Journal of Accountancy

Volume 48 | Issue 2 Article 1

8-1929

Auditing an Investment Trust

Edward A. Benson

The JOURNAL *of* ACCOUNTANCY

Official Organ of the AMERICAN INSTITUTE OF ACCOUNTANTS

Vol. 48 AUGUST, 1929 No. 2

Auditing an Investment Trust

By EDWARD A. BENSON

In view of the numerous descriptions of the various types of investment trusts, this paper will be limited to some phases of auditing procedure affecting the management type of investment trust, whose activities are international in scope.

On first confronting the responsibility of verifying the ownership of vast sums invested in various kinds of securities, and of cash in banks here and abroad, and realizing the difficulty of attaining a reasonable certainty as to the income produced therefrom, one is apt to feel that an unqualified certificate could never be given by an auditor, at least sufficiently near the date of examination to be of any value. However, when the accounting system provides for control of these factors, the auditor meets with no special difficulties.

BALANCE-SHEET

Assets. The first concern of the auditor is the verification of the existence and ownership of the portfolio. Preparation for the confirmation from the depots should be made in advance of the end of the fiscal period in order to obtain replies by letter or cable during the time of examination. Authorized depositories should be approved by the executive committee and requests should be sent to all of them to confirm securities and cash in their possession as of the date of examination, as well as securities paid for but not delivered to them and sales consummated where actual delivery has not been made. This latter information is necessary to arrive at a proper cut-off point and to set up the necessary assets and liabilities affecting sales and purchase failures. Securities on hand and in safe-deposit vaults will, of course, be examined as of the closing date.

A classified list of all investments by country or by type of security should be prepared by the client and checked by the auditor, or be made up by the auditor himself. The units and description are compared with confirmation received and with vault count. The book values will be compared with the individual security card.

Sufficient space on the list of securities should be provided for the recording of market quotations and comparison of market value with book value. Any appreciable differences should be carefully scrutinized and commented upon. It would serve no good purpose to publish a detailed list of the investments of the portfolio, but reserves from surplus should be set aside to take care of any shrinkage in value.

Domestic cash balances and call loans offer no particular problem. An accepted basis for handling foreign deposits is to record the dollar equivalent of current transactions at the exchange rate of the day of the transaction and to value the balance at the close of the fiscal period at the then prevailing rate of exchange, taking any gain or loss into income.

Ordinarily the only accounts receivable, other than amounts due for securities sold but not delivered, might be classified as items in course of collection. The main item under this classification is interest accrued or receivable on bonds or cash deposits and dividends receivable but not collected. Conservative practice does not approve of accruing dividends declared prior to but not receivable until after the end of the fiscal period. The one exception, perhaps, is in the instance of cumulative dividends on preferred stocks which would be added to the price of the security if it were sold between the date of declaration and the date of record for payment. Verification of accrued interest and dividends receivable is mentioned under audit of income. If bonds which have been called for redemption are not considered with the regular sales, they are set up as accounts receivable at their called prices.

Furniture, fixtures and statistical records are usually carried at their cost less depreciation of 10 per cent. per annum.

Other assets would consist of prepaid expenses, bond discount unamortized and organization and financing expenses. Annual charges by the registrar, trustees, paying agents, etc., should be examined not only to see that proper liabilities are set up but also to defer any prepayment of expense. Postage and transfer-tax stamps might be included in this category.

Many of the American investment trusts are adopting the policy of issuing bonds or debentures at a low interest rate and selling them at a discount. The amortization of this discount acts as an increase to the amount of interest paid and should be prorated over the life of the indebtedness, the remaining balance being deferred at the end of any year. Initial trustees' fees and other expenses involved in the issuance of bonds might be considered with the cash discount as being additional cost of obtaining funds, the benefit from which is to be derived over the life of the indebtedness, and hence such items might be added to the discount and be treated in like manner.

Organization expenses, expenses of listing capital stock and expenses incurred by reason of a change in the corporate structure or in the classes of capital stock all constitute an investment in a non-productive asset which should disappear as rapidly as advisable, either through annual amortization or as a direct charge against surplus.

Liabilities. The liability for securities purchased but not received has already been mentioned.

In addition to the accrual of bankers' fees and ordinary expenses, the management type of investment trust usually pays to its fiscal agents or managers a fee for supervision of its investments. This may be calculated on the average current resources or may be a percentage of the income after taxes. In calculating the accrual of federal income taxes, consideration should be given to the credit for income taxes paid to foreign governments. Proper accrual should be set up for interest on fixed indebtedness and temporary borrowings. Cumulative dividends on preferred stock are included with the current liabilities.

Bonds or debentures outstanding should be compared with the indenture with the trustee, full description being noted on the balance-sheet. Confirmation should be obtained showing bonds authorized, authenticated and outstanding, as well as any provisions for sinking fund, etc.

A method of raising capital is to issue units of preferred and common stock indivisible until a future date or in separate certificates. The issuing company usually considers that the par value of the preferred shares is fully paid, the remainder being for the common shares. Sometimes a stated value is given to the common stock and the balance received is placed in "capital surplus." At any rate only the net cash received can be taken as the consideration for the stock issued. If stock is sold directly to bankers at a stated price, attorneys' fees, expenses of listing the stock, expenses of "blue sky" approval in some states and other incidental expenses may be deferred, as they are unusual expenses and warp comparison with other annual expenses.

The various classes of preferred and common stock authorized and outstanding can be confirmed by the registrar and also by transfer agents. Each class of stock should be fully described on the balance-sheet.

The surplus of an investment trust may consist of many elements. Capital surplus is the excess of amount received from sale of common stock over the stated value thereof, less any financing or other charges as approved by the trustees. Appropriations and contractual reserves should be verified and shown separately from the balance of surplus and undivided profits.

INCOME AND PROFIT AND LOSS

The extent to which purchases and sales are verified depends entirely upon the internal control. Usually two records of the securities are kept, one constituting the accounting record and the other for the investment and trading department. These separate records are posted independently and are compared from time to time by the house auditor and sometimes by the appraisal department. The main discrepancies are apt to be between different securities of the same issues or because of confusion in similar names. Inability to make proper delivery when a security is sold, confirmation of inventory and verification of income receivable will ultimately point out any discrepancies.

Settlements for purchases and sales of securities are made through banks, bankers or fiscal agents. This means independent verification of both securities and cash, which is of some value to the auditor. No conservative investment trust would buy or sell through a margin account with a brokerage house, so any real difference in securities would entail collusion between the "investor" of the trust and its banker.

A method which an auditor can follow is to check the opening inventory of securities, prove in total the accountability in securities for money expended and, conversely, the accountability in money for securities sold and make independent confirmation of the inventory at the end of the period. Purchase and sales tickets for, say, two months of the year may be checked in detail to both the purchase and sales blotter and individual investment cards. This procedure has only one apparent weakness, that is, in the verification of the cost of securities sold and resultant profit and loss on sales. For proof of profit or loss we turn to the individual investment card, which becomes the center of the audit of income and should show the following information:

Full title of security.
Interest rate, dates payable in the case of bonds and expected dividend rate and dates of declaration and payment of dividends on stocks.
Place where security is lodged.
Columns for:
  Purchases—date, units, dollars paid and price.
  Sales—date, units, dollars received and price.
  Cost of sales (at average cost per unit) and profit or loss.
  Inventory—units and average cost in dollars.
  Income—accrued interest to date and collection of income.

While units should be footed and proved it is only necessary to "read" the sum of costs of purchases and sales, as any entry which appears out of line is readily seen and should be thoroughly checked. If a security were entirely sold out the cost of sales would, of course, be the same as the cost of purchases, and the excess of sales over such cost would be the resultant profit. If only partly sold, a calculation of the average cost per unit before sales and comparison with the average unit cost after sales would confirm the accuracy of the cost of securities sold. The sum of the individual purchase, sales and net profits of each group is checked with the respective control accounts in the general ledger.

Verification of income from securities may be made at the same time as the inspection of investment cards for verification of purchases and sales. The description of each security calls for the earning of income at the prescribed dates and amounts. The investment card should record the collection of such income, if due, and monthly accrual of interest receivable. The relation of income due with interest on purchases and sales affords a valuable comparison. Care should be exercised to see that the income collected represents the correct number of units. An aid to the calculation of income is to prepare a chart in advance of the audit showing interest on $1,000 at various rates and from one-half-month to six-month periods. Similar tables showing the dollar equivalent of the major foreign currencies will be found useful.

A method to facilitate the work is to have the client prepare a monthly trial balance of the portfolio, listing against each security income purchased and sold, monthly accrual of income and income collected in addition to the principal. Such a record will be found useful to the bookkeeper in proving the correctness of his postings. It is not necessary to check each monthly accrual but the cumulation of the monthly accrual should equal the collection of semiannual interest. Income accrued at the end of the fiscal period should be verified.

Interest on bank balances, call loans, etc. can be compared with the statements received from the depositories.

Expenses of an investment trust are limited to few types and present no particular problem. Annual expenses for trustees' fees, depository fees, etc. are compared with the invoices and provision is made for their prepayment or accrual.

Compensation to fiscal agents or managers, whether based on average resources or income, can not be calculated until after the completion of the rest of the audit.

Income taxes paid to foreign governments can be vouched against the statements of the collection agent and are a credit against federal income taxes. Reserve for taxes to be paid to foreign governments on accrued income should be set up.

Interest paid on bonds, debentures or temporary borrowings is easy to verify. Amortization of bond discount and expenses covering a proportionate part of the life of such indebtedness is an addition to the interest charge.

Dividends payable as authorized by the directors are compared with the number of shares outstanding which are entitled to receive them.

Cash receipts and payments should be proved in total with the bank statements and for the last month of the period should be checked in detail. Inspection of cheques for large amounts payable to bankers is not as good a voucher as the securities paid for by those cheques. Paid invoices are good proof of the payment of funds.

In conclusion, the variety of transactions of an investment trust is limited and each transaction is closely allied to cash. An audit conducted along the lines described in this paper covers all the necessary steps needed for a report which can be certified by an auditor.