture, the following:

Exact title of the issue
Authorized amount and currency in which payable
Dates of maturities, serial or other, and premium on redemption
Interest dates and rates
Conversion and warrant privileges
Identity of trustee and fiscal agent
Sinking-fund provisions, limitations on dividends, current asset ratios, etc.
Financial statements to be filed with the trustee
Amount of insurance required and disposition of policies
Disposition of proceeds of sale of property or collateral

Collateral requirements and restrictions on further issues
Tax-free covenants.

All these provisions may affect the accounting. If any other special requirements are mentioned in the indenture and affect the accounting, the details should be transcribed on the working papers.

TITLE

In the working papers the complete exact title should be given; on the balance-sheet abbreviations should be avoided or minimized. Some bonds have such long titles that some abbreviation is necessary if a balance-sheet is to be kept within reasonable bounds. Two issues may have titles so nearly alike that confusion is to be feared if abbreviations occur. Maturity date and interest rate should be shown on the balance-sheet. If a separate exhibit giving particulars of outstanding issues be annexed to the balance-sheet full titles may be given without difficulty.

AUTHORIZED AMOUNT

The total amount originally authorized should be shown on the balance-sheet; it indicates the possible increase in the amount of bonds secured by the property on which the issue is a lien, since additional sales may be permitted by the indenture.

CURRENCY IN WHICH PAYABLE

The currency in which bonds are payable should be

noted; bonds sold abroad may be payable in United States gold, United States currency, foreign gold or foreign currency. If payable in a foreign currency other than gold, the liability should be stated at the higher of the values computed at the rate of exchange at the date of issue and the rate of exchange at the date of audit. A paper profit arising from valuation based on a fall in the value of the foreign exchange is not to be taken. At this time (1933) many currencies are badly depressed and fluctuate violently; well managed corporations with issues payable in depreciated currencies are not assuming that the depreciated currencies will remain at present rates until the maturity of the bonds. Profit from this source may be taken only when the bonds are retired.

MATURITY

Issues maturing within one year are ordinarily to be included in current liabilities as already stated; but if arrangements have been concluded to refund the issue this requirement may be overlooked.

If there be serial bonds payable over a number of years, those falling due within a year are usually separated and stated as current liabilities. If current assets are very largely in excess of current liabilities and it is desired to show the total of each of several types of obligation it may be permissible to show all serial bonds, including those due within a year, as funded

debt, stating the maturity dates and, in particular, the amount due within a year.

Bonds called for redemption before balance-sheet date but not redeemed at that date are to be shown as current liabilities.

PREMIUMS ON REDEMPTION

Provisions regarding premiums payable on redemption of bonds should be shown on the working papers and the correctness of such premiums paid during the year should be verified. Premiums are payable only when bonds are called, but indentures may permit the issuing company to buy them for the sinking fund in the open market if obtainable below call price. There will then be no premium or an amount less than that payable on called bonds.

INTEREST

Interest accrued to the date of the balance-sheet is to be included in current liabilities. If the amount payable is affected by such special factors as number of tons of rock quarried or barrels of oil produced it is necessary to check the provision accordingly.

CONVERSION, PARTICIPATIONS, WARRANTS

If there be conversion privileges or stock purchase warrants given with bonds, the auditor must see that sufficient authorized stock is retained unsold to cover possible calls under these rights. There may also be

participation in profits for which provision will be required.

SINKING-FUND PROVISION

The annual sinking-fund provision may be mandatory and inflexible, or it may be determined wholly or in part by profits, sales or by other variables. The requirements of the indentures must be studied and fully met before accounts may be certified. Sinking-fund provisions are not generally to be charged against profit-and-loss account, even though their amount may be dependent upon profits; they are in fact segregations of surplus rendering it unavailable for dividends until the maturity and retirement of the bonds for which the sinking fund is established.

If they are made to protect bonds secured by wasting assets, however, they may be treated as substitutes for depletion reserve. The mechanism may be:

Dr. Operating costs
  Cr. Sinking-fund account

and at the same time

Dr. Sinking-fund assets
  Cr. Free cash, securities, etc.

In the balance-sheet the sinking-fund account is then deducted from the value of the wasting asset as a depletion reserve would be.

In such cases the sinking-fund provision is so ar-

ranged as to retire the bonds before the wasting asset is exhausted, and it therefore exceeds the annual provision that would be set up for straight-line depletion. The auditor must ascertain that the sinking fund thus set up is at least equivalent to an adequate depletion reserve.

In making a first audit the provision made in the past should be reviewed to see that it meets all the requirements of indentures and is adequate in other respects. The trustee is charged with the duty of demanding that the full provision stipulated in indentures is made. If sinking-fund requirements have not been fully met the failure should first be brought to the attention of the client and if not corrected it may be the subject of comment in the report or certificate.

LIMITATION OF DIVIDENDS

Restriction may be placed upon the declaration of dividends during the life of bonds. The provision may be to the effect that dividends exceeding a stated amount shall not be paid or that no dividends shall be paid unless specified conditions of current ratio, amount of current assets, amount of net tangible assets or profits exist. The auditor's duty in case of failure to observe these conditions is to bring to the attention of the client the unfulfilled requirements and then if necessary consult the trustee. Primary responsibility rests upon the trustee, and if the auditor is satisfied that all the information to enable him to determine

whether or not the requirements have been met is available to the trustee and if the latter is satisfied with what has been done, the duty of the auditor is generally considered to have been fulfilled.

FINANCIAL STATEMENTS REQUIRED

The duty of preparing the financial statements required by the indentures may be assigned to the auditor. Such statements have to be made up to meet stated requirements which may cause them to vary from those prepared for ordinary purposes. They should be so worded as to demonstrate unmistakably that they are made in the prescribed manner with its consequent limitations and implications. Among such specifications may be exclusion or inclusion in current assets of certain items, valuation specifications and special treatment of accounts with subsidiary companies.

INSURANCE

It is proper for the auditor to see that the provisions of indentures as to insurance have been observed. Failure to insure as prescribed in indentures may cause technical immediate maturity of the obligations.

DISPOSITION OF PROCEEDS OF DISPOSAL OF ASSETS

Indentures provide for the disposition of the proceeds of sales, insurance recoveries, or other liquidations of assets pledged under them, and of pledged

securities. Replacement of property sold, transfer to the cover of the mortgage of other unpledged fixed property, even part or entire liquidation of the obligation, may be required. It is part of the duty of the auditor to see that proceeds of sales and fire insurance are applied properly.

COLLATERAL

Collateral for bond issues may be real estate, securities of subsidiary companies, marketable securities, notes and almost all the assets of a corporation. The adequacy of collateral, disposition of any income from it and propriety of any substitutions must be checked by the auditor.

ADDITIONAL AUTHENTICATION AND ISSUE

Before additional bonds should be authenticated, where an entire authorized amount is not originally issued, the trustee will ordinarily require a certificate from an engineer that there have been capital additions since the preceding issue at least equivalent to the bonds, the sale of which is now to be authorized, and a certificate from the company and its auditor that the earnings have been at least equal to the amount specified in the indenture as a requirement preliminary to the authentication of the additional amount now to be issued. The duty of the auditor is obvious.

TAX-FREE COVENANTS

Many indentures contain a covenant that certain local taxes and federal income tax to the extent of not more than two per cent shall be paid for the bondholder by the company. Comparatively few bondholders take advantage of this privilege, but a liability exists and provision should be made for it in the accounts.

MORTGAGES

Verification of mortgages, as already stated, can be covered by examination of public records. There is a distinction between a "bond and mortgage" and a "mortgage." When a mortgage is placed on a piece of property a "bond," which is a primary obligation of the party executing it and a "mortgage," which is an assignment of property as collateral are executed. Upon change of ownership of the property the bond may remain the obligation of the original mortgagor while the mortgage follows the property. The original mortgagee is not obliged to accept the substitution of another for the signer of the original bond, and if the credit rating of the first signer is better than that of the new owner of the property the substitution will probably not be allowed. There then remains a contingent liability upon the first owner; its remoteness is dependant upon the margin of value between

the amount of the mortgage and the value of the property.

An owner of mortgaged property who is also liable on the bond should record the liability separately because it is a lien on all his property and assets, while if the liability be only on the mortgage it is limited to the mortgaged property and may be shown as a deduction from the gross value of the property.

LONG-TERM NOTES PAYABLE

Long-term notes are to be verified in the same way as short-term notes. Certificates from payees are the best verification. Such certificates should show date to which interest is paid, collateral, endorsements and any other relevant facts. It is much more common to deposit collateral for long- than for short-term notes.

In the balance-sheet they may be classified as loans from subsidiaries, officers or stockholders, purchase money obligations or notes representing purchase of fixed or current trade assets.

Instalment "lease" contracts may provide for rent-purchase over a term of years. For their treatment see "Fixed assets, instalment purchases" (page 104).

Analysis of the interest account should show any payments of interest on account of long-term obligations. They usually bear interest payable before maturity.

·XII·

CONTINGENT LIABILITIES

CONTINGENT liabilities are existing commitments that in certain circumstances may become direct liabilities. A note receivable discounted is an illustration; the payee has endorsed it and obtained its value from another party; if the maker does not pay it the endorser must; that is a "contingent liability."

The existence, amount and degree of remoteness of liability are to be checked by the auditor. The accounting records may not show the existence of some contingent liabilities but minute books of executive and financial committees and files relative to litigation may disclose them.

Because of the impossibility of determining positively from the records what contingent liabilities there may be, the legal department and the principal officers of a client corporation should be consulted. The specimen liability certificate given under "Current liabilities" contains a clause relative to contingent liabilities.

ENDORSEMENTS

Endorsements are given on notes discounted, in financing arrangements, in other ordinary business transactions and as an accommodation to other parties.

When raw materials are obtained from growers of farm products, lumber operators and other primary producers a loan of credit during the growing or developing period may take the form of endorsement of notes. These should be taken up on the books but sometimes they are not. An examination of the source of the supplies of the company and its purchasing policy may disclose the facts in such a case. Sugar-growing companies that obtain credit in this way often deposit as security their own bonds, authenticated but not yet issued.

Notes of subsidiary companies are often endorsed by parent companies, especially when they are to be sold to banks or to the public. Mortgage notes also are sometimes sold.

Accommodation notes are difficult to trace. It is bad practice to give them and admission that they have been given may be withheld. Those authorized to sign such notes may be asked to give a statement of all outstanding endorsements of this kind. The auditor is responsible for the use of diligence in finding such liabilities, but he is not responsible for the existence of endorsements not indicated by the records

nor admitted by the client upon the auditor's request for information.

GUARANTIES AND WARRANTIES

Liability on accounts receivable sold does not differ from liability on discounted notes. In each case payment is guaranteed; if payment be not made by the debtor, cash or good accounts must be substituted. There is a contingent liability for all accounts sold and not yet paid unless, as occurs rarely, the accounts are sold as they are, without recourse.

Sales guaranties for quality, service and suitability should be provided for by definite reserve and not as contingent liabilities.

Financial guaranties which may be the subject of mention in a footnote may cover payment of principal and interest of obligations of subsidiaries and of their dividends.

PENALTIES

Contracts for construction projects required to be completed within a time limit may provide penalties for delay. No contingent liability is to be noted unless there be a probability of penalty exceeding the unbooked profit on the work.

COMMITMENTS

A contingent liability need be noted only when commitments indicate probability of loss. Purchase commitments may provide for firm purchase over a

period of years of a commodity at a fixed price or at a price variable with conditions. Actual liability arises only when a shipment is made, but the purchaser is contingently liable for the entire purchase. In times of rising prices a commitment at a fixed price may be of much value; in times of falling prices it may produce serious loss; and in these circumstances a contingent liability is to be noted on the financial statement. If the commitment be to take merchandise at prices determined by the current market from time to time no serious loss is probable and no note of contingent liability is required.

Sales for future delivery may be made at fixed prices and will then produce similar gains, losses and contingent liabilities. In any case hedging operations may affect the future liability and may make any note of contingent liability unnecessary.

CLAIMS, DAMAGE AND OTHER

Damage and other claims may be for personal injuries to employees, perhaps chargeable to insuring companies, claims for damage to merchandise while in transit offset by counterclaims against transportation companies, claims for short shipments, imperfections and delays and claims by outsiders for damage due to use or consumption of the product sold.

TAXES

Proposed additional assessments of federal and state

income taxes sometimes are of large amount. The auditor should always review the reports of revenue agents and Treasury Department correspondence relative to tax returns.

LAWSUITS

While the existence of lawsuits may sometimes be disclosed by bills for legal services the auditor can not by himself form an intelligent idea of the amount and remoteness of contingent liability, and he should avail himself of the information that can be given to him by the legal staff and the officers of a client company. Patent litigation is particularly difficult to estimate.

If judgments have been rendered against the client the amount of the judgment should ordinarily be set up as a definite liability, although the case may have been appealed.

UNPAID PORTIONS OF STOCK SUBSCRIPTIONS

If part-paid stock of subsidiary companies be held, it suffices to show that there is a part of the capital not yet paid. The unpaid balance, if not called, need not then be shown among the contingent liabilities. If the stock be part paid and the remainder have been called, the amount unpaid becomes a current liability, with the full-paid stock as an asset. Such a liability is a preferred claim.

Capital stock issued for cash or property with a

stipulation that it will be repurchased at stated times and at stated prices or that it will be repurchased on demand constitutes a contingent liability as soon as the market price of the stock falls below the repurchase price.

TREATMENT OF CONTINGENT LIABILITIES IN THE BALANCE-SHEET

Contingent liabilities are disclosed in the balance-sheet by footnotes stating briefly the nature, amount and remoteness of the liability. A liability, contingent at the date of closing but becoming an actual liability before the end of an audit, must be stated in the balance-sheet as an actual liability.

Some reserve may be provided for certain other contingent liabilities, particularly against claims for additional taxes.

Notes receivable discounted which, between the date of closing and the end of the audit, have been dishonored are current liabilities. Other notes receivable discounted and endorsements are contingent liabilities. It may be noted that the conversion of a contingent into a current liability is generally accompanied by the acquisition of a new asset. A dishonored note brings into the assets a claim against the maker of the note for its amount.

Extremely remote contingent liabilities are ordinarily ignored, but large commitments which, while not probably productive of loss, will affect materially

the liquidity of the current position should be mentioned. Contracts for new construction and purchase commitments largely in excess of current requirements are of this class. If no special arrangements for financing have been made a note of such commitments is essential to a fair presentation.

· XIII ·

DEFERRED CREDITS AND RESERVES

THE Federal Reserve *Bulletin* does not mention either deferred credits or general reserves. Deferred credits are seldom of importance in the accounts of manufacturing companies but may be of large amount in the accounts of shipping, publishing and insurance companies. They may consist of advance collections or billings for royalties, interest, subscriptions and dues, unrealized profit on instalment sales and premiums on funded indebtedness.

Any income received in advance of rendering service must be regarded as deferred until the service is rendered. Royalties for the use of patented processes and machines are often paid in advance and not refundable except by use of the process or machine. The amount paid in is to be taken as income only when earned either by use of the privilege or by the passage of time. Interest received in advance is also to be taken as income when earned.

An example of deferred credits and debits is afforded by the accounts of shipping companies. All

cash collections on account of unfinished voyages are set up as liabilities and all disbursements are set up as assets until, at the end of the voyage, they are brought together and profit or loss on the voyage is ascertained. The accounts for unfinished voyages are set up at the full amount of assets and liabilities respectively, not at the net amount of difference between receipts and expenditures. It is to be noted that it is unnecessary to attempt to make any provision for expenses or income of uncompleted voyages not already on the books.

On instalment sales risk of loss in collection is greater than on other sales and varies with the kind of merchandise sold—for example sales of clothing on this basis are subject to greater loss than sales of refrigerators. The most cautious treatment is to apply first instalments to absorb cost and to take profit only when actual cash profit is in hand. In any case no greater proportion of the whole profit than that corresponding to the proportion of cash collected should be taken. The unearned profit is then stated as a deferred credit.

Premiums on funded debt or other obligations should be treated as deferred credits for the same reason as that which requires discount to be treated as a deferred charge. The premium should be so prorated that the profit-and-loss charge for interest is reduced to the effective rate.

Temporary suspense accounts may be found among

deferred credits; if they can be analyzed so as to allocate the amounts to more definite classifications it should be done.

RESERVES

Reserves may be "valuation" reserves or allowances which represent a definite reduction in the value of specific assets. Depreciation, bad debt and discount reserves and reserves to reduce investments to market value are of this kind. They should be shown on the balance-sheet as deductions from asset values, not set up as independent liabilities.

So-called reserves for current income taxes and for overlapping expenses are current liabilities under the name of reserves, because the exact liability can not be ascertained and set up. They should appear among the current liabilities as accrued expenses or accrued liabilities. Reserves for purposes less well defined, such as reserves for repairs, for unascertained loss on foreign exchange, for loss on commitments or for contingencies are to be stated as "reserves" on the liability side of the balance-sheet.

Reserves for maintenance of construction done for others and for insurance are also to be stated as true reserves.

There is another class of credits called "reserves" which are no more than segregations of surplus. Such reserves as those for sinking funds, for new construction and development or for redemption of obli-

gations or retirement of preferred stock are not additional liabilities but serve to show that part of the surplus is not presently available for dividends. They do not arise out of a charge to operations and should be shown as segregated parts of surplus. Eventually they will return to free surplus.

LOSS ON COMMITMENTS

It is better to provide directly for a decline in prices when there are outstanding firm commitments for purchases not offset by corresponding sales contracts than to make only a note on the balance-sheet without a direct provision.

MAINTENANCE OF CONSTRUCTION DONE FOR OTHERS

Estimated cost of future servicing and maintenance under contracts should be covered by a reserve, the amount being charged against the cost of the construction. Then the cost of servicing is to be charged against the reserve, as expenditures are incurred, and not to subsequent operations.

LOSS ON FOREIGN EXCHANGE

So far as loss on foreign exchange can be ascertained it should be provided for in the conversion of the foreign to domestic currency. Foreign assets other than fixed assets are to be converted at the current rate of exchange and fixed assets at the rate existing when they were acquired. It may not be possible to

convert foreign assets into cash immediately and if further declines are inevitable before the assets are realized a reserve is desirable.

INSURANCE

Self insurance is adopted by some corporations which have many and scattered assets. Periodic charges to operations equivalent to the premiums that would have to be paid to insuring companies are made against operations. If the insurance reserve accumulates, it may occupy a position between true reserves and segregations of surplus. On liquidation it would be considered as surplus; but while regular operations are continued it is best to regard it as a true reserve.

NEW CONSTRUCTION AND DEVELOPMENT

It has already been stated that cost of acquisition and development of mining, lumber or other properties is properly to be capitalized. It follows that reserves set apart for such purposes are segregations of surplus and not true reserves.

REPAIRS AND RENEWALS

Allowances for repairs and renewals, in addition to depreciation reserves, serve to equalize maintenance costs between periods. Repairs are more easily made during dull periods of operation and are delayed when business is good, whereas the cost of such re-

pairs is applicable to the busier seasons in a measure as great or greater than that applicable to seasons of smaller production.

SINKING FUNDS

Appropriations to sinking-fund reserves are segregations of surplus. Sometimes they are said to be appropriated out of earnings or out of surplus, but in effect they reduce neither earnings nor surplus but do render a part of surplus or earnings unavailable for dividends during the life of the sinking fund. Upon retirement of the obligations to protect which the fund is set up the amount provided returns automatically to free surplus. Sinking-fund reserves used as a substitute for depletion or depreciation allowances are an exception; they are called "valuation reserves," to be deducted from the book value of the assets to which they apply.

CONTINGENT RESERVE

Contingent reserves are of an indefinite character; so far as they may represent losses of any kind, anticipated or feared they are true reserves; if provided without expectation of loss, as a general precautionary measure, they are part of the surplus.

The voluntary designation of a portion of the surplus to some specific purpose does not irrevocably commit a corporation to make use of the amount set aside for the intended purpose. Such reserves may be

created and restored to free surplus if no longer required, but sinking-fund and other reserves made to conform to indentures and agreements are compulsory during the life of the indentures or agreements.

No operating expenses should be charged against reserves provided out of surplus. If expenditures otherwise chargeable against operations be charged to such reserves the profit-and-loss account is misrepresented.

When surplus is set apart for uses that will result in additions to assets or reduction of liabilities, such as reserves for new construction or for retirement of preferred stock, the acquisition of the asset or the liquidation of the liability, if placed on the books in the usual orderly way, will not absorb any part of the reserve so set up. Such reserves are then no more than expressions of intention to acquire assets or to liquidate liabilities, and ultimately they revert to unappropriated surplus.

· XIV ·

CAPITAL STOCK AND SURPLUS

THE net worth of a corporation is the excess of the value of assets over the value of all liabilities, except those to stockholders on account of the stock they hold. It is equal to the amount of capital paid in plus surplus acquired since organization. Capital paid in may be represented by par or non-par shares, preferred, common or special. Paid-in surplus is derived from the receipt for stock issued of more than the amount stated on the balance-sheet as the value of the stock. To these is added surplus accumulated from earnings, and the grand total is net worth.

CAPITAL STOCK

Before capital stock can be verified it is necessary to know the several classes and preferences of the issues, amounts authorized, par or stated value of each kind, number of shares outstanding, consideration received for their issue and particulars of stock reacquired.

In a first audit the articles of incorporation and by-

laws should be examined, and a copy should be filed in the auditor's permanent file. These documents show the kinds and amounts of stock authorized. Then a schedule showing all changes in the capital stock since incorporation should be prepared for the working papers.

In subsequent audits a full analysis of changes in stock accounts during the audited period is to be made. Sales and reacquirements of capital stock are to be vouched with brokers' advices, cashbook and journal entries and other relevant data.

It is always necessary to determine what consideration was received for capital stock and to check the treatment of the proceeds on the books to see that it conforms to requirements of statutes and to such other rules as may be prescribed by regulatory bodies.

OUTSTANDING SHARES

The larger corporations employ trust companies to act as registrars and transfer agents for capital-stock issues. The transfer agents actually issue new certificates for old under the supervision of the registrar, whose signature must appear on all certificates before issue. The official record of all certificates issued and retired is kept by the registrar, who is responsible for prevention of over issue and for the correctness of the number of shares outstanding. Confirmations of the amount of each issue outstanding should be obtained from the registrar.

If a corporation keep its own stock records a trial balance of the stockholders' ledger is to be taken and checked to the stubs of the certificate books from which the certificates have been detached. As a rule all surrendered certificates will be found attached to the stubs from which they originally were detached. A list of stubs to which no canceled certificates are attached should agree with the trial balance of the stockholders' ledger.

On the balance-sheet it is customary to show for each kind of stock the number of shares authorized as well as the number actually outstanding. Treasury stock should preferably be deducted from the shares issued—not shown as an asset. There are exceptions which will be discussed later.

Certificates for treasury stock should be in the name of the corporation or endorsed so that they can be transferred only to the corporation. An endorsement in blank or a power of attorney is less satisfactory.

CAPITAL VALUE—ORIGINAL ISSUE

Capital stock of all classes may be issued for cash, property or services. In most states, when stock having par value is issued, the directors must declare the value of the consideration received to be at least equal to the par value of the stock issued, and while their declaration is to be accepted in the absence of fraud or obvious insufficiency of consideration they may be

liable for misrepresentation. When assets are acquired for par value stock with a par value greater than the value of the tangible assets the deficiency is generally set up as goodwill. Any apparent excess of value of assets acquired over par of stocks paid for them may be taken up as a reserve for adjustment of asset values or as paid-in or capital surplus. The first method is applicable when old plant, accounts receivable, and other assets of a going concern are acquired and the new owners doubt the sufficiency of the valuation reserves provided by the old owners. It may be followed by a formal or informal appraisal and adjustment of asset values accordingly, with or without the establishment of a capital surplus. Paid-in surplus is indicated when the shares issued to pay for property have a market value above par.

Upon the issue of shares without par value there is fixed a "stated" value which rests upon the declaration by the directors that the shares are worth *at least* the stated value per share. The shares may then be sold for any price not less than the stated value. The excess received on sale has received various treatment; the soundest method is to state as capital value the whole proceeds of sale of stock. Often the stock is set up at the stated value and the excess received for it as paid-in or capital surplus. The laws of some states permit it to be set up simply as "surplus," which is unsound accounting. The corporation laws of the

states vary as to after treatment of such surplus. Some prohibit payment of dividends out of the excess and some permit it.

SUBSEQUENT ISSUES

The conditions under which original issues may be made also apply largely to subsequent issues. Accumulated surplus or deficit and the existence of market quotations have some effect on the terms of issues after a corporation has operated for some time. In most states issues of stock having par value may not be made for a consideration less than par, exactly as in original issues. If stock be issued for property or services the amount credited to capital and charged to assets or expense should not be less than the current market value of the stock so issued.

STOCK DIVIDENDS

Stock dividends payable in par value stock must be accompanied by charges to surplus at least equal to the par value of the stock issued. Stock dividends payable in non-par stock may be accompanied by the transfer from surplus to capital stock of any amount not less than the stated value per share of the non-par stock. The statutes of the several states on this subject are not alike and the whole question is at present in an unsettled condition. Some authorities, notably a representative of the New York Stock Ex-

change,* say that the minimum to be transferred from earned surplus to capital accounts should be the sum of the capital and capital surplus per share. This is desirable, especially where the capital surplus arises from sale of original stock at a price higher than the stated value. In any case the auditor must determine first that the transaction as set up in the accounts accords with the governing statute and, second, that the accounts show so clearly what has been done that no one will be avoidably misled.

"SPLIT-UP"

The term "split-up" has acquired such general use that it is no longer looked upon as slang. It connotes the issue in place of each existing share of more than one share without increasing the capital value of the total issue. A split-up of par value stock is accomplished by reducing the par value of each share and issuing a number sufficiently larger to bring the total value to the original amount, or by substituting for the par value stock a greater number of no-par shares with the same total capitalization.

A true split-up does not cause any part of the surplus to be capitalized. If any be capitalized the operation is wholly or partly a stock dividend, although it may also have some of the character of a split-up.

* J. M.: A. Hoxsey, Address to American Institute of Accountants, September, 1930.

REPURCHASES AND DONATIONS OF STOCK

If a corporation purchase its own stock it is necessary for an auditor to see that the purchase is permitted by the corporation statute applicable to the case and by the articles of incorporation of the company, and that the specific purchase was authorized by stockholders, directors or executive board.

Trading in its own stock by a corporation is improper, but purchases for retirement, for use in acquiring other properties or for issuance to employees may be justifiable.

The capital stock of a corporation in theory should be—and by the laws of New York and some other states may be—acquired only to the extent of existing surplus, the amount paid being set apart from surplus available for dividends so that the published amount of capital upon which creditors may rely is maintained. Some states permit purchases from other funds; New Jersey expressly permits purchase of stock for cancellation; Nevada statutes permit a corporation to purchase its own stock, to hold, sell and transfer it, out of capital, capital surplus, surplus or other property or funds. So long as such conflicting statutes exist it is absolutely necessary to know the applicable statutes and to insist upon full disclosure of the facts.

Actually much stock of corporations has been bought recently at prices far below book value, and capital surplus has been created out of the cancella-

tion of the stock. Dividends, principally to preferred stock, have been paid out of such surplus. The statutes of most states permit this, and when so authorized and with the approval of attorneys the auditor can not question it if the stockholders are informed of the source of the dividends paid to them.

Stock purchased for this purpose is seldom held for long in the treasury but is promptly canceled and retired. If stock be purchased to be held temporarily, for sale to employees or for other definite purposes it may be held in the treasury for some time; if intended for reissue its valuation should not exceed the lower of cost or book value nor may it exceed the agreed sale price if it be contracted for sale.

When purchased stock is canceled any excess of book value over cost is treated as an addition to capital surplus. The purchase of a company's own stock can not give rise to a profit or to an increase in earned surplus.

The treatment of a purchase may be as shown below: Issue price 100, surplus per share 60, purchase price 140;

JOURNAL ENTRY:

	Dr.	Cr.
Dr. Capital stock	100	
Earned surplus	60	
Cr. Cash		140
Capital surplus		20

This leaves the per-share interest in earned surplus of the remaining outstanding stock unchanged.

DONATED STOCK

Donated stock should be carefully investigated—it is often a device to erect a false surplus. If it be canceled the book value of the property for which it was issued may have to be reduced, especially if any good-will has been set up as part of the consideration for the issue of the stock. It is possible, however, for a donation to be a proper basis for capital surplus.

OTHER REDUCTIONS OF CAPITAL

Statutes of almost all states provide machinery for the reduction of capital value, by pro-rata cancellation of shares, substitution of no-par for par value shares, reduction of par value, purchase and retirement of stock and in other ways. Retirement of preferred stocks may be provided for in an indenture. Such reductions may be for the purpose of giving effect to actual reductions in value of capital assets produced by a heavy fall in the general price level, for the purpose of absorbing a deficit, to distribute funds not needed by a company having its capital invested in wasting assets and for other reasons.

GENERAL

The amount of stock reserved for issue under agreements, warrants and conversion privileges should be

stated on the balance-sheet, so that the possible effect of the issues may be seen. Commitments to repurchase stock and amounts of cumulative dividends in arrear should appear for the same reason.

Subscriptions to capital stock partly paid may be shown, as to the amount paid in, next to the capital stock, but it is improper to show the whole of the capital stock as outstanding with the unpaid subscriptions as accounts receivable.

It is part of the duty of an auditor to see that requirements contained in indentures covering the issuance of preferred stock have been met.

SURPLUS

All surplus accounts should be fully analyzed; upon a first audit the working papers should contain a summary of the surplus accounts from the earliest available record or from the date of a reorganization. Earned surplus is to be separated from other surplus.

EARNED SURPLUS

Earned surplus is the accumulated total of earned profits from operation after deducting dividends and transfers to capital. The earned surplus of the parent company of a group of companies should contain the surplus earnings of subsidiaries only from the date of their acquisition—surplus previously earned represents part of the value of the subsidiaries capitalized upon acquisition. The accounts should set forth a re-

conciliation of the balance of earned-surplus account at the end of the preceding period with that at the close of the audited period, giving net profits, dividends and other reductions for the period.

Charges and credits made directly to surplus account should be investigated; they may more properly be treated as charges or credits to operations. So-called "surplus adjustments" are often losses or expenses that appear to have been omitted from previous profit-and-loss accounts. There are always minor overlapping expenses not exactly provided for at the end of a period, and if such unanticipated expenses be regularly charged against surplus and omitted from profit-and-loss account the operations over a period of years will not show the actual results.

Extraordinary profits and losses are often charged or credited directly to surplus; but it is better practice to charge or credit them to profit-and-loss account, especially if they are losses related to operations or operating assets. Losses or profits on investments outside the regular business of a corporation, goodwill written off and a few similar debits and credits under certain conditions go directly to surplus account, but even in such cases there are advantages in showing them in the profit-and-loss statement. Practice should be consistent; if profits on sale of securities bought for investment are taken into the profit-and-loss account then losses of a similar kind should also be taken in the same way. Extraordinary credits

and debits to profit-and-loss account should be shown separately below the ordinary operating profit or loss.

Some special credits are not applicable to earned surplus and therefore not to profit-and-loss account. Appraisal surplus is of this character.

DIVIDENDS

Dividends are primarily chargeable to earned surplus. If charged against current earnings the effect is the same, except where statutes permit dividends to be paid out of the profit of any year even though there be a deficit left over from preceding years.

If dividends be paid out of anything but earned surplus the accounts must show what was done and stockholders must be notified of the character of the dividend. Dividends paid in kind should be charged to surplus at their net book values.

CAPITAL SURPLUS

Capital surplus includes initial, paid-in and donated surplus and surplus arising from transactions in a corporation's own stock or reductions in par or declared values of capital stock. Appraisal surplus is a variety of capital surplus.

Paid-in or initial surplus may arise out of the issue of capital stock for a consideration greater than the par or stated value of the stock. Inasmuch as it depends upon the value of the consideration received for it, the auditor should see that the accounts take up

correctly the values assigned by the directors, who are legally charged with the duty of fixing the value of the assets other than cash for which stock is issued.

Formal reductions in the par or stated value of shares may produce a capital surplus; this may accompany a reorganization and the capital surplus so produced may be used wholly or partly to eliminate a deficit. Such surplus may arise also from purchase below book value and retirement of shares of a corporation's own stock. In each case it is the duty of an auditor to see that there has been proper authorization by directors and stockholders and that the transactions are recorded in conformity with authorization. "Donated" surplus is surplus arising from gifts of cash, property or a corporation's own stock. Donations of property should be credited to donated surplus at the fair value of the property received, or they may be deducted from goodwill. Donations are to be regarded with care. Stock may be issued with the expectation that some of it will be donated back and form an excuse for setting up a surplus account.

A capital surplus or a reserve for adjustment of asset values comes into existence when a parent company acquires the stock of a subsidiary for less than the book value of the tangible assets of the subsidiary. When the net assets are substituted for the investment in a consolidating statement such an excess should not be taken immediately as surplus but should be offset by a valuation reserve until an ap-

praisal can be made. If any surplus over cost then appears it may be set up as capital surplus. The appraisal may be formal or informal.

Changes in capital surplus should be few in number. They should be scrutinized to see that no charges properly applicable to operations are made against capital surplus.

If capital stock be issued for a mixed aggregate of property and a tentative value be assigned, with an accompanying capital surplus, changes on subsequent ascertainment of true values may properly be made. Petty adjustments for minor differences should not be made—they should be absorbed in current operations. In all transactions affecting capital surplus it is the auditor's duty to see that all entries are properly authorized and are reasonable so far as he can judge. A reconciliation of capital surplus at the end of the preceding period and at the end of the audited period, showing nature and amount of changes, should appear in the balance-sheet or other financial statement.

Organization expenses, extraordinary capital losses on sale or abandonment of plant or on the liquidation of investments in affiliated companies under certain conditions may be charged to capital surplus. The auditor must see that in the statements which he certifies there is full disclosure of such transactions.

On the balance-sheet a deficit from operations is sometimes deducted from capital surplus; this is permissible if both amounts be shown, but it is not

proper to show the net amount alone. Upon reorganization and by vote of stockholders capital surplus may be used to absorb a deficit, a net balance being carried forward as capital surplus.

The statutes of some states make little distinction between the several kinds of surplus and allow dividends to be paid out of any of them. This is unsound accounting and the existence of such laws does not excuse failure to separate capital and earned surplus in the balance-sheet. If the equity of stockholders is set forth in the unmodified headings "Capital Stock" and "Surplus" it is understood that "Surplus" means earned surplus.

SURPLUS FROM APPRAISAL

Surplus from appraisal results from revaluation of fixed assets. If the appraisal values are taken up on the balance-sheet such a surplus should be shown separate from any other surplus and should not be charged with any part of the depreciation provision. If the appraisal value is taken upon the books only as a basis for insurance or for purposes other than inclusion in the balance-sheet, and if it has not appeared in any official balance-sheet the auditor will be justified in ignoring the appraisal increase and the corresponding appraisal surplus, leaving the corporation statement just as it would have been had no appraisal been made.

·XV·

PROFIT-AND-LOSS ACCOUNT

THE most useful form of profit-and-loss statement consists of a condensed statement from which the important facts are readily seen, with separate schedules of supplementary details of sales, cost of sales and operating expenses, and other income and other expenses. The detailed schedules may be departmentalized: comparative figures for preceding periods in parallel columns and percentage figures are also of value. Percentages are generally computed on the basis: net sales = 100. A comparison of percentages throws light on the results of operation more clearly and more quickly than a comparison of amounts.

Following the profit-and-loss account or in a separate statement will be the earned surplus account, showing opening surplus, profit or loss, carried forward from the profit-and-loss account, dividends, transfers to capital account and closing balance. It has already been said that other entries in this account are to be subjected to rigid scrutiny.

The importance attached to the profit-and-loss ac-

count has increased in recent years somewhat at the expense of the importance attached to the balance-sheet. Prices of corporation stocks are based more and more on demonstrated earning capacity rather than on the value of tangible assets; and the requirements of clients who have their accounts audited have been affected by this change. The stockholder looks for the operating results first when he reads an annual report.

Certification of a balance-sheet without a statement of profit and loss has become unusual and is always unsatisfactory. Adequate verification by the auditor of the form and content of the profit-and-loss account is imperative. The ratio of gross profit to sales may be of more consequence than the ratio of current assets to liabilities.

The type of audit covered by the Federal Reserve *Bulletin* requires a sufficient verification of the statement of profit and loss to warrant its certification. The auditor's responsibility for it differs from his responsibility where a detailed audit is made mainly in the absence of responsibility for defalcations and minor bookkeeping errors. Indeed, it is impossible to verify a balance-sheet without a review of the profit-and-loss account. For example, the determination of unit costs of goods manufactured affects the inventory valuation.

The extent of the auditor's verification of operating accounts will be governed by his judgment based

upon the risks of the business, the number of transactions, the accounting system and the internal check.

Comparisons with the results of operations of earlier periods should be made freely; important inaccuracies may be brought out in such a comparison. Comparison with operations of other similar companies is desirable when it can be made but it is rarely practicable.

Abnormal fluctuations should be examined and explained. The officers of the client company should be consulted as to such fluctuations and their opinions should be given due but not conclusive weight. The auditor would not be held free of blame if, accepting without verification the opinions expressed by officers, those opinions were found to be in error. Independent investigation of wide variations from normal are necessary.

Verification of opening and closing balance-sheets, if made as described, will afford substantial support to the amount of total profit or loss shown by the operating statement; the two balance-sheets must be on the same basis. It is not sufficient that both be acceptable from the static point of view; excessive depreciation provided in prior years may have resulted in subnormal charges against earnings; liberal reserves against inventory values may have seemed needed at the time of the previous closing but changes of business conditions may have made part of such

reserves unnecessary, producing distortion of the current earning statement.

That the verification of profit and loss is intimately involved in the verification of balance-sheet items is indicated by the following brief summary of some items the verification of which affects directly both the balance-sheet and profit-and-loss account:

CASH

The discovery of charges applicable to the period under review by examination of subsequent cash payments.

The clearing of cash funds of incidental expenses at the beginning and end of a period.

The proper classification of expenses vouched by examination of cheques as observed in the comparison of cheques with the cashbook.

The disclosure of receipts from sources outside the normal operation of the business by examination of the cashbook.

ACCOUNTS AND NOTES RECEIVABLE

The inquiry into the adequacy of the provisions for bad debts, made when aging the accounts and investigating their collectibility.

The determination of amount needed for trade discounts, rebates and allowances.

The treatment of instalment sales, billings for future delivery, part billings on uncompleted contracts and sales to affiliated companies, all of which should be ascertained and if necessary adjusted when examining the receivables.

INVENTORIES

The determination whether they are or are not on the same basis at the beginning and end of the period.

The analysis of costs of material and manufacture for the purpose of verifying the valuation of inventory.

INVESTMENTS

The determination of the sources from which income should have been received.

FIXED ASSETS

The adequacy of provisions for depreciation and depletion, found when analyzing the accounts and reserves.

The adequacy of the charges for repairs and maintenance.

Profit or loss from the disposition of fixed assets.

Ownership of property and consequent fixed charges for taxes and insurance.

DEFERRED AND ACCRUED ITEMS

The verification of the amount properly to be carried forward and the amounts to be charged to the period for insurance, taxes, wages and salaries, commissions, royalties, rent, bond discount and other similar expenses.

ACCOUNTS AND NOTES PAYABLE

Verification of the inclusion in the accounts of the period of all purchases and expenses applicable to it.

Proper accruals of interest and taxes.

SURPLUS

Analysis of charges and credits to find items more properly charged or credited to the profit-and-loss account.

SALES

The sales should be analyzed to determine the amount of regular merchandise sold to outside customers. This analysis may best be made by months. Sales to affiliated companies, sales of capital assets, charges for returnable containers and sundry charges for scrap material, rental income and similar items should be excluded or be shown separately.

Sales may be summarized by products, branches, territories or other classifications. The actual sales reported should be compared with the sales budget, if one has been prepared. Quantities as well as money amount should be shown if possible in all these analyses.

Abnormal fluctuations may be brought out by comparisons with budgets and with prior experience, and they should be investigated. The sales record can be scanned for unusual entries and test checks made of the footings and of their postings to the general ledger.

Sales records should be checked to the shipping records for a few days at the close of the period to disclose sales put on the books in advance of actual ship-

ments or fictitious sales. Orders for future delivery should not appear as sales until the period in which physical or constructive delivery is made. No sales should appear that would not be confirmed if the customers were asked to confirm statements of their accounts. Commissions or expenses of such sales if they are made at a profit may properly be deferred until the period in which the sales are entered. Orders for future delivery may be subject to adjustment in case of price declines and as a matter of policy may be canceled although covered by written contracts.

The amount of unfilled orders at the close of the period should be compared with the amount at the beginning of the period or with the amount one year ago if the period be not one year. Seasonal fluctuations may render comparison with amounts at another time of year of little value.

Changes in the level of prices during the period should be compared with the price lists issued. Consideration should be given to possible inability of the company to fulfil sales contracts at a profit.

Work in progress may be billed and included as sales in some circumstances particularly in shipbuilding and other big construction work. The policy of deferring all profit until the completion of a contract is more conservative but where the contract extends over a longer period than one year this does not result in a correct statement of the profit of any period

and is not permissible for tax purposes, especially if an eventual profit is substantially assured.

If construction is on a "cost plus" basis the amount of profit for a period may be definitely ascertained; the full profit on work done in this way is to be taken whether it be due for immediate payment or not. If the contract be one for a fixed price the auditor must be satisfied that the proportion completed has been estimated by a competent person and that sufficient allowance has been made for possible contingencies and unforeseen expenses. If it is apparent that there will be a loss upon completion the total estimated loss on the contract should be absorbed at once; if there be no evidence that a loss will result any loss that may occur later will be taken in the period in which the loss becomes apparent.

Instalment sales should be shown separately from ordinary cash or credit sales. It is not sound accounting to take up the full profit when the sale is made. As explained in the chapter on "Deferred credits" the more cautious treatment is to apply instalments against cost until it has been covered, taking profit only when it is received in cash. When the risk is great or there is no sufficient experience to determine the probable losses from failure to pay all instalments, this is the only safe plan. The usual practice is between the plans mentioned—profit is taken on all instalments on the basis of allowing for probable losses, the

amount taken being that proportion of the whole profit which corresponds to the proportion of the whole price that has been received.

Where the unit of sale is small and the volume large there may be no attempt to allocate profit on each unit. The amount of profit taken up in these circumstances may be the estimated proportion on collections made during the period after deducting an adequate allowance for losses, based on the previous experience of the business as modified by present conditions.

Consignment shipments should be included in sales only to the extent that the goods have actually been sold by the consignees. If consignment sales actually made are taken into the account, there must be provision for commissions, storage, freight and any other expenses of selling the goods. Unsold consignments that are the property of the client as consignor should be included in the inventory at cost or less. Freight to the consignee may be part of cost.

Interdepartmental transfers are treated as sales by some companies, but they should be excluded from gross sales in the income account. Sales to affiliated companies should be shown separately and be eliminated on consolidation.

DEDUCTIONS FROM SALES

Most of the deductions that are taken by customers on making remittances should be stated as deductions

from sales on the statement of profit and loss; these deductions may consist of returns, allowances, rebates, trade discounts, etc., but they do not include corrections of errors in billing, which are applied directly to gross sales. Freight allowances and outward freight and express charges are sometimes treated as deductions from sales and sometimes as cost of sales or delivery or selling expense, according to the character of the business. All are permissible.

Returns and allowances should be investigated if disproportionate to the volume of business. Some corporations treat returned sales as purchases sometimes even charging to purchases and to inventory the full selling price. That, of course, is wholly improper. It results in an inflation of the apparent amount of sales and purchases and in distortion of the percentage statement of gross profit ratio; and if there be a "cost of sales" account, and the returned goods be charged back to inventory and credited to cost of sales at the amount credited to the customer returning the goods, the profit appearing on the original sale is left in the account and the inventory is burdened with returned goods at selling price.

Trade discounts are usually deducted directly on the invoices rendered and the net amount is taken up as a sale. Special rebates based upon quantities purchased over a definite period can not be determined until the end of the period. If that period extends beyond the date of audit the provision made for future

rebates should be checked by the auditor and corrected if necessary.

Cash discounts may be shown as a deduction from sales. If the rate be not more than two per cent they may be included under "other charges," although, strictly speaking, any discount of more than one half of one per cent for thirty days is greater than a normal interest allowance.

Credit memoranda issued to customers after the close of the period should be scrutinized to see if there have been any allowances applicable to the period under audit and for which provision has not been made. "Pro-forma" and provisional price billings, common in the textile and some other industries, should be investigated to determine whether or not adjustments have been made in subsequent periods. Consideration should also be given to possible price protection and allowances if the market has declined since the close of the period. In the ice-cream industry "surcharges" are often added to the sales prices as a method of payment for equipment sold to customers. The sale of the equipment is not part of the normal business of the selling company and should be excluded from the regular trading account. Any loss from these transactions should be included with selling expenses and any profit with "other income."

COST OF SALES

All charges entering into the cost of products sold

are classified as cost of sales. The nature of some of these charges varies in different industries but in general they include cost of material, manufacturing labor, purchasing and receiving expenses, manufacturing overhead and installation charges.

Purchases of materials for manufacture are major items of cost of manufacture and therefore of cost of sales. It is generally of advantage to maintain a "manufacturing account," showing cost of manufacture, and to transfer from this account the cost of goods sold. Often the manufacturing account and cost of sales account are one, and they may be considered together.

The proper verification of opening and closing inventories is essential in determining the unit cost of merchandise produced. The testing of the separation of purchases for the period under audit and the next period by examination of receiving records has been described as necessary for balance-sheet purposes; it is equally necessary here.

If cash discounts are treated as a deduction from sales, purchase discounts should be deducted from cost of sales.

Purchasing expenses of country stations in the dairy industry and traveling expenses and salaries of buyers for department stores are illustrations of the kind of charges that may be classified as "purchasing expenses" and may be included in cost of goods sold.

A summary of expenses charged to cost of goods will usually be prepared by the client's staff. Scrutiny

is required to ascertain that no improper charges are included, but detailed verification of the subdivision into classes of such charges is not necessary.

Receiving-department expense is usually a minor item. Comparison with corresponding costs in previous periods is generally sufficient for profit-and-loss purposes. Wages, trucking and sometimes customs charges may be found in the expenses of the receiving department; there may also be charges transferred from other departments for use of trucks. The ratio of these costs to the quantity of goods received should be justified.

Manufacturing labor, if not paid on a piece-work scale, should be totaled by months, the monthly total should be compared with the monthly output and any material variations in ratio should be explained.

Manufacturing expense is to be analyzed and the cost of each item compared with that of previous periods in sufficient detail to disclose any substantial variations. The results of the inquiry, made for balance-sheet purposes, into the adequacy of depreciation provision should be reviewed with respect to the fairness of its effect on the profit-and-loss account.

It may be that assets still in use have been covered fully by the depreciation reserve and that no depreciation charge in this respect now appears in the cost of goods. While this may not affect the balance-sheet because the plant in question has little sale value, still if it is for the time being giving efficient service the

cost of goods produced will be misrepresented to the extent that no depreciation provision is included. The efficiency of such old assets is generally so impaired that the cost of manufacture with the old asset and without depreciation is quite as great as it would be with new and efficient plant and a full depreciation charge. The auditor must judge whether the cost is fairly representative of normal cost and comment accordingly in his report. Operations should bear a reasonable depreciation charge for the use of plant.

Property is sometimes carried on the balance-sheet at a nominal or abnormally low value with a correspondingly low depreciation provision; this affects the apparent cost of goods produced and should be made the subject of comment.

Depreciation should be computed on the values set up on the balance-sheet if they be in excess of cost. The application to cost of production of only a part of the total depreciation provision with a charge of the remainder to the appraisal surplus is improper. In effect such an "appraisal surplus" is no more than an additional valuation reserve.

In consolidated statements depreciation of fixed assets of subsidiaries should be based upon the values of the depreciable assets as determined by the parent company at the time of acquisition, so that at the end of their life the reserve will suffice to extinguish the values carried on the parent company's books in respect of them.

Depreciation provisions are sometimes deducted in the profit-and-loss account after showing the result of operation after all charges except depreciation. This is common in the accounts of public utilities. The amount of depreciation provided should appear in all published accounts. Depreciation is definitely a part of cost, for the plant is consumed by use just as certainly as manufacturing supplies, although over a longer period. It is preferable therefore to show depreciation in the accounts of manufacturers as part of the cost of manufacture.

Insurance, taxes, rent and royalties are sufficiently checked in the verification of assets and liabilities.

Fixed charges on abandoned or permanently idle plant may be excluded from cost of manufacture. Plant that is temporarily idle but needed for seasonal business or other peak loads must be maintained as a condition of normal trade and the cost of maintaining it, including depreciation, must be spread over the product of a full operating cycle.

Income from the sale of waste and by-products should be deducted from cost of manufacture and therefore from cost of sales, except in the case of merchandise derived from a by-product requiring further elaboration, when the sale is properly to be included in total sales.

Inventory write-downs to conform to lower price levels may properly be included as part of cost of manufacture but shown as a final adjustment after

first determining the cost of manufacture unaffected by the write-down. If the adjustment is to have its full effect it should not enter into the unit cost of goods produced but should be charged against the goods that actually have been sold.

Inventory adjustments of large amount due to great changes in the general price level are sometimes shown separately in the profit-and-loss account among "other charges." This is permissible if all pertinent facts are given.

Losses arising from changes of styles, deterioration from handling or display and from similar causes should be charged directly against goods sold.

Delivery and installation expenses are part of cost of sales if the service is rendered as part of the sales contract. Delivery of milk or electric refrigerators and radios, installation of machinery and some other services are classified as cost of sales. Minor services such as occasional delivery by stores are treated as selling expenses.

Servicing, in such work as road construction extending over long periods, may best be treated as a deduction from sales and provided for by reserves. At the time the sales are booked the servicing has not been and can not immediately be done. Thus the installation of an electric refrigerator can easily be taken up as cost of sales; but the servicing for a period of perhaps three years represents a liability assumed, the cost of which is quite uncertain. It is usual to estimate

the probable cost, and provide a reserve by a charge against sales, not against cost of sales. Either procedure is permissible.

GROSS PROFITS

Deduction of cost of sales from sales gives the amount of gross profit; its ratio to sales should be compared with the rates for other periods. The best comparison is between the same months for several years.

For comparison with prior years it is desirable to show the percentage to sales of the actual cost of goods sold, eliminating inventory write-downs; it is therefore convenient to show write-downs separately.

The ratio is remarkably constant in the accounts of department and chain stores but fluctuates more widely in manufacturing accounts. A comparison with other periods affords a valuable check on the general correctness of the accounts, which is of most value if the comparison be made by departments or products and by months rather than by longer periods. Manipulation of accounts made toward the end of a period might produce apparently normal ratios for a year, but it is scarcely possible that it could bring each month into agreement with normal ratios.

SELLING AND DELIVERY EXPENSES

Selling expenses are the costs of securing and recording sales as differentiated from the cost of the

goods sold. The most important items are salesmen's salaries, commissions and expenses, advertising, sales-office salaries and office expenses and cost of samples. If there are budget estimates the actual expenses should be compared with them.

Advertising contracts may specify a minimum amount of space to be taken within a period. Bills will be rendered only when the space actually is taken. The minimum amount, at least, must be paid at the end of the contract and the charge to any period must be checked with that fact in mind.

Advances to salesmen and accruals of salaries, commissions and expenses will be checked in verifying the balance-sheet. There must be provision for full liability to salesmen for services rendered.

Cost of samples is generally a small item and may be included in advertising expense.

Delivery expenses are made up of the expenses of the packing and shipping department. They are treated variously—as cost of sales, as selling expense or separately as delivery expenses. Conditions will govern. Delivery of sand, bricks or other cheap material is clearly a cost of goods sold and may be the principal cost. Regular delivery of bottled goods, such as milk, spring water and beer is so large an item of cost that it should appear separately.

Credit and collection expenses are readily determinable. They are made up of salaries, agency and collection fees and other direct charges.

GENERAL AND ADMINISTRATIVE EXPENSES

Expenses necessary to the conduct of business, other than those applying to the product sold, cost of securing sales and cost of delivering goods sold, are classified as general and administrative expenses. They include state or franchise taxes and salaries and expenses of persons engaged in the general direction of all activities and of the general office and bookkeeping staff. Local taxes apply principally or altogether to plant used for production and are charged to cost of manufacture or cost of sales.

Verification of general and administrative expenses is largely covered by comparison with figures for prior periods, budget estimates and by examination of payrolls. Unlike other costs they can not be expected to follow closely the fluctuations in amount of business done, although changes in volume of business have some effect on the total of these expenses. Comparison with previous figures should be made item by item.

Executive salaries and expenses may be chargeable to cost of production and sale to the extent that the officers concerned have been engaged directly upon such matters. Only that portion of their salaries applicable to time spent on general administration and finance should, in theory, be taken up as general expenses, but close distinctions are unnecessary.

It is the practice of some companies to issue capital

stock to employees as a bonus. The auditor should see that earnings are properly charged with the book value of the stock at the date of distribution or at the average book value during the period in which the services were rendered, unless specific shares were purchased in the open market, when the cost of the shares acquired may be used.

Pension provisions are classified as general expenses. Inquiry should be made as to the possible existence of any provision obligatory under agreements.

OTHER INCOME

Revenue not derived from the ordinary operations of a business is taken up as "other income," below the statement of operating profit or loss for a period. Such income as interest, rentals received and dividends on miscellaneous stocks owned are included here. Analysis of the account is desirable, but verification may sometimes be confined to determination of the income-producing assets and comparison with similar income in other periods.

Dividends from fully owned or controlled companies should be verified by examination of the accounts of those companies. The amount to be taken up as income is limited to the proportionate share accruing to stock owned and earned since the date of acquisition. Dividends paid by a subsidiary that have the effect of reducing its surplus below the amount at the date of the acquisition of its stock by the parent

company are to be applied, to the extent of the depletion of earned surplus, against the book value of the investment.

If the dividends largely exceed or fall short of the earnings for the year the facts must be shown. The New York Stock Exchange requires that earnings of non-consolidated companies be disclosed in the accounts of a parent company.

Since the proportionate share of earnings of a consolidated subsidiary is taken up as earnings in the consolidation, dividends declared by the subsidiary are not income to the parent. They operate only to reduce the value of the capital stock of the subsidiary and increase the debt due to the parent on current account or to increase the cash of the parent company when the dividend is paid in cash.

OTHER CHARGES

Expenses of financing, such as interest, bond-discount amortization and expenses and losses not due to ordinary operation or not applicable to the operations of the period, are classified as "other charges." Extraordinary losses, expenses incurred in but omitted from prior periods and losses on commitments may be included under this title.

The charges should be analyzed and the auditor satisfied that none should more properly be taken as part of the ordinary cost of operation.

Interest on current indebtedness is to be shown

separate from interest on funded debt. Amortization of discount, also, should be shown by itself. In a recent ruling the New York Stock Exchange held that where interest at the option of a bondholder was paid in no-par stock, the charge to profit and loss in respect of the payment could not be less than the amount of cash that otherwise would have been payable.

Payments of income tax are often included here. It is customary to show the profits before taxes but after all other charges.

Appropriations for contingencies or special purposes are chargeable to profit and loss if they are intended to cover losses presently foreseen.

Losses of partly owned and controlled companies should be reflected in the accounts of the parent company, at least to the extent of the loss of value of the stock owned. If, however, the surplus of a controlled company remain as great as when its stock was acquired and the profits taken up from time to time have been restricted to the dividends declared by the controlled company there is no need to provide for a loss in any one period.

Losses of partly owned or controlled companies should be provided for in the accounts of the parent company at least to an extent corresponding to the stock ownership.

·XVI·

INTERNAL CHECK

By "INTERNAL CHECK" is meant the subdivision and arrangement of the work of an office staff in such a way that any error or dereliction by one employee would so disarrange the accounts that the error would come to the attention of another, and indeed render it impossible for that other employee to keep his own accounts in order until the error was rectified. Thus, one keeping a customers' ledger, receiving cash and mailing to the customers monthly statements of account might so make the monthly statements and so manipulate the ledger as to enable him to misappropriate customers' payments without probability of early detection. But if the ledger were kept by one clerk, cash handled only by a cashier, and monthly statements listed and mailed by a third employee, who checked the total of his list with the control in the general ledger, a defalcation would be impossible of concealment without collusion.

Where securities are dealt in there is a triple combination, the bookkeeper, who keeps the customers'

ledger, the stock clerk and the cashier and sometimes also a security custodian who does not handle any cash. Every business has its own characteristics, partly depending upon the nature of the business, partly upon the character and experience of the employees and partly upon the degree of excellence of the accounting arrangements. Inquiry into all these factors is necessary if the work is to be done adequately and without wasting time.

Examples of the kind of questions that an auditor might raise with respect to the internal check follow:

CASH

1. Is incoming cash registered or controlled before it is turned over to cashier, and if so, is this record later checked to cashbook?
2. Are all cash receipts deposited in banks?
3. What duties, other than the keeping of cash records, are performed by the cashier?
4. To what extent and for what purpose has cashier access to accounts-receivable ledgers?
5. Who handles petty-cash payments?
6. Are petty-cash vouchers approved by an officer before payment?
7. Are vouchers and supporting documents presented to officers for inspection simultaneously with the cheques presented for signature?
8. Who signs cheques and by whom are they countersigned?
9. Who reconciles the bank accounts?

10. How often is petty-cash fund counted and verified by an employee other than the cashier?
11. What disposition is made of voided cheques?
12. How are cash sales or other currency receipts handled?

PAY-ROLL

1. What is the procedure in recording and disbursing the pay-rolls? What employees (a) prepare list, (b) check computations, (c) approve and sign cheque or cheques, (d) make up envelopes and (e) distribute envelopes?
2. What disposition is made of unclaimed pay envelopes and how are these subsequently controlled?
3. Is there a check on pay-roll increases and inclusion of fictitious names?

ACCOUNTS RECEIVABLE

1. As of what date were accounts receivable last checked by circularizing the debtors?
2. If not circularized within the past year, why not?
3. What extra duties has the ledger keeper?
4. Who approves credits?
5. Who follows up collections of delinquent accounts?
6. Who approves credit memoranda for returned goods and allowances to customers?
7. Who approves bad debt write-offs?
8. What is the procedure in the preparation and mailing of statements to customers?
9. How often are customers' ledgers compared with control accounts?

NOTES RECEIVABLE

1. Who is custodian of notes?
2. Does the company discount notes receivable and, if so, what is the procedure?

SECURITIES

1. Who is custodian of securities?
2. Who other than the custodian has access to securities?
3. Does one person alone have access to securities?

INVENTORIES

1. What is the procedure in taking physical inventories?
2. Are the inventories in charge of a storekeeper?
3. If book inventories are maintained, are these regularly adjusted to agree with physical counts?
4. Who approves of adjustments to book inventories?

GENERAL

1. Who has authority to sign notes and acceptances payable?
2. How many signatures are required on notes and acceptances payable?
3. Are purchase orders executed in writing?
4. Are purchase invoices sent to receiving department?
5. By whom are invoices for all purchases approved before payment?
6. Who approves purchases by and loans to employees?

7. Is there any check to see that sales orders are shipped and posted to accounts receivable?
8. Who opens the mail and how is it distributed?
9. Are the employees bonded?
10. What is the procedure in accounting for and controlling transactions of branch offices?

Many of the above questions might well be raised by the auditor at the outset of his examination; the answers will assist him in determining upon its scope. Others might be raised during his examination.

·XVII·

AUDITOR'S CERTIFICATE

THE auditor's certificate should set forth his conclusions as the result of his examination clearly and concisely. If the statements submitted in his opinion set forth the financial position of the company and the results of operations for the period examined, he should so indicate. The sample certificate given in the bulletin is a satisfactory one:—

"I have examined (or made an examination of) 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."

It is good practice to address the client and also to include reference to the fact that the statements, in the auditor's opinion, have been correctly prepared from the books. There is an increasing feeling among accountants and others that the word "certify" is un-

necessary and misleading. The auditor has made his examination and is reporting to his client that, "in his opinion," the statements set forth the financial position and results of operations. As an alternative, therefore, the following is submitted:

"..................... Company:

I have made an examination of the accounts of .... Company for the year ended .... and report that, in my opinion, the attached statements have been correctly prepared therefrom and set forth the financial position of the company at .... and the results of operations for the period.

........................"

A number of good forms is in use. Such phrases as "fairly set forth" or "correctly reflects" may be employed if preferred. The foregoing so-called "short form" of certificate is suitable in many cases and often preferred by bankers and others. Whenever used, the auditor should make sure that all the essential facts are clearly set forth on the face of the balance-sheet.

Even with adequate explanations in the balance-sheet and no qualifications in the certificate, it may be desirable for the auditor to give a more complete statement of the essential features of his examination. Following is an example of the "long form" certificate:

"We have examined the books of the .... Company and its subsidiary companies for the year ended Dec. 31, 1924, and certify that the balance-sheet at that

date and the relative profit-and-loss account are correctly prepared therefrom.

"The charges to property account during the year cover only actual additions and extensions to the properties and plants and the provision made for depreciation and depletion is, in our opinion, fair and reasonable. The item of deferred charges represents expenditures reasonably and properly carried forward to operations in subsequent years.

"The valuations of the stocks of materials and supplies on hand, as shown by the inventories certified by responsible officers, have been carefully made at prices not in excess of cost or market, and, as stated in the directors' report a substantial reserve has been deducted from the values so determined. Full provision has been made for bad and doubtful accounts receivable and for all ascertainable liabilities.

"We have verified the cash and securities by actual inspection or by certificates from the depositaries and are of the opinion that the marketable bonds and stocks included in current assets are worth the value at which they are stated in the balance-sheet, and

"We certify that, in our opinion, the balance-sheet is properly drawn up so as to show the financial position of the corporation and subsidiary companies on December 31, 1924, and the relative income account is a fair and correct statement of the net earnings for the fiscal year ended on that date.

"Public Accountant & Co."

The auditor should not attempt to hide behind enigmatic phraseology but should always bear in mind

that his statements are nothing more than an expression of opinion. It is no longer usual to find the phrase "certified correct" at the bottom of a balance-sheet, with the name of the auditor. Whenever a statement of fact is made in an auditor's certificate, it should be susceptible of absolute proof.

QUALIFIED CERTIFICATES

The question of qualifications in the certificate is one of the most difficult faced by the auditor. A qualification is unsatisfactory; in fact, it has been said that a qualification in an auditor's certificate is an indication of defeat. He should be able to persuade his client to incorporate his suggestions in the statements without the necessity for qualifying his certificate. This, however, is not always possible and, inasmuch as the balance-sheet, in the last analysis, is that of the client, the auditor is sometimes forced to qualify his certificate when he feels that there is doubt as to the entire fairness of the presentation or when the scope of his verification has not, in his opinion, been satisfactory.

One general objection to a qualified certificate is the difficulty a casual and untrained reader has in interpreting the accountant's meaning. It is usually true that the accountant gives much more consideration and thought to the formulation of a qualification than the reader does to its interpretation. The reader may pass over a significant qualification as unimportant or, on the other hand, may over-emphasize a

relatively unimportant qualification. It is necessary, therefore, for the auditor to have constantly in mind the point of view of the reader as well as his own responsibility and to attempt to present his exact meaning clearly and concisely. He must not unduly prejudice the position of his client by over-emphasizing a point; yet he must place the reader on guard if certain of the facts are not adequately disclosed. If the statement itself is clearly misleading, the auditor should never sign the statement at all. A qualified certificate implies a reasonably full disclosure. For instance, in the case of an investment trust where the securities are carried at cost and the market value is substantially below cost, the market value must be indicated either on the face of the statement or in a footnote, and it is not satisfactory to submit a balance-sheet without this information even with the qualification "subject to the fact that the securities are valued at cost."

Important qualifications are usually introduced by the phrase "subject to." If the qualifications are less important and are set forth in the long-form certificate, it is sometimes satisfactory in the last paragraph to use the phrase "on the above basis, we certify."

ENGLISH AND CANADIAN FORM

The English and Canadian form of certificate, which has been approved by act of parliament, is as follows:

"We have examined the books and accounts of .... for the year ending .... and have obtained all the information and explanations which we have required; and we certify that, in our opinion, the above balance-sheet at .... is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs, according to the best of our information and the explanations given to us and as shown by the books of the company."

Its difference from our customary form is likely to make the certified public accountant feel that it is more of a "qualified" than a "clean" certificate. Such is not the intent, however, and any qualification must be clearly indicated. It is possible that some such form may ultimately be adopted in this country to emphasize to the reader that the statement must be prepared on the basis of the book figures and from the information and explanations given to the auditor. It is believed, however, that the courts will support this common-sense opinion and that a material change in the customary phraseology in the United States will not be required.

APPENDIX

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"

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.

18. Notes (including instalment-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 business whose sales are based largely on instalments 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 instalment-sales accounts) maturing later than one year from the date of the

balance-sheet should be separately shown on the balance-sheet.

27. The total 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 coördinated 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 accounting 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 payroll, but the distribution of fac-

tory 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 hey may be deducted if that is the practice of the tr. de.

(*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 fol-

lowing 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 payroll, store, and supply charges to jobs, payroll 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 instalments are due on account of construction work in progress which is being carried on by outside parties; if so, the liabilities for these instalments

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, payroll.

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 indorsements of unrelated commercial paper have 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 bal-

ance-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 payroll 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 reg-

istered, 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 be-

comes 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 certificate 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 instalment 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 pay-

able, 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 of 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.

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.....................

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.

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.

INDEX

PAGE

ACCOMMODATION NOTES 156
ACCOUNTS PAYABLE 133
  Trade discount 135
  Verification of 134
ACCOUNTS RECEIVABLE:
  Aging 36
  Circulars for debtors' confirmations 33
  From subsidiaries 42
  Internal check 30
  Liens on 35
  Other tests of correctness 34
  Reserves for loss and for deductions 38, 40
  Verification of 31
ACCRUED LIABILITIES 137
ADVANCES:
  To affiliated companies 85
  To subsidiaries 79, 85
AMORTIZATION:
  Intangible Assets 110
APPRAISALS:
  Fixed assets 106
  Intangible assets 109
  Surplus arising from 180, 183
  Wasting assets 124
AUDITOR'S CERTIFICATES 77, 185, 211
  Qualified 214
BAD DEBTS:
  Estimate of 38
  Reserve for 40

BANK ACCOUNTS: PAGE
Certificates 22
Kited cheques 21
Overdrawn 20
Reconciliation 19
Verification of 18
BONDS (LIABILITIES) 142
Additional issues 152
Authenticated, not sold 143
Collateral 152
Discount on 125
Indentures 145
In sinking fund 144, 149
In treasury 143
Payable in foreign currency 147
Redemption premium 148
Serial 147
Tax-free covenants 153
"BOND AND MORTGAGE" 153
CAPITAL STOCK:
Auditor's permanent records 170
Consideration for 171
In treasury 88
Non-par 169, 172
Par 169, 172
Repurchased 88, 175
Sold to employees 91
Verification of amount outstanding 170
CAPITAL SURPLUS 89
CASH AUDIT 15
Cash at branches 22
Counting cash 17
Internal check 27
Other funds 16
Special funds 25
Unclaimed wages 16
CASHBOOK HELD OPEN BEYOND PROPER DATE 26

CERTIFICATES: PAGE
Auditors 77, 185, 211, 214
To accounts receivable 45
To inventory 77
To liabilities 141
To notes receivable 45
CONSOLIDATED ACCOUNTS 86, 197
CONTINGENT LIABILITIES 155
For law suits 159
For tax assessments 158
On guaranties and contracts 157
CONTRACTS, INTERIM ESTIMATES OF PROFIT OR LOSS 69
CONVERSION WARRANTS 149
"COST":
As applied to inventory 57
Depreciation part of cost 65
Interest as part of cost 64
COST OF SALES 194
DEFERRED CHARGES 125
Advertising 128
Development expense 128
Discount on bonds 126
Insurance 126
Rent and taxes 127
DEFERRED CREDITS:
Instalment sales 163
Shipping—unfinished voyages 162
DEPARTMENT STORE INVENTORIES 61
DEPLETION 112, 123
DEPRECIATION:
Charts 116, 117
Diminishing-value plan 119
Fixed assets 112
General policy 113
In profit-and-loss account 197, 198
Obsolescence 123
Of idle plant 65, 198
On small but numerous items 122
Part of cost of production 65

DEPRECIATION—*Continued* PAGE
Sinking-fund plan 120
Standards 114
Straight-line plan 119
DETAILED AUDIT 2
DISCOUNT:
Cash 40
Trade 135
DISPOSITION OF RESOURCES 10
DIVIDENDS:
As a liability 139
Funds from which payable 176, 180
Paid in stock 173
DONATED STOCK 177
EARNED SURPLUS:
In consolidated accounts 87
ENDORSEMENTS, CONTINGENT LIABILITY 156
FIXED ASSETS:
Acquired as part of aggregate 94
Additions 98
Buildings and improvements 96
Construction by owner 102
Depreciation 65, 112, 113, 119, 122, 123
Installation 99
Instalment purchases 104
Intangible 109
Land 95
Replacements 97, 105
Tangible 94
Title 88
Valuation 93
Working papers 97
FUNDED DEBT 142
Discount on issues 125
GOODWILL 110
GROSS PROFIT TEST 56
INSTALMENT SALES 163
INSTALMENT PURCHASES, FIXED ASSETS 104

INTANGIBLE ASSETS: PAGE
Amortization 110
Valuation 109
INTEREST—AS PART OF COST 64
INTERNAL AUDITORS 2
INTERNAL CHECK:
Accounts receivable 30, 207, 210
Cash 27, 207, 210
Inventory 51, 207, 210
Notes receivable 207, 210
INVENTORY:
Balanced quantities 55, 59
Base of pricing 57
department stores 61
farm products 60
joint products 61
Burden included in cost 64
Consistent basis 49, 70
Damaged goods 68
Depreciation as part of cost 65
Interest as part of cost 64
Liens 73
"Market price" 60, 65
"Permanent inventory" 52
Physical methods 50
Price verification 48
Quantity verification 48
Realizable value 67
Records of stocktaking 52
INVESTMENT TRUSTS 82
INVESTMENTS:
Advances to affiliates 84
Marketable securities 79
Other securities 79
Stocks of subsidiaries 79
JOINT PRODUCTS, VALUATION OF 61
KREUGER FAILURE 6
LAND 96, 100

PAGE

LEASE CONTRACTS, RENT-PURCHASE 104, 154
LEASED PROPERTY, IMPROVEMENTS 104
LIABILITIES:
  Accrued liabilities 137
  Current 130
  Declared dividends 139
  Long-term liabilities 142
  Notes payable, confirmations 131
LIENS:
  On accounts receivable 35
  On inventory 73
LIFE-INSURANCE POLICIES 90
LOANS:
  For purchase of stock 41
  To officers, shareholders, employees 42, 91
MORTGAGES, REAL ESTATE 101
NOTES PAYABLE 131
  Long-term 154
NOTES RECEIVABLE:
  Discounted 160
  Dishonored 160
  Verification of 31, 45
OFFICERS, STOCKHOLDERS, EMPLOYEES, AMOUNTS DUE FROM 91
PAID-IN SURPLUS 172
PARENT COMPANIES' FINANCIAL STATEMENTS...... 85
PRELIMINARY WORK OF AUDIT 8
PROFIT:
  Interdepartmental and intercompany 70
  Of subsidiaries not consolidated 85
  On own securities repurchased 89
  On partly completed contracts 69
PROFIT-AND-LOSS ACCOUNT 184
  Consolidated profit account 197
  Cost of sales 194
  Depreciation 197, 198
  Idle plant charges 198

REAL ESTATE: PAGE
Buildings 96
Land 96, 100
Mortgages 101
Title 88, 100
REALIZABLE VALUES, INVENTORY 67
RECEIVABLES (see accounts receivable)
RECURRING AUDITS 9
RESERVES, SEGREGATIONS OF SURPLUS:
Contingent 167
Expansion 168
Payment of liabilities 168
Sinking-fund 167
RESERVES, VALUATION:
For contingencies 167
For debtors' accounts 38, 40
For fixed asset valuation, depreciation and other...112, 172, 181
For inventory valuation 78
RESERVES FOR SELF INSURANCE 166
RESOURCES, DISPOSITION OF 10, 11, 12, 13
REVALUATION OF FIXED ASSETS 106
SCOPE OF EXAMINATION 1
SECURITIES OWNED:
As inventory (brokers, etc.) 82
As investments 81
Count to accompany cash count 28
Unlisted 83
Verification and control 27
SELF INSURANCE 166
SINKING FUNDS:
Assets 90, 144
Provisions of indentures 149
Reserves 167
"STATED VALUE" OF NON-PAR STOCK 172
STOCK:
Dividends 173
Donated 175
Split up 173

PAGE

SUBSCRIPTIONS TO STOCK NOT FULLY PAID IN....91, 178
SURPLUS:
  Appraisal 180, 183
  Capital 89
  Earned 179
  Paid-in or initial 172, 180
TAXES:
  Additional liability 158
  Federal 138
  General 127
TRADE DISCOUNT 135
TREASURY BONDS 88, 143
TREASURY STOCK 88
VALUATION:
  Fixed assets 93
  Inventory 57
    change of base 70
WARRANTS FOR CONVERSION OR PURCHASE.... 148
WASTING ASSETS 107
WORK IN PROGRESS:
  Fixed assets in construction 103
  Inventory 60, 65