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Assets and Liabilities at Beginning of Audit Period

BY JOSEPH ROBINSON

If an audit or examination of assets and liabilities is to be made in a satisfactory manner, it is imperative that verification be not confined to the transactions occurring during the period under review, but that it also include verification of certain of the assets and liabilities at the beginning of the period. As concerns this verification as at the beginning of the period, the usual distinction between a balance-sheet audit, a detailed audit, or even a special examination, if it calls for the submission of a statement of assets and liabilities, is of no material import. Such distinction primarily determines the degree and extent of verification only of the income and expense accounts, and should not be considered as a restriction of verification of assets and liabilities.

A certified (or if not certified, an unqualified) presentation of assets and liabilities in an accountant's report should warrant the confidence that their authenticity and adequacy have been established in accordance with sound procedure and that their classification and terminology are in conformity with recognized accounting, financial and legal custom. In the absence of any expressed qualification to the contrary, those who are financially interested in the client's business in particular, and the public in general, have every reason to assume that the accountant's verification of the assets and liabilities as reported by him was complete in every respect, regardless of any restriction which may have obtained in the verification of the income and expense accounts.

It is to the interest of the accounting profession that this confidence be so assumed. To be merited, verification must be thorough and satisfactory; and to be thorough and satisfactory it must not be limited to transactions during the period under review but must include the transactions which previously entered into the accounts, where determination of the integrity of the balances is contingent wholly upon the correctness of the items which entered into their entire composition and which, because of the nature of the accounts, permit of no corroborative method of verification.

PREVIOUS EXAMINATION

Where an audit or examination has previously been made by the same accountant (or firm of accountants), verification of the assets and liabilities at the beginning date of that period should have been made at the previous time. If the audit is not a regular annual engagement, such verification should not be inferred, and if the accountant in charge of the current audit is diligently exacting he will refer to his firm's previous working papers to convince himself that satisfactory verification had been made at such previous time. Where the audit is a repeat engagement, it is not to be expected that the accountant in charge of the current audit should unduly concern himself with the composition of the assets and liabilities as at the date of the last previous audit, except to obtain such information as may be required in determining the proper treatment of the accounts during the interim period, as, for instance, that which relates to established provisions for reserves or for other adjustments, or concerns proper classification and terminology. If the accountant should disclose an indication of irregularity which refers to a previous period, he should, of course, carry his investigation back into that previous period, or at least bring it to the attention of the client with a view to obtaining further instructions.

In comprehensive audit procedure, it is advisable to take (in parallel columns) a general ledger trial balance as at both the beginning and ending dates of the period under examination. It is sufficient for the beginning trial balance to be post-closing, and thus include only the assets and liabilities. The ending trial balance should, of course, be prior-closing, and include all income and expense accounts; or if the books have been closed an analysis of the profit-and-loss accounts should be made.

If the audit is a repeat engagement, it is generally desirable that the assets and liabilities at the beginning date of the current period, as shown by the books and as entered in the first two columns of the trial balance, should be checked against the balance-sheet as submitted at the end of the previous audit period.

It is not at all safe to assume that because all adjusting and closing entries of the previous period have been taken upon the books, even if recorded and posted by the examining accountant, the balances in the book accounts at that date are correct. A conniving person might easily have manipulated the accounts after the closing entries were applied, either before or after such balances were brought down, especially if the balances were brought forward in a new ledger. A manipulation of this kind could be made to conceal an irregularity and thus escape detection. The beginning and ending trial balances will further serve the purpose of readily and conspicuously showing the changes or the absence of changes in the accounts during the period, and such comparative reflection is very desirable.

If the engagement is not a succeeding repeat one, satisfactory verification of the assets and liabilities at the beginning date of the current audit would be accomplished by starting with the balances in the accounts at the end of the period previously audited, which should be checked against the balance-sheet submitted at that date, and by examining the subsequent transactions.

If a previous audit has been made by some other accountant (or firm of accountants), it is not improbable that such audit can be made to expedite the current verification of the beginning assets and liabilities. A copy of the report on such audit should be obtained and inspected. If agreeable to the client, the copy should be retained in the current working papers. If this is not agreeable and if the audit was made as of a recent date, a schedule should be made of the assets and liabilities reported, together with a notation of any material comments as to limitation of verification or as to any pertinent information disclosed. The date of the report, the period covered and the accountant's name should also be noted.

If the previous audit report sets forth the assets and liabilities in such detail and with such information as to evidence substantially their authenticity and adequacy as at that date, there would appear to be no reason why verification should be carried beyond such report, except with regard to more important particulars. It can not be expected, however, that any accountant should attempt to vouch for the correctness of another accountant's report, and for sufficient cause there need be no hesitancy in making a satisfactory verification notwithstanding any examination which previously may have been made, unless the client limits the examination.

NEW ENGAGEMENT

If the engagement is a new one, the responsibility for making a satisfactory audit is greater than in a repeat engagement, for a new engagement always demands the verification of certain of the assets and liabilities at the beginning date of the period. If the client does not place a restriction upon the engagement by which verification is strictly confined to the transactions during the period under review, and if no previous audit has been made by some other accountant, the beginning verification should be complete and thorough, substantially in accordance with the suggestions hereinafter offered. If a restriction was placed upon the beginning verification, the report should be so qualified.

At first thought, it may appear that verification of the assets and liabilities at the beginning date of the audit period involves an appreciable amount of work. But usually this is not so, as the specific verification involves only certain assets and liabilities, for verification of the other assets and liabilities is comprehended in and attained by the usual scope of verification during the course of the current audit.

TWO DISTINCT PHASES OF VERIFICATION

There are two distinct fundamental phases of verification of accounts. One is verification of the items which entered into composition of the balances; the other is verification of that which physically or otherwise actually represents the balances (excepting plant properties). The composition may be correct in every particular and, based upon that composition, the book balances may likewise be correct, but that which actually represents the book balances may be greatly out of agreement with those balances. Conversely, that which represents the book balances may be in exact agreement therewith, but the book balances may be materially wrong because of errors in the composition of the accounts.

The nature of the accounts determines the method and degree of verification which should be made. Accounts having balances which can be proved by independent corroborative verification (i. e., physical inspection, except as to plant properties, direct confirmation, subsidiary records, or by computation of unexpired amounts) should be so verified for assurance of the integrity of that which actually represents the balances, and should be verified as to composition only for the actual period under review. Such accounts are notes and other securities, inventories, accounts receivable, prepaid or accrued expenses, accounts payable and outstanding amounts of notes, bonds and mortgages payable and capital stock. In such cases, verification as to entire composition (other than compliance with stipulations of agreements) is accomplished in the regular course of the current audit, for if the balances at the end of the period are verified and if the correctness of the composition during the period is established, it is generally proper to accept the correctness of the accounts as they then stand. It is, of course, possible for an irregularity to have occurred in some previous period which had been cleared out of the balances at the beginning of the current period, but even that would not militate against the propriety of accepting the balances at the beginning date, because such irregularity would not affect the integrity of the remaining balances as actually stated at the end of the current period.

Accounts having balances which can not be proved by independent corroborative verification should be verified as to their composition not only for the actual period under review but for their entire period of composition, because in the absence of an alternative method of verification the integrity of the balances at the end of the current period is wholly predicated upon their entire composition. It is in respect of such accounts that the accountant in charge of the current audit should make satisfactory verification of the balances at the beginning date of the current period, in addition to verifying the transactions therein during the period. Such accounts are fixed properties and reserves for depreciation, depletion, etc.; sinking fund and other fund assets and contra reserves; patents, copyrights, franchises and leaseholds; patterns, drawings, lasts, electrotypes, etc.; goodwill, brands, trademarks, formulas and secret processes; suspense items; deferred expenses; accrued commissions and royalties; reserve for federal and state taxes; consideration for and accounting requirements of bonds and mortgages payable and capital stock; accumulated dividends on preferred stock, and surplus.

Information should also be obtained regarding the history of the accounts of officers and employees and of other receivables or payables which do not represent regular trade accounts; and in questionable circumstances, indicating an apparently abnormal or subnormal cost of goods sold, some measure of check should be made of the inventory at the beginning of the period, if the audit also covers the income and profit-and-loss accounts. Such inventory check should not be at all complicated if the product can be identified by serial numbers, as in case of automobiles, machines, etc., or if it can be checked by exact computation of the quantity consumed during the period, as in cases of natural resources or of raw syrup consumed in bottled products. The writer knows of an instance where such computation showed that the sales contained about twenty thousand more cases of bottled goods than could possibly have been produced with the quantity of syrup which the records showed as having been consumed. Under pressure, the management admitted that the inventory of syrup at the beginning of the year had been intentionally understated. In certain businesses the verification of the consumption of stock in trade can and should be carried through the various processes. For instance, in a detailed audit of a lumber company the stumpage of timber cut is followed through its many processes until it is ready for the finished market. The accounting for the stumpage further forms the basis for the determination of the adequacy of sinking-fund instalments.

In verifying the composition of the accounts at the beginning of the current period, special care should be observed to confine the work to procuring only important particulars, since otherwise valuable time may be unnecessarily spent in inquiring into an interminable mass of details.

The following suggestions may serve to outline the more important particulars which should be obtained in the respective instances. Where public utilities are concerned, whose accounting is largely prescribed by the interstate commerce commission or, if intrastate, by state commissions, the suggestions should not be observed in disregard of any special conflict with such prescriptions.

FIXED PROPERTIES

The classification of fixed properties includes land, buildings, machinery and equipment, floating equipment, natural resources, furniture and fixtures, and accounts of a similar nature. Such accounts should be examined from the date of organization so as to ascertain the propriety of the charge and the basis of valuation, and to determine whether or not a conservative policy has been followed in accounting for replacements and extraordinary improvements and for depreciation or depletion, etc. This examination usually can be confined to the larger amounts in the respective ledger accounts supplemented by reference to journal entries, the inspection of vouchers being limited to such items as may not otherwise be explained or which may appear questionable. Investigations and analyses previously made of such accounts for invested capital for excess-profits-tax purposes should serve to facilitate the verification. The balances should be compared with insurance coverage, assessed values, appraised values (if any), and known valuations of properties of similar businesses to test the reasonableness of the book values.

Values placed by proprietors, directors or stockholders upon fixed properties acquired from a predecessor company, from stockholders or otherwise, which may possibly appear unreasonable to the accountant, are rather difficult to refute successfully, unless fraud can be established. The law generally holds that if property is found to be overvalued and there is no evidence of fraudulent intent, and if the valuation was of necessity a matter of personal opinion and all parties acted in good faith, the valuation will stand. But if there is evidence of fraudulent intent or secret knowledge of overvaluation, or if the value of the property is estimable to a reasonable degree of fair valuation and the valuation shown is excessive, or if the accountant has actual or reasonable evidence of fraudulent overvaluation, he must refuse to issue a certificate or if he issues one he must take out of the property the excess valuation or expressly qualify his certificate so as to disclose the true condition. The inquiry into such acquisitions should be made with this right of judgment in mind.

If capital stock was issued for fixed properties, the agreement should be inspected to ascertain that the accounting properly complied with the facts. Discount on stock or bonus stock issued without legal consideration should never be charged to property or other actual asset accounts. If bonds were given in payment and if the agreement stipulated that they were to be issued at par value, the property accounts should be charged at par notwithstanding any lower market which may possibly have prevailed at that time, except that if the discrepancy in values was unreasonably large the questions of good faith and of sound accounting should be considered. If the agreement stipulated a stated price which was lower than par, the discount should not be charged to the property accounts, except that amortization of both interest and discount for the actual period of construction is a correct charge to property accounts.

Extraordinary repairs and replacements should be investigated carefully, particularly as to their depreciable status. It is possible for such expenditures to constitute (in effect) a proper charge to reserve for depreciation if the reserve had been accumulated at rates and in amounts sufficiently high to make such treatment indisputably requisite. However, every legitimate effort should be made to circumvent such possible treatment and instead to treat extraordinary repairs and replacements as deferred property charges—but full cognizance should be given to the possibilities. Ordinary repairs and renewals, unless too trivial to adjust, should of course be rejected as deferred property charges.

If the book values include charges to reflect adjustment or appreciation, exact particulars should be obtained to show the basis, authority and soundness of such charges. The fact that the book values were adjusted to agree with appraisal values does not relieve the accountant of the responsibility of verifying the other charges to such accounts, for should the accounts contain improper transactions the amount of such error would be cleared out through a corresponding incorrect amount of appreciation.

Increases in valuation which may be substantiated as being attributable to excessive provisions for depreciation, or to the charging off of improvements or repairs which should have been capitalized, would not represent true appreciation but would represent a restoration of previous profits to earned surplus.

Proper clearance should have been made from the accounts for the entire book value of any assets which may have been sold or abandoned, including the reserve for depreciation.

The property accounts should be stated at full contracted cost, and any balance payable thereon should be set up as a liability. Under ordinary conditions cash discounts earned on the purchase of fixed properties should not be treated as income but should be treated as a reduction cost. In the absence of any indication of irregularity, it is not generally the custom to examine titles to properties. However, if property was acquired by gift or by purchase from an officer, director, stockholder or other person who had influence in the business, the titles should be examined to prove actual ownership.

RESERVES FOR DEPRECIATION, APPRECIATION, ETC.

The reserves should be examined to ascertain that proper provisions had been made in all years for depreciation, depletion, obsolescence or other form of exhaustion or extinguishment. Not only should adequate provisions have been made, but if provisions have been claimed for federal income-tax purposes (and also made on the books) at obviously excessive rates, consideration should be given to the probable liability for an additional assessment. In the latter event, consideration should also be given to the increase in surplus which would result from a restoration of such excessive provisions, and in view of this circumstance a probable additional assessment of only a comparatively small amount could be disposed of by way of comment, without necessitating an adjustment.

If the property accounts are carried at appreciated values, the depreciation, etc., written off or set up as a reserve should be examined specifically for the purpose of ascertaining whether the provisions were calculated upon actual cost or upon the appreciated values. For federal income-tax purposes depreciation on amounts which represent appreciation is a proper charge against operations only if the appreciation was based upon March 1, 1913, values.

The soundly conservative accounting for depreciation of appreciation is to charge the provisions directly against the specific surplus or reserve account which was credited as a contra to such appreciation. If the operating charges for depreciation were calculated upon the appreciated values, the accountant would have to choose between rejecting and eliminating as operating charges the amounts which represented depreciation on appreciation, or including such amounts as operating charges and expressly qualifying the income account in that respect. The latter course is always advisable, as it is quite easy for the accountant to go beyond his province in eliminating from his report transactions which were not illegal and which were taken up on the books in the regular course of business.

While it is well recognized that under conservative and proper accounting theory appreciation should not be given expression in the accounts, unless for tax purposes, except as contra memorandum accounts, accountants should bear in mind that preferences as to conservative and proper treatment should not lead them into taking an arbitrary or inflexible stand as to the treatment of such appreciation in their reports, in disregard of the way in which it was treated on the books.

LEGAL INHIBITION RELATED TO APPRECIATION

It seems that the only legal inhibition relating to the question of reflecting in the accounts appreciation of assets, other than regulation by federal income-tax laws, is embodied in the statutes of most (and probably all) states, which provide that dividends (other than liquidation) can be paid only out of earned profits. It is highly doubtful that the provision as to earned or realized profits would ever be held to exclude profits on sale of capital assets, or any actual profit which may have been realized from transactions other than the regular operations: at least it is sound accounting to treat such profits as earned surplus.

Notwithstanding this inhibition, there have been innumerable cases in which appreciation not only was merged with the general surplus, but where cash dividends were also paid out of such appreciation. The extremity is reached when cash dividends are paid out of appreciation, and even then there appears to be no actionable recourse unless payments to then existing creditors or to holders of preferred stock are thereby jeopardized. Statutes in this relation usually provide that the directors of the corporation in whose administration the dividends shall have been declared or made, except those who may have caused their dissent therefrom to be entered upon the minutes of the meetings of directors at that time or who were not present when such action was taken, shall be liable jointly and severally to such corporation and to the creditors thereof to the full amount of any loss sustained by such corporation or by its creditors, respectively, by reason of such dividend. As a rule, it may be said that only the state and those who were financially interested at the time of such payment can complain, and then only in event of jeopardy as a consequence.

The accountant is neither a prosecutor nor a governing authority, and it is hardly within his province to attempt to set aside or regulate transactions which may be in technical violation of inhibitions but which are amenable to actionable recourse only in event of subsequent jeopardy to those who were directly interested, and he certainly would be without right if such parties had subsequently been satisfied in full. The accountant's obligation is to make certain that in his report there will be no concealment or misrepresentation of material facts, and that, in so far as it may be within his province, the appreciation will be treated in accordance with proper accounting theory. His responsibility is discharged when he clearly qualifies or describes the surplus as shown in the balance-sheet.

REALIZATION OF APPRECIATION THROUGH DEPRECIATION

If the provisions for extinguishment include depreciation of appreciation and if the provisions were charged by the company against operations or directly against earned surplus, and if such charges are permitted to remain, it is usually desirable that adjustment be made in the accounts to give effect to realization of appreciation through depreciation, provided the appreciation was not originally merged with the general surplus. That is, the amount that represents the accumulated depreciation of appreciation which was written off against operations would be charged to the contra capital surplus or reserve for appreciation account and credited to earned surplus. This transfer accomplishes the same effect with respect to the earned surplus as would be accomplished by charging such provisions directly against the contra account instead of reflecting them in the earned surplus as charged in the income account. While usually desirable, such transfer is not at all essential, as it is properly within the judgment of the management to continue to carry such realized appreciation as a special reserve, as capital surplus, or as some other form of segregated surplus.

It is proper under certain conditions to reflect as a credit in the income account the amount which represents the realization of appreciation, but, as concerns the final net earnings for the year, this has the effect of charging profits only with the actual depreciation based on cost, exactly as if the depreciation of appreciation were charged directly to the reserve account.

SINKING FUND OR OTHER FUND ASSETS AND CONTRA RESERVES

The verification of sinking fund or other fund assets and contra reserves is not limited to proving the existence and ownership of the assets which actually represent the fund balances, but should essentially include a determination of the correctness of the basis of the periodical accumulation of such funds and provisions for contra reserves. The trust deed or other instrument under which the funds were created should be examined and the calculations of the instalment accumulations should be carefully verified. It has often been found that some of the requisite payments to the sinking fund have not been made. Failure to make such payments not only creates a potential current liability, but it virtually constitutes a breach of the agreement, and if the breach should continue for such time as no doubt was stipulated therein, the creditors would be empowered to assert their rights. Also, it is customary for the instrument to contain a stipulation that dividends shall not be paid out of profits prior to compliance with the requirements.

Particular caution should be exercised to ascertain whether or not the requirement as to provisions for the retirement reserve embraces also the regular provisions for depreciation or exhaustion. The depreciation charge is an operating expense and should, of course, be provided for regardless of sinking-fund requirements. The retirement provision (exclusive of such portion as may actually represent depreciation) is a charge against free surplus to create a restricted surplus, and is in no sense an expense, but is really an impounding of profits. To carry out both charges simultaneously would not result in a double charge against operations but would result in a double charge against free surplus. Such regular diminishment and additional restriction of otherwise free surplus places an unnecessary burden on common stockholders during the periods of the maintenance of the sinking fund, inasmuch as the surplus available for dividends will have been doubly reduced.

If the sinking-fund reserve comprehends also the depreciation provision, the proper treatment to avoid a double charge against free surplus would be to charge the portion of the sinking-fund provision which represents depreciation directly against operations and to charge the remaining portion, which represents the additional temporary margin of safety to the creditors or preferred stockholders, as an impounding of final net profits. In this case two distinct reserve accounts would have to be carried on the books to reflect the sinking-fund requirement, one as a depreciation reserve, the other as a retirement reserve segregation of surplus. Upon final accomplishment of the purpose of the requirement, only the retirement reserve should be credited back to free surplus, the depreciation reserve remaining as an asset diminishment.

The treatment of sinking-fund reserves is fully covered in Montgomery's *Auditing Theory and Practice,* Vol. I, third edition, pages 283–286, and also in Kester's *Accounting Theory and Practice,*Vol. II, second edition, pages 471–473.

PATENTS, COPYRIGHTS, FRANCHISES AND LEASEHOLDS

Accounts such as patents, copyrights, franchises and leaseholds should be examined to obtain their concise description, their authenticity and basis of valuation, dates of acquisition and the exact periods of time for which the rights or privileges were conveyed. In each instance formal documents should be inspected to support the legitimacy of the account. If the account has been so named simply as an offset to capital stock, without authentic consideration, or if it is in any other way of the true nature of goodwill, the accountant should insist upon a renaming to represent clearly the exact facts. The accounts should be charged only with actual cost. Expenses of litigation which do not add any actual value to the grants should be written off within the year. If the book values do not represent actual costs, but represent values based upon arbitrary estimate or upon independent appraisal, either as of March 1, 1913, or subsequent thereto, the basis, authority and soundness of such values should be determined so that any fictitious value (if such can be established) can be rejected, or so that specific qualification in respect thereof can be made directly on the balance-sheet. Any appreciation subsequent to March 1, 1913, will not be recognized for federal income-tax purposes.

Proper provisions should have been made in such amounts as will extinguish the book values before or upon expiration of the designated time periods, the charges for which should be treated in accordance with the general procedure as outlined in respect of property accounts, as concerns both actual cost and appreciated values.

A patent is granted in this country for a term of 17 years, and a copyright is granted for a term of 28 years with the privilege of renewal, under certain conditions, for another 28 years. Their principal value lies in the fact that they grant monopolistic rights, and as these rights cease upon expiration their value is then practically ended. Even though some intangible value may continue with the production of an article under such a grant after the rights thereunder expire, it is the settled custom to write off the entire cost within the legal life of the grant (which in case of copyrights would be within the first 28-year period). However, it often happens that such rights do not remain valuable during the entire life of the grant, because of obsolescence or other terminating factors, and circumstances may require that the remaining value be written off in any one year, or that the sound value be based upon frequent downward revaluations. Franchises are granted for many different privileges and for various periods of time, and their entire cost should be extinguished upon expiration (sometimes before expiration) of the specified period, with due consideration to the conditions obtaining in each individual case.

Leaseholds should be amortized during their terms of life from the date of purchase. While no mention of them is made in the 1917, 1918, 1921 or 1924 income-tax laws, the treasury has issued regulations dealing with their treatment.

Patents, copyrights, franchises and leaseholds may be depreciated for federal income-tax purposes, subject to the regulations issued by the treasury.

PATTERNS, DRAWINGS, LASTS, ELECTROTYPES, ETC.

Patterns, drawings, lasts, electrotypes, etc., often represent large expenditures, and are difficult for the accountant to value soundly. The importance of conservative treatment in dealing with them is succinctly set forth by Montgomery in his *Auditing Theory and Practice*, Vol. I, third edition, pages 189 and 190, as follows:

"If they (patterns, etc.) are used for stock, or regular output, their value depends upon their life and upon the probability of renewed use. If acquired or made for special jobs, their residual value is small, and the cost should have been a charge against the jobs themselves. . . . The auditor may meet with strong opposition in his efforts to reduce this item to a reasonable value, for it represents the skill and often the affections of the proprietors, who dislike to see its value depreciated.

"However, the auditor must be firm and must decline to set up sentimental values as tangible assets.

"The charges against the account are usually cumulative, i. e., they follow the output almost automatically, whereas, if any considerable percentage of the old patterns, etc., were available for use, the additions to the account would not keep pace proportionately with the production, but would increase less rapidly. The auditor should apply these tests before accepting the book valuations.

"Wherever feasible, he should advise that a conservative course be followed, such as writing down the book value to forced sale value."

(The arguments as to patterns apply equally to electrotypes, woodcuts, etc.) "Conservative publishers charge off almost the entire cost of plates as a direct cost of a first edition, and they are careful to revalue the balance of the account frequently. If a book or other publication is successful, the cost of plates, etc., can be readily absorbed in its cost, but if it is not successful, no reorders can be looked for and it would be folly to carry the plates in the balance-sheet at *any* valuation except as scrap metal. A number of bankruptcies have occurred in the publishing business through disregard of the uncertain value of such assets."

The verification of the basis of valuation of such accounts and the provisions for extinguishment should be established in general accordance with the foregoing principles, and in substantial conformity with the procedure as outlined in respect of property accounts, as concerns both actual cost and appreciated values.

With regard to the tax treatment of such items, under the 1917 regulations it was required that the cost of successful patterns, etc., be capitalized and written off over their life, but under both the 1918 and 1921 laws the regulations permitted the taxpayer the option of capitalizing such items or of writing them off as expense within the year. No doubt the regulations to be issued under the 1926 law will contain a like provision. Where the "salable" life of certain books will expire before the copyrights, the treasury, when all facts have been placed before it, will permit the cost to be spread over the income-earning period.

GOODWILL, BRANDS, TRADEMARKS, FORMULAS AND SECRET PROCESSES

Accountants have often found that the class of items included under the titles of goodwill, brands, trademarks, formulas and secret processes covers a multitude of sins, for such items frequently are the dumping ground for fictitious considerations as offsets to capital stock. If they were acquired through bona-fide purchase, it should be quite simple to determine their authenticity and basis of valuation. If they were acquired at the time of taking over a predecessor business and if they merely represent a balancing amount between other assets and liabilities, the agreement should be examined and the other assets and liabilities should be scheduled so that the balancing amount can be specifically verified. If such items were taken up on the books of a going business to give expression to arbitrarily estimated or independently appraised values, as a contra to capital stock, surplus or even a liability account, the basis of valuation and the authority for such action should be ascertained.

The appreciation of such accounts, as well as any other fictitious value which they may represent, should be looked upon with suspicion. However, it should be remembered that unless fraud can be established the judgment of the management of a business is not to be lightly impugned in matters of valuations. In a large measure, the public has grown to be rather skeptical of valuations assigned to items of this class, and it seems well recognized that there is very little within the province of the accountant in passing upon the soundness of the values. At least he should in every case ascertain the basis and authority for valuation, the consideration given and, if recorded by way of appreciation, the offsetting account which was credited. The treatment of appreciation and the amortization of appreciation should be in accordance with the procedure as outlined with regard to property accounts. The accountant's primary responsibility in dealing with such items is to make certain that the true condition and the exact facts are clearly reflected in the balance-sheet.

For income-tax purposes, no claim for depreciation, as such, of items of this class will be allowed. However, when goodwill was purchased or had a value March 1, 1913, and later declined in value on account of national or state prohibition, depreciation in the nature of obsolescence will be allowed. Also obsolescence of assignable goodwill is allowed in exceptional cases, usually upon discontinuance of business. Brands, trademarks, formulas and secret processes likewise are not subject to annual depreciation, as such. The fact that a trademark can be registered for a period of 20 years, with privilege of renewal, does not give it a definite life within the meaning of the income-tax regulations. However, if after acquisition these latter items are found to be worthless their cost may be charged off during the year in which the worthlessness was discovered. In all such cases the cost must be established to the full satisfaction of the commissioner of internal revenue.

Notwithstanding the question of deductibility of such items for income-tax purposes, attention should be given to the question of writing down such assets to a nominal value as a measure of financial conservatism. It seems that custom has left this question entirely to the judgment of the business management. Established practice apparently sanctions the indefinite carrying of goodwill at the value at which it was originally acquired, or even to which it subsequently appreciated. Its actual value fluctuates so, and there is so much uncertainty in any attempt to adjust its book value, that by common consent it is generally left alone, except in the event that earnings are unusually large, when it is sometimes written down. It is so commonly used as an offset to over-capitalization and it is so often viewed with suspicion that the recent tendency with certain large concerns has been to write it off gradually.

SUSPENSE ITEMS

Sufficient analyses should be made of any accounts which are carried in suspense to disclose their true status, to ascertain their correct terminology, degree of liquidity and probable disposition, and to show whether or not any provision should be made for possible loss upon disposition or for any unrealized profit which may possibly be reflected in the particular transaction.

DEFERRED EXPENSES

The investigation of deferred expenses should disclose whether or not the accounts represent items which may properly be written off over a reasonable period of years and should make certain that adequate provisions have been charged off during the period since the items were first considered as deferred expenses. If the facts are such that the expenses are not properly deferrable, the accounts should be rejected as asset items and written off on the books. Such amounts as may be chargeable to the respective years under review should be so treated and the balance should be charged directly against surplus.

The accountant should also ascertain the deductibility or non-deductibility of the respective items over such period which may have been claimed for income-tax purposes. Organization expenses can not be written off for tax purposes over a period of years and can not be claimed during the year in which they were incurred or paid, but must be treated as capital expenditures. If large amounts of such unallowable items were claimed as deductions the taxes will have been understated for those years.

ACCRUED ROYALTIES AND COMMISSIONS, ETC.

It is not always practicable to obtain a written confirmation of amounts due on royalties, commissions, etc. For instance, many publishing concerns which sell their periodicals on the instalment plan, and which pay certain commissions only as collections are made, frequently have disputes with the salesmen as to the amounts of commissions, and they are not willing that the amounts accrued on the books be disclosed to the salesmen.

Even if a confirmation can be obtained, it should be looked upon as a secondary corroboration; the contracts should be examined and a close check made of the calculations of the liabilities as set up on the books. The accountant should not only guard against understatements of such accounts, but he should look for possible overstatements which may have been calculated in hope of avoiding taxes. Unless verification can be made to the accountant's full satisfaction, the report should be qualified.

RESERVES FOR FEDERAL AND STATE INCOME TAXES

The determination of the correct federal and state income-tax liabilities and the adequacy of the provision therefor is one of the most important features of the accountant's investigation, and when the examination is for refinancing or merger purposes its importance can not be too strongly stressed.

In a new engagement, the federal income-tax returns should be examined for possible underpayments for all years subsequent to the period under which the right of additional assessment by the government has become outlawed.

In examining for possible overpayments, the accountant should bear in mind that the taxpayer is not barred from recovery in all instances in which it may ordinarily appear that claims for refund are outlawed. The exception is provided for in the act of 1926, section 284(c), as follows:

> If the invested capital of a taxpayer is decreased by the commissioner, and such decrease is due to the fact that the taxpayer failed to take adequate deductions in previous years, with the result that there has been an overpayment of income, war-profits, or excess-profits taxes in any previous year or years, then the amount of such overpayment shall be credited or refunded, without the filing of a claim therefor, notwithstanding the period of limitation provided for in subdivision (b) or (g) has expired.

Similar provisions were contained in the acts of 1921 and 1924, and under these provisions the right to demand such refunds extends as far back as 1909, the first year in which there was a federal tax on corporate income.

Special attention should be given to the effect of sales of fixed assets upon the tax liability to be set up in the balance-sheet. The 1924 revenue act lays down certain principles to be followed in ascertaining the profit or loss upon disposition of property. In many cases the profit or loss so determined will not differ very materially from the profit or loss reflected on the vendors' books, and in consequence the use of the net income shown by the books in compiling the tax liability will not, in such cases, produce any material error.

However, the 1924 law provides for the use in certain cases of a "basis" other than cost in arriving at the profit or loss to be considered for tax purposes. In some instances, the profit to be included in taxable net income will be so much greater than that shown by the books that the tax liability computed on the basis of book income would produce a materially erroneous result, with corresponding distortion of the balance-sheet.

In case of sale of property which had been acquired after March 1, 1913, and the book value written up, the profit would be figured on actual cost and not on the appreciated value.

In order to prevent the setting up of a tax liability materially different from the correct amount, all sales or other dispositions of property involving large sums of money should be carefully investigated and full details obtained of the method by which such property was acquired. If the purchase consideration was cash, no further investigation is necessary. If the property was otherwise acquired, it will be necessary to give further consideration to the basis to be used in computing the taxable profit on the transaction.

As an example showing the need for careful investigation, the following may be considered: A owns certain property which cost him $400,000 in 1914. In 1921 a corporation is formed which issues to A all its outstanding stock (except qualifying shares) of a par value of $2,000,000. The corporation enters the asset on its books at the par value of the stock issued therefor. In 1924, this property is sold for $2,500,000, depreciation of $200,000 having been provided since its acquisition. The profit per books will be $700,000. The taxable profit under the 1924 law will, however, be at least $2,300,000 since the basis will be that which would have been used by A, adjusted for depreciation allowed. A tax reserve computed on the book profit of $700,000 would be insufficient to the extent of at least $200,000.

Even if the asset in question had been transferred to another corporation for all its stock, the same basis as would have been used by A will be applied when the asset is sold. The constitutionality of this procedure has been questioned but from the balance-sheet viewpoint the tax liability should be computed in accordance with the law as it now stands. Cases such as this are not uncommon, particularly where patents or other intangibles are involved, and they illustrate the necessity for considering most carefully the tax liability set up in the balance-sheet.

In addition to examination of the returns, the correspondence file covering income-tax matters should be requested and perused. A record should be made of the findings by the treasury in the audit which it may have made of any returns, and of the status of any exceptions noted. Unless the accountant is able to procure from these respective sources information to his full satisfaction, he should obtain from the management a signed statement of the correctness of the tax liability as shown by the books and the absence of knowledge of any exception or additional assessment which may have been noted by the treasury, and appropriate qualification should accordingly be made on the balance-sheet or in the report.

It should be remembered that where state tax laws closely parallel the federal income-tax laws, a material misstatement of federal income taxes will indicate a similar misstatement of state taxes. In New York, corporations pay a franchise tax of 4½ per cent. based upon practically the same taxable income as was reported to the federal government. Therefore, it is quite important that in providing for additional federal income taxes, including interest and penalties (if any), provision should also be made for possible additional state taxes.

Provision for taxes which are payable on the current year's income and for additional assessments which have been finally authorized and the dates of payment of which have been determined should be treated as current liabilities. Provisions which are virtually certain, but which are still problematical as to final assessment, exact amount and period of payment, need not always be classed as current. In some circumstances, particularly if the proposed additional taxes are uncertain or are being contested, such provisions need not be included in the liabilities, but may properly be covered by a qualifying note on the balance-sheet.

BONDS AND MORTGAGES PAYABLE AND CAPITAL STOCK

Authorizations for the issuance of bonds, mortgages and capital stock should be carefully studied to determine that proper accounting had been made for the considerations received and that the discount thereon, if any, had been properly recorded and, as relates to bonds and mortgages, adequately amortized. Exact details should be obtained as to description, interest, rate and maturities of bonds and mortgages, the designated trustee (if any) and the property mortgaged as security. The verification of sinking-fund requirements in respect of bonds and mortgages has previously been discussed.

As distinct from the usual verification of the outstanding capital stock as shown by the general ledger by listing the outstanding certificates as shown by the certificate book and by inspecting the stock record book, the accountant should inspect the minutes or specific agreements covering the issuance of the capital stock so as to determine that proper accounting had been made for the considerations received. It is important that the offsetting charge was made to the proper account. If cash was received, the receipt should be checked into the cashbook; if property accounts were charged, the particular accounts and the basis of valuation should be checked; if personal accounts were charged, it should be ascertained whether the accounts are still carried as receivables, either as accounts or notes. Receivables which represent uncollected stock subscriptions should always appear as uncollected stock subscriptions, and should under no conditions be merged with the regular trade receivables. Failure to collect the latter results in a charge against profits. Failure to collect stock subscriptions does not decrease the profits or surplus, but decreases the offsetting capital stock.

Full details should be obtained as to the exact class of the stock, the par value, or in the case of no-par common stock the amount (if any) declared to have been paid in, and in cases of preferred stock the dividend rate, and whether cumulative, noncumulative, participating, etc.

Any provisions for the redemption or conversion of preferred stock should be noted. The amount at which no-par stock is carried usually represents the proceeds of the sale of the stock. When, however, it is required by statute or for other special reason that no-par stock be carried at a stated value, the excess of the amount for which the stock was sold over the stated value should be considered as capital surplus.

In investigating the capital stock as issued, it should be borne in mind that the issuance of the certificate itself is independent of the issuance of the actual stock.* While it is not essential that a certificate be issued concurrently with the issuance of the actual stock, if a certificate is illegally issued and passes into the hands of

* Conyngton's *Corporate Management*, Sec. 32.

an innocent holder, it is a valid claim against the corporation. Stock which has been unqualifiedly subscribed, or conditionally subscribed and the conditions complied with, and accepted, no matter if unpaid either in full or in part, is issued stock, and the subscription dues should be considered as an asset unless the subscriber has forfeited his rights so as to give the company power to annul his subscription and unless such annulment has been made. The certificate merely evidences the ownership of the stock.

The treatment of discount on capital stock depends upon state laws and the particular facts. If it is permitted by statute to issue original stock at a discount, there is, of course, no question as to showing the discount as such. If prohibited by statute, but if nevertheless issued at a discount by agreement with the subscribers, in some states the subscription would be void, whereas in other states the agreement alone is void provided there was fraud upon the other stockholders or upon creditors. In the latter event, those injured could enforce payment of the discount. But in most states, if there is no fraud upon the other stockholders, and no rights of creditors intervene, and the subscription is not necessary to make up the amount of stock required by the charter, so that there is no fraud upon the state, the agreement is binding upon the corporation and the other stockholders.*

Real discount on stock is not collectible by a corporation and it is not an asset. It is not a deferred charge. It is absolutely valueless, yet it is not a loss. It is not a liability of the corporation as an entity to its stockholders. It is, in effect, nil. It merely represents a difference between the par of the capital stock and the actual value of the consideration received therefor. It should be extinguished only as a direct charge against surplus. There is no legal requirement for its extinguishment, but it is preferable that it be written off so that the par value will in time become real (except for possible losses). The unextinguished discount should be shown as a deduction in the capital section of the balance-sheet or as the last item on the asset side, after first showing the total assets. In the latter instance, the caption "capital" should not be used to describe the combined capital stock and surplus.

Any issuance of stock not properly authorized should be noted so that appropriate qualification can be made on the balance-sheet. The writer recalls two widely separated instances where

* Clark's *Corporations*, second edition, page 297.

stock certificates were issued without any consideration whatsoever and were pledged as collateral to bank loans. In the hands of innocent holders such certificates can be enforced against the corporation, and if creditors or other stockholders suffer loss as a result the offending officers can be held personally liable.

ACCUMULATED DIVIDENDS ON PREFERRED STOCK

Passed dividends on preferred stock are not a liability until they have actually been declared. Some accountants incline to the extreme view that a passed preferred-stock dividend becomes, in effect, declared if a common-stock dividend is declared during such passed period. This view is not sound. The sound view is: "A dividend paid before reserving profits, where the by-laws require antecedent reservation, or one paid to common shareholders ahead of an accumulated dividend to cumulative preferred shareholders, is classed as illegal."*

It is important that the amounts of the passed dividends be calculated and that a qualifying note be made on the balance-sheet, because such amounts become a lien on the surplus as concerns common stockholders. They also usually become part of the principal amount due preferred stockholders, who are also preferred as to assets upon dissolution.

SURPLUS

The surplus should be analyzed so as to segregate the earned surplus from the so-called capital surplus. The latter term has a wide range of meaning, often including all accretions to capital other than regular operating earnings. True capital surplus should be restricted to represent only contributions by the owners of a business, such as original paid-in surplus, premiums on capital stock, subsequent contributions by stockholders, etc. Appreciation arising from re-appraisals preferably should be shown as reserve for appreciation, or surplus from appreciation or other identifying caption. Surplus arising from outside gifts should be referred to as donated surplus. Surplus arising from the sale of capital assets may properly be included in the earned surplus, but should be so indicated in a detailed report.

If direct charges and credits to surplus include adjustments of prior years' operations, such adjustments should be applied to the respective years if income statements are to be submitted for

*Kester's *Accounting Theory and Practice*, Vol. II, second edition, page 478.

a period of years. Attention should be directed to the treatment which was given such transactions in the clients' federal income-tax returns for those years.

If the amounts which represent surplus arising from appreciation can not be so segregated, because of having been paid out in dividends, the report should be so qualified. However, if such payment occurred long years back, and if the creditors who existed at that time have been satisfied in full, and if there is no detriment to no-par or preferred stockholders and if the asset account which was appreciated is so noted in the balance-sheet, a brief comment in the report should dispose of the matter satisfactorily without a special qualification on the balance-sheet.

The treatment of appreciation and of reserves for sinking funds (as parts of the surplus) have been discussed at length under those respective captions.

In showing segregated surplus in the balance-sheet in a way materially different from its status as claimed by the client and as shown by the books, the surplus should be described so as to avoid any possible misrepresentation. If a certain portion of the surplus is found to be capital surplus, and if it is segregated as such from the free earned surplus in the balance-sheet, and if the client insists upon carrying it on the books as earned (or general) surplus, those who are financially interested in the client's affairs should know of the client's refusal to treat such capital surplus as distinct from free earned surplus. While in no event is there any assurance that the client will not divert capital surplus to uses other than those which ordinarily may be proper, the rejection by the client of the accountant's segregation should be taken as a warning that such segregated surplus is in danger of unexpected dissipation.