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Auditing: theory and practice

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In partial fulfillment of requirements
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1. The Purpose of This Book.
2. Auditing vs. Accounting.
3. Definitions of Auditing.
4. Description of Auditing.
5. The Function of the Auditor.

1. The Purpose of This Book.-- The purpose of this text is to state, explain, and illustrate the leading principles and procedures representative of modern auditing practice. Moreover, the writer will frequently draw upon his experience and reflections to express his own personal opinions, both in an endeavor to make some contribution to the thought and advancement of the profession, and to explain how he stands on the matter whenever there is a debatable issue under consideration.

2. Auditing vs. Accounting.--Accounting is commonly divided into two fields; constructive and operative.

Constructive accounting concerns itself with accounting systems and system building. Whenever an accountant installs a bookkeeping system, in whole or in part, he must call upon his knowledge of constructive accounting.

The next step is for the bookkeeper to record in the newly installed books the various transactions of the business, estate, individual, or institution. This requires a knowledge of accounting principles and is, therefore, known as operative accounting.

After the transactions have been recorded, they are often subjected to an analysis, called auditing, for purposes which will be explained subsequently in chapter two.

3. Definitions of Auditing.-- As to a definition of auditing, Professor Bornhofft has said that it is "that part of accounting that has to do with a review, analysis, and verification of financial transactions and value fluctuations, and the preparation and certification of statements disclosing financial condition and/or change and/or other ascertained facts." For this purpose he also explains that "a transaction is a completed act resulting from a contractual relationship for money or money's worth, and usually results in a transfer of value. whereas value fluctuations refer to provisions for depreciation, bad debts, and the like."

Montgomery says, "Auditing is a systematic examination of the books and records of a business or other organization, in order to ascertain or verify, and to report upon, the facts regarding its financial operations and the results thereof."

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1 The student is instructed to send 15 cents to the Superintendent of Documents, Washington, D.C. for two pamphlets entitled: "Verification of Financial Statements"; and "Depreciation Studies"
2 Montgomery, p. 3
As each of these two excellent definitions suggests points of view not found in the other one, it may reasonably be conjectured that no definition will ever be formulated that will adequately describe auditing, especially since its scope is continually expanding from year to year in response to new demands made upon it by leading business managers.

4. Description of Auditing.-- "It will be seen that auditing is essentially retrospective. Another distinguishing feature is that it is analytical. It differs from accounting, which is concerned with the current recording of business facts. The function of the auditor is the subjecting of existing records to critical analysis for the purpose of proving or disproving their accuracy; and in most cases the preparation from the records, with such adjustments as are necessary, of statements and reports which will convey to the interested persons in an intelligent manner the information they require for their particular use."

5. The Function of the Auditor.-- Briefly stated, a main function of the auditor is to supply the special skill and judgment necessary to analyze, interpret, and present the facts to be gathered from the financial records, etc. In most instances the company's accountant is not qualified to do this highly technical piece of work. Moreover, there are many times when the situation demands that the work be done by a DISINTERESTED expert, i.e. a neutral party. Thus a banker, or stockholder, or investor much prefers the report of a certified public accountant to that issued by the business itself because it is the work of a neutral and expert person.

The reader must not infer from this statement that the work of the public auditor and accountant is strictly limited to the checking and the analyzing of accounts. As Eggleston says, "The study of scientific accounting and the auditor's profession should be fascinating to an ambitious student. There is scope enough in the work to develop his talent for growth and engage his best powers. It will bring him into acquaintance with men and measures that are vital and dynamic."  

Again, the scope of the curriculum of our modern schools of accountancy clearly indicates the breadth of the training required by a successful public accountant. For example, general economics, business mathematics, taxes, commercial law, business English, production, personnel management, finance, distribution, salesmanship, and accounting are some of the more technical subjects which the student studies AFTER he has acquired a general basic foundation in literature, history, sociology, political science, and so on.

Obviously, it is not expected that an auditor will be, or needs to be, equally efficient in all of the above subjects or as expert in any of them (except accounting) as are various specialists. Nevertheless, as the day of the auditor as a mere checker and reporter of past financial transactions has long since passed, he must necessarily ground himself in these business fundamentals so as to be able to coordinate his specialized field with other fields of commercial life.

1 Bell-Powelson, Page 4.  
2 Eggleston, Page 1.
CHAPTER 2
THE OBJECTIVES AND ADVANTAGES OF AN AUDIT

A--THE OBJECTIVES

6. The Two Main Objectives of Auditing (Sections 1, and 2)

Section Z

17. Donors. 18. Credit Committees.

Section Y


B--THE ADVANTAGES

27. The Advantages of an Audit.

Review Questions.

A--THE OBJECTIVES

6. The Two Main Objectives of Auditing.--Although the objectives of auditing could be expanded, the following twofold classification comprises the most important ones.

Sec. 1.--To verify the balance sheet, and/or profit and loss statement, and/or other statements of a business, estate, organization, institution, or individual, and so on, for the purpose of reporting as to the financial condition, and/or the operating results, and/or the financial integrity of the administration, either to stockholders, partners, individual owners, officers, boards of directors, bankers, investment houses, creditmen, trustees, receivers, courts, prospective purchasers, executors, credit committees, fiduciaries, donors, credit agencies, stock exchanges, financial publications, and/or any other parties.

Sec. 2.--To ascertain any other specific matters involving the financial records such as those arising in connection with fraud, costs, royalty agreements, inventories, prevention of operating losses, patent and copyright infringements, mortgage indentures, system installations, taxes, fire losses, listing, bonding, and the like.

Elaboration of Section 1

7. General Discussion.--The main objective of most audits is to verify the balance sheet, and/or profit and loss statement, and/or other statements, and report thereon so that those who are interested therein may feel confident that the figures before them are complete, trustworthy, and properly
drawn up so as to present a true and correct picture of affairs.

On other audits, such as where the client is a club, institution, estate, charity, hospital, or university, the verification of the financial integrity of the administration is likely to be of equal importance with the ascertaining of the correct financial condition, and/or profit and loss. In some instances it may be of greater importance than either of these two latter objectives.

8. Stockholders.—In England the stockholders very often elect the auditors for the ensuing year, but in America this excellent practice is largely unknown. There is no doubt but that in the United States the stockholders of today get from most boards of directors only those portions of the auditor's statements and reports which it pleases the directors to pass on. The writer affirms that the stockholders, as the OWNERS of the business, are entitled to first hand, unabridged information. Despite numerous objections that have been voiced to the contrary (such as the one which maintains that private matters would thereby be revealed to competitors), the auditor ought to address his report direct to the stockholders rather than to the chairman of the board of directors, or to an officer. Unfortunately, in most audits this can not be done.

The main use which a stockholder will make of the auditor's report is to determine from it how successful HIS business has been during the past period and to see what shape it is in at present. If the conditions are satisfactory, the stockholder will probably retain his stock holdings. If, however, the outlook is poor, he may sell out, or, if his holdings are substantial, he may try to change the management and/or the board of directors. In any case, it is the stockholder's inalienable right to know just how good or just how bad matters in HIS business really are. But the truth of the situation is that time and again officers and directors have disposed of their holdings long before the stockholders over got wind of an impending disaster, or, on other occasions, stockholders have sold out not knowing of a rich "melon" to be cut in the near future. On the other hand, however, the directors and executives have often anticipated this "melon" by buying up, at bargain prices, all of the available shares on the market.

1 Note.—See the Companies Consolidation Act, etc. at the end of this chapter.
2See Appendix C, Sec. 15-1.
3Resolved, That the Chamber of Commerce of the state of New York urges upon the directors of all corporations whose accounting methods are not under federal or state supervision but whose securities are dealt in publicly, to amend their bylaws to require that independent certified public accountants shall be selected by the shareholders; that the reports of such accountants shall be rendered in full to each and every director and be made available for inspection by the shareholders; and that the text of the accountants' certificate be spread on the minutes of the company and printed in the annual report; and, be it further

"Resolved, That the chamber recommends that all close corporations and firms as well as counties, cities and other political subdivisions which require substantial loans from financial institutions or others, inaugurate the practice of periodical audits by independent certified public accountants."

As it now exists, the auditors' report goes to the President, say, Under the authority of the Board, he prepares a report to the stockholders in which may be given those extracts from the auditors' report which are favorable. If possible no criticism in the auditors' report will be carried over by the President into his report to the stockholders.
9. Partners.-- In most instances an auditor is employed by a partnership to determine its financial condition, the results of its operations, to give it advice on various accounting and business problems, and to set forth the Partners' Accounts.

One very important benefit accruing to a partnership from an audit by a disinterested expert auditor is the minimizing of misunderstandings which often arise among partners as to their respective equities in the business. As these breaches are apt to destroy an otherwise profitable and harmonious business, many partnerships have wisely secured the continual services of a certified auditor in order to nip these dissensions in the bud. Whenever one partner has been assigned control over the office and the accounting records, or whenever there is an absentee partner, or a partner chiefly on the road as a salesman, the services of an auditor are well nigh a necessity in maintaining harmony.

10. Directors.-- The board of directors of an enterprise often desires a report from a certified public accountant so that it may be informed correctly as to the efficiency of the officers which it elected for the past period. Moreover, as personal liability is attached to directors for the illegal payments of dividends, the board is naturally desirous of being assured that the profits reported to it by its own chief accountant are in fact profits legally available for distribution. Then too, since the board of directors generally institutes the major policies of the business, it must be absolutely certain that the financial statements upon which it acts, be complete, trustworthy, and properly drawn up.

As a rule the company's accountant can not be relied upon to draw up these aforesaid statements and reports properly. Even though the internal accountant may be as competent as the auditor, nevertheless, it is generally true that his nearness to, and interest in, the success of the business, together with the intervention of "higher ups" etc., will prevent his drawing the same picture of the business that a disinterested expert will do.

11. Officers.-- The officers of a business may be interested in securing an auditor's certificate as a confirmation of the integrity of their administration during the period.

Moreover, if the officers have conducted the business successfully, the auditor's report will reflect it to the board of directors. If, on the other hand, the business is doing poorly or failing, the officers know that a competent auditor can be relied upon to help them by making one or more important constructive suggestions as to changes in financing, in costs, in production, in sales, and so on.

Again, the executive officials may engage an auditor in order to comply with a trust indenture of a mortgage. Many open-end mortgages, for example, require that no additional bonds may be issued by the company and approved by the bond trustee without the certification of an auditor as to the value of the new capital additions upon which the new bonds are to be based. Still other mortgage indentures require an auditor's certificate as to the correctness of the ratio of current assets to the current liabilities before the directors may declare a dividend.

On other occasions the officials may be interested in knowing to what extent their own accounting department is capable of presenting correct financial statements since important managerial policies are often initiated upon these interim reports. In such instances, these interim and special statements will generally be prepared by the company's accountant, but the yearly statements will be audited and perhaps prepared by a certified public accountant.
12. Errors—The prevention of errors is a major objective of practically every audit listed under this subdivision. A competent auditor will always seek to instruct the office force in the proper accounting principles so that errors will not be repeated. If an auditor on detecting an error simply corrects it without instructing (where possible) the clerk at fault in the proper accounting theory, he is accomplishing next to nothing, and is guilty of gross inefficiency. Moreover, although it is reasonable for the auditor to assume that the majority of the errors coming to his attention are due to ignorance, carelessness, or natural lapses of accuracy, nevertheless, he should always keep in mind the fact that "often what seem at first blush to be merely clerical errors eventually are found to be due to fraudulent manipulation."

Errors are customarily divided into errors of technique and errors of principle. An error of technique is a clerical error, as when an item of rent is erroneously posted to the advertising account, even though the debit in the book of original entry did read "rent". An error of principle, on the other hand, involves an incorrect application of accounting principles to the business transaction, as when the cost of a machine is expensed when it should have been capitalized.

In addition to errors of technique and errors of principle, there are also errors of omission and errors of commission. For example, if goods which were received on consignment are included in the inventory, there is an error of commission. But if, on the other hand, goods out on consignment are omitted from the inventory, there is an error of omission.

13. Bankers and Creditmen.---Owing to the very wide spread, and hence largely "unknown", clientele now-a-days, bankers and creditmen readily admit that financial factors are just as important and often more important than the few known personal factors in sizing up a credit risk. Time and again leading bankers have spoken to their respective associations on the importance of demanding certified statements of all borrowers who are allowed a substantial line of credit.

The following quotations are excerpts from the addresses of leading bankers, and show conclusively that the value of certified statements is fully appreciated.

"In passing on credits, a loan officer of a bank requires exact facts which can best be supplied by expert accountants. The progressive business making substantial profits is the one having a proper system of records and controls. A business such as this presents an audited statement and has no difficulty in obtaining proper credit accommodation. There are many cases where business men fail to obtain credit to which they may be entitled because of haphazard methods of recording their business transactions and failure to render audited statements."

"We strongly advocate and prefer to buy the paper of those concerns whose accounts are audited by established firms of accountants. --- It is our belief that the time is not far distant (1913) when the demand for an audit of all statements by certified public accountants of established reputation will be practically universal.

"We not only feel more comfortable with their business (those who have audits) but actually do give them a larger line of credit and better rate of discount by reason of the fact that we know their statement is unquestionably true.

"See the end of this chapter, "Bennett". Errors of principle, of omission, and of commission are often the most important in that they usually result in an erroneous profit or an incorrect balance sheet. Clerical errors may be of paramount importance as when, for example, an advertising budget is kept but is exceeded because an advertising charge was debited to salesmen's salaries.
"Every bank and trust company of the country is obliged to undergo expert examination at least once (and in many cases three times) each year. Their officers are obliged to make a sworn affidavit of the correctness of the statement, the banking laws making it a penal offense if they swear falsely."

One reason why a banker or creditman wants a certified statement is because a business is not usually able to prepare a correct financial picture of itself. Few business men can assume the detached attitude which the auditor maintains. Moreover, the client's accounting force is very often not nearly as expert as the auditor's force in matters of accounting principles and in drawing up correct statements wherein all accounts must be properly classified and exhibited, if the statement is to be worth the paper on which it is typed.

Few internal accountants, for example, would classify separately on the balance sheet notes payable given to trade from those given on bank loans. But all certified public accountants know the extreme importance of segregating these two distinct classes of note liabilities.

Then again, fraud in the form of deliberate misrepresentations causes tremendous losses to bankers sufficient in size to warrant their demanding certified statements for all sizable loans. Bankers and creditmen know this fact, but, strangely enough, many individual bankers and creditmen will take the attitude that whereas these losses certainly do happen each year with other bankers and creditmen they will not and cannot happen to them. It is simply a repetition of the same attitude which many persons have about carrying fire insurance or life insurance. Such people freely admit the yearly losses from these causes but somehow feel that they are immune from such losses.

What most bankers need to grasp is the point of view of those in their profession who are recognized leaders. These men have always sought to act as advisers to their clients, not as mere lenders of money. As one of them puts it, "We must insist upon our client's submitting to a real audit which is undoubtedly as beneficial to the client as to anyone else." That is, whereas it may appear that the insistence of a banker upon securing a certified statement is for his protection only, he may, as a matter of fact, be doing so largely because he knows that the client needs an audit which otherwise would never be made.

14. Investment Houses. Investment houses of good standing may be relied upon to investigate rather thoroughly from all angles those businesses whose securities they are to float. If an investment house were to recommend to its clientele a business which it did not recognize as being on the decline, its reputation would be irreparably injured if the decline occurred. This would be true despite the fact that the investment circular might have stated 'We believe that the above statements are from reliable sources, but we are not in a position to guarantee them.'

On several occasions, large investment houses have redeemed in whole or in part securities which they had floated, simply because the conditions under which the securities declined in value were very apt to be interpreted by the general investing public as due to negligence on the part of the issuing investment house. As the goodwill of an investment house is often its chief asset, its voluntary assumption at rare times of its clientele's loss is thus readily explained, even though it floated the issue in good faith and only after reasonable investigation. It is far better to stand a quarter-of-a-million dollar loss to clients in "making good" than it is to run the chance of having a valuable goodwill destroyed forever.

4See Appendix C, Sec. 6, -5a and 5b. 2 The Federal Securities Act (1933) will undoubtedly result in more calls by Investment House for Auditors' services. 3 It is realized, of course, that many disclosures in 1932-33 do not bear this statement out.
Most audits for an investment house, which is to underwrite an issue of corporation securities, consist of a verification of the amount of the individual yearly profits of the corporation for the past few years, together with a verification of the balance sheet as of a recent date. Occupied with this request the banker may ask the auditor to show the balance sheet after giving effect to the proposed financing.

15. Trustee and Executors.-- One of the many duties of trustees and executors is to file with the probate court an accounting of their financial administration of the estate. The manner of presenting this record to the court is generally provided for by state law. As trustees and executors are expected and entitled to employ experts whenever their own knowledge is insufficient to solve the problem at hand, auditors are often employed to install the accounting system, to supervise the keeping of the accounts, to vouch for the integrity of the administration, to prepare or verify the periodic statements, and to prepare or verify the legal exhibits to be filed with the probate court.

16. Receivers.-- This is one of the newest fields to which the public accountant is rapidly addressing himself. In the past, lawyers alone have been appointed as receivers since receiverships fall under the jurisdiction of a court, and since a receiver is required to know law. Recently, however, some auditors have reported that they have prepared themselves with the requisite legal knowledge and are being called upon to act as accountant-receivers. Other auditors have reported that they are being called upon to act in cooperation with the lawyer-receiver because the latter sees that there is a decided need for expert accounting knowledge of a kind which he himself does not possess.

The type of statement which an auditor is called upon to prepare in these cases is exemplified in part by a statement of Realization and Liquidation, and, a Statement of Affairs.

17. Donors.-- In organizations of a public or quasi public nature, such as certain charities, hospitals, universities, and the like, the obvious thing for the board of trustees or other governing body to do is to reciprocate public munificence and confidence by publishing the annual financial statements, and by having the integrity of the organization attested to by an unqualified auditor's certificate.

18. Credit Committees.-- Since in many instances a credit committee is merely a group of business men, together with possibly a lawyer, the need for an auditor both in an accounting and auditing capacity is self evident when one considers that in such a situation much and often complicated accounting is required. Moreover, the credit committee should radiate an atmosphere of integrity and impartiality in the performance of its duties by having its financial statements certified by a public accountant.

19. Efficiency of the Office Force.-- In general an office force is always more alert and efficient than customary if it knows that its work is going to be audited.

As most clerks feel that an auditor can and will find every error, it

While having no legal status in this country, the statement of affairs, as it is called, is used to serve certain purposes in connection with matters in solvency proceedings. Under English bankruptcy laws such a statement is required of every insolvent debtor. Its complementary schedule, known as the deficiency account, is also required. In this country the chief significance of these two forms of statement is found in the examinations set by the various governing boards of certified public accountants."--Kester, Vol. 2 (p. 644)
is but natural that they will be more careful and nectar with their work than usual. Moreover, as an auditor must inform the company's accountant of any delays due to a clerk's work being incomplete, this cause of annoyance is rarely experienced twice with the same clerk. So then, auditing has the salutary effect of keeping the work up to date, and of preventing errors. Then too, clerks in a large office know that their chief accountant will often ask the auditor either to confirm his (the accountant's) opinion of a certain clerk, or even possibly select for advancement some one whose work has impressed him as being laudable. The effect of this procedure is to create a body of alert and efficient clerks since promotion on the basis of real merit is a method which commands the respect of every office force.

Elaboration of Section 2.

20. General Discussion.—On many occasions an auditor is called upon to ascertain specific matters calling for a much less complete audit than that involved either in verifying the balance sheet, or in verifying the profit and loss statement, or in vouching for the integrity of the administration. Such work is often called an examination as distinct from an audit.

In the following paragraphs the nature and scope of a few of these limited examinations will be briefly described.

21. Fraud.—Although the detection of fraud seems always to be associated with money, the reader, and the auditor too for that matter, must remember that the term also applies equally well to the theft of goods, or to the manipulation of accounts upon the basis of which a bonus may be paid to an official and so on. Likewise, there is a prevalent notion among the general public that the detection of fraud is the main objective of all or most auditing. But any up-to-date auditor will state emphatically that he makes the detection of fraud only a minor objective in most audits unless indeed the audit is distinctly for the purpose of ascertaining the extent of fraud.

1 "It has been estimated that the loss due to embezzlement in the United States exceeds $125,000,000.00 a year. This loss to some degree falls on all business through high insurance, bad debts, and loss of trade." —Directory of Members (p.3), The Michigan Association of Certified Public Accountants.

2 The accounts may also be manipulated by one or more officials, without actual direct misappropriation of goods or money in order that the stockholders, investing public, bankers, etc. may not lose confidence in the waning or temporarily unfortunate enterprise. Again, a single official may be at the bottom of it all in an attempt to make his management appear successful to the directors and/or owners when it is decidedly otherwise. On other occasions the falsification of the books of account may be made under the direction of, or at least with the knowledge of, the directors so that dividends may be paid, taxes evaded, etc.

Since all of these frauds are the work of "the higher ups", they are very apt to be artfully concealed. Moreover, as the auditor is entitled under the rules of common law to accept the statements of responsible and trusted officials without penetrating investigation when the nature of the inquiry and the attendant circumstances are such that a reasonably prudent person would not be suspicious of the answer given, the fraud is likely to escape the auditor's detection unless he is more wary than usual. Finally, even should the auditor pick up a clue, he will undoubtedly be misled in his investigation by the reassuring false explanations and information given to him. Hence, it is axiomatic that the slightest trace of fraud involving an official is due notice that all information and explanations received from him and others is not valid without independent proof.
a defalcation known to exist, or unless the client especially requests him to make the detection of fraud a matter of special inquiry, or unless in the course of an audit suspicious circumstances develop.

Moreover, the general public fails to realize that few auditors are requested by their clients to make their examination extensive enough to uncover ingenuity or any reasonable degree of certainty. However, this is as it should be since a majority of employees and officials are honest. Then again, the expense of having auditors go over every entry in the books is far too costly a method of preventing and detecting fraud. The best procedure by far is to bond all employees of whatever rank (provided they handle cash, merchandise, securities, or the like), and in addition the auditor should be requested to make a test for fraud, the extent of the auditing to depend upon the system of internal check and similar factors.

22. Taxes.-- At times an auditor will receive a request from a client to ascertain the correctness of certain accounts for the purpose of computing the state or federal tax, or in order to press a claim for a refund, or in order to refute a claim of additional assessment. As the computation of the correct federal tax is often a difficult matter requiring a thorough knowledge of the tax law, the Treasury Department restricts the practice before the Board of Tax Appeals to licensed accountants—i.e., those who can meet certain federal requirements. As the sums involved in these tax cases are often very substantial, this field has often yielded the auditor his best remuneration, especially during and after the period of high war taxes.

23. Fire Insurance Adjustments.—Although no one expects that his business is going to suffer a fire loss, nevertheless, we all know that millions of dollars worth of fire losses are occurring yearly just as surely as death and taxes,—except that many fire losses are entirely preventible. Therefore, one of the purposes of an audit, and a very important one at times, is the aid which reasonably current certified statements give the client in substantiating his claims in case of a disputed fire loss. As insurance adjusters are not "lambs", the insured must PROVE his losses if he is not satisfied with the adjuster's settlement. Fortunate indeed, then, is the business which is in a position to produce recent certified statements as to inventories, sales, cost of sales, property accounts, and so on, in proof of its claims for additional compensation over that allowed by the adjuster.

24. Parties Having an Equitable Interest.— On occasions an auditor will receive an engagement from the owner of a patent or other right whose royalties may be based upon the sales, or upon some other basis which requires the services of an auditor. In this type of work the scope of the audit is very limited as when, for example, the auditor is asked to ascertain the exact sales of a particular article for such and such a period of time.

25. Prevention of Operating Losses.— Since the modern auditor has prepared himself in the basic essentials of production, distribution, finance, salesmanship, and personnel management, and since there passes under his observation various methods employed by many different businesses, the alert auditor as a result of this training and experience is in a unique position to act as a business analyst and counselor. The day of the auditor as a mere analyst of past performances is already far in the background. Leading auditors are everywhere endeavoring to render constructive services realizing that this type of advice is the most useful, the most appreciated, and the most remunerative.
26. System Installations. — Although stationary stores have many accounting systems and forms for sale, they are rarely satisfactory because they are not at all fitted to the individual requirements of the purchaser. Auditors install many accounting systems each year and will always continue to do so despite the stationer's ready made forms, however cheap they may be.

As a part of every job in installing an accounting system for a new client, the auditor will have to inspect some of the vouchers, examine transactions in various books of original entry, investigate the methods of purchasing, of production, of distribution, and of financing, and in various other ways become familiar with the business routine. And, after visualizing the statements needed by the executives, the auditor will then be in a position to design the accounting records to the peculiarities of the business.

B--THE ADVANTAGES

27. The Advantages of an Audit. — Although the advantages of an audit are very closely identified with the objectives thereof, they are nevertheless given at this time as the following points:

(1) After a general audit has been completed the certified public accountant, as a disinterested expert, can draw up a full and correct balance sheet, and/or profit and loss statement, and report, for use by directors, officers, stockholders, or any other similar parties.

(2) Auditing permits the certifying of statements which are invaluable to the debtor as a basis for securing a large loan from bankers, merchandise creditors, or note brokers. Moreover, banks which are members of the Federal Reserve System prefer the paper of businesses presenting certified statements.

(3) Auditing catches and also helps to prevent errors of principle, errors of technique, errors of omission, and errors of commission.

(4) Certified statements and reports result in an enlarged body of intelligent stockholders. Therefore new issues of securities are much more readily floated and sold at better prices.

(5) Published certified statements often dispel hostile or false public opinion, and may even squash the propaganda of labor agitators as to the existence of excess profits.

(6) In partnerships, auditing is a means of preventing misunderstandings and trouble which may arise among partners as to their respective equities in the business. Fraud by a partner is often caught at its inception or otherwise lessened. Silent or absentee partners can feel adequately protected by securing the services of a certified public accountant.

(7) Businesses periodically audited can be disposed of much more readily and at better prices than if they were not audited.

(8) Certified statements aid in settling fire losses more quickly and equitably than usual. They are invaluable in case of dissatisfaction with the amount of settlement offered by the adjuster.

(9) Auditing helps to prevent fraud.

(10) Auditing helps to detect fraud.

(11) Auditing increases the efficiency of the client's office force.

(12) Claims for over assessment of past taxes often result with a first audit, and the correct computation of present taxes is more certain.

(13) Auditing is advantageous as a means of reporting to the public as to the financial integrity of the management of public and quasi public organizations, committees, and institutions.

(14) Now-days auditors, being in a position to act as business counselors and analysts, endeavor to give advice in matters of finance, production, purchasing, salesmanship, costs, and so on, as a regular and important part of their auditing services.¹

¹See Appendix C, Sec. 14 - #19.
**ADDENDUM**

**English Companies Consolidation Act of 1908, as amended to 1927:**

Section 106. "Once at least in every year the directors shall lay before the company in general meeting a profit and loss account for the period since the preceding account or (in the case of the first account) since the incorporation of the company, made up to a date not more than six months before such meeting.

Section 107. A balance-sheet shall be made out in every year and laid before the company in general meeting made up to a date not more than six months before such meeting. The balance-sheet shall be accompanied by a report of the directors as to the state of the company's affairs, and the amount which they recommend to be paid by way of dividend, and the amount, if any, which they propose to carry to a reserve fund.

Section 108. A copy of the balance-sheet and report shall, seven days previously to the meeting, be sent to the persons entitled to receive notices of general meeting in the manner in which notices are to be given hereunder.

Audit: Section 109. Auditors shall be appointed and their duties regulated in accordance with sections 112 and 113 of the Companies (Consolidation) Act, 1908, or any statutory modifications thereof for the time being in force.

Section 113. The auditors shall make a report to the stockholders on the accounts examined by them, and on every balance sheet laid before the company in general meeting during their tenure of office, and the report shall state:

(a) Whether or not they have obtained all the information and explanations they have required; and,

(b) Whether, in their opinion, the balance sheet referred to in the report 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 their information, and the explanations given to them, and as shown by the books of the company.

**The Canadian Bank Act—1923**

(Sessions 10 – 14)

"10. It shall be the duty of the auditors to report individually or jointly, as to them may seem fit, to the general manager and to the directors in writing, any transactions or conditions affecting the well-being of the bank which are not satisfactory to them, and which in their opinion require rectification, and without restricting the generality of this requirement they shall report specifically to the general manager and to the directors from time to time upon any loans exceeding one per cent of the paid-up capital of the bank, which in their judgment, are inadequately secured, but this provision shall not be construed to relieve any director from the due and proper discharge of the duties of a director. The report shall be transmitted or delivered by the auditors to the general manager at his office and to each director at his last-known post office address, and the said report shall be incorporated in the minutes of the directors' meeting first following the receipt of the said report.

"11. The auditors shall make a report to the shareholders on the statement of the affairs of the bank to be submitted by the directors to the shareholders under Section 54 of this Act during their tenure of office; and the report shall state:

(a) Whether or not they have obtained all the information and explanations they have required."
(b) Whether, in their opinion, the transactions of the bank which have come under their notice have been within the powers of the bank;
(c) Whether, in their opinion, the statement referred to in the report discloses the true condition of the bank;
(d) Whether the statement is as shown by the books of the bank.

"12. The auditors' report shall be attached to the statement submitted by the directors to the shareholders under Section 54 of this Act, and the report shall be read before the shareholders in the annual general meeting.

"13. Any further statement of the affairs of the bank submitted by the directors to the shareholders under Section 55 of this Act shall be subject to audit and report, and the report of the auditors thereon shall state:
(a) Whether or not they have obtained the information and explanation they have required;
(b) Whether, in their opinion, such further statement discloses to the extent thereof the true condition of the bank.

"14. The auditors' report shall be attached to the further statement referred to in next preceding subsection, and shall be read before the shareholders at the meeting to which such further statement is submitted, and a copy of the statement and report shall be mailed to every shareholder at his last-known address."

Dominion Companies Act of 1908, as amended to 1927.

"Section 94a. (1) Every company shall at each annual general meeting appoint an auditor or auditors to hold office until the next annual general meeting.

(2) If an appointment of auditors is not made at an annual general meeting, the Secretary of State of Canada may, on the application of any shareholder of the company, appoint an auditor of the company for the current year, and fix the remuneration to be paid to him by the company for his services.

(3) A director or officer of the company shall not be capable of being appointed auditor of the company.

(4) A person, other than a retiring auditor, shall not be capable of being appointed auditor at an annual general meeting unless notice of an intention to nominate that person to the office of auditor has been given by a shareholder to the company not less than fourteen days before the annual meeting; and the company shall send a copy of any such notice to the retiring auditor, and shall give notice thereof to the shareholders, either by advertisement or in any other mode provided by the by-laws of the company not less than seven days before the annual general meeting;

Provided that if, after notice of the intention to nominate an auditor has been given, an annual general meeting is called for a date fourteen days or less after the notice has been given, the notice, though not given within the time required by this provision, shall be deemed to have been properly given for the purposes thereof, and the notice to be sent or given by the company may, instead of being sent or given within the time required by this provision, be sent or given at the same time as notice of the annual general meeting; Provided, however, that a person other than a retiring auditor may be appointed auditor of the company at an annual general meeting as hereinafter provided, upon a resolution passed by the votes of shareholders present in person or by proxy and holding at least two-thirds of the subscribed stock represented at the meeting.
The first auditors of the company may be appointed by the directors before the first annual general meeting, and if so appointed shall hold office until the first annual general meeting, unless previously removed by a resolution of the company in general meeting, in which case the company at that meeting may appoint auditors.

The directors may fill any casual vacancy in the office of auditors, but while any such vacancy continues the surviving or continuing auditor or auditors, if any, may act.

The remuneration of the auditors of a company shall be fixed by the company in general meeting, except that the remuneration of any auditors appointed before the first annual general meeting, or to fill any casual vacancy, may be fixed by the directors."

Detection of Errors. "Auditing" (p. 6), Bennett

"Errors may consist of:
1. Errors of principle
2. Clerical errors
3. Errors of omission
4. Errors of commission
5. Offsetting or compensating errors

"Errors of principle occur when transactions are recorded in a manner fundamentally incorrect according to accounting theory; they may be committed purposely or accidentally. They are most important as a class and may affect the accounts considerably; for their detection, the auditor should exercise the utmost care. If made intentionally, they may amount to falsification; but they may have been made unintentionally as well as due a lack of knowledge of correct accounting principles. Minor errors of principle may have no effect upon the final profit outcome, as where they arise from posting to a wrong account within the correct group thereof—as factory office expense to sales office expense, auto equipment to machinery, etc. Major errors of principle have a direct effect upon profits as reflected in the surplus, or upon the proper statement of asset and liability values in the Balance Sheet; they arise from capitalizing a revenue expenditure or vice versa, from valuing an asset upon an incorrect basis, from inadequate provision for depreciation and bad debts, etc. In order to discover such errors, the auditor should have an extensive knowledge of accounting, and should make a most thorough audit. Ordinarily, routine checking will not uncover errors of principle; only intelligent inquiry, analysis, and research discovers them. Frequently, it is difficult to convince the management they exist.

Clerical errors are common, but few books of account being free from them. They may represent items posted as debits instead of as credits or vice versa (as to these, the Trial Balance is out double the amount in question), transpositions of figures (causing the Trial Balance difference as to these being divisible by nine), carrying forward totals from one page to another in error, posting a debit to one account (as a customer's account) when it should have been posted as a debit to some other account (as another customer's account, etc.), etc. It is seen that certain of these errors affect the agreement of the Trial Balance, and must be eliminated before the latter can be placed in balance; others have no effect upon the Trial Balance and, even if not detected, may not cause the profit to be in error, or the Balance Sheet to be generally incorrect. Care should be used to see that an apparent clerical error is not really fraudulent; only experience teaches the necessary discrimination. On the whole, a reasonable test for these errors should be sufficient."
Errors of omission arise when transactions are omitted partly or entirely from the books of account intentionally or unintentionally. Where a transaction is omitted in part, the Trial Balance cannot be agreed; usually this type arises because of the non-posting of items. If an entire transaction is unentered, the agreement of the Trial Balance will not be affected; hence, detection may be a fairly difficult matter. These errors include such items as omitting invoices from the Purchase Record, delivering goods or rendering services but omitting to bill the customer, omitting provision for rent, salaries, interest, etc. Sometimes the balance of a particular account will indicate that an entry has been omitted; a comparison of the Rent account current year with the last may show a difference representing an outstanding current obligation; the examination of creditors' statements may prove the suspicion that the current purchases are less than they should be. Although the discovery of these omissions forms an important part of an auditor's work on an assignment and he is justified in spending a considerable time in looking for them, in a business where considerable reliance is placed upon internal checks for short-cutting the amount of the detail work that might be done, all errors of omission may not be discovered. On the other hand, if the plan of audit decided upon is complete, and is carried out thoroughly and efficiently, they should all be uncovered. Where a reasonable test for these errors uncovers some of considerable importance, whether or not further work should be done thereon depends primarily upon a hire contract with the client. Where errors of omission have been made intentionally, serious discrepancies may result in the accounts, and a fraudulent falsification thereof arises.

Errors of commission occur when transactions are recorded incorrectly, wholly or in part; therefore, they may involve errors of principle. On the one hand, the Trial Balance may not be affected; on the other, where partly incorrect, the Trial Balance may be cut to that extent. Usually, these errors are encountered in the Journals; their detection may cause considerable trouble.

Offsetting or compensating errors offset or counterbalance each other so that the total effect upon the Trial Balance is one of neutral tendency. They require the most careful attention since they are a dangerous type, and at times to detect, inasmuch as there is no evidence that they exist. The auditor should be certain none are to be found before passing a piece of work as correct. They may or may not affect the profit; if an error of one amount arises in a revenue account and another of equal amount in a Balance Sheet account, the Trial Balance will agree, but the profit will be incorrect.

In general, if some errors are discovered, unless a detail examination is in order, it seems that no need exists of having instructions revised so as to verify every posting, and no necessity arises of verifying every posting to discover such errors. Tests and account analyses carefully made, on the whole, seem sufficient for all purposes. (Note: The writer has taken the liberty to quote this passage at length because of its unsurpassed excellence.)
1. In England who generally elects the auditors? What are the advantages of this system to the stockholders? To the auditor?
2. What are the special problems of an audit of a hospital?
3. Why do partners employ an outside auditor?
4. What is a clerical error? Give an example of one.
5. Why should public organizations be audited?
6. Why does a stockholder want an audit report?
7. Why does a bondholder want an audit report?
8. Name the two main purposes of an audit.
9. What is an error of commission? Give an illustration of one.
10. Distinguish between a public accountant and a public auditor.
11. How could a manager manipulate for his own personal benefit certain accounts without stealing anything?
12. When the word examination or audit is used, why must there be a further explanation of the work done?
13. What is meant by an error of principle? Give three examples.
14. What types of businesses would find it valuable to publish certified statements? Why?
15. What is an error of omission? Give three illustrations.
16. How may a prior audit be of benefit in case of a fire loss? Make your answer definite.
17. If you knew that the statements which you were to prepare were to go to a certain banker or credit manager in town, what, if anything at all, would you do that you would not customarily do?
18. Why does a banker or creditman have to rely upon financial statements to a much greater extent than he did fifty years ago?
CLASSIFICATION OF AUDITS

28. Balance Sheet Audit. — A balance sheet audit consists of a verification of the assets, liabilities, and net worth, as at a specific date, together with a general examination of the profit and loss accounts, and in addition thereto an examination of the essential features of the accounting.

Or again, a balance sheet audit consists of "a review, analysis, and verification of financial transactions and value fluctuations sufficient to enable the auditor to certify to the existence of certain assets, liabilities and capital as of a specific date."

From these two definitions it should be observed that the auditor must prove in a balance sheet audit that the assets as shown by the books were on hand or otherwise properly accounted for; that there are no assets of the business which have not been recorded; that all of the assets recorded are in fact the property of the business; and that all of the assets are properly valued in accordance with sound principles of accounting. In regard to the liabilities, the auditor must ascertain that all of the liabilities are stated; that they actually exist; that they were properly incurred; and that they are properly valued. As to the networth section of the balance sheet, the auditor must verify the correctness of the capital stock and the surplus, particularly with reference to seeing that the proper heading and segregations are used.

In auditing the ledger accounts in a balance sheet audit, no one method of procedure is adaptable to proving the balances of the accounts. For example, in the case of certain assets, such as petty cash, the mere counting of the cash and current vouchers is often sufficient to prove the ledger account balance as at the audit date. And, not much more work is required, as we shall see, to prove the general cash balance by direct confirmation, although most auditors audit the cash book to some extent even though it is not strictly necessary in a balance sheet audit.

In auditing other types of assets, such as the machinery account, for example, it is necessary to analyze every entry in the ledger account in order to prove the correctness of the final balance. Again, in the case of

2 Prof. H. J. Bornhofft.

In instances where a partner (or partners) wishes to freeze out another partner, or where the officers and/or directors wish to freeze out other stockholders or discourage them so that they will dispose of their shares at a loss, the balance sheet may show as liabilities items which are not liabilities; and so on.

If they were not properly incurred, they are not liabilities. Thus the Illinois Corporation Act reads: "The directors shall be jointly and severally liable for the debts and contracts of the corporation in the following cases: (1) For assenting to an indebtedness in excess of the amount of the capital of the corporation, to the amount of such excess; (2) etc., etc."
prepaid advertising, the proof of the balance of the account, if it is charged with all expenditures during the period, is not arrived at by auditing every entry in the account, but by checking the balance against facts taken from vouchers evidencing expenditures for advertising yet to appear.

In brief, then, there is no uniform method for auditing the balance of a ledger account as of a specific date. As we have seen, the counting of a physical asset is sufficient at times, or every entry in an account may have to be verified, or on other occasions computations based upon the readings of vouchers may be sufficient.

While the above paragraphs are only a very fragmentary glimpse of auditing methods and procedures, they are required at this point, it is believed, in order to indicate more definitely the nature of a balance sheet audit.

In the first definition of a balance sheet audit, it should be noted that there is a reference to the profit and loss accounts. The idea expressed there is that certain profit and loss accounts must be examined in connection with, and to complete the verification of, the asset, liability, and net worth accounts. Thus, for example, in a balance sheet audit, the auditor must review the maintenance and repairs account for the entire period to see if there is included therein items which ought to be capitalized. At times the interest expense account may be analyzed to see if there are interest charges therein on items for which there is no liability shown on the books. The fraudulent understatement of liabilities is often detected by this very method of auditing. Or again, the sales account and the sales book may be vouched for the last few days of the period under audit, against the shipping records, and sales invoices in order to determine that a sale has been recorded for every shipment, and in order to determine that sales which are recorded as being made prior to the audit date were in fact shipped not later than the first or two in the new period. By using such methods as these to audit the profit and loss account sales, fraud and misstatement of accounts receivable, and of sales have been uncovered time and again.

These few illustrations might be multiplied at length, but they are sufficient to show that a balance sheet audit is usually incomplete without some analysis of certain profit and loss accounts in order to ascertain that the balance sheet is fully and correctly stated. But the auditor does not submit a certified profit and loss statement on a balance sheet audit, although, for the client's convenience, he may submit in the report one prepared by the company's own accountant, or one taken from the books without verification of the accounts.

As a part of every definition of a balance sheet audit, there is usually some mention of "an examination of the essential features of the accounting". These words have reference to the system of internal check of a business. "Such a system implies that the accounting records, methods, and details generally, of an establishment are so laid out that no part of the accounts or procedure is under the absolute or independent control of any one person; that, on the contrary, the work of one employee is complementary to that of another; and that a continuous audit is made of the details of the business." Or again, "An internal check is an accounting device whereby proof of the accuracy of figures can be obtained through the expedient of having different persons arrive independently at the same result. A proper system of internal check requires that the same result be obtained not only independently but also by employing a different method. The system of internal check provides a double safeguard as follows:

"(a) If totally different methods are employed in arriving at the same

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1Montgomery, p.67.
result, it is very seldom that errors of the same amount will be made both
persons making the calculation. Hence if the same result is obtained by means
of both calculations it is reasonable to accept the figures as being correct.

"(b) If two persons share the labor of making the calculations leading
to a given result, collusion on the part of those persons would be necessary
in order to force a balance so as to make an erroneous result appear correct.
Many persons who might otherwise be willing to falsify figures in order to
cover up the misappropriation of funds will be deterred from doing so when
collusion on the part of same one else is required."

Thus in large department stores, the chief accountant, through his
several accounts receivable controlling accounts, has a check by an independent
and different method over the thousands of individual customers' accounts
which are kept by a number of clerks. Again, if Z's work is strictly limited
to the cash books, and if Y's work is strictly limited to the keeping of the
accounts receivable subsidiary ledger (including of course the posting of
cash to these accounts), then two persons share in the labor of making a
complete accounting transaction; namely, the recording of the receipt of cash
and its entry in the customer's account.

In brief, in order to carry out a balance sheet audit,2 which is based
upon a limited amount of auditing, the auditor must satisfy himself that the
system of internal check is adequate. Thus the work of one clerk must either
be checked by another method (not duplicated) by another clerk, or used by
another clerk in such a way that neither clerk could make an error or commit
a fraud independently. If, however, the system is inadequate in any particulars, the auditor must remedy this deficiency by auditing these particulars
more extensively than usual. Thus, for example, if a system of internal
check on cash payments is poor, as when the treasurer signs the checks without
an approved voucher, the auditor must examine the check and the voucher
registers for several months even though he is making a balance sheet audit.

1Eggleston, p. 19.

2"_ Is any auditor in a position to give the ordinary
unqualified company balance sheet certificate if he has only conducted what
is known as a 'Balance Sheet Audit'? By this term I believe to be meant an
examination of the books at a certain date and a verification of the assets
and liabilities as appearing on the balance sheet. Personally I cannot under-
stand how with such a limited audit an unqualified certificate can be signed,
though I know there are many eminent Chartered Accountants who disagree with
me. One of the items either on the debit or credit side of the balance sheet
is the balance of Profit and Loss account, and in my view, nothing short of a
full audit covering the period from the date of the previously certified
balance sheet should satisfy the auditor as to this item.

"If in any case the system of internal check is such that an intelligent
examination of the composition of the Profit and Loss account is enough to
satisfy the auditor that the balance is correct, I do not necessarily regard
that as a limited audit, but in the absence of such a system I do not see how
a full examination of the records and transactions for the period can be
reasonably dispensed with."

The Accountant (Nov. 1923), H.L.H.Hill, F.C.A.
29. Detailed Audit\(^1\)-- The purpose of a detailed audit is to verify the income and expense items of the profit and loss statement as well as the assets, liabilities, and capital items of the balance sheet. For this reason a detailed audit covers a period of time, usually a fiscal period, whereas a balance sheet audit is as of the close of business on a specific day.

Moreover, although the detailed audit is called a complete examination, and although it goes into details of the business, nevertheless, the auditing is essentially limited to scrutiny, review, and tests. Rarely ever, it must be noted, is an auditor called upon to examine every entry and every supporting voucher and document.

In a detailed audit, the examination starts from a prior verified position since the exact profit or loss for the period under audit can not be ascertained otherwise. For example, if the opening inventories are not verified, the profit or loss for the current period has not been proven no matter how careful and how extensive the rest of the auditing has been. Again, if the plant accounts are not verified as of the opening date of the audit period, the current provision for depreciation has not been proven to be correct because one of the bases of each depreciation computation is the final balance in the plant account. Application of the same line of reasoning to prepaid assets, accrued payables, deferred income, liabilities, and so on, will show that each of these balance sheet items must be verified as of the opening date of the audit period, if the auditor is to certify that the profit and loss figure for the current period is correct.

Finally, in summary, the leading objectives of a detailed audit include not only those of a balance sheet audit but also the verification that the reported income is in fact income; that no income has been omitted; that no income has been included which belongs to another period; that all expenses were properly incurred; that all expenses have been included; that the reported expenses are in fact expenses; and that no expenses have been included which belong to another period.

30. Cash Audit\(^2\)--In a cash audit, the auditor must verify the opening cash book balance; he must see that all cash received has been recorded; he must see that the receipts have been properly classified as to debits and credits; he must see that the receipts have been deposited regularly; he must see that all expenditures were authorized; he must see that all expenditures have been properly classified as to debits and credits; he must see that all expenditures were proper; he must see that the Cash Book balance is in agreement

\(^1\)"Even though the majority of audits made by the large firms are said to be Balance Sheet audits, it is believed that the large portion of the cases handled by the smaller firms and by auditors working alone on their own account with a handful of assistants approach nearer the detailed type than the Balance Sheet kind. Under either condition, it seems that (a 100% pure) Balance Sheet audit is a rarity since, as mentioned previously, an unqualified audit certificate should not be granted unless the weak spots in a system have been covered thoroughly . . . . . Although the writer's experience is not believed to have been anything peculiar only covering what has happened to arise in the day's work of the general practitioner, in looking back through his audit plans for a series of years, during a period of some three and a half years not one audit was made which could be labeled a pure Balance Sheet examination; at times one matter, at others many, developed calling for a method of procedure to be applied to a specific point or points that could not be considered anything else but detailed in nature." —Bennet (p.66)

\(^2\)The purpose of a cash audit is to prove that the final cash balance is correct.
with the figures for the true receipts and expenditures; and, he must see that there was cash of this amount on hand, in banks, or otherwise accounted for.

As cash items weave into most transactions, and since fraud and errors are very often found in transactions that are not recorded in the cash books, the auditor must examine many other records than the cash books before he can certify to the correctness of the Cash Book balance. For example, in order for an auditor to know what cash should have been received in dividends during the period, he must prove, and make an analysis of, the stock investment accounts in order to ascertain what stocks have been held during the period. Or again, as he must certify to the propriety of the cash expenditures, the auditor must examine the supporting vouchers in addition to the checks. Likewise, he cannot tell how much should be received from accounts receivable unless he has audited the Sales Book.

These three illustrations are sufficient to show that if the auditor is requested to audit the Cash Book as is, or, if he cannot verify the correctness of the reported receipts or expenditures because of the inadequacy of the client's accounting records, or for any other reason, he has not made an unqualified cash audit. Moreover, he must protect himself in his certificate by stating exactly what responsibility he assumes as to the completeness of the cash audit.

Thus a complete cash audit is often a large and difficult assignment. In fact, as has been hinted, in many situations it is absolutely impossible for an auditor to attain all of the objectives of a complete cash verification. If so, the auditor must inform his client of the situation and protect himself by a carefully worded certificate descriptive of the work done and the responsibility assumed.

From what has been said as to the difficulties of making an effective, complete cash audit, it is evident that an inefficient auditor will have a thousand and one plausible reasons for not doing much of any auditing on the most difficult angles of the audit, but the competent auditor courageously pitches in to these difficulties until he is satisfied that NO ONE could do more than he has done.

31. Continuous Audit.—— If a detailed audit, cash audit, or balance sheet audit is worked upon at intervals during the year, the term continuous audit is applied to such work. Many advantages flow to the client from a continuous audit. Errors are corrected sooner; congestion and rush, incident to completing a year's work at one time, is avoided, resulting in the goodwill of the office force and the reduction of all kinds of errors; fraud is caught sooner; the client gets the auditor's constructive suggestions sooner; an excellent moral effect is created; the efficiency of the office force is kept at its best throughout the year; a closer relationship is created between the client and the auditor; and the final audit report can be rendered directly after the closing date so that it never becomes "ancient history".

There are, however, a few petty disadvantages to the client in a continuous audit, but they are wholly insignificant. For example, as the auditor will be on the job several times a year instead of only once, the client may feel that this is a disrupting factor. Auditors know that such need not be the case, if the client really wishes to cooperate.

From the auditor's point of view there are also many valuable advantages to be gained by him in securing continuous audits. As this type of audit distributes the work throughout the year, the terrible burden of the rush season, between November and March, would be lightened. As a direct consequence, the quality of the auditor's work would undoubtedly be improved to the benefit of both the client and the auditor. Moreover, as the auditor

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*A periodic audit is one made monthly, quarterly, semi-annually, annually, or at some other stated period, each one being complete in itself.*
would bill and receive his fees more regularly, and since more business could be handled with the same size auditing staff, the remuneration of the principals and their staff would be considerably enhanced. Finally, as noted above, the report is able to be delivered to the client while the information is still "current events". The importance of this attribute of a report is prone to be overlooked by many accountants; its importance, however, can NOT be over emphasized.

It is sometimes stated that in this type of audit the auditor runs the risk of having the figures which he has audited altered, either intentionally or unintentionally. In the writer's opinion the auditor can easily take care of this danger by noting on his work sheet the vouched and footed totals of the ledger accounts, Cash Book column totals, etc. as the case may be.

Another interesting point (interjected here) concerns the advisability of sending the same auditor continuously to a client. It is held by some that if he is, the audit procedure will become so well known to him that he is quite apt to proceed mechanically rather than thoughtfully and cautiously from one detail to another, and hence make a superficial audit. It is even held that he may be lulled asleep by the routine to such an extent that irregular matters, which would catch the attention of a fresh mind, will pass unnoticed. Moreover, those who favor alternating the auditor feel that he is not only thereby kept more alert on each audit, but that he also is able to get a richer experience by having conducted a wider variety of audits than would otherwise be the case. Finally, it is said that the auditor and the client's officers and office force will become too friendly to permit the auditor to conduct his audit with the independence, detachment, and thoroughness which are the very essence of an auditor's method of attack.

On the other hand, it is pointed out that an auditor needs all of the familiarity with a client's business and records that he can possibly obtain. Too much is impossible. Then too, this familiarity is said to enable the auditor to conduct his work with the minimum of interference with the client's time and his clerk's routine. Furthermore, as the audit can be conducted in less time, the cost to the auditing firm is considerably reduced. In practice, so far as the writer has observed, the same senior auditor and even semi-seniors and juniors are assigned to the same engagements from period to period in so far as this is practical. In the writer's opinion it is also the better procedure.

32. Completed Audit.-- A completed audit is one performed after the close of the audit period. Of course, some preliminary work may have been done prior to the audit date, but this fact will not take it out of this class of audits.

A completed audit may be either a balance sheet audit, a cash audit, or a detailed audit. It will be seen, therefore, that the completed audit is to be thought of as over against the continuous audit.

33. Other Audits.-- "Other audits" may be said to comprehend any examination made for a specific purpose other than those dealt with above. For example, if an audit is made of a certain few accounts in connection with the installation of a cost system, the writer would classify it under this heading.
CLASSIFICATION OF ACCOUNTANCY SERVICES

THE AMERICAN SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

Introduction to Second Report

"The report herewith presented contains a statement classifying, defining, and differentiating the various classes of services rendered by the profession of accountancy. Briefly, it is a Classification of Accountancy Services.

"No claim is made for the perfection of the classification. It was evolved from a study of five thousand engagements as they flowed through a practice office. It has been tested by application to twenty thousand additional engagements. Minor changes only resulted from the tests. Therefore, the classification bears the stamp of practicability.

"The need for a classification of this character becomes increasingly apparent as accountancy assumes a place of increasing importance in affairs of the business world. So numerous have become the outside interests which are concerned with accountancy and its products, that common understanding as to its functions, capabilities, duties and responsibilities are vital to the progress, success, and peace of the profession.

"A classification of accountancy services affords an intelligent basis for action in the following respects:

1. Negotiating with clients and arriving at a clear understanding as to the service to be rendered.
2. Administering practice; planning and supervising field work, reviewing reports, correspondence, judging performance on the part of members of the staff, compiling statistics of operation.
3. Contact with other professions or lines of activity; attorneys, bankers, credit men, engineers, appraisers, investment houses, etc.
4. Litigation, threatened litigation, controversies with clients concerning negligence, etc.
5. Publicity concerning the certified public accountant and his work.
6. "Instances are numerous of time and effort economized and of friction avoided by partners, principals, and staff, through the use of a common language afforded by the classification.

"The classification should serve not only as a means of assistance to the profession, but as a guide in the formulation of study courses designed for students who are preparing to enter the profession."

Third Report

To the Directors of The
American Society of Certified Public Accountants: July 9, 1931

"Your committee on Classification of Accountancy Services herewith renders this report supplementary to its reports of December, 1929, and of September, 1930.

"Following the publication of the report of September 5, 1930, other professional accounting organizations either continued to study the subject of classification or initiated such studies.

"See also Appendix C, section 23."
"Among such studies was one by a Joint Committee of the New York State Society of Certified Public Accountants. This Joint Committee consisted of the entire membership of the State Society's Committee on Classification of Accountancy Services and the Committee on Practice Procedure, with the Society's President as ex-officio member.

"The Joint Committee of the New York State Society considered not only the subject of accountancy service classification but also the very important related topic of auditors' certificates. Recently, this Joint Committee completed its labors and rendered its report to the Directors of the State Society. The following is quoted from the letter of transmittal of the Chairman of the Joint Committee:

"The joint committee recommends adoption of a classification and appropriate forms of certificates, to be promulgated as suggestions for the guidance of members and for such public educational value as the suggestions may have. Such action, the members of the committee feel, would tend to promote uniformity of thought and expression in the profession, to result in clearer understandings between accountants and their clients, to establish better working contacts with prospective clients and with those who have occasion to consider the services, reports, and certificates of public accountants, and to afford a better basis of judgment in case such services, reports, or certificates ever are questioned. Further, it is believed that the promulgation of a classification, with forms of certificates for the first time accompanying the specifications for various types of services, would have great educational value, not alone to instructors and students, but to all concerned. Finally, such action would mark a progressive stride in the development of the profession."

"The Joint Committee's report was received by the Directors and, in mimeographed form, was submitted to the members of the State Society for their information. The Board authorized the appointment of a subcommittee to confer with other accounting organizations with the hope that a report might be presented in the fall carrying the endorsement of both national accounting bodies and several State societies as well. The Joint Committee's report and the recommendations of the subcommittee will be acted upon at the annual conference of the New York State Society.

"Pursuant to the request of President Hermann C.J. Peisch, your Committee responded to a call from the Chairman of the New York State Society's subcommittee. Your Committee has thus had the benefit since the presentation of its second report, of the matured conclusions reached when a larger number of active committeemen are accessible to each other so that a freer oral exchange of opinion is possible. Your Committee appreciates that an accountancy classification to be effective should be acceptable to the entire profession of certified public accountants. It also appreciates that no two individuals can be in absolute verbal agreement with respect to all phases of so large and important a problem. The New York State Society's report on Classification of Accountancy Services is, in all essentials, similar to your Committee's report. Differences consist only in phraseology and in captions of the major classes of services. The suggested forms of certificates, which did not form a part of either of your Committee's reports, are a very valuable addition and are really an essential and practical part of a service classification.

"Your Committee, therefore, recommends to the Directors of The American Society, both because of the recognized need to secure uniformity among all organizations of professional accountants and because of the intrinsic value of the suggestions and additions made by the Joint Committee of the New York State Society of Certified Public Accountants, the adoption of the report here with presented in the form in which it will be presented by the
New York Committee to the New York State Society. Moreover, it is recommended that either your present Committee or a subcommittee thereof be authorized to cooperate with similar committees of other accounting organizations to the end that uniformity of service classification and appropriate certificates be attained as expeditiously as is consistent with thorough discussion and consideration.

Respectfully submitted,

Committee on Classification of Accountancy Services
Philip F. Alther,
Fayette H. Elwell,
Seth Hadfield,
Edward P. Moxey, Jr.
John R. Wildman,
Joseph J. Klein, Chairman.

PART A

CLASSIFICATION

The first five sections below relate to classes of service in which audit and examination procedures are the essential characteristics. Such services constitute the major part of accountancy practice. The sixth section contains information dealing in a more general way with a variety of services which may be rendered.

"Auditing, as used in a professional sense, may be defined as the procedure whereby one undertakes to pass judgment on the correctness of financial statements and accounts, by scrutinizing accounts, vouchers, documents, and other supporting records and data, corresponding, if necessary, with independent third parties, and orally questioning officials and employees.

"Auditing procedure may be used in connection with financial balances at the end of a given period and the financial transactions, for the period, which culminate in those balances; or it may be used in connection only with the balances at the end of a period.

"The term "transactions;", as used herein, is intended to mean any change affecting the accounts during a period. Accounts relating to income, expense, profits, and losses will be referred to as "operating accounts"; the transactions relating thereto as "operations"; those relating to cash receipts and disbursements as "cash transactions.

"A report usually is submitted at the conclusion of an audit or examination. A report presents the accountant's findings and conclusions and may contain an expression of the accountant's opinion in a formal statement commonly known as a certificate, either as part of the report itself or appended to the financial statements.

"While the engagements which constitute the major part of accountancy practice probably will fall into the first four classes suggested, it must be recognized that there will be instances in which the wishes of clients will dictate specifications of service which may overlap the clean-cut lines which have been set up to distinguish one type of service from others. It should be obvious, of course, that any suggestions for the guidance of practitioners in arranging undertakings with clients cannot be permitted to interfere with the free operation of a client's wishes with respect to the service to be performed."
Section 1. Examination of Financial Condition and Detailed Audit of Transactions for a Period. Short Title -- Detailed Audit:

"A detailed audit, sometimes referred to as a complete audit, has as its purpose substantiation by audit procedure of the correctness of the assets, liabilities (actual and contingent), reserves, capital, and surplus as at a balance sheet date and of all transactions for a period ended on the balance sheet date.

The audit report, addressed to the client, may take the form of a balance sheet, and a statement or statements of income and surplus for the period together, with comments in which a certificate may be incorporated. The certificate may be appended to the financial statements, provided that any essential qualifications are incorporated in the certificate.

Section 2. Examination of Financial Condition and Audit Tests of Transactions for a Period. Short Title -- Test Audit:

"A test audit has as its purpose substantiation by audit procedure of the correctness of the assets, liabilities (actual and contingent), reserves, capital, and surplus as at a balance sheet date, and selective audit tests of the transactions for a period ended on the balance sheet date. The character and extent of the tests will be governed by the circumstances of each case and should be so designed as to satisfy the auditor of the general correctness of the recorded transactions for the period, although such tests will not necessarily disclose every irregularity.

The audit report, addressed to the client, may take the form of a balance sheet, and a statement or statements of income and surplus for the period, together with comments in which a certificate may be incorporated. The certificate may be appended to the financial statements, provided that any essential qualifications are incorporated in the certificate.

Section 3. Examination of Financial Condition and Review of Operations:

"An examination of financial condition and review of operations while applicable to engagements other than those involving financing arises frequently in connection with the proposed issuance of securities, as in financings, mergers, consolidations, reorganizations, etc. This type of service has as its purpose substantiation by audit procedure of the correctness of the stated assets, liabilities (actual and contingent), reserves, capital, and surplus as at a balance sheet date, together with analytical review, comparison, investigation of questionable matters, statistical and other tests of the income, expense, profits and losses for a period (usually three to five years) ended on the balance sheet date.

The particular object of this type of service is to substantiate the representations made in respect to the organization under examination, with a view to determining that there is no overstatement of net assets or of net profits; that the net assets and net profits are at least as good as represented. It is not designated to detect lapses of fiduciary integrity or any understatement of assets which may have been concealed in the operating accounts.

An examination of financial condition and review of operations is distinguished from a test audit by omission of the audit of cash transactions, and by analytical study, comparison, investigation, statistical and other tests of the income, expense, profits and losses rather than by selective audit tests of the transactions reflected in those accounts.

The report on an examination of financial condition and review of operations, addressed to the client, usually contains a balance sheet, a statement or statements of income and surplus, a certificate, and, when used in connection with the issuance of securities, usually contains
statistical and other explanatory data which will be of assistance in interpreting the financial history and status of the company under review. Such report frequently is supplemented by a statement, or statements, duly certified, giving effect to financial transactions consummated, or to be consummated, subsequent to the date of the balance sheet. Transactions to which effect is given in the supplementary statements should be adequately confirmed.

Section 4. Examination of Financial Condition:
"An examination of financial condition has as its purpose substantiation by audit procedure of the correctness of the stated assets, liabilities (actual and contingent), reserves, and capital at a balance sheet date, and an analysis of surplus, including as an incident to the substantiation of the balance sheet accounts, examination of such transactions at or about the balance sheet date as may affect the stated financial condition. This type of service, while requiring examination of the records with a view to substantiating the assets as stated and affording reasonable assurance that there are no liabilities (actual or contingent) other than those stated, does not include audit of cash transactions, such as is required in a test audit, or review of the income, expense, profits and losses, as is required in an examination of financial condition and review of operations, and may not be relied upon to disclose lapses of fiduciary integrity or any understatement of assets which may have been concealed in the operating accounts. A report on an examination of financial condition, addressed to the client, may contain properly a certified balance sheet, but if a statement of income and surplus is included in the report, it should be qualified as having been prepared from the books without audit of the transactions for the period.

Section 5. Audits of Specific Accounts.
"This class of service may cover any particular account, or accounts, of which the following are examples:
(a) Cash
(b) Securities
(c) Payroll
(d) Manufacturing cost
"An audit report on an account, or accounts, falling in this group, may take the form of a statement of the account or accounts audited, together with comments in which a certificate may be incorporated, or the certificate may be appended to the statement, provided that any essential qualifications are made a part thereof.

Section 6. Other Services:
"This section should not be considered as definitive or restrictive, but as containing general information only of various activities which are considered to fall within the field of the public accountant. Miscellaneous activities in the nature of research, verification or constructive work should be designated in each case with accurate description of the work undertaken.
(1) Investigations of Specific Matters:
"Such investigations comprehend examinations of one or more specific features of a business and are undertaken usually in connection with such matters as suspected fraud, disputes regarding payments of royalties, etc., reasons for increases or decreases of profits, financial policies, determination of possible extent of civil liability, measurement of contract obligations, insolvency, bankruptcy, measurement of rate-making factors of utilities
and carriers, and other financial or administrative matters.

"In each case the accountant's instructions from his client should be specific as to the object of the investigation.

"The scope of each investigation is determined by its objects and the extent to which the accountant considers it necessary to go in order to accomplish those objects.

"The accountant's findings in an investigation usually are communicated to his client in the form of a detailed report.

(2) Preparation of Statements from Books or Records without Audit:

"Statements prepared from the books or records without audit should be made preferably on unwatermarked paper, bound (if at all) in a plain back, without any indication in the statements themselves or in anything attached to the statements that they were prepared by public accountants. If, on the other hand, watermarked or regular stationery is used, a footnote should be added to balance sheet or other statements showing that they have been prepared from the books of account without audit.

"In cases where it is necessary to include in a report any statements which have been prepared from the books without audit, or only partial audit, such statements should be marked under the descriptive heading and at the bottom, so as clearly to indicate that they were prepared from the books without audit or with only such audit as is indicated opposite the respective items, depending on the situation.

(3) Tax Services:

"Tax services may consist of:

Preparation for reviewing tax returns:
(a) From records which have been audited.
(b) From records which have not been audited.

Contesting assessments or prosecuting tax claims before tax officials or boards.

Preparing and rendering opinions on tax claims.

Acting as adviser or agent in tax matters.

(4) System Services:

"System services may cover:

(a) General accounting systems:

Devising and installing systems of account and of record.

(b) Cost systems:

Devising and installing cost-finding and reporting systems.

(5) Budgetary Services:

"Budgetary services may consist of investigation and survey work, formulating budget policies, designing budget procedures, and offering counsel with reference to budget policies and procedures.

(6) Opinions:

"This class of service consists of preparing and rendering opinions having to do with accounting and financial matters.

(7) Miscellaneous:

"This class includes services not comprehended in the foregoing classes, such as acting as liquidating trustee, as advocate in the arbitration of commercial disputes, as arbitrator in commercial disputes, as umpire in accounting controversies involving accountants, or clients, or as comptroller, auditor, or bookkeeper, giving testimony in court and arbitration cases,
interpreting financial data, rendering advice in accounting matters, preparing and recording bookkeeping entries, instructing bookkeepers, and checking statements, etc., etc.\textsuperscript{1}

\textbf{The Committee on Accounting Terminology of the A.I.A.}\textsuperscript{2}

(The following is a third classification of audits.)

**AUDIT**: An examination of the books of account, vouchers and other records of a public body, institution, corporation, firm or person, or of any person or persons standing in any fiduciary capacity, for the purpose of ascertaining the accuracy or inaccuracy of the records and of expressing opinion upon the statements rendered, usually in the form of a certificate.

In the absence of any expression defining the extent to which it has been limited, an audit is understood to be an examination of the subject matter or the accounting in all its financial aspects, including, so far as the several classifications of account may be involved, the verification of assets, liabilities, receipts, disbursements, income, expenditure, capital and reserves and their application; surplus and profits and their disposition, in such detail as may be necessary in the circumstances of each individual case to permit an unqualified certification of the statements rendered and of the accountability of the fiduciary parties.

In practice an audit is in many cases limited in varying degrees recognized by custom and indicated by qualifying expressions, the definitions of which are given below, as follows:

- Balance-sheet audit
- Cash audit
- Partial audit
- Special audit

Audits not necessarily limited in scope are frequently given other designations or descriptions, as follows:

- Complete audit
- Continuous audit
- Detailed audit
- External audit
- Internal audit
- Private audit
- Public audit

(See also "examination and investigation.")

**AUDIT, BALANCE-SHEET**: A balance-sheet audit consists of the verification, as of a given date, of the assets, liabilities, capital, surplus and all reserve accounts, including as incidental thereto such examination of the operations as may be necessary to give credence to the stated financial condition.

It does not include the detailed vouching of all receipts and disbursements or all details of income and expenditures, nor does it establish the accountability of the fiduciary parties, except broadly.

It should be accompanied by a report stating the nature and extent of the verifications which have been made, drawing attention to any items requiring explanation or comment, or by certificate stating the opinion of the auditor as to the correctness or incorrectness of the statement submitted, or by both report and certificate.

\textsuperscript{1}See chapter 5, question 7.

\textsuperscript{2}The Journal of Accountancy pp. 448-452--December 1927
AUDIT, CASH: An audit limited to the verification of cash transactions for a stated period, for the purpose of determining that all cash received has been brought into account and that all disbursements are properly authorized and voucher.

A cash audit is detailed in character but limited in scope. It is concerned with the sources of receipts and the nature of disbursements only to substantiate their accuracy. Such an audit establishes the accountability of the persons charged with responsibility for cash. A certificate may be given in appropriate form on a summary of the cash transactions for the period.

AUDIT, COMPLETE: One in which the examination extends to a verification of the details of all the books of account including subsidiary records and all supporting vouchers, as to mathematical accuracy, complete accountability and correctness of accounting principle. In modern practice such an examination is seldom made.

AUDIT, CONTINUOUS: One in which the detail work is performed either continuously or at short regular intervals throughout the fiscal period, usually at the shortest intervals (e.g., weekly or monthly) at which subsidiary records are closed and made available for audit in controllable form. Such "continuous" work leads up to the completion of the audit upon the closing of the accounting records at the end of the fiscal period.

A continuous audit differs from a periodical audit, even though the detail work be performed, for example, monthly, in that no report is made, except of irregularities detected and adjustments found to be necessary, until the end of a complete fiscal period, and, further, in that the certification of balance-sheet figures, as such, may be deferred until the fiscal closing.

A continuous audit is not necessarily a complete audit but may be limited in scope according to understanding and to meet the requirements of the case.

AUDIT, DETAILED: This is similar to a complete audit, but usually a series of tests is substituted for a complete audit of every entry.

An audit may be detailed and yet limited in scope, e.g., a cash audit.

The form of report will depend on the scope of the work, but, as far as the work goes, it will follow the corresponding portion of a report of a complete audit.

AUDIT, EXTERNAL: This term is not in common use but is occasionally used to indicate an audit by someone, such as a public accountant, external to the concern which is being audited.

AUDIT, INTERNAL: This term refers to an audit made by members of the staff of the concern audited. Frequently "staff auditors," "traveling auditors" or "inspectors" are employed to make continuous or periodical audits of some or all of the transactions. The scope is not definite, and their work is frequently supplemented by examinations made by public accountants.

AUDIT, PARTIAL: A term used to describe (a) a special examination of some portion of a set of accounts or records or of all the accounts for an incomplete period, such work being the subject of specific instructions describing and limiting its extent; or (b) more inexactly, a test of the detailed transactions made in conjunction with a balance-sheet audit.

AUDIT, PRIVATE: The use of this term is confined to British practice and is defined by Pixley as follows:

"Private audits may be divided into two classes: (1) where the auditor is instructed by his client to perform certain specified auditing duties which, when he has discharged them in accordance with such instructions, terminate such duties and at the same time his responsibilities; (2) where he is instructed by one or more individuals, who may be interested in some
business or estate, which although not registered under any act of parliament,
is nevertheless subject to some agreement or deed, or testamentary document,
and perhaps also subject to some act or acts of parliament and subsequent
legal decisions." Pixley's Accountants' Dictionary, p. 54.

AUDIT, PUBLIC: This is an English expression defined by Pixley as follows:
"Public audits are those which are carried out under the provisions
of an act or acts of parliament, or under the clauses of a royal charter.
In such cases the auditors are appointed in accordance with the provisions
of the act of parliament or of the royal charter, combined with special
regulations or by-laws made in conformity therewith, and although these
duties are not actually defined, the forms of the accounts which they
have to certify, either with or without qualification, are frequently
prescribed." Accountants' Dictionary, p. 54.

AUDIT, SPECIAL: "An audit made for any purpose other than the verification
or certification of statements of account presented according to regular
procedure at the close of an accounting or fiscal period. Such an examina-
tion may be one where specially exhaustive attention is given to detail,
or it may, on the other hand, be a sketchy examination of some limited
feature of the accounts. An interim or periodical audit made in the
regular course, however, is not a special audit.

EXAMINATION: Without some qualifying term this word has no definite
accounting meaning beyond that given by the dictionary. It is used in
accounting in conjunction with a statement of what has been examined.

INVESTIGATION: "An investigation, in the accounting sense, is a special
examination of books and records, in the course of which the auditor
selects and follows any lines of inquiry that seem to him most useful in
obtaining the specific information that is the object of the investigation.
As a rule some parts of the audit are stressed and some passed more lightly;
and reference may be made to records and books other than those that are
being investigated. The programme of work lies largely in the auditor's
discretion and is varied during the course of the work whenever matters
are found needing inquiry.

"An examination made for the purpose of financing, frequently cover-
ing accounts extending over a period of years which may or may not have
been previously audited, is commonly referred to as an investigation.

INVESTIGATION--SPECIAL: "The proper use of the word 'investiga-
tion' in connection with accountancy implies some particular object to be gained or
particular result stated, and indicates something different from an audit;
and it is seldom, if ever, necessary to qualify it by the addition of
'special' or any similar expression." 1

1 The audit classifications formulated by the above two committees should
be regarded as more authoritative and representative than those of any
single individual.
1. In what type of audit would every entry in the books of account be verified by a supporting voucher?
2. Distinguish between an audit and an examination.
3. Give a classification of audits with each type sufficiently separated by name to be clear to a fellow auditor.
4. What special uses are made of a profit and loss audit?
5. Why is it impossible to confine a complete cash audit to an examination of the cash book? Illustrate with several examples.
6. Define a continuous audit.
7. What is meant by "a general examination of the profit and loss account"?
8. What is meant by "an examination of the essential features of the accounting"?
9. Define a completed audit.
10. Define a detailed audit.
11. What are the advantages to the client of a continuous audit? To the auditor?
12. What is meant by a "system of internal check"? What is its bearing on a balance sheet audit?
14. Define a cash audit.
15. What is meant by preliminary audit work?
16. What kind of an audit would an investment house probably require of a client who is issuing a new series of bonds?
17. Why is it difficult to detect the misappropriation of cash by auditing only the cash book?
18. What is meant by "test" and "scrutiny"?
CHAPTER 4
THE TRAINING AND QUALIFICATIONS OF AN AUDITOR

35. General Discussion.

A - PRELIMINARY TRAINING

36. Curriculum.
38. Apprenticeship.

37. Business and Bookkeeping Experience.

B - QUALIFICATIONS

39. Ability to Analyze.
41. Constructive Ability.

40. Ability to Explain.
42. Professional Bearing.

Review Questions

35. General Discussion.—A public auditor and accountant is one who can be employed by anyone to prepare financial budgets, to prepare tax returns, to certify to the accuracy of financial statements already drawn up, to install accounting systems, to write-up books of account, to prepare financial statements and reports, to give advice on business problems of all sorts, and so on.

Whenever an auditor is engaged in writing up books of account, in installing a bookkeeping system, in preparing a financial budget, in preparing a tax return, and the like, he is acting in the capacity of an accountant. On the other hand, whenever an engagement requires an analysis, an examination of the financial books and records, the work is designated as auditing. For this reason many firms and individuals call themselves "Accountants and Auditors." 1

"Accountants and Auditors"—The caption "Accountants and Auditors" is often found on the stationery and/or on the window of the office door of a public accounting firm. To the layman this phraseology appears to be a mere repetition of the same thing, but to the initiated there is a real vital difference between the two.

In the early beginnings of the accounting profession the work of the public accountant was largely concerned with installing simple sets of books, with checking the arithmetical accuracy of the books of account, in writing up books of account, in getting trial balances to balance, in preparing statements from the general ledger without verification of the accounts, and in sundry other similar activities which are properly designated as "accounting" as distinguished from "auditing".

As a rule a large part of the work of most of the smaller public accounting firms still continues to be accounting. There are many businesses whose bookkeeper is unable to prepare the financial statements (or who is "stumped" when there is an unusual transaction or situation to be recorded, or who is unable to install a simple set of books). In such cases the auditor will NOT certify the statements which he has been called upon to prepare, if he has not audited the accounts. His sole duty is to render a report based upon the unverified figures of the trial balance given to him by the client's bookkeeper. (Blank paper and cover should be used in all such reports.)

On other occasions, the accountant may be called upon to install a
A - PRELIMINARY TRAINING

36. Curriculum. — Although auditing is concerned with business yet the practice of auditing is strictly a profession. A good definition of a profession is: "A profession is a calling which demands of its members a high order of intellectual attainment which can be acquired only by a long and arduous preliminary training." 1

As stated above, the present day auditor must prepare himself in the subjects of economics, business mathematics, taxes, commercial law, business English, production, personnel management, finance, distribution, salesmanship, and accounting. Of course, it is not expected that an auditor will be or needs to be equally efficient in all of these several branches of knowledge, or as expert in each of them as are various specialists. Nevertheless, as the day of the auditor as a mere checker of figures has long since passed, he must necessarily ground himself in certain of the above business fundamentals and become expert in others. After this background of training has been seasoned by years of auditing experience under the guidance of a certified public accountant, the auditor should be in a position to become an expert business analyst and counselor. Moreover, as the fundamentals of business are everywhere the same, the auditor with the above training and experience can readily adapt himself to any new audit engagement although it may be an absolutely new type of business to him.

37. Business and Bookkeeping: Experience. — If a young man has also had some business experience and has kept the accounting records of a business prior to getting on the staff of an auditing firm, he is in an admirable position as compared with others who have had only a training in theory.

There is a world of difference between knowing accounting and business principles and in being able to apply them. Moreover, the discipline which comes from having kept a set of books neat and correct, together with the concentration and accuracy demanded of one in order to "pull off" a correct trial balance, and correct list of balances for the controlling accounts, is excellent training for a prospective junior auditor.

38. Apprenticeship. — Although the desire to get into the profession for oneself as soon as possible is laudable, nevertheless, most anyone could spend several profitable years working for a certified public auditor. Indeed, one of the most direct routes of getting ahead on one’s own practice is first to get on the staff of an auditing firm of good standing. As such firms will have clients engaged in a number of different types of business, the junior (cont’d) simple set of books or to write up the books of account, and possibly to certify the statements which he prepares for them. Obviously, such work as described above is not auditing as will be seen as the content and nature of the latter is developed in the subsequent chapters.

H. Montgomery, p. 8. 2 The auditor does not need to know the technique of how to put over a sales talk, but he should know from his various audit engagements whether or not, for example, his most successful client (in the X line) is handling his sales through wholesalers, through door to door canvass, through locally owned warehouses, etc., etc. Furthermore, the auditor should have a clear idea of this client’s selling costs by major functions. When armed with such salesmanship facts as these, the auditor is in an excellent position to act as a business counselor to his less fortunate clients (in the X line). In doing so no breach of confidence will have been betrayed as long as the source of the information is not divulged. The information given is simply a part of the sum total of the auditor’s experiences.
auditor should be able to gain considerable knowledge as to how different businesses buy their goods, what sales policies and methods they use, how they deal with personnel problems, how they do their financing, and so on, throughout the whole gamut of business fundamentals. Moreover, the alert junior should be able to observe and profit by the methods and procedures used by the various seniors under whom he will work on the different audit engagements.

39. Ability to Analyze.—As auditing is essentially analytical work, an auditor must first of all have considerable analytical ability. His chief duty is not only to get at the facts exhibited by the maze of figures in the financial books and records, but also to get at the facts not shown on the face of the books. If the most that an auditor can accomplish is to certify that the balance sheet and profit and loss statement are in agreement with the books, he ought to withdraw because of incompetency.

What the business man, banker, and general public want is an auditor who can ascertain and present the real facts in a simple, understandable report. If the facts can be reasonably ascertained from the books and other information available, or by diligent inquiry, the auditor must be held responsible therefore for no matter what the figures in the financial books may show. Most persons are able to check vouchers against entries but only a few are able to tell at the end of their work what are the salient points which require correction, or what things or departments are in excellent shape. But the competent auditor, at the end of his work, has very definite ideas about the efficiency of each subdivision of the business. He will know, for example, that the financing of the business is in excellent shape; that the purchasing agent was not very successful this year in forecasting prices or in keeping the inventories to rock bottom levels; that the production manager had an unusually successful year; and that the credit and collection department is woefully incompetent.

40. Ability to Explain.—No matter how skillfully an auditor may have executed his work, no matter how clear a picture of the business he may have himself, no matter how valuable his constructive suggestions may be, if he cannot convey his ideas to others, so that they grasp and believe in them, his talents are lost.

Financial statements and exhibits are one of the main ways an auditor sets forth his ideas and opinions. The method of drawing up a statement is always flexible. There is a world of difference between a statement drawn up by an expert and a statement drawn up by a novice, although each one may have had the same figures and information to begin with. Too often a senior and even a partner will meticulously follow the same statement presentation which was used last period, item for item and word for word. To be sure, businesses want statements drawn up so as to be comparable from period to period, but this requirement still leaves ample room for an expert to display his deftness in bringing out points which last period were insignificant, and in relegating to the background those features which formerlycommanded attention.

The report is a second method by which an auditor puts over his ideas. It is at this point that he needs all the command of effective written English which he can assemble. Many an auditor is an expert in the field of auditing but only a miserable third rate in drawing up an enticing report. It seems that the type of mind which is excellently adapted to analytical work is not often blessed with the fluency demanded of a good report writer.
A report has to be written in a style that commands attention. In a large auditing organization, there may even be several men whose chief duty is to write or remodel all of the reports, and they are generally among the highest paid men on the staff. In a small organization the principal always helps to shape up the report.

Peculiarly enough, not many business executives will study a report; they want to read it. As figures are not naturally adapted to holding one's attention, it must be conceded that considerable art is required to give quality as well as zest to a financial report. But as it is being done by the most successful auditors, all who aspire to leadership in the auditing profession must recognize that the ability to write forceful and effective English is of paramount importance to a successful career.

As auditors are now suggesting and even being asked to present the audit report in person to the board of directors, to the banker, and to the creditman, a good command of oral English is most useful. The impression which the auditor makes at such meetings are either very damaging or very helpful to him. Considerable new auditing work has often arisen out of these contacts. Directors and bankers, having other important business interests than the one at hand, are always looking for an auditor who has ability to state his findings and constructive suggestions in a comprehensive manner. On the other hand, auditors have lost possible future engagements because of their poor oral presentations although their technique was known to be flawless.

41. Constructive Ability.—As auditing pure and simple concerns itself only with an analysis of past transactions, auditors at first confined themselves strictly to this sphere of activity. But the modern auditor by training and experience is able to act as a business counselor. In fact, many leading auditors feel that unless they are able on each audit to make at least one important constructive suggestion either on finance, or on costs, or on production, or on sales, and so on, they are at fault. This is in marked contrast to the attitude of many present day lesser lights who talk for months whenever they make a single successful suggestion.

Clients are very appreciative of any constructive suggestions that the auditor can make. They can discern a direct benefit from suggestions but look upon mere auditing as a dead overhead expense. For example, on one engagement the auditor learned that the client was being called upon to make good as an endorser of a dishonored note drawn for a substantial sum. This information pricked the auditor's ambition to see if he could be useful. After getting the facts, the auditor was able to point out that as the client had not been legally notified of the maker's refusal to pay the note, he (the client) could not be held on his endorsement. Naturally this advice was a great boon to the client since without a doubt the maker was well-nigh a bankrupt.

On another occasion, for illustration, the auditor was able to tell a client about a guaranteed belting (which was manufactured by another client) for driving machinery. Not only was the new belting more satisfactory than that used in the past, but it was also considerably cheaper, so that the total saving, especially in the minimizing of lost time due to breakdowns, ran into considerable money.

And so the list of illustrations could be multiplied to show that alert auditors are everywhere seeking to make at least one important constructive suggestion on each audit.

1See quotation at the end of this chapter.
42. Professional Bearing.— Professional bearing concerns such matters as dress, honesty, impartiality, courtesy, tact, courage, helpfulness, and the like. No one who wishes to assume leadership in his profession can afford to be indifferent about his personal appearance. To be sure, a clean shaven face and a pair of blacked shoes will not take the place of ability, but, nevertheless, everyone knows that they are important details if only from the point of view of building up one's own self respect.

Honesty not only applies to not stealing, but also to keeping secret those private matters of a client which the auditor has learned because of his trusted position. No better rule could be enforced by an auditing firm than that which strictly forbids its staff members to discuss a client's affairs in public. Too often auditors, while en route to or from the engagement, are apt to strike up a conversation about it. Sometimes an eavesdropper gathers important information therefrom.

Although an auditor's first duty is to his client, nevertheless, he has always to bear in mind his duty to the public, be it banker, stockholder, creditman, or other interested party. The value of an audit increases in proportion to the detachment with which the auditor views each matter calling for his professional opinion. As an unqualified certified statement is looked upon as the opinion of a disinterested expert, the auditor must make certain that IT IS an impartial verdict.

Many auditing firms have rules which absolutely forbid anyone on their staffs from fraternizing with anyone on a client's staff. Often a defrauder has gained the friendship of the auditor for the sole purpose of putting the latter off his guard. Time and again auditors have forgone digging into certain important or suspicious matters and have accepted the word of the defrauder friend as the equivalent. If no friendship had existed, the auditor would most certainly have challenged the defrauder's statements by asking for proof thereof.

The successful auditor is always courteous. Although there are times when the idiosyncrasies of clerks and executives are exasperating, nevertheless, the auditor gains absolutely nothing by giving vent to his feelings.

If an auditor is unable to get a client to see his point of view, he should never ridicule the client's supposed "dumbness". This is the correct point of view to hold even if one doesn't expect to get the audit again. Many a client has respected a discharged auditor's insistence on stating matters as he saw them, even to the extent of securing the auditor's services on another occasion. But no client would ever think of employing again an auditor who had resorted to ridicule.

The auditor simply must have the faculty of getting along with the client and his office force. The opportunities for friction are legion so that time which an auditor uses to assure a clerk that he is not trying to show him up, is time well spent.

If an office force dislikes a particular auditor, he might as well quit right then and there, even though he is blameless because somehow or other an antagonistic office force simply frustrates the auditing program by refusing to locate vouchers, by not knowing anything about matters which the auditor knows it is their business to know, and so on. It might be suggested that the auditor should report the matter to the chief executive, but if he does, the latter will naturally stand by his office staff since he can not afford to disrupt his organization. The net result will be that the offending auditor will be recalled to the office by his principal to be replaced by another auditor.

As some auditors hate to admit that there are some things about the business they are auditing which they do not understand, they will endeavor to bluff their way through. However, as office clerks are instinctively able
to sense sham, an auditor never loses an ounce of prestige by asking questions as long as they are intelligent ones.

Sometimes a clerk is antagonistic simply because he is not acquainted with the purposes and procedures of an audit. For example, the writer on being assigned to check up on a physical inventory, found that the factory clerks sent to aid him were beginning to revolt at having to go over the inventory a third time since they were pretty well worn out. When they were asked why they were thinking of quitting their jobs, they answered that they had already been checked up once by same clerks from the main office and that was good enough for anyone. When the writer explained to them at some length that auditors could not certify the audit without personally checking up on the inventory, and that it was positively not a case of the auditor's trying to catch something on them, the inventory clerks took hold again in splendid shape.

At times an auditor will have to differ with his client on certain very important essentials. This demands courage since an auditor often knows that such a stand will result in his losing the engagement, or at least not getting it again. If the client will not permit him to follow that which is demanded by professional ethics or current auditing practice, the auditor should unhesitatingly withdraw from the engagement. But before doing so, the auditor might profitably get another auditor's opinion on the point at issue to be certain that he is not simply arbitrary on some matter to which there are two points of view of practically equal weight and merit.

Finally, common sense and a sense of value and proportion must always pervade all of the auditor's work, just as they should in any other line of endeavor. Too many auditors, for example, are apt to spend their time in making a fifteen dollar adjustment, whereas they will leave thousands of dollars worth of inventories unchecked against the physical existence of the goods. What we need is more comprehensive auditing. This sounds like a brave statement when the congestion which now exists during the early part of the calendar year seems to call for less rather than more comprehensive work. It would seem that there is not enough time now for the proper verification of all important items. How can it be possible to do more rather than less detailed work than is now the case? The elements of pressure and congestion do not lend themselves to frequent changes in audit programs. The result is that the accumulated experience of many years, which should find expression in constructive suggestions, is not used by auditors to the fullest possible extent and there is a natural disposition to continue old methods. But it is entirely possible to cover the irreducible necessities immediately after the end of the fiscal period of each concern and defer to subsequent months matters which, in some respects, are of more importance than the balance-sheet items. Early publication of net results is highly desirable but I believe that the most valuable service which professional auditors can render is in reports which are not for general publication.

"Generally it is difficult for an auditor to arrange to do more than a small part of an audit in advance of the date of the balance-sheet, but it may be feasible for him to state, in the report which accompanies the certified balance-sheet, that he proposes to supplement his report by an investigation of certain items and the examination of certain methods in which no irregularities or insufficiencies are known but with respect to which he feels that he may be able to make helpful suggestions. This is a ser ice which can be rendered between April and December. The success or failure of the innovation depends on what the auditor can deliver in the way of money-saving suggestions. An unskilful auditor may not be able to make a valuable suggestion in each audit but an experienced and skilful auditor should be able to make at least one. It is difficult to make constructive suggestions
1. State some of the various kinds of accounting work which a public auditor performs.

2. Why does an auditor need analytical ability?

3. In what way or ways does an auditor use constructive ability?

4. Why does an auditor need to have a good command of both oral and written English?

5. Give a situation in which an auditor would need to know some fundamental of business law.

6. Why is some practical bookkeeping experience invaluable to an auditor?

7. Why is the "ability to explain" an essential qualification of a public auditor?

8. What is meant by professional bearing?

9. Why must an auditor be especially accurate with all kinds of mathematical calculations?

10. Why is it inadvisable for a person to start in as a public auditor directly after leaving school?

11. Why is the junior auditor who has had some previous business experience in a better position than his co-worker who has had none?

12. Give a list of the essential qualifications of an expert public auditor.

(cont'd) when working day and night on a balance-sheet audit, but in the leisure which follows, the auditor does not labor under the same handicaps. There is a corresponding demand for professional advice and service which cannot be rendered except by a comprehensive examination of the income account, the cost system and other phases of business life. If the auditor can so divide his service as to deliver routine and necessary reports within the prescribed time and constructive and desirable reports at a later time, he will help his clients as well as himself." --Montgomery, p.4.
CHAPTER 5

PROFESSIONAL ETHICS

43. The American Institute, and The American Society.

Review Questions.

43. The American Institute, and The American Society.—At this point a discussion of professional ethics is thought to be appropriate. And, as every accountant ought to look forward to being affiliated with the American Institute of Accountants, and The American Society of Certified Public Accountants, the rules of professional conduct of these two bodies are given in full.

THE AMERICAN INSTITUTE

RULES OF PROFESSIONAL CONDUCT

Including amendments prepared by the committee on professional ethics and declared effective May 16, 1929.

(1) A firm or partnership, all the individual members of which are members of the Institute (or in part members and in part associates, provided all the members of the firm are either members or associates), may describe itself as "Members of the American Institute of Accountants," but a firm or partnership, all the individual members of which are not members of the Institute (or in part members and in part associates), or an individual practising under a style denoting a partnership when in fact there be no partner or partners, or a corporation, or an individual or individuals practising under a style denoting a corporate organization shall not use the designation "Members (or Associates) of the American Institute of Accountants."

(2) The preparation and certification of exhibits, statements, schedules or other forms of accountancy work, containing an essential misstatement of fact or omission therefrom of such a fact as would amount to an essential misstatement or a failure to put prospective investors on notice in respect of an essential or material fact not specifically shown in the balance-sheet itself shall be, ipso facto, cause for expulsion or for such other discipline as the council may impose upon proper presentation or proof that such misstatement was either wilful or the result of such gross negligence as to be inexcusable.

(3) No member or associate shall allow any person to practise in his name as a public accountant who is not a member or an associate of the Institute or in partnership with him or in his employ on a salary.

(4) No member or associate shall directly or indirectly allow or agree to allow a commission, brokerage or other participation by the laity in the fees or profits of his professional work; nor shall he accept directly or indirectly from the laity any commission, brokerage or other participation for professional or commercial business turned over to others as an incident of his services to clients.

The student is instructed to send to the American Institute, to The American Society, and to the local C.P.A. society for a copy of its constitution and by-laws.
(5) No member or associate shall engage in any business or occupation conjointly with that of a public accountant, which in the opinion of the executive committee or of the council is incompatible or inconsistent therewith.

(6) No member or associate shall certify to any accounts, exhibits, statements, schedules or other forms of accountancy work which have not been verified entirely under the supervision of himself, a member of his firm, one of his staff, a member or an associate of this Institute or a member of a similar association of good standing in a foreign country which has been approved by the council.

(7) No member or associate shall take part in any effort to secure the enactment or amendment of any state or federal law or of any regulation of any governmental or civic body, affecting the practice of the profession, without giving immediate notice thereof to the secretary of the Institute, who in turn shall at once advise the executive committee or the council.

(8) No member or associate shall directly or indirectly solicit the clients or encroach upon the business of another member or associate, but it is the right of any member or associate to give proper service and advice to those asking such service or advice.

(9) No member or associate shall directly or indirectly offer employment to an employee of a fellow member or associate without first informing said fellow member or associate of his intent. This rule shall not be construed so as to inhibit negotiations with any one of his own initiative or in response to public advertisement shall apply to a member or an associate for employment.

(10) No member or associate shall render or offer to render professional service, the fee for which shall be contingent upon his findings and the results thereof.

(11) No member or associate of the Institute shall advertise his or her professional attainments or service through the mails, in the public prints, by circular letters or by any other written word except that a member or an associate may cause to be published in public prints what is technically known as a card. A card is hereby defined as an advertisement of the name, title, (member of American Institute of Accountants, C.P.A., or other professional affiliation or designation), class of service and address of the advertiser, without any further qualifying words or letters, or in the case of announcement of change of address or personnel of firm the plain statement of the fact for the publication of which the announcement purports to be made. Cards permitted by this rule when appearing in newspapers shall not exceed two columns in width and three inches in depth; when appearing in magazines, directories and similar publications cards shall not exceed one quarter page in size. This rule shall not be construed to inhibit the proper and professional dissemination of impersonal information among a member's own clients or personal associates or the properly restricted circulation of firm bulletins containing staff personnel and professional information.

1See the end of this chapter.
2See the end of this chapter.
(12) No member or associate of the Institute shall be an officer, a director, stockholder, representative, an agent, a teacher or lecturer, nor participate in any other way in the activities or profits of any university, college or school which conducts its operations, solicits prospective students or advertises its courses by methods which in the opinion of the committee on professional ethics are discreditable to the profession.

THE AMERICAN SOCIETY
OF
CERTIFIED PUBLIC ACCOUNTANTS

PRECEPTS OF PROFESSIONAL CONDUCT

A certified public accountant should exemplify the spirit of the Golden Rule in all his relations and observe these precepts of conduct in his professional practice, viz:

(1) Should exercise and display fairness and justice to the public as well as to clients.

(2) Should not prepare, sign, or certify any report or statement which contains an essential misstatement of fact or conceals such a fact as would result in the misrepresentation of the assets or liabilities, the solvency, the revenue, the income or profits, of any business or institution, or the relation thereto of any individual, firm, or corporation. Reservations or qualifications, if not set forth in the affected items of any statement, should be set forth in referenced footnotes thereon or in an appended and signed recital or certificate.

(3) Should not approve, sign, or certify accounts or statements which have not been verified under the supervision of himself or a person representing him in conformity with the next following precept.

(4) Should not allow or permit any person to practice as his representative who is not a partner or regular employee, or who is not a certified public accountant in good standing and regularly engaged in the public practice of accounting.

(5) Should not accept a retainer or perform any service or act which possibly might conflict with the interests of any client, without the knowledge and consent of such client.

(6) Should hold inviolate, as confidential, all information obtained from any client or from the records of any client, except as permission to disclose information is obtained from the client or as disclosure may be required by legal process in proceedings under a criminal law or the bankruptcy law.

(7) Should conduct himself so as not to come under suspension or disbarment by the United States Board of Tax Appeals, the Committee on Enrollment and Disbarment in the Treasury Department of the United States, by any superseding boards, committees, divisions, or tribunals, or by any department of a State government.
(6) Should not agree to allow, or allow or pay directly or indirectly, to the laity any commission or brokerage on, or other participation in, the fees, proceeds, or profits of his professional work.

(9) Should not agree to accept, or receive directly or indirectly, from the laity any commission, brokerage, or other participation for professional or commercial business turned over to others as an incident to service for a client except with the consent of and for the benefit of the client.

(10) Should not engage in any other occupation or business conjointly with his professional practice in such a manner as would not be compatible or consistent therewith.

(11) Should not solicit the client of another certified public accountant. This precept may not be construed to deny to any member the right to render service to any person, firm, or corporation specifically requesting it.

(12) Should not offer employment to any employee of another certified public accountant without first informing the latter of such intention. This precept may not be construed as inhibiting negotiation with any person who seeks employment on his own initiative or in response to a public advertisement.

(13) Should confine the holding out of himself as a certified public accountant to his right and privilege so to do under the laws of the State in which he is engaged in the public practice of accounting.

(14) Should not advertise in a manner detrimental to the dignity or other interests of the profession of public accounting.

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**ADDENDUM**

**Contingent Fees.**

"That the Louisiana State Board hereby notifies all holders of certificates issued under the authority of the state of Louisiana that from and after this date it will be considered as unprofessional conduct for any certified public accountant to accept employment on the basis of a contingent fee for services rendered a client."

**Advertising.**

"Whereas it is the consensus of opinion of the individual members of the District of Columbia Institute of Certified Public Accountants that the money now expended in display or professional card advertising in the directories is, at least in spirit, violative of professional ethics, and "Whereas the members of the Institute recognize that certain educational measures could be used to the benefit of the certified public accountant and his client; therefore be it

"Resolved that the District of Columbia favors and urges the individual members of the Institute to discontinue individual display or professional card advertising in the directories; and further

"Resolved that the District of Columbia Institute recommends the use of space in the classified section of the telephone directory for group advertising of an educational nature; and be it further
"Resolved that it is the consensus of opinion and the recommendation of the Institute that the Educational Advertising Campaign Committee be requested to give its consideration to the immediate development of a plan for the educational advertising so that if possible the plan can be approved at a special meeting of the Institute early in January, if that is thought necessary, and the advertising actually be gotten under way not later than January 10."

The following (taken from the Journal of Accountancy, July 1931, p.46 - names omitted) is given here as a sample of the findings of the Trial Board of the American Institute of Accountants.

AMERICAN INSTITUTE OF ACCOUNTANTS

TRIAL BOARD

"The council of the American Institute of Accountants sitting as a trial board in the Chamber of Commerce of United States at Washington, D.C., on Monday April 13, 1931, heard charges preferred by the committee on professional ethics and adjudicated them as follows:

A member of the council and his partners were charged with having sent a letter and pamphlet containing an address by one of the members of the firm to a bank which was not a client of the firm. The senior partner of the firm appeared before the trial board on behalf of himself and his partners. He expressed himself as out of sympathy with the Institute's rules against advertising and solicitation.

The trial board unanimously resolved that the members be found guilty and that they be reprimanded and required to refrain from any further acts such as that which was the subject of complaint.

Two members practising in partnership were accused of having published advertising matter contrary to the rules of the Institute and of displaying window signs which were offensive to good taste. Both members were found guilty. One, who had previously been accused of offences against the rules of conduct, was suspended for a period of six months. The other member who had previously offended and had promised to refrain from such practices in the future was reprimanded and discharged.

"... an associate of the Institute, of Columbia, South Carolina, was accused of advertising and refusing to conform to the requirements of the committee on professional ethics. The defendant was found guilty and suspended from the Institute for a period of six months.

".... were charged with a breach of the rules of professional conduct by preparing and certifying a statement omitting facts which amounted to failure to put prospective investors on notice in respect of essential and material facts not specifically shown in the balance-sheet which was the subject of the statement. The members concerned appeared before the trial board and answered the charges preferred against them. After a full hearing the trial board found that the rules had been violated, and ordered that the members thus charged be reprimanded."
REVIEW QUESTIONS

1. What is the gist of rule 3 of the American Institute?
2. What is the gist of rule 2 of the American Institute?
3. What is the gist of rule 6 of the American Institute?
4. What is the gist of rule 5 of the American Institute?
5. What is the gist of rule 11 of the American Institute?
6. What is the gist of rule 1 of the American Institute?
7. What is your opinion of the following?

"1. Years of study by various committees have failed to develop unanimity on what may be a proper classification.
2. The services which public accountants are prepared to render are so wide in scope and so varied in character that it is as purposeless to attempt to classify them as it would be to classify the functions of the physician or the lawyer. Each proposed classification of services has emphasized certain types of service at the expense of others, naturally reflecting the particular experiences of the members of the committee which prepared it. It is felt that every accounting firm and every individual practitioner would prefer a classification adapted to the type of practice in which he happens to be engaged, and that no standard classification would be applicable to all the practitioners in this country.
3. An attempt to define different types of audits is difficult and perhaps dangerous. Broadly, there may be said to be two types, the complete or detailed audit and one which deviates to any extent from the complete audit. Efforts to differentiate distinct types among the many possibilities of variation, for specific purposes, from the complete audit have been unsatisfactory because they did not reflect in true proportions the experience of representative practitioners as a whole.
4. Adoption of a classification of services which would not be universally accepted by members of the Institute would hardly be a substantial contribution to the profession. There has been doubt in the minds of some members of the various committees dealing with this question whether or not any particularly substantial purpose would be served by the classification.
5. Anything which might tend to standardize accounting services or to restrict even in the slightest degree the exercise of initiative, judgment and original thought by accountancy practitioners would be harmful rather than helpful. The exercise of judgment based upon experience and integrity is chiefly what the accountant has to offer the public.

"In short, it grew out of the discussion in the council that the possible advantages of adoption of such a classification were not sufficiently tangible and that the possible disadvantages were real and numerous." --A.I.A.
44. General Discussion. The legal responsibilities of an auditor have not been thrashed out to any considerable extent in American courts of law, but there are numerous English cases which set forth the rights and duties of public auditors.

As American courts will naturally look to English decisions for at least the basic principles upon which to decide any cases brought before them, we may confidently use the substance of the English decisions, plus known principles of common law in force in the United States.

45. Basic Principles.

(1) Material facts disclosed by an audit must be passed on to the client.

This statement means that the auditor is not at liberty to suppress any facts which his audit may uncover. The client is entitled to the undiminished benefits of the audit irrespective of the auditor's personal wishes, or negligence in reporting them. For example, if an auditor is at all suspicious of fraud, he must immediately disclose this fact to the client. It would be entirely improper for the auditor to wait until the next audit for more definite proof before reporting the same.

(2) An auditor is not permitted to communicate with third parties on any matter whatever involving a client unless he has first secured the client's permission to do so.

This prohibition is not limited to those cases of gross impropriety as where a confidential person broadcasts the personal business of his employer, but rather those cases where an uncautious person might be led to give information to a third party in the full confidence that no violation of ethics had been committed. For example, banker D might call upon auditor F to express his opinions on his client's (H) financial statements, which H has just presented to banker D as a basis for a loan. Auditor F, in an unguarded moment, might comply with banker D's request, especially if H's statements are favorable. If auditor F does express his opinion, professional ethics decree that he has been very indiscreet since he has not secured H's permission to talk over the situation with banker D.

(3) An auditor is entitled to use a basis of procedure similar to that adopted at law; namely, that all persons are assumed to be honest until proven to be dishonest.

In other words, an auditor is not a "bloodhound but a watchdog." In no sense whatever is he a detective even if one of his minor duties is to prevent and detect fraud. But on the other hand, he must show considerable aptitude in finding fraud especially among officials since these persons are usually in a position to easily misappropriate large sums because of their trusted offices.

The say so of an official on certain points in an audit may be

1See Review Question #1.
accepted by the auditor as the gospel truth, but in other circumstances the
say so of the highest executive must be proven independently. For example,
the auditor must not accept the president's say so in regard to the amount
of his salary, but the auditor may properly rely upon the president's
affirmation that three extra persons were employed in the office during
the month of January.

(4) If anyone holds himself out as being skilled in a profession, he
is charged at law with having that skill because "if he is not as expert as
he represents himself to be, he is committing fraud upon everyone who
employs him in reliance thereon."

Unfortunately one has to admit that a rigid application of the above
common law would disturb many public auditors from practicing. Nevertheless,
it is also true that most auditors are Far More Competent than the standard
required by the law.

(5) An auditor may and must, at times, withdraw from an audit for just
causes, but he is not at liberty to make known to the public the reason for
his withdrawal.

Since the public looks upon a certified statement as representing the
opinion of a disinterested expert, the auditor must always feel free to
withdraw from any audit engagement if he is not permitted to express his
professional opinions in the statements and report. Some few auditors yield
to pressure, but the majority courageously withdraw to the distinct credit
of themselves and of the auditing profession.

On the other side of the fence is the question of what to do where one
is employed to replace an auditor who has been dismissed. It seems to the
writer that the new auditor must insist for his own good on being told the
reason for his predecessor's dismissal even though that story is naturally
onesided. No auditor can afford to work in the dark, or undertake an
audit where the client hopes that something to which the first auditor
objected will slip by the new auditor's attention.

(6) On practically all audits except those where the purpose is to
determine the extent of fraud known to exist, and the like, test and scrutiny
are legitimate methods of auditing.

Montgomery explains those terms thus: "To test is to try by subjecting
to some experiment, or by examination and comparison; to subject to condi­
tions that disclose the true character." And again, "A test is an examina­
tion made for the purpose of proving or disproving some matter in doubt." In explaining scrutiny, the same auditor says, "That part of the audit which
is not covered by tests will generally be subject to scrutiny for unusual
and/or significant amounts which will be examined carefully." These methods of test and scrutiny are legitimate as long as they are
in the hands of an expert. A careful housewife does not examine every
huckleberry in a quart box, but she does have the fruit dealer turn the box
over. In brief, "by experience the expert auditor learns to eliminate un­
necessary work and to substitute therefore constructive work."

If every entry in the financial records of even a medium sized business
had to be vouched, the auditor would have two or three men on the job for a
very long time. Clearly, the cost of such an audit would be prohibitive.
Moreover, leading auditors maintain that they can accomplish just about as
much for the client by using test and scrutiny methods as by examining
every pecuniary detail.

(7) An auditor is held accountable for the arithmetical accuracy of the

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1 Montgomery, Page 523
2 Montgomery, Page 524
As this is an obvious and minor task, the writer will pass on to the next point without further comment.

(8) An auditor must get behind the maze of figures in the financial books and records and present the facts in an understandable manner.

If the books of account do not show all of the facts, the auditor is charged with getting hold of them if they can be reasonably ascertained from other records, by inquiry, and so on. In fact, if an auditor can not get at facts omitted from the book accounts, his audit is but the work of a semi-skilled person. In many audits, the chief reason for the auditor's being employed is to pick up additional assets, additional liabilities, and in other ways to round out a full and correct picture of the business such as only an expert could be expected to do.

(9) An auditor is by no means an insurer. All that he undertakes to perform his work in good faith and with reasonable care and skill.

As a court once said, "No man ever undertakes that the task he assumes shall be performed successfully and without fault and error. An auditor does not undertake with absolute certainty to discover any dishonesty and every mistake that exists or to protect the client against such things."

"The defalcations of the employee were not the proximate result of the negligence of the accountants. The loss was sustained by reason of the firm's faulty supervision of the employee, as the firm can not rely exclusively on the work of the accountants."

In brief, if a jury of auditors should hold that taking into consideration the scope of the audit and all other factors, the defendant auditor should have discovered the fraud, then the defendant auditor must bear the penalty of his negligence. But if the scope of the audit was limited, or if other circumstances were such that the fraud would not have been revealed if any auditor of average ability were substituted for the defendant auditor, then the defendant auditor is blameless. No auditor guarantees that his balance sheet audit, or even complete audit, will detect every ingenious scheme of fraud. To make auditors assume a position other than this is to make them assume the impossible and the unbearable.

(10) A third party may or may not be able to recover damages from an auditor if the latter has been negligent. As the following cases covers both situations thoroughly, it is given in considerable detail.

THE ULTRA MARES CASE

Ultra Mares Corporation v. Touche et al
Supreme Court, N.Y. 1929

"This action was tried before the court and a jury and resulted in a verdict for the plaintiff. Motions were made at the close of the plaintiff's case and again at the conclusion of the trial to dismiss the complaint upon which decision was reserved. After the rendition of a verdict a motion was made to set aside, as to which decision was reserved. Defendants are public accountants. In February of 1924 they were employed by Fred Stern & Company Inc. (hereafter referred to as Stern), to audit its books and prepare a balance sheet as of December 31, 1923. The audit was made and the balance sheet prepared. Attached to the balance sheet was a certificate of defendants attesting to their examination and certifying that the balance

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1 See final decision, Appendix C., Section 1.
sheet was in accordance therewith and represented in their opinion a true and correct view of Stern's financial condition as of December 31, 1923. Defendants negligently performed their work. The balance sheet prepared by them was incorrect and showed Stern to be a going concern with assets greatly in excess of liabilities whereas had defendants' audit been carefully made the balance sheet would have shown that Stern was insolvent. Defendants were not informed by Stern that the balance sheet was to be used by it for any particular purpose or that the same was to be presented to any particular person or persons. They knew generally that the same would be used by Stern to evidence its financial condition; that it probably would be exhibited to banks or to creditors or to stock brokers or purchasers or sellers; that balance sheets prepared by auditors are used for the purpose of securing credit and that the balance sheet furnished by them might be used by Stern to extend loans, secure credit and to induce banks and others to advance money to it; also that lenders to whom Stern might apply for loans would probably rely upon the balance sheet as indicative of its financial condition. Beginning in March 1924, and continuing for the balance of the year, plaintiff advanced to Stern large sums of money, relying upon the correctness of the balance sheet prepared by defendants. In the latter part of 1924 Stern was adjusted a bankrupt. Some of the moneys so advanced were not repaid to the plaintiff. It is to recover the amount of these unpaid advances that this action was brought. Negligence is not actionable unless there is a breach of duty owing by the defendants to plaintiff. There must exist between the party inflicting the injury on the one injured some privity by contract or otherwise by reason of which the former owes some legal duty to the latter. Contractually, defendants owed no duty to plaintiff because no such relationship existed between them, nor was there such privity between the plaintiff and the defendants as to impose upon the latter a liability to the former for their negligence in performing their contract obligation with Stern. While in this state a party may sue on a contract made expressly for his benefit, though he is not a party thereto, the doctrine has not been extended as to place upon the promises under a contract a duty to all who either potentially or incidentally may be beneficiaries thereof. The doctrine of beneficial interest is recognized as an exception to the general rule, which proceeds on the natural presumption that a contract is intended for the benefit of those who are parties to it, and therefore before a stranger can avail himself of its benefits he must at least show that it was intended for his direct benefit. The right of the beneficiary to sue on contracts made for his benefit is confined to a limited class of cases (Scavor vs Ranson 234 N.Y. 233) in which this neither categorically nor in principle is included. To hold that the defendants' duty extended not only to Stern but to all persons to whom Stern might exhibit the balance sheet and who would act in reliance thereon, would compel defendants to assume a potential liability to those for whose direct benefit, to defendants' knowledge, the work for Stern was performed (Savings Bank v. Ward 100 U.S. 195; Day v. Reynolds 23 Hun. 131; Clawatz v. Peoples Guaranty Search Co., 49 A.D. 465; Derry v. Peek, L.R. 14 App. Cas., 337; Le Lievre v. Gould, 1 Q.B., 491; Natural Wire & Steel Co. v. Hunt, 312 Ill. 245) The cases relied on by plaintiff are no authority to the contrary. In Glanger v. Shepard (in 233 N.Y. 236) plaintiff, to defendant's knowledge, was a direct beneficiary of the work performed by defendant. So also in the cases in other jurisdictions where liability has been fastened on abstractors, notaries, inspectors, as for negligently furnishing a certificate or performing work, it has invariably been shown that the work was to be performed or the certificate was made to the knowledge of the one performing the work, or issuing the certificate, that the
same was for direct use and benefit of the injured persons (Economy Building & Loan Association v. West Jersey Title Guaranty Co., N.J.L., 27; Denton v. Nashville Title Co., 112 Tenn., 320; Murphy v. Fidelity Abstract Company, 31 Mont., 448.) International Products Co. v. Erie R.R. (244 N.Y., 331) merely holds that a negligent statement when acted upon by one to whom a duty is owing may be the basis for the recovery of damages. McPherson v. Buick Motor Co., (in 217 N.Y., 302) is an extension of the doctrine of Thomas v. Winchester (6 N.Y., 397) as liberalized by Devlin v. Smith (69 N.Y., 476) and Statler v. Hay Manufacturing Co., (195 N.Y., 478). The rule in these cases is that a person supplying goods or machinery which may be used by others which articles were negligently made, are reasonably certain to place the lives and the limbs of others in peril, is under a duty to make same carefully, and the right to enforce liability for the manufacturer's negligence is not confined to the immediate buyer but extends to the persons or class of persons for whose use the thing is supplied. Liability in such cases is not held to rest upon contract or direct privity between the manufacturer and the persons injured but upon the general duty which the law imposes on every one to refrain from doing that which is dangerous to the lives and limbs of others. This doctrine has not been extended beyond personal injury cases as defendants were under no duty to plaintiff, no cause of action against them has been established, and hence the complaint must be dismissed. This determination renders unnecessary a consideration of the other grounds urged by defendant to set aside the verdict. Submit order on notice."

46. Extracts from Leading Cases.— The first nine principles above were abstracted mainly from the following cases.

In re The London and General Bank
(Accountants' Law Reports 2 Chancery 166 (1895) page 173)

"It is no part of an auditor's duty to give advice, either to the directors or shareholders, as to what they ought to do."

"As auditor has nothing to do with the prudence or imprudence of making loans with or without security. It is nothing to him whether the business of a company is being conducted prudently or imprudently, profitable or unprofitably. It is nothing to him whether dividends are properly or improperly declared, provided he discharges his own duty to the shareholders."

"His business is to ascertain and state the true financial position of the company at the time of the audit, and his duty is confined to that, but then comes the question: How is he to ascertain such position? The answer is: By examining the books of the company. But he does not discharge his duty by doing this without inquiry and without taking any trouble to see that the books themselves show the company’s true position. He must take reasonable care to ascertain that they do so. Unless he does this his audit would be worse than an idle farce. Assuming the books to be so kept as to show the true position of a company, the auditor has to frame a balance sheet showing that position according to the books and to certify that the balance sheet presented is correct in that sense. But his first duty is to examine the books, not merely for the purpose of ascertaining what they do show, but also for the purpose of satisfying himself that they show the true financial position of the company. This is quite in accordance with the decision of Stirling J. in Leeds Estate, Building and Investment Co. v. Shepherd. An auditor, however, is not bound to do more than exercise reasonable care and

The extent to which the auditor's position is different today than in 1895 should be elaborated by the teacher."
skill in making inquiries and investigations. He is not an insurer; he does not guarantee that the books do correctly show the true position of the company's affairs; he does not even guarantee that his balance sheet is accurate according to the books of the company. If he did, he would be responsible for error on his part, even if he were himself deceived without any want of reasonable care on his part, say, by the fraudulent concealment of a book from him. His obligation is not so onerous as this. Such I take to be the duty of the auditor; he must be honest — i.e., he must not certify what he does not believe to be true, he must take reasonable care and skill before he believes that what he certifies is true. What is reasonable care in any particular case must depend upon the circumstances of that case. Where there is nothing to excite suspicion very little inquiry will be necessary; and in practice I believe business men select a few cases at haphazard, see that they are right, and assume that others like them are correct also. Where suspicion is aroused more care is obviously necessary; but, still, an auditor is not bound to exercise more than reasonable care and skill, even in a case of suspicion, and he is perfectly justified in acting on the opinion of an expert where special knowledge is required. Mr. Theobald's evidence satisfies me that he took the same view as myself of his duty in investigating the company's books and preparing his balance sheet. He did not content himself with making his balance sheet from the books without troubling himself about the truth of what they showed. He checked the cash, examined vouchers for payments, saw that the bills and securities entered in the books were held by the bank, took reasonable care to ascertain their value, and in one case obtained a solicitor's opinion on the validity of an equitable charge. I see no trace whatever of any failure by him in the performance of this part of his duty. It is satisfactory to find that the local standard of duty is not too high for business purposes, and is recognized as correct by business men. The balance sheet and certificate of February, 1892 (i.e. for the year 1891), was accompanied by a report to the directors of the bank. Taking the balance sheet, the certificate, and report together, Mr. Theobald stated to the directors the true financial position of the bank, and if this report had been laid before the shareholders Mr. Theobald would have completely discharged his duty to them. Unfortunately, however, this report was not laid before the shareholders, and it becomes necessary to consider the legal consequences to Mr. Theobald of this circumstance. A person whose duty it is to convey information to others does not discharge that duty by simply giving them so much information as is calculated to induce them, or some of them, to ask for more. Information and means of information are by no means equivalent terms. Still, there may be circumstances under which information given in the shape of a printed document circulated amongst a large body of shareholders would, by its consequent publicity be very injurious to their interests, and in such case I am not prepared to say that an auditor would fail to discharge his duty if, instead of publishing his report in such a way as to insure publicity, he made a confidential report to the shareholders and invited their attention to it and told them where they could see it. The auditor is to make a report to the shareholders, but the mode of doing so and the form of the report are not prescribed. If therefore, Mr. Theobald had laid before the shareholders the balance sheet and profit and loss account, accompanied by a certificate in the form in which he first prepared it, he would perhaps have done enough under the peculiar circumstances of this case. I feel, however, the great danger of acting on such a principle; and in order not to be misunderstood I will add that an auditor who gives shareholders means of information respecting a company's financial position does so at his peril and runs the very serious risk of being held judicially to
have failed to discharge his duty.\(^1\)

"... We were told that a statement to that effect (The value of the assets as shown on the balance sheet is dependent on realization) is so unusual in an auditor's certificate that the mere presence of those words was enough to excite suspicion. But, as already stated, the duty of an auditor is to convey information, not to arouse inquiry, and, although an auditor might infer from an unusual statement that something was seriously wrong, it by no means follows that ordinary people would have their suspicions aroused by a similar statement if, as in this case, its language expresses no more than an ordinary person would infer without it.\(^1\)

"... A dividend of 7% was, nevertheless, recommended by the directors, and was resolved upon by the shareholders at a meeting furnished with the balance sheet and profit and loss account certified by the auditors, and at which meeting the auditors were present, but silent. Not a word was said to inform the shareholders of the true state of affairs. It is idle to say that those accounts are so remotely connected with the payment of the dividend as to render the auditors legally irresponsible for such payment. The balance sheet and account certified by the auditors, and showing a profit available for dividend, were, in my judgment, not the remote, but the real operating cause of the resolution for the payment of the dividend which the directors improperly recommended. The auditors' accounts and certificate gave weight to this recommendation, and rendered it acceptable to the meeting."—Lindley, L.J.

East Grand Forks v. Steel

(121 Minn. 296; 45 L.R.A. (N.S.) 205; 141 N.W. 161; Ann. Cas. 1914 C. 720)

"Defendants represented themselves as expert accountants, which implied that they were skilled in that class of work. In accepting employment as expert accountants, they undertook, and the plaintiff had the right to expect, that in the performance of their duties they would exercise the average ability and skill of those engaged in that branch of skilled labor. They were employed to ascertain, among other things, whether any irregularities had occurred in the financial transactions of the city clerk, and, if so, the nature and extent of such irregularities. If, from want of proper skill, or from negligence, they did not disclose the true situation, they failed to perform the duty which they had assumed, and failed to earn the compensation which plaintiff had agreed to pay them for the proper performance of such duty. The work of an expert accountant is of such technical character and

"Properly drawn up."—This implies that the different headings in the accounts submitted are proper descriptions of the items included thereunder; that there is no concealment of material facts, the knowledge of which is essential in enabling the present or prospective stockholders to form a judgment of the value of the investment, and the omission of which would be prejudicial to their interests. In deciding whether this requirement has been met, the auditor must recognize that there are often facts as to which it would be of interest and value to stockholders to be informed, but the public disclosure of which might damage the company and its stockholders, yet which in the opinion of the public accountant are perfectly proper transactions, and in the best interests of the company. The public accountant should be the best judge as to what should or should not be disclosed, and be able to satisfy his client that his views are correct and should be adopted." Dickinson, p. 236.
requires such peculiar skill that the ordinary person cannot be expected to know whether he performs his duties properly or otherwise, but must rely upon his report as to the thoroughness and accuracy of his work. . . . . . . The City is entitled to recover back the amounts paid, upon proving that, through the incompetence or the negligence of defendants, the report was in substance misleading and false . . . . . . . . . . . . . . . The damages claimed on account of the losses resulting from the defalcations of the clerk and the insolvency of his surety are too remote to be recovered, without showing the existence of special circumstances, known to defendants, from which they ought to have known that such losses were likely to result from a failure to disclose the true condition of affairs."

Re City Equitable Fire Insurance Co., Ltd.
(Decided by the Master of the Rolls, Lord Justice Warrington and Lord Justice Sargant in the Court of Appeal, 11th July 1924)

"It is said it was quite wrong to accept the certificate of the brokers, and we are asked to accept the evidence of Mr. Cash and Mr. van de Linde as meaning this, that you may accept the certificate of a bank apparently in all cases but you may never accept the certificate of stockbrokers. I cannot agree that the evidence is so to be read, or is intended by the witnesses to be so understood. What I think the witnesses meant to express was this: Banks in ordinary course do hold certificates of securities for their customers; it is part of their business, and therefore certificates in the hands of bankers are in their proper custody, and if then a bank is a reputable bank, a bank which holds a high position, you may legitimately accept the certificate of that bank because it is a business institution in whose custody you would expect both to find and to put securities, and also it is respectable, but the fact that it calls itself a bank does not seem to me to conclude the matter either one way or the other. On the other hand, it may be said that it is the duty of an auditor not to take a certificate as to possession of securities unless from a person who is not only respectable—I should prefer to use the word "trustworthy"—and also of that class of persons who in the ordinary course of their business do keep securities for their customers, and it may be said that a broker does not in the ordinary course of business keep securities for his customers, and therefore he is ruled out because the auditor ought not to accept from a person of that class, whether he be respectable or not, a certificate that he has got securities in his hands. Now accepting the rule as stated, that it is right to find the securities in the hands of the bank whose business it is to hold securities and applying the proviso that that bank must be one that is trustworthy, it seems to me that rule may be a right rule to follow, and I think it is prima facie, but it is going too far to say that under no circumstances may you be satisfied with securities in the hands of a stockbroker because it seems to me in the ordinary course of business you must from time to time, and you legitimately may, place in the hands of stockbrokers securities for the purpose of their dealing with them in the course of their business. With a large institution like the City Equitable Company, with a very considerable amount of investments to make, and investments to sell, it may well be that for the purpose of the convenience of all parties it may have been a useful method of business even if it had been examined with the most exiguous care, for the directors to decide that they would in the interests of their business leave securities of a considerable amount in the hands of their stockholders, who, I suppose, at that time held a position not less trustworthy or respected than the City Equitable itself. I therefore do not wish
In any way by anything that I say to discharge the auditors from their duties as laid down in the Kingston Cotton Mills case, far less do I wish to discharge them from their duty of seeing that securities are held and only accept the certificate that they are so held from a respectable, trustworthy and responsible person, be that person the bank or be it somebody else, but in applying my mind to the facts of this case I am not content to say that simply because a certificate was accepted otherwise than from a bank therefore there was necessarily so grave a dereliction of duty as to make Messrs. Langton & Lepine responsible. I think in the light of the evidence which has been given it is for the auditor to use his discretion and his judgment, and his discrimination as to who he shall trust, indeed I think that is the right way to put a greater responsibility on the auditors.

"If you merely discharge him by saying he accepted the certificate of a bank because it was a bank you might lighten his responsibility. I think he must take a certificate from a person who is in the habit of dealing with, and holding, securities, and who he, on reasonable grounds, rightly believes to be in the exercise of the best judgment, a trustworthy person to give such a certificate. Therefore I by no means derogate from the responsibility of the auditor, I rather throw a greater burden upon him, but, at the same time, I throw a burden upon him in respect of which the test of common sense can be applied, and common business habits can be applied, rather than a rigid rule which is not based on any principle either of business or common sense."

In re Kingston Cotton Mill Company
(Law Reports 1896 Chancery Division 1, p. 531)

"I come now to the real question in this controversy, and that is whether the appellants have been guilty of any breach of duty to the company. To decide this question it is necessary to consider (1) what their duty was; (2) how they performed it, and in what respects (if any) they failed to perform it. The duty of an auditor generally was very carefully considered by this court in "In re the London and General Bank," and I cannot usefully add anything to what will be found reported therein. It was there pointed out that an auditor's duty is to examine the books, ascertain that they are right, and to prepare a balance sheet showing the true financial position of the company at the time to which the balance sheet refers. But it was also pointed out that an auditor is not an insurer and that in the discharge of his duty he is only bound to exercise a reasonable amount of care and skill. It is further pointed out that what in any particular case is a reasonable amount of care and skill depends on the circumstances of that case; that is, if there is nothing which ought to excite suspicion less care may properly be considered reasonable than could be so considered if suspicion was or ought to have been aroused. These are the general principles which have to be applied to cases of this description. I protest, however, against the notion that an auditor is bound to be suspicious as distinguished from being reasonably careful. To substitute the one expression for the other may easily lead to serious error.

"The summary (of the inventory) was signed by the manager, and the value as shown by it was adopted by the auditors and was inserted as an asset in the balance sheet, but "as per manager's certificate." The summary always corresponded with the accounts summarized, and the auditors ascertained that this was the case. But they did not examine further into the accuracy of the accounts summarized. The auditors did not profess to
guarantee the correctness of this item. They assumed no responsibility for it. They took the item from the manager, and the entry in the balance sheet showed that they did so. I cannot see that their omission to check his returns was a breach of their duty to the company. It is no part of an auditor’s duty to take stock.¹ No one contends that it is. He must rely on other people for details of the stock in trade on hand. In the case of a cotton mill he must rely on some skilled person for the materials necessary to enable him to enter the stock in trade at its proper value in the balance sheet. In this case the auditors relied on the manager. He was a man of high character and of unquestioned competence. He was trusted by everyone who knew him. The learned judge has held that the directors are not to be blamed for trusting him. The auditors had no suspicion that he was not to be trusted to give accurate information as to the stock-in-hand, and they trusted him accordingly in that matter. But it is said they ought not to have done so, and for this reason: The stock journal showed the quantities—that is, the weight in pounds of the cotton and yarn at the end of each year. Other books showed the quantities of cotton bought during the year and if these books had been compared by the auditor they would have found that the quantity of cotton and yarn in hand at the end of the year ought to be much less than the quantity shown in the stock journal, and so much less that the value of the cotton and yarn entered in the stock journal could not be right, or at all events was so abnormally large as to excite suspicion and demand further inquiry. This is the view taken by the learned judge. But although it is no doubt true that such a process might have been gone through and that, if you think the fraud would have been discovered, can it be truly said that the auditors were wanting in reasonable care in not thinking it necessary to list the managing director’s returns. I cannot bring myself to think that they were, nor do I think that any jury of business men would take such a view. It is not sufficient to say that the frauds must have been detected if the entries in the books had been put together in a way which never occurred to anyone before suspicion was aroused. The question is whether, no suspicion of anything wrong being entertained, there was a want of reasonable care on the part of the auditors in relying on the matters on which information was essential. I cannot think there was. The manager had no apparent conflict between his interest and his duty. His position was not similar to that of a cashier, who has to account for the cash he receives, and whose own account of his receipts and payments could not reasonably be taken by an auditor without further inquiry." By Lindley, L.J.

"It is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable skill care and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective, nor as was said, to approach his work with suspicion or with a forgone conclusion that there is something wrong. He is a watchdog, but not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion he should probe it to the bottom but in the absence of anything of that kind he is only bound to be reasonably cautious and careful . . . . . . . . .

"It is not the duty of an auditor to take stock; he is not a stock expert; there are many matters in respect of which he must rely on the honesty and accuracy of others. He does not guarantee the discovery of all fraud . . . . . . . . . . The duties of auditors must not be rendered too onerous . . . . . . . . . . Auditor must not be made liable for not tracking out

¹As will be explained later, this is not quite so in today's audits.
ingenious and carefully laid schemes of fraud when there is nothing to arouse their suspicion, and when those frauds are perpetrated by tried servants of the company and are undetected for years by the directors. So to hold would make the position of the auditor intolerable." By Lopez, L.J.

'They do not say to the public; 'Let us examine your books and vouchers, and we will with absolute certainty discover any dishonesty, every mistake, that exists in those books, and we will protect you against that.' "--Court Instruction to the Jury

Deyo v. Hudson
(225 N.Y. 602; 122 N.E. 635)

'We think the damages cannot be said to flow naturally and directly from defendants' negligence or breach of contract. Plaintiffs should not be allowed to recover for losses which they could have avoided by the exercise of reasonable care.'

Sargent v. Mason
(101 Minn. 319; 112 N.W. 255)

"In an action for damages for breach of contract, the defaulting party is liable only for the direct consequences of the breach, such as usually occur from the infraction of like contracts, and within the contemplation of the parties when the contract was entered into as likely to result from its nonperformance."

Sungerties Bank v. Delaware & Hudson Co.
(236 N.Y. 425; 141 N.E. 904)

"But I think there is one fundamental rule which has been clearly established in the discussion of the subject, which is decisive of this case, and that is the one that the act of a party sought to be charged is not to be regarded as a proximate cause, unless it is in clear sequence with the result, and unless it could have been reasonably anticipated that the consequences complained of would result from the alleged wrongful act; that if the consequences were only made possible by the intervening act of a third party, which could have reasonably been anticipated, then the sequential relation between act and results would not be regarded as so established as to come within the rule of proximate cause." --Merrell and Finch, JJ., concur.

The contract of audit was not one merely to discover if inadvertent clerical errors had been made in the bookkeeping, but was one of protection of the plaintiffs' firm from their own failure to find any error in their books of account. This contract the defendants failed to perform. Admitting the neglect of the plaintiffs to discover the embezzlement and falsification of the accounts through an examination of the books on their own part, the defendants' work in pursuance of the contract, owing to the manner in which it was performed, failed to save plaintiffs from the consequence of such failure and neglect, which was the very subject of the contract."--Clarke, P.J. (dissenting)1

1The student should note that this is a dissenting opinion; i.e. it was NOT the one followed in deciding the case.
REVIEW QUESTIONS

1. Name and develop in several paragraphs 5 leading principles of common law and of court decisions in respect to a public auditor's legal duties and liabilities as embodied in the cases given in section 46 but exclusive of the ten given in section 45.

2. Do you agree with the decision in The Ultra Mares case? Give reasons for your answer.

3. Do you agree with the premises setforth in The London and General Bank case? Give reasons for your answer.

4. Does an auditor go beyond the verification of the figures in the accounts? Why?
CHAPTER 7

HOW TO BEGIN AN AUDIT

A - WHAT TO DO BEFORE THE FIRST INTERVIEW

47. Financial History.

B - THE FIRST INTERVIEW

49. General Discussion.
51. Purpose of the Audit.
54. Cost.
56. Vouchers.
58. What Kind of a Certificate?
60. Schedules.
61. Memorandum of Engagement.
63. Explanation of Plate 1.

PLATE 1 - A Memorandum of Engagement (1st type).

64. Explanation of Plate 2.

PLATE 2 - A Memorandum of Engagement (2nd type).

65. Explanation of Plate 3.

PLATE 3 - A Letter of Engagement.

Review Questions.

A - WHAT TO DO BEFORE THE FIRST INTERVIEW

47. Financial History - Before an auditor interviews a prospective client, there are many things which he can do which are not only very helpful in securing the job, but also necessary on certain occasions. For example, before an auditor interviews a prospective client who has arranged for a conference with him, he might find it very profitable to review the financial history of the business by referring to Moody, and/or similar financial services.

Such a review of financial services may show the auditor that the company is wholly or largely a holding company, or that the company has been running at a loss for several years, or that the inventory situation is the key to the company's success or failure, or that the company has a number of directors on its board who are known for their ability or lack of it, or that the current position of the company has been growing decidedly worse from year to year, or that there have or have not been other auditors, or that the company was just recently a partnership, and so on.

If the auditor does this, he ought to have a much more intelligent idea of what type of audit the prospective client probably needs, what are the outstanding auditing problems and business problems, what points he must insist on being allowed to examine to make a satisfactory audit, and also what special information (suggested by the accounts and other information stated in the services) he needs to secure from the client on this first interview, provided the engagement is secured. At the same time, the auditor cannot fail to make a good impression upon his prospective client because the client is bound to see from the discussion that the auditor has already interested himself in the business.

48. Treatises. - If the prospective client operates a type of business
in which the auditor has had no experience, it may be possible for the auditor to post himself with a general knowledge of the business by getting hold of a scientific treatise on the production process.\footnote{Thus if the new engagement is at a rayon plant, the auditor should ascertain where rayon comes from, how it is manufactured, and to what uses it is put. Many such treatises are to be found in The Journal of Accountancy.} As successful auditing cannot be undertaken as a thing detached from the physical operations, the value to an auditor of knowing what is going on in the factory cannot be overemphasized.

An auditor should frankly admit his unfamiliarity with the details of a business new to him, but he need not turn down the engagement, because the fundamentals of business are everywhere essentially the same. But once the auditor is on the job, he must diligently seek to master some of the details of the business. Of course, he will never have a knowledge of the business details anywhere near the extent of that of the executives nor does he need to. Nevertheless, the efficient auditor always makes it a point to learn something about his client's business on each succeeding audit.

B - THE FIRST INTERVIEW

49. General Discussion. - Although it is impossible to state in a specific way just what should be done in a first interview, the following suggestions are expected to be helpful in showing the reader some of the matters that might properly be discussed at that time.

50. Who is the Client? - It may be thought that the writer is making a mistake in saying that the auditor must be certain as to whom his client is, because surely that fact is always known. But cases at law prove that it isn't always known who the client is.

For example, in an audit for a board\footnote{Lansing, Mich., June 9. - Auditors employed by Senator Edward B. McKenna's committee investigating the Michigan State College have billed the State for $6500. Now the question is, where and how are they going to get their money.} of a municipality, make certain that the board has a legal right to have the audit made, and also that it has the funds with which to pay for it. A board may have the wherewith to pay for the audit, but certain political enemies, or the city counselor, may prove that the board is not empowered to expend funds for that purpose. Again, the board may engage the auditor on the strength of future funds which the legislature or city may not appropriate.

51. Purpose of the Audit. - Perhaps the first thing that will be discussed is the objectives which the prospective client has in mind for the auditor to accomplish. The aim of the audit is naturally set by the client, but the auditor must define the scope and amount of auditing required to accomplish this project.

52. Balance Sheet or Detailed Audit\footnote{Assuming a good system of internal check.} - It is at this point that the auditor generally has to explain to the client the essential difference between a balance sheet audit and a detailed one. If, for example, the client is having the audit made as a basis for negotiating a loan, a balance sheet audit will usually be in order,\footnote{See appendix C, Sec. 9 - #2.} but if the purpose of the audit is to determine the reasons for the past year's loss, a complete audit may seem best.

Moreover, as many business men often have the detection of fraud in mind as a major objective, the auditor will do well to discuss this matter thoroughly, so that both the client and he may be in agreement thereon. And, in the report itself, when rendered, the auditor should state clearly what responsibility he assumes at this point.

53. The Report. - Among other things that the auditor will need to
discuss is the question of how many copies of the report, if any, are required; when they must be delivered; and to whom they are addressed. In certain instances the answer to these questions will have a vital bearing upon the cost of the audit, or upon the arrangement of other auditing engagements already contracted for with other clients. If, for example, the audit is to be made during a dull period, the auditor may legitimately set the price of the audit with this fact in mind. Or again, it may be necessary to rearrange the order of doing certain other audits in order to make room for this new one.

54. Cost. - An experienced auditor will always take up the matter of compensation as early in the interview as seems expedient. On broaching this subject the auditor may find that the client has in mind the price of an audit given to another business by another firm of auditors. The auditor should anticipate instances of this kind by having at hand effective reasons showing that there is absolutely no way of comparing the value of one audit with that of another on the basis of "So and so had an audit and we want one like it for the same price." It should be fairly easy to convince any reasonable person that auditing is a profession whose services cannot be measured and valued like commodities. Obviously, an opinion might be given in ten minutes which will save a business $5000. But who would maintain that a bill ought to be rendered for only ten minutes time at such and such a price per day of eight hours?

The history of auditing fees is somewhat as follows. In the infancy of auditing, auditors had to meet the insistent demand of business men for a flat fee price. The acceptance of these demands took auditing clearly out of the realm of a profession into the realm of business. But as the pioneer auditors were confronted with a fact and not a theory, they had to lower their professional colors in this respect for the time being. However, it is doubtful if many clients got more than they paid for, since human nature everywhere is such that corners will be cut to make each job yield a profit.

The second stage of advancement was gained when business men in general recognized the legitimacy of day rates. One auditor states the situation this way, "I tell a client that auditing is a profession. One cannot estimate the product of the mind like that of manual labor. No one thinks of getting a physician to say how much it will cost to get well. It simply isn’t done. Moreover, the client may rest assured, I tell him, that since I want his work in the future, much more than this one particular engagement, I certainly am not foolish enough to render an exorbitant bill. If he still insists on a flat price, I say, ‘All right, let’s see. As you certainly don’t want me to do your work at a loss, I’ll have to overestimate the probable time considerably as it is absolutely impossible for me to foresee what difficulties will arise. That being so, don’t you think that it is clearly to your advantage to pay me per diem rates and discharge me at the end of the audit if you are not satisfied?’ As a rule, most business men see the fairness of this proposition and agree to per diem rates."

The third and last stage of development which is making some headway is that of charging what the traffic will bear. Lawyers have rendered bills on this basis since time immemorial. When rightly understood and applied, it is not a holdup scheme, but simply a recognition that if $10,000 is saved by a day’s work, that day’s reward should be greater than one whereby only $100 is saved. Montgomery has a court quotation which states the situation thus: "The circumstances to be considered in determining the compensation to be recovered are the amount and character of the services rendered; the labor, time and trouble involved; the nature and importance of the litigation of business in which the services were rendered; the responsibility imposed; the
amount of money or the value of the property affected by the controversy, or involved in the employment; the skill and experience called for in the performance of the services; the professional character and standing of the attorney; the results secured; and whether or not the fee is absolute or contingent, it being a recognized rule that an attorney may properly charge a much larger fee when it is to be contingent than when it is not. The financial ability of defendant may also be considered by the jury, not to enhance the amount above a reasonable compensation, but to determine whether or not he is able to pay a fair and just compensation for the services rendered, or as an incident in ascertaining the importance and gravity of the interests involved in the litigation. But what is a reasonable fee must in a large measure depend upon the facts of each particular case, and be determined like any other fact in issue in a judicial proceeding. While opinions are receivable and entitled to due weight, the courts are also well qualified to form an independent judgment on such questions, and it is their duty to do so. (6 C.J. 75C)

Again, one auditor says, "More and more I am dissatisfied with auditors who give per diem rates as if the ability of all seniors, or managers, or partners were alike, or if each engagement required the same skill. Where-in is skill and excelling to be rewarded if business men get the idea that all men of a certain nominal rank are to be paid alike? As for me, I have seen to it that my auditing has been constructive as well as analytical. I have time and again rendered bills without any statement of the time and price of the juniors, semiseniors, seniors, and partners employed on the audit."

55. Place of Work. — It may be thought that an auditor can always get a convenient place in the client's office to work, but the writer's experience as a junior on the staff of a New England auditing firm does not bear this out. In two instances he was obliged to stand up every day at a high desk. On another occasion, the auditors were assigned to an enclosed inner room where the only light was electric. In all of these instances the writer feels positive that it was simply a case of the senior auditor's being too weak kneed to insist upon reasonable working conditions.

If the auditor will take up this matter of a good place in which to work at the first interview, no trouble whatever will be experienced in securing adequate attention on this point, but if the matter is overlooked the chances are that the auditor's working conditions will not be as good as they would have been, and possibly even decidedly poor.

56. Vouchers. — In regard to vouchers, many auditors arrange with the client whereby his clerks will get them out of the files and put them in the order called for by the voucher register for the particular months that are going to be tested.

At first the client may murmur at this request and say that his clerks are already too busy to tackle such a large additional undertaking. But as these last few words are the truth of the matter, the auditor will point out that since it does take such a long time to "pull" the vouchers, sort them in order, and refile them, the fee which the auditor must charge (at auditor's rates) for this purely clerical work is going to be rather burdensome. As this statement is so obviously true, few clients will still insist on having the auditors pull, sort, and refile the vouchers.

Of course, if the vouchers are only few in number and readily accessible, the auditor will generally do this work himself.

Another important angle for the auditor to consider in this matter is

Montgomery, Page 43.
this. If at any time in the future a voucher should be missing or found to be misplaced, the auditor will most certainly blame it, even though he definitely knows that he couldn't possibly have handled any of the vouchers in that section of the files.

In brief then, the auditor's motto should be: "Let the office clerk who tends to the voucher files, pull and refile the vouchers."

57. Preliminary Work. -- Since a great deal of preliminary auditing work can be gotten out of the way before the audit date, the auditor will practically always arrange for it.

This procedure is beneficial to the client since it makes it possible for the auditor to render his report nearer to the audit date than would otherwise be possible. Naturally the "fresher" the audit report is, the more vital and interesting it is.

Moreover, if the client's clerks are making errors, these will be caught sooner; if the auditor has any constructive suggestions to make these will be given at the time they mature; and, if fraud is taking place, it may be detected earlier.

At the same time the auditor, himself, also reaps an immense benefit from this arrangement for preliminary work since it smooths out his working load, and also often supplies him with something to do in the midst of the customary dull period. He also shares indirectly in the benefits gained by the client; for, if the audit report is "fresh", it is more readable, more useful and more vital to the client. That is, whereas the client may formerly have looked upon the audit report as more or less ancient history required by his bank, he is now likely to look forward to it as a very useful current chart by which to map out plans for the immediate future.

58. What Kind of a Certificate? -- Still another point to be covered in the first interview will be the kind of certificate which the client wants. This refers not so much as to whether it is to be in the "long" or in the "short" form (terms which are explained later in section 874), but as to whether or not it is to be unqualified, or qualified in certain respects.

For instance, if the auditor is not permitted to audit and consolidate the records of a subsidiary with those of the parent company into a consolidated balance sheet and a consolidated profit and loss statement, he will have to qualify his certificate in this respect, since the subsidiary is an integral part of the parent company. Without an audit of the books of account of the subsidiary, the auditor is not even in a position to value the investment in the subsidiary on the parent company's balance sheet, nor able to certify as to the true profits of the parent company.

59. Status of the Books of Account. -- Of major importance in the first interview is the necessity of coming to some agreement as to the stage of competition in which the bookkeeping work will be, before the client requests the auditor to make his appearance for the completion of the audit.

As a rule, the auditor will insist that the general ledger must be in balance, and that the personal ledgers must agree with their controlling accounts, and so on.

Of course, no auditor refuses to bring the general ledger into balance if he is paid for it, but, nevertheless, every auditor likes to feel that he is cut out for more important work than mere checking.¹

¹Indeed, the auditor's advancement is in some measure dependent upon his being able to get away from clerical matters into executive functions. If not, the client will always regard the auditor as a mere expert bookkeeper.
60. **Schedules.** - Some auditors get the client to prepare schedules on prepaid insurance, investments, accruals of all sorts, notes payable, ageing of accounts receivable, and so on, on regular audit paper which the auditor has headed with the proper columns.

On large audits this procedure saves the auditor considerable time, since all that he has to do is to check the schedule. On small audits, the time which the client saves the auditor by the mechanical preparation of these schedules is too significant to bother the client about it. Moreover, the auditor gets a bit more acquainted with his audit by the very process of preparing it for himself. In addition, the auditor will usually request the client to secure price quotations on the chief inventory items, and a statement of account from each creditor. And, if the customers are to be circularized, the client will prepare the statements for the personal inspection and mailing by the auditor.²

61. **Memorandum of Engagement.** - As soon as the auditor gets back to the office after the interview with the client, he ought to write up a Memorandum of Engagement because the details of the interview will be much clearer than at any other time.

Plate 1 stands for the blank forms used by some auditing firms for this purpose. It should be observed that the form brings the salient points out in relief, and that it then permits the writer to "go on with his story" in his own way under the caption, "Remarks."

Plate 2 represents a Memorandum of Engagement characteristic of those firms which do not have printed forms, as illustrated by Plate 1.

In the writer's opinion, the first method of writing up the engagement (Plate 1) is the better of the two methods.

62. **Letter of Engagement.** - Soon after the Memorandum of Engagement has been written up for the office files, the interviewer ought to dictate a Letter of Engagement to the client.

Although only a few audits are made secure by a hidebound contract, nevertheless, letters of engagement (Plate 3) are frequently written to clients. As these letters state the essentials agreed upon at the interview, misunderstandings thereon are reduced to a minimum. Moreover, these letters have often proved to be invaluable to the auditor. Instances are known where he has been charged with negligence in uncovering fraud, or in other matters which these letters showed were not within the scope of the audit which the client requested.

63. See plate 1.

64. See Plate 2.

65. See Plate 3.

¹ That is, although it slows up the audit to prepare one's schedules, nevertheless, there is thereby more time for reflection, and the nearness to the work is often fruitful in the matter of detecting errors.

² There are often many, many other considerations to be taken up and settled with the client: E.g., "Consider the desirability of outlining the methods to be used in taking inventory." "If no audit was made for the previous period, are or are not the opening balances to be accepted for granted?" "Are the subsidiaries to be audited or are the investments therein to be carried merely as assets?" "If there were previous auditors, may they be interviewed as to the cause of their dismissal?"
A MEMORANDUM OF ENGAGEMENT (1st type) - PLATE 1

HOLT, GOOCH, HADLEY & CALDER
Certified Public Accountants
Pawtucket, R.I.

MEMORANDUM OF ENGAGEMENT

File No. -- Interviewed By -- -- To-day's Date -- -- --

Client -- -- -- -- -- -- -- -- -- -- -- -- -- -- -- -- --

Address -- -- -- -- -- -- -- -- -- -- -- -- -- -- -- -- Telephone -- -- -- --

Date of This Interview -- -- With Whom -- -- -- -- -- -- -- -- -- -- --

Audit Assigned To:
Partner -- -- -- -- -- -- -- -- -- -- -- -- -- -- At Rate Of $ -- -- --
Seniors -- -- -- -- -- -- -- -- -- -- -- -- -- -- -- --
Semi-seniors -- -- -- -- -- -- -- -- -- -- -- -- -- --
Juniors -- -- -- -- -- -- -- -- -- -- -- -- -- -- --

Date To Be Started -- -- -- -- -- Date To Be Ended -- -- -- --

Date Started -- -- -- -- Date Ended -- -- -- -- -- -- -- -- -- --

Reports To Be Addressed To: -- -- -- -- -- -- -- -- -- -- -- -- -- -- --

No. Of Copies Required -- -- To Whom Sent -- -- -- -- Charge To -- -- --

Date Required -- -- Date Sent -- -- Type Of Business -- -- -- -- -- --

General Type Of Audit -- -- -- -- For What Period -- -- -- -- -- --

Names And Offices Of The Chief Executives

Kind of Certificate: -- -- -- How qualified: -- -- -- -- -- --

REMARKS

(Write a full summary of the interview)

63. Explanation and Comments.-- In many accountants' offices there will
be filled out a Memorandum of Engagement for each audit. The one illustrated
herein sets out individually the information most likely to be of special
interest. Under "Remarks", at the bottom of the form, a full report of the
interview (similar to that in Plate 2) is given.

It is surprising how often such a record proves to be a "life-saver". It
sometimes happens, for example, that the interviewer is out on another audit
in a far distant city at the very time when a typist wants to know in regard
to a new audit the number of reports which are required, or the date on which
they are required, or the names and addresses of those to whom they are to be
sent. Obviously, such a situation causes considerable friction unless there
is a Memorandum of Engagement.
On November 5th Mr. T.G. Wood, President of the Wood Cotton Manufacturing Corporation, 410 Dexter Street, Fairlawn, Mass. telephoned requesting us to call upon him to discuss the possibilities of his having us make an audit.

Mr. R. Jordan, the writer, interviewed Mr. Wood in reference to this matter on the morning of the sixth at about 11 a.m.

After considerable discussion, a balance sheet audit as at November 30, 1929 was decided upon together with a detailed audit of two months' transactions in all books of original entry. No special emphasis is to be laid on the detection of fraud. An unqualified short certificate for the balance sheet is wanted.

There are to be fifteen reports to be addressed to Mr. Thomas R. Lewis, Chairman of the Board of Directors, and they are to be delivered to 410 Dexter St. by January 27th.

We are to begin the auditing immediately in so far as the preliminary work is concerned. The general ledger is to be in balance, and the subsidiary ledgers are to be in agreement with their controlling accounts by December 5th. Their clerks are to pull the vouchers, put them in order, and refile them. They are also to age the accounts receivable, and prepare the schedules on all accruals upon working paper headed up by us.

We quoted the following rates: partner - $50; senior - $35; semi-senior - $25; junior - $20; and office clerks - $10. We estimated that the total cost would be between $1,500 - $2,000.

We are to work in Mr. Atwood's office.

---

Omissions

The business makes cotton sheeting. Its balance sheet and profit and loss account for last year were as follows:

November 30, 1928

<table>
<thead>
<tr>
<th>Items</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$15862.51</td>
</tr>
<tr>
<td>Notes Rec.-Trade</td>
<td>1074.12</td>
</tr>
<tr>
<td>Accounts Rec.-Trade</td>
<td>17591.76</td>
</tr>
<tr>
<td>Inventories</td>
<td>349162.87</td>
</tr>
<tr>
<td>Marketable Securities</td>
<td>25079.00</td>
</tr>
<tr>
<td>Land</td>
<td>52678.42</td>
</tr>
<tr>
<td>Buildings</td>
<td>278261.12</td>
</tr>
<tr>
<td>Machinery</td>
<td>569424.83</td>
</tr>
<tr>
<td>Deferred Charges</td>
<td>17090.14</td>
</tr>
<tr>
<td>Other Assets</td>
<td>3567.17</td>
</tr>
<tr>
<td>Total</td>
<td>$1486211.94</td>
</tr>
</tbody>
</table>

---

Omissions
I recommend putting the following men on the job:
Senior - T.B. Baxter
Others - R. Bequette, M. Proctor, F. Heywood, T. Glass, S. Diamond, J. Fox
This work ought not to be started until the senior in charge has reviewed the engagement with me.
Several other matters not discussed here are fully detailed in the working papers which have been started.

R. Jordan

64. Explanation and Comments.-- This exhibit represents a portion of a Memorandum of Engagement characteristic of those firms which do not have printed forms as illustrated by Plate 1.
In the writer's opinion the first method (Plate 1) is the better of the two methods because (1) it makes the important points immediately available out of the mass of detail, and (2) it makes certain that the interviewer reports on these important points.
EXPLANATION OF PLATE 3

A LETTER OF ENGAGEMENT

HOLT CLARKSON & HOLT
Certified Public Accountants
Chattanooga, Tennessee

65. Explanation and Comments.-- As it is highly desirable that there shall be some written record of the main essentials agreed upon by the client and the auditor as a result of their first interview, the Letter of Engagement serves that purpose.

When the interviewer, generally a partner, gets back to his office, he should write out a Memorandum of Engagement -- (Plates 1 and 2). And, in the course of the next day or two, he should send a Letter of Engagement to the client so that any misunderstandings as to what was agreed upon may be straightened out long before the audit is begun. Time and again this sort of correspondence has settled important disputes as to what fee-rates are agreed to, or as to what aid the client's clerks are to give the auditor, or as to the importance to be attached to the detection of fraud, or as to when the report is to be ready, and so on.
Mr. Frank R. Holliewell, President
Holliewell & Company, Inc.,
462 Read Block,
Little Falls, Illinois

Dear Sir:

This letter confirms our interview of last Thursday in respect to the
detailed audit which you are having us make of your books and records for the
year ending November 30, 1929.

The following is a brief resume of that interview as we understand it.
If we are mistaken, please advise us as soon as possible.
(1) The general ledger is to be in balance and the subsidiary ledgers
are to be in agreement with the controlling accounts at approximately December
20th.
(2) Your clerks are to age the accounts receivable on the paper headed
up by us; and, they are to pull the vouchers, arrange them in order, and refile
them.
(3) A complete detailed audit is to be undertaken, but no special
examination is to be made to detect fraud. About five months' transactions,
selected at random, will be audited in all books of original entry.
(4) We are not to prepare any tax returns.
(5) Ten copies of the report, addressed to Mr. Ralph K. Schroeder,
Chairman of Board of Directors, Holliewell & Company, Inc., Little Falls,
Illinois, are to be delivered by February 17, 1930.

(6) Rates:                                   Partner $50 per day
                                                 Senior accountants 35 "$"
                                                 Semi senior " 25 "$"
                                                 Junior " 20 "$"
                                                 Office clerks 10 "$"

Cordially yours,
Holt, Clarkson, And Holt
By Philip Holt

P.H./H.B.J.
REVIEW QUESTIONS

1. How much emphasis does an auditor place on the detection of fraud? Assume various situations.
2. How does auditing effect the morale of an office force?
3. How can an auditor often secure some information about a prospective client's financial condition, history, etc. even before interviewing the client? Why is this procedure desirable?
4. Why doesn't an auditor hesitate to accept an engagement to audit a type of business with which he has had no experience?
5. Write a Record of Engagement to a client with whom you have just discussed the scope, terms, etc. of a first audit for the year ended April 30, 1930.
6. How is it possible for an auditor not to know who his client is?
7. Show that auditing is an analytical process.
8. Distinguish between per diem rates and flat rates. Which type does an auditor prefer? Why?
9. Give some of the important rules of law applicable to fixing the compensation for expert services.
10. What is the American Institute's feeling toward a contingent fee? Why?
11. State the difference between an accrual basis and a cash basis of accounting.
12. Why should an auditor write a Record of Engagement to his client?
13. At what time should an auditor stipulate for an agreeable place in which to work? Why?
CHAPTER 8

HOW TO BEGIN AN AUDIT (Continued)

C - WHAT TO DO BEFORE GETTING ON THE JOB

66. Prior Reports and Correspondence
67 Supplies

D - WHAT TO DO ON THE JOB

68. Letter of Introduction.
69. Explanation of Plate 4.
   PLATE 4 - A Letter of Introduction.
70. List of Books and Records.
71. Explanation of Plate 5.
   PLATE 5 - A List of Personnel, Books, System, etc.
72. Organization Chart and Introduction to Executives.
73. Tour of Plant.
74. Signatures.
75. Prior Report.
76. Audit Program.
77. Explanation of Plate 6.
   PLATE 6 - A Section of an Audit Program (1st type)
78. Explanation of Plate 7.
   PLATE 7 - A Section of an Audit Program (2nd type)
79. Explanation of Plate 8.
   PLATE 8 - A Section of an Audit Program (3rd type)
80. Absence of Plant Ledger.
81. System of Internal Check.
82. Work Sheet.
83. Explanation of Plate 9.
   PLATE 9 - A Work Sheet (1st type)
84. Explanation of Plate 10.
   PLATE 10 - A Work Sheet (2nd type)
85. Explanation of Plate 11.
   PLATE 11 - A Work Sheet (3rd type)
86. Explanation of Plate 12.
   PLATE 12 - Auditor's Adjusting Entries (for Plate 11)
87. Individual Schedule.
88. Explanation of Plate 13.
   PLATE 13 - A Schedule
90. Confirmations.
91. Minutes.
92. Explanation of Plate 14.
   PLATE 14 - Excerpts from Directors' Minutes.
93. Explanation of Plate 15.
   PLATE 15 - Excerpts from Stockholders' Minutes.
94. The Charter.
95. By-Laws.
96. Capital Stock.
97. Explanation of Plate 16.
   PLATE 16 - Excerpts from Provisions of a Preferred Stock.
98. Explanation of Plate 17.
   PLATE 17 - Excerpts from the Provisions of a Debenture Bond.
99. Explanation of Plate 18.
   PLATE 18 - An Indexed Balance Sheet
100. Explanation of Plate 19.
    PLATE 19 - A Schedule on Memos.
101. Explanation of Plate 20.

PLATE 20 - A Schedule on Agenda

102. Contracts.
103. Partnership Agreements.
104. Wills.
105. Mortgages.

Review Questions.

C - WHAT TO DO BEFORE GETTING ON THE JOB

66. Prior Reports and Correspondence. - If the engagement is one which the auditor has handled before, he will usually find his time well spent in brushing up on it by reviewing his prior reports and working papers. In this way the senior auditor will have refreshed his memory on the peculiarities of the business, and upon special points which he mapped out and listed last time to be covered on this coming audit.

If it is the case of a new senior auditor being placed in charge of the work, this man is practically obliged to review the prior correspondence, working papers, and reports for sometime past, if he expects to complete a successful audit.

67. Supplies. -- The matter of the auditor's carrying a full supply of paper, pens, pencils, clips, erasers, etc. may seem to be too trivial a matter to devote a sentence to it. But such is certainly not the case. If an auditor borrows first this and then that from a client, he annoys his client and reveals his (the auditor's) inefficiency. A plumber has a traditional right to forget his tools, but an auditor must always have his equipment on hand.

D - WHAT TO DO ON THE JOB

68. Letter of Introduction. -- Many auditing firms give the senior in charge a Letter of Introduction (Plate 4) to each new client. This letter ought to be brief by confining it to giving the name of the senior, and to placing him at the client's disposal.

69. See Plate 4.

70. List of Books and Records. -- Soon after the auditor arrives on the job, he will need to get a list of ALL of the financial books and records in use, together with the names of those keeping these records.

In England the law requires the auditor to secure this important information when auditing certain types of businesses. Here in the United States, many auditors entirely overlook this very important point, whereas others always get this information in their working papers as soon as possible.

Those who do not cover this matter fail to see that it is easily possible for an auditor to overlook an important record because it is peculiar to this one particular client. In a trial for negligence in connection with fraud, for example, a court of law may say that since this record was an integral part of the client's accounting system, the auditors were grossly negligent in not auditing it. For instance, the writer recalls the case of a Cotton Book kept by a client in its main office located in the city. This book (also common to others in the same line of business) kept a minute record of each bale of cotton so that at any time the main office knew the bale mark, the grade and staple, the weight, the freight, the insurance, the cost per pound, the cotton broker, etc. of each bale.
A LETTER OF INTRODUCTION—PLATE 4

HOBSO\N & OLD\RICH
Boston, Mass.

Auditors Tel. Conn. H.ogarth 8647 Accountants

Mr. John L. Mitchell, President,
The Mitchell Company, Inc.
Tucson, Arizona

Dear Sir:

The bearer of this letter, Mr. Raymond Wilson, C.P.A., has been placed in charge of your audit with instructions to be at your service.

Cordially yours,
Hobson & Oldrich

By
F.H., Hobson, C.P.A.

69. Explanation and Comments.—This Letter of Introduction is a sample of the contents of such a letter. All that it contains is the name of the person in charge of the audit, and a remark or two placing him at the client's disposal.

Also, the auditor's stationery and his signature assure the client that "the stranger" is the authorized representative of the auditing firm.
factory storehouse in the mill village. Since this record would not be thought of by an auditor unfamiliar with this type of business, he would overlook one of the most important checks on the accuracy of the raw cotton inventory, if he failed to ask for a complete list of the books and records. By vouching this record, the auditor knew just what bales of cotton the mill superintendent must report on the final inventory sheets which he sent up to the city. He also knew all of the essentials as to weight, price, staple, grade, etc. which were necessary in valuing the inventory at cost. Moreover, this was an invaluable book for the auditor to take along to the factory storehouse in checking up personally on the physical existence of the bales.

Or again, how foolish an auditor would appear if he had in his report some information which he had spent days and days working up, because he knew it was "good stuff", only to find that the client had been getting this information himself for the last several years.

On other occasions, the auditor may find that the client has certain statistics which he, the auditor, can couple with other information into a new schedule of paramount importance. This procedure is permissible as long as the auditor gives the client due credit for the client's own statistics. In fact, the auditor should do so for his own protection in case the client's figures are incorrect.

71. See Plate 5.

72. Organization Chart and Introduction to Executives. —If the auditor has not already done so, he should draw up an organization chart listing therein the chief executives and their rank in respect to one another. But as it is far more important to make the acquaintance of these gentlemen, the auditor should see to it that he is introduced to them.

The reason why the auditor should himself request an introduction to the chief executives is this. First, in any event the auditor will have to make their acquaintance sooner or later since his auditing in its various ramifications will very likely bring him into contact with all of them. And second, this procedure will reduce possible friction to a minimum since the chief executive will most likely say something like this to his subordinates as a part of his introduction of the auditor, "Bill, I want you to see that your clerks give Mr. (name of the auditor) all of the information and assistance he wants, as the chairman of the board of directors is very anxious to get his report within the next few weeks."

73. Tour of The Plant. — The sooner an auditor learns that efficient auditing cannot be accomplished by burying one's nose in the vouchers, records, and books of account, the better it will be for him.

For example, if the cotton inventory calls for 1500 bales, the auditor will have to go to the warehouse and make a test count which should approximate that number. So also, as each property account represents certain physical items, the competent auditor will know either in a specific or in a general way that they are in existence. If an analysis of the plant ledger shows, for example, that fifty new looms have been bought, the auditor will take care to observe this fact as he goes through the weaving shed. Again, as a result of his tour through the plant the auditor may note that the buildings or machinery appear to be in poor maintenance. As a result, it may be that he will decide to dig into this matter further and work up the facts as the major feature of his audit report. Or, as he passes through the storesroom, the auditor may notice that the goods are not being stored properly, and that
the general condition of the storeroom is slovenly, and therefore decide to feature this point in the audit report. Again, as he goes from department to department, it may be that he will get the general impression that the goods-in-process are lying around or are not being promptly routed through the factory. From this "hunch" the auditor, let us assume, analyzes the goods-in-process inventories and definitely substantiates his general impression by showing that on the average there is a 3 months' inventory, whereas inquiry of the factory superintendent reveals that the shortest time for any of the many products is 2 weeks and the longest time is 2 months. As he goes through department KFCM, the auditor, for example, may notice that one section of it is closed down because they are rearranging the machinery. On getting back to the books, the auditor will be on the lookout to see how these machinery rearrangement charges are being handled.

As the above paragraph should be sufficient to illustrate how the auditor can get many constructive suggestions, and how he must check the physical items against the book entries, and vice-versa, the writer will not amplify it further than to say, "GO THROUGH THE PLANT INTELLIGENTLY."

74. Signatures.—Early in the audit, perhaps at the time when the auditor is introduced to the chief executives, he will secure their signatures so that he can properly identify them on vouchers, contracts, checks, requisitions, and so on.

75. Prior Reports.—If the auditor knows of the existence in the client's office of a report for a prior period by another firm of auditors, he should get hold of it if he possibly can. Many times an auditor has learned things in this manner which he might otherwise never have discovered, or at least not until he had handled the engagement for a number of times. As stated previously, an auditor should insist on being told why the previous auditor was displaced. No auditor can afford to work in ignorance of the reason why another supposedly reputable firm of auditors was not reengaged.1

76. Audit Program.—An essential part of all working papers is an audit program (Plates 6, 7 and 8). The senior will draw up the audit program, which will give a brief description of the work to be done on the audit. Opposite each section of the work will be placed the initials of the one who did it. Often the schedule is expanded so as to show the time it took to do the work, and the dates on which it was done.

In times past many auditing firms had printed audit programs, but these have disappeared since they destroyed the senior's initiative. Then too, as the auditing procedure varies on different engagements, and often on the same audit for two successive periods, the modern practice is for each senior to draw up his own audit program, after he gets on the job and has sized up the system of internal check, the carelessness and ability of various clerks, and other similar matters.

An audit program is valuable to the senior auditor because it does away with memory work. For example, at any particular time he can tell by referring to the program what and how much of the audit has been completed, and what and how much has yet to be done. If an audit schedule is incorrect, he is able to tell in a second's time who drew it up, even though that question

1See also Appendix C, Section 6, #5b. "Where the accounts have been previously professionally audited, the late auditor's reports on the last few accounts should be read, and any qualifications duly noted. If there are qualifications of importance, it will usually be considered necessary, or advisable to communicate in confidence with the late auditor, to ascertain more fully his cause for dissatisfaction." Taylor & Perry, pg.13
EXPLANATION OF PLATE 5

A LIST OF PERSONNEL, BOOKS, SYSTEM, ETC.

THE SMITH MANUFACTURING COMPANY
Audit For Year Ending Dec. 31, 1929

71. Explanation and Comments.—Plate 5 shows sections of working papers on the names of the officials with their titles and their interests in the business; and the nature of the approvals required by the prescribed office routine together with the names of the persons authorized to initial their approval.

As emphasized in the text, many auditors cannot be bothered with such details because they (the auditors) are too practical. But are they? As a matter of fact, careful auditors everywhere prepare such schedules for their working papers because of the reasons developed in the text.
A LIST OF PERSONNEL, BOOKS, SYSTEM, ETC. PLATE 5

THE SMITH MANUFACTURING COMPANY
Audit For Year Ending Dec. 31, 1929

Chief Persons

<table>
<thead>
<tr>
<th>Title</th>
<th>Shares Held</th>
</tr>
</thead>
<tbody>
<tr>
<td>President</td>
<td>150 Common 35 Pfd.</td>
</tr>
<tr>
<td>Vice-president</td>
<td>500 &quot;</td>
</tr>
<tr>
<td>Sec'y and Treas.</td>
<td>10 Pfd</td>
</tr>
<tr>
<td>Accountant</td>
<td></td>
</tr>
<tr>
<td>Purchasing Agt. (and other duties)</td>
<td></td>
</tr>
<tr>
<td>Cashier (and other duties)</td>
<td></td>
</tr>
</tbody>
</table>

(x) Due to age he is relinquishing control to S. Ross who is really "the boss". Lately S. Ross purchased 400 shares of common from Mr. Wightman.

Omissions

Principal Books and Records

<table>
<thead>
<tr>
<th>Name</th>
<th>Type of Approval</th>
<th>Name</th>
<th>Type of Approval</th>
</tr>
</thead>
<tbody>
<tr>
<td>Miss Parker</td>
<td></td>
<td>E. Johnson</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Miss C. Swee</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Miss Southern</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>M. Jordan</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>I. Eddy</td>
<td></td>
</tr>
</tbody>
</table>

(1) Checks are approved by E. Johnson and signed by Sam Ross.
(2) Journal entries must be supported by Journal Vouchers approved by E. Johnson and signed by M. Jordan. (i.e.: Ordinary journal entries.)
(3) Invoices must bear "approval stamp" fully initialled. The voucher jacket must be approved by E. Johnson. Those authorized to initial the "approval stamp" are:

Name: R. Seannan
      M. Smith
      S. Jones

Type of Approval:
Receipt of goods
Prices and extensions
Distribution

(4) The duplicate sales invoices must bear "approval stamp" fully initialled as follows:

Name: P. Reese
      S. Sampson
      P. Reese
      M. Robbins

Type of Approval:
Goods shipped
Compared with Sales Order
Terms Prices and Extensions OK
Distribution and final approval

(5) E. Johnson approves (alone) the petty cash vouchers of Miss Parker.

Omissions

(21) R. Wightman must approve the write-off of uncollectable notes and accounts.
(22) R. Wightman must approve all surplus-adjusting journal entries.
EXPLANATION OF PLATE 6

A SECTION OF AN AUDIT PROGRAM (1st type)

THE HADLEY MANUFACTURING CORPORATION
Audit Program
Audit For the Year Ending May 31, 1930

77. Explanation and Comments.-- This plate 6 shows the first page of an audit program which has been just started. From the nature of the first nine items, it is evident that this is a first audit. And, from the nature of the cash audit program, considerable more than a strict balance sheet audit is being undertaken.

The program also shows the time required to complete each step, the date on which it was done, and the initials of the person who did the work. Note that the name of the one who prepares a schedule is always given (see the upper right hand corner of the schedule).

The student is referred to "Auditing and Accounting Handbook", Kilduff, p. 1.

(The auditor's working paper used in these plates has been reduced three inches in length.)
The Hadley Manufacturing Corporation  
Audit Program  
Audit for the Year Ending May 31, 1930  
O. K. Baxter  
6-2-30

<table>
<thead>
<tr>
<th>E.K. Barker</th>
<th>G. Carter</th>
<th>Time</th>
<th>Date</th>
<th>By</th>
</tr>
</thead>
<tbody>
<tr>
<td>N. Maxon</td>
<td>O. K. Baxter</td>
<td>Taken</td>
<td>When</td>
<td>Whom</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>E. Watt</th>
<th>in Hours</th>
<th>Done</th>
<th>Done</th>
</tr>
</thead>
</table>

### (1) Abstract the minutes of the
- (a) Directors
- (b) Stockholders
- (c) Special Committee

### (2) Abstract the
- (a) Charter
- (b) By-laws
- (c) Common Stock provisions
- (d) 1st Preferred Stock provisions
- (e) 2nd Preferred Stock provisions
- (f) Mortgage indenture.

### (3) Take trial balance of general ledger.

### (4) Cash Receipts:
- (a) Reconcile the opening cash book balance against the bank statement balance. Confirm, Verify checks O/S, etc.
- (b) Test the receipt of interest from securities for Dec., Feb., and March.
- (c) Test the correctness of cash discounts for April 1-15, May 1-15.
- (d) Check transfers of funds between banks for entire year.
- (e) Compare each total daily receipts per cash book with each daily deposit per bank statement for June, January, April, May and June.
- (f) Check the details of each daily deposit slip against the details of the cash book for May 28-31 and June 1-4 incl.
- (g) Foot all columns, check forwards, and crossfoot for June, January, April, May and June.
- (h) Accept without footing the monthly totals of cash and prove to bank statement deposits, for the year as a whole.
- (i) Check postings to general ledger for June, January, April, May and June.
- (j) Check postings to personal ledgers for May.

### (5) Cash Payments:
- (a) Check the name of the payee and the amount against that given in Voucher Register for June, January, April, May and June.
- (b) Compare the checks with the entries for June, January, April, May and June. — Cash Book
- (c) Examine the checks for correctness of payee, amount, signature, date, and endorsement; Also account for check numbers.
- (d) Foot all columns, check forwards, and crossfoot for June, January, April, May and June.
- (e) Accept without footing the monthly totals and prove to bank statement withdrawals, for year as a whole.
- (f) Check postings to General Ledger for June, January, April, May and June.
EXPLANATION OF PLATE 7

A SECTION OF AN AUDIT PROGRAM (2d type)

THE MORRISON AND MURR CORPORA TION
Audit Program
Audit For the Year Ending December 31, 1929

76. Explanation and Comments.--- This plate 7 shows page 5 of an audit program. Although only January and February are shown, there would be a column for each of the twelve months in the year.

This program is designed for an audit where some preliminary work is done each month. Not all of the items, as can be seen, receive attention each month. For example, the voucher register will be audited for January, June, and December only, whereas the payroll will be audited for February only. No work is shown as being done on the Sales Book because April is the first month in which it is to receive attention.

From the nature of the steps under Voucher Register, Pay Roll, Sales Book, and so on, it is clear that a detailed audit is being undertaken.

Note that this audit program gives very detailed instructions.
(41) **Voucher Register:**

- **a.** Vouch all items for Jan., June and Dec. 2-6-29.
- Pay strict attention to the date, the name of the purchaser, the nature of the items purchased, the initializing of the approval stamp and to the distribution in the register.

- **b.** Vouch all property items for the whole year and build up the property schedules.

- **c.** Vouch all items $300 and over for the whole year.

- **d.** Foot, check forwards, and crossfoot for January, June and December.

- **e.** Check postings to G/L for January, June and December.

- **f.** Examine the V Register for Jan. 1930 for items belonging to 1929.

- **g.** Make certain that those items recorded in the last few days of December 1929 were received and/or included in 1929 inventory.

- **h.** Test the Receiving Record against the V Register for Dec. 15-31, 1929 and Jan. 1930.

(42) **Sales Book:**

- **a.** Check duplicate sales invoices to the Sales Book for April and Dec. Account for all invoice numbers.

- **b.** Check the Shipping Record to Sales Book for Dec. 15-31 and January 1930.

- **c.** Foot all columns, check forwards, and crossfoot - April and December.

- **d.** Check all postings to G/L for Apr. & Dec.

- **e.** Check postings to P/L for Dec. 15-31.

(43) **Pay Roll:**

- **a.** Get from the department heads their Feb. pay roll sheets, and compare them with the Feb. pay roll voucher. Check carefully.

- **b.** Foot the Feb. pay roll sheets and voucher. Check the total of the voucher to the pay roll check. Check the pay roll distribution in the V. Register.

- **c.** Check out the unclaimed wages as at Dec. 31.

- **d.** Verify the correctness of the accrued pay roll at Dec. 31.

(44) **General Ledger:**

- **a.** Check about 500 additions P & Loss items at random from the G/L back into the books of 2/15/29 W.W. 3/20/29 A.O. (100)

- **b.** Foot about 1/2 of the P&L accounts taken at random 2/15-16/29 W.W. 3/20-21/29 A.O. (70)

- **c.** Take off monthly trial balance 2/28/29 W.W. 3/21/29 A.O.

(45) **Inventories:**

- **a.** Check cotton invoices into Cotton Register 2/13-14/29 F.K. 3/7-8/29 C.W. (The other items under Inventories, etc. are not shown.)

---

**The Morrison and Mury Corporation**

**Audit Program**

**Audit for the Year Ending December 31, 1929**

<table>
<thead>
<tr>
<th>Jan. Date</th>
<th>Initial</th>
<th>Feb. Date</th>
<th>Initial</th>
</tr>
</thead>
<tbody>
<tr>
<td>2-6-29</td>
<td>W.B.H.</td>
<td>2-10-29</td>
<td>W.B.H.</td>
</tr>
<tr>
<td>3-28-29</td>
<td>M.P.</td>
<td>2-11/29</td>
<td>W.B.H.</td>
</tr>
<tr>
<td>3/12/29</td>
<td>W.B.H.</td>
<td>3/12/29</td>
<td>W.B.H.</td>
</tr>
<tr>
<td>2/12/29</td>
<td>W.B.H.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
A SECTION OF AN AUDIT PROGRAM (3d type) PLATE 8

The Keyes Manufacturing Corporation

General Audit Program

Audit for the Year Ending August 31, 1929

<table>
<thead>
<tr>
<th>Extent of</th>
<th>Date Auditor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Testing</td>
<td>Done</td>
</tr>
</tbody>
</table>

1. Count and reconcile the Petty Cash.
2. Count and reconcile the General Cash.
3. Inspect and prove the securities.
4. Take trial balance of the general ledger.
5. Abstract the directors' minutes.
6. Abstract the Stockholders' minutes.
7. Abstract the Bond indenture.
8. Compare the list of account receivable balances with their accounts. Foot and compare with total in controlling account.
9. Check the additions in books of original entry including forwards. Crossfoot.
10. Vouch entries in books of original entry.
11. Check postings to general ledger from books of original entry.
12. Foot the general ledger.
13. Check postings to subsidiary ledgers.
14. Check postings from general ledger into books of original entry (Not the same as #11)
15. Check postings from personal ledger into books of original entry (Not the same as #13)

Omissions

76. Prepare asset schedules.
77. Prepare liability schedules.
78. Prepare networth schedules.
79. Prepare Income schedules.
80. Prepare expense schedules.
81. Review any contracts in existence.
82. Get the client's certificate on inventories.
83. " " " liabilities.
84. See that the bookkeeper enters the adjusting entries.
85
86

79. Explanation and Comments.— This plate illustrates a type of general audit program often found in auditor's working papers. As it is too general to be of much use to anyone, the writer does not recommend it unless each individual analysis sheet contains a complete story of the audit procedure taken.
should come up six months or two years after the work has been done.

Again, the audit program is just the place for the senior auditor to
record new ideas as to what must be audited, or as to changes in the audit
procedure from that of last period. If the ideas are not written down as
they are thought of, the probability is that they will be overlooked in the
rush attendant on practically all audits.

If a senior is called away from the audit to start another audit, or
for any other reason, those remaining on the job will be able to go ahead
with the work since the program will be clear and definite as to what work
has yet to be completed.

Then too, if a partner of the auditing firm wants to know how much time
a section of the work takes, (such as the time to audit the cash book), the
senior has simply to refer to his program for the answer. Or, if the partner
wants to know to what extent the Voucher Register is audited, the audit
program is again made use of.

Likewise, if there should be a controversy in court about some matters
on the job, the audit program is invaluable as a means of answering a
million and one questions about the audit which the opposing attorney will
always ask in an effort to show that the prosecuted auditor doesn't know
what he did, or when he did it, and so on. Obviously, if a real audit
program exists, the auditor's answers will be so quick and definite as to
destroy the prosecuting lawyer's attempt to discredit the auditor before
the eyes of the jury.

Finally, one more use for an audit program will be stated, although
many other reasons for one could be given. The audit program is a great
help to a new (another) senior as showing the extent of the auditing which
the previous senior in charge of the engagement considered necessary. Of
course, as the auditing procedure on the same audit for two successive
periods should vary in certain important respects, the new man will still
have to do his own thinking. Nevertheless, the prior audit program is
always a welcomed model.

77. See Plate 6.

78. See Plate 7.

79. See Plate 8.

80. Absence of Property Ledger—If there is no property ledger and if
the auditor is not to analyze the plant accounts for some time prior to his
audit period, he should request the client to draw up a list of the buildings
and machinery. This list must give a clear and full description of each
item, its location, its approximate cost, and any other information which the
auditor may desire.

From period to period the auditor should change this schedule to accord
with the facts which his auditing discloses so that at any time he can tell
what machinery, for example, is in each department. Although many auditors
do not check up on the existence of machinery and similar plant items
(because they feel that the machinery cannot disappear without its being
noticed through a drop in production), nevertheless, the writer feels that
it should be checked because he, the writer, knows that machinery can dis-
appear without an auditor's knowing it, especially if he is the type who

1Supervising seniors.  2A ledger giving the details of the machinery
and other fixed (plant) assets.  3Without this list an auditor can not pass
upon the adequacy of the depreciation rate(s); thus a frame building is NOT
like a brick, steel and concrete one.  4Thus the bookkeeper may debit cash
and credit miscellaneous income instead of handling it properly through the
reserve and asset accounts.
does all of his auditing in the office.

81. System of Internal Check.— If the writer were to emphasize several things more than the others, he would certainly include the discussion of the system of internal check (see section 28 and section 106) among them, because upon this point turns the question as to whether or not a strict balance sheet or a more detailed audit is required.

A good system of internal check exists where each clerk carries on a branch of the work only part way. At this point another clerk picks it up and pushes it on a little further, and so on, throughout a series of clerks until the work is finished. By this procedure the work of one clerk dovetails into that of her successor, and, as no one clerk controls a complete branch of the office work, there is little or no opportunity for error or fraud.

As has been emphasized previously, a strict balance sheet audit is proper only when the auditor is satisfied with the adequacy of the system of internal check. If the system is deficient in any respect, the auditor must do some detailed auditing at that point. Thus the method of preventing fraud and errors in the matter of cash receipts may be satisfactory, whereas the method of making expenditures may be poor, as when, for example, the treasurer does not insist on seeing an approved voucher for each check that he is asked to sign by the chief accountant, or signs checks in advance.

82. Work Sheet.— At an early date the auditor may possibly assign to a semi-senior the job of pulling off the trial balance of the general ledger on to a Work Sheet (plates 9, 10, and 11). As a rule, a work sheet shows the names of the ledger accounts, the ledger pages of the accounts, the analysis sheet numbers, the final balance sheet of last period, the present preclosing trial balance, the auditor’s adjustments, the profit and loss items, and the balance sheet items.

After the preclosing trial balance for the current year has been drawn off on to the Work Sheet, all items should be traced into the balance sheet, if one is prepared, to prove among other things, that no contra assets or liabilities have been omitted from it. Moreover, the auditor should see that the assets and the liabilities have been grouped in the same manner both at the beginning and at the end of the period.

As to the necessity for showing last period’s figures on the work sheet, it may be said, and indeed emphasized, that such a procedure permits the auditor to detect any accounts closed during the year. Of course, those which have been opened after the beginning of the period and closed before the end of it can be ascertained only by a careful scrutiny of the current general ledger from cover to cover, including a review of any previous ledger closed out during the period. To repeat, it can not be assumed that accounts which are closed at the end of a period have no bearing upon the company’s financial position.

Finally, and most important, the auditor can quickly ascertain the major changes that have taken place during the audit period by comparing this period’s figure with that for last period. Or, a preliminary statement of application of funds should be prepared.

Thus, as the auditor goes down the trial balance he may ask himself somewhat as follows: My! what a drop in the cash position! I wonder why? What makes the Account Receivable so large? Are the collections poor or are the sales larger this period? (Then turning to the sales account) No, the sales

1 "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."—F.W. Thornton.

2 See Appendix C, Sec. 8-#3.
# A WORK SHEET (1ST TYPE) PLATE 9

**The Smith Company**  
*Work Sheet - Audit for Year Ending Dec. 31, 1929*  
**R. Mason**  
1-10-30

<table>
<thead>
<tr>
<th>Ledger</th>
<th>Name of Accounts</th>
<th>Adj. T.B.</th>
<th>Trial Balance Adjustments - 1929</th>
</tr>
</thead>
<tbody>
<tr>
<td>Page</td>
<td>Dec. 31, 1928</td>
<td>Dec. 31, 1929</td>
<td>Dr.</td>
</tr>
<tr>
<td>1</td>
<td>Petty Cash</td>
<td>1506.50</td>
<td>1000.00</td>
</tr>
<tr>
<td>2</td>
<td>Second National Bank</td>
<td>158309.40</td>
<td>165917.63 (1)</td>
</tr>
<tr>
<td>3</td>
<td>Accounts Receivable - Trade</td>
<td>397517.43</td>
<td>381955.48 (8)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Col. 9</th>
<th>Col. 10</th>
<th>Col. 11</th>
<th>Col. 12</th>
<th>Col. 13</th>
<th>Col. 14</th>
<th>Col. 15</th>
<th>Col. 16</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec. 31, 1929</td>
<td>No.</td>
<td>Remarks</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1000.00</td>
<td>A</td>
<td>This year the fund was kept on the imprest system.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>186384.78</td>
<td>A</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>363052.27</td>
<td>B</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**83. Explanation and Comments.** This plate shows the first three items of a series of work sheets. It illustrates a very common procedure whereby at least four separate sheets are used: one each for the balance sheet, and the profit and loss debit balances; and one each for the balance sheet, and the profit and loss credit balances. Hence only one column is needed for a trial balance.

Notice again that the trial balance figures for the prior period (here for the year ending 12/31/28) are an essential part of every well drawn up work sheet. Some auditors, when making a balance sheet audit, list in this column only the balance sheet items as of the close of the last period, but the writer favors including the profit and loss items as well. In his opinion a comparison of these figures for the two periods is an essential aid in conducting a balance sheet audit. For example, it is just as important to compare this period's depreciation charge with that of last period as it is to note the increase in the machinery account over the figure for the prior period. Again, it is just as essential to compare the sales of the two periods as it is to compare the totals of accounts receivable for the two periods.

It is the writer's opinion that as the auditor never knows at what point fraud or error is going to show up, and, as he knows that many of the profit and loss accounts are very intimately bound up with the balance sheet accounts, he can ill afford to overlook this very valuable method of scrutinizing the accounts for errors and fraud. Moreover, if the auditor compares all of the accounts, both profit and loss as well as balance sheet accounts, he is using one of the best known methods of analyzing the business. The bases for important constructive suggestions are very often discerned by just such a comparison analysis as this one.

The column headed "Analysis Sheet No." shows the page letter of the schedule which analyzes the account listed on that line; thus, schedule B analyzes Accounts Receivable - Trade.
64. Explanation and Comments.— Plate 10 consists of three sections taken at random from page 2 of a group of two work sheets.

When the auditor arrived, the books had been closed, so that only a post closing trial balance (i.e. only balance sheet accounts were open) could be taken. For this reason the auditor reversed the closing entries found in the general journal and placed them in the column headed 1929 Closing Entries, and thereby secured a Before Closing trial balance by combining the post closing trial balance and the reversed closing entries. (The business had no trial balance of any kind).

Note that the totals of each work sheet are not forwarded to the next work sheet. They are listed on the last work sheet, and added to make the grand total. By this method a mistake in, or the alteration of, a total of any sheet will require only three changes no matter how many sheets are in the unit; i.e., the erroneous total, this total forwarded on the last sheet, and the grand total.
### A WORK SHEET (2d TYPE) PLATE 10

The P.S. Smith Corporation
Work Sheet—December 31, 1929

**S Miller**

1/10/30

Page 2 Exhibit 5

---

**LEFT HALF (Columns 1-8)**

<table>
<thead>
<tr>
<th>Accounts</th>
<th>Acct</th>
<th>Adjusted 1928</th>
<th>Before Closing</th>
<th>Post Closing</th>
<th>Reversed 1929</th>
<th>Closing Entries</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Trial Balance</td>
<td>Dr.</td>
<td>Cr.</td>
<td>Trial Balance</td>
</tr>
<tr>
<td>Omissions</td>
<td></td>
<td></td>
<td>Surplus</td>
<td>183</td>
<td>13176.96</td>
<td>104187.16</td>
</tr>
<tr>
<td>Purchases</td>
<td>204</td>
<td>179304.60</td>
<td>197603.20</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Freight-in</td>
<td>205</td>
<td>2986.51</td>
<td>2407.30</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rent Expense</td>
<td>206</td>
<td>10300.00</td>
<td>10200.00</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>301</td>
<td>355146.30</td>
<td>357109.30</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Returned Sales</td>
<td>302</td>
<td>3427.39</td>
<td>2864.29</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest Income</td>
<td>303</td>
<td>1467.30</td>
<td>1329.01</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Omissions</td>
<td></td>
<td></td>
<td>Total This Page</td>
<td>260309.40</td>
<td>439327.80</td>
<td>104187.16</td>
</tr>
<tr>
<td>Total Page 1</td>
<td>548695.20</td>
<td>299141.92</td>
<td>421015.42</td>
<td>421015.42</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Grand Total</td>
<td>809002.60</td>
<td>478114.84</td>
<td>421015.42</td>
<td>421015.42</td>
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<td></td>
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</table>

**RIGHT HALF (Columns 9-16)**

<table>
<thead>
<tr>
<th>1929</th>
<th>Col. 9</th>
<th>Col. 10</th>
<th>Col. 11</th>
<th>Col. 12</th>
<th>Col. 13</th>
<th>Col. 14</th>
<th>Col. 15</th>
<th>Col. 16</th>
</tr>
</thead>
<tbody>
<tr>
<td>Before Closing</td>
<td>Auditor's Adjustments</td>
<td>1929 Profit and Loss Balance Sheet</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trial Balance</td>
<td>Dr.</td>
<td>Cr.</td>
<td>12910.52</td>
<td>13176.96</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Omissions</td>
<td>13176.96(2)</td>
<td>12910.52</td>
<td>13176.96</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Omissions</td>
<td>197603.20</td>
<td>197603.20</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Omissions</td>
<td>2407.30</td>
<td>2407.30</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Omissions</td>
<td>10300.00</td>
<td>10300.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Omissions</td>
<td>357109.30</td>
<td>(14)</td>
<td>13407.60</td>
<td>370516.90</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Omissions</td>
<td>2864.29</td>
<td>1329.01</td>
<td>1329.01</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Omissions</td>
<td>Profit for 1929</td>
<td>91010.20</td>
<td>91010.20</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Omissions</td>
<td>433218.76</td>
<td>533398.84</td>
<td>22661.41</td>
<td>3986.02</td>
<td>439298.76</td>
<td>530306.96</td>
<td>12910.52</td>
<td>13176.96</td>
</tr>
<tr>
<td>Omissions</td>
<td>402239.08</td>
<td>302309.00</td>
<td>46798.39</td>
<td>65493.78</td>
<td>404049.34</td>
<td>309162.70</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Omissions</td>
<td>835547.84</td>
<td>835547.84</td>
<td>69479.30</td>
<td>69479.30</td>
<td>530306.96</td>
<td>530306.96</td>
<td>413349.86</td>
<td>413349.86</td>
</tr>
</tbody>
</table>
show about the same amount as for last period. It looks as if I'll have to 
be more careful than usual in sizing up the bad debts. However, I'll first 
compare November and December sales with the amount last year; it may be 
that the rise is due to large increases in the sales for these two months. 
Then too it'll be advisable to compare the Shipping Record with the Sales 
Book and see if some of the January shipments have been treated as December 
31st sales.

The inventories compare favorably with last year's. But look at the 
increase in the Prepaid Assets account! I guess they have deferred some 
advertising expenses, just as they told me last year they were thinking of 
doing. I know I'm due for a "tough battle" here. Even when the amount is 
finally agreed upon, I'll have another "sweet job" in getting it placed 
among the "Other Assets". ¹

Well, so the new addition to PLANT-F cost them $150,000 in buildings 
and $310,000 in machinery. Better get Harper to analyze those accounts 
right away so they'll be finished in ample time before we leave here. Etc., 
Etc., Etc.

83. See Plate 9.
84. See Plate 10.
85. See Plate 11.
86. See Plate 12.

87. Individual Schedule²—As a rule, the senior auditor, himself, will 
head up the individual analysis sheets, and index them to the trial balance 
(or other figures) on the work sheet before assigning them to his subordinates 
for completion.³

In order to catch some of the accounts which may have been closed⁴ during 
the period, and especially in order to see that the opening figures in the 
ledger are the ones which were there last period, the senior should make the 
opening entry on each one of the analysis sheets from the closing figure as it 
appears on the work sheet of last period.

88. See Plate 13.

89. Checking Books of Original Entry and the General Ledger.—As a 
certain amount of checking of the books of original entry has to be done on 
every audit, the senior can safely start the juniors in on the cash book, 
voucher register, sales book, and so on. Since the last month of the audit 
period is always one of the months selected for complete testing and scrutiny, 
the juniors can be assigned that month to begin with, and later such other 
months as the senior may choose as a result of his analysis of the system of 
internal check and other matters.

At this time, it may be pointed out that in a strict balance sheet 
audit, it is not customary (for many auditors) to check the postings to the 

¹E.g. A major radio broadcast in November and December the benefits of 
which the client BELIEVES will be carried over into the first four months of 
the next year. ²As to ownership of Working Papers, see Ipswich Mills v 
Dillon which is cited at the end of this chapter. ³Sometimes, however, 
the indexing is not done until the audit is completed. ⁴All accounts 
opened and closed during the year must be analyzed. Thus an officer may 
continually pay up his loans just before the end of the year and then re-
borrow just after the first of the year.
EXPLANATION OF PLATE 11

A WORK SHEET (3d type)

THE WATJEN COMPANY

Work Sheet

Audit For the Year Ending December 31, 1929

85. Explanation and Comments.— This plate shows sections (selected at random) of the four pages composing a complete set of work sheets.

The accounts were drawn off in the order of assets, liabilities, networth, income, and expense,—the amounts being put in the two columns headed—Trial Balance December 31, 1929.

The figures for December 31, 1928 were taken from the work sheet made last year. These figures (i.e. those for the prior period) ought to appear on every work sheet for, among other things, they are useful in catching changes in account classifications. The writer prefers having these figures placed in the last two columns of the sheet because they will then be directly opposite the final figures for the current period.

Plate 12 gives the details of the auditor’s adjustments shown in the two adjustment columns.

The offsetting entries for adjustments 11 and 12 appear on sections of the work sheets not shown here.

Finally, it may be noted that when the books are closed prior to the audit, a good plan is to prepare the Work Sheets in two sections; one will consist of the balance sheet accounts and balance in itself; the other will consist of the profit and loss accounts and balance in itself. The balancing amount on each of these two sections will be, of course, the current profit or loss.
A WORK SHEET (3d type) PLATE 11

The Watjen Company
Work Sheet for the Year Ending December 31, 1929

<table>
<thead>
<tr>
<th>Name of Accounts</th>
<th>Ledger Analysis 1928 Adjusted T.B.</th>
<th>1929 Trial Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Page</td>
<td>Sheet</td>
</tr>
<tr>
<td>Cash-First National Bank</td>
<td>1</td>
<td>(1)</td>
</tr>
<tr>
<td>&quot; National City Bank</td>
<td>3</td>
<td>(2)</td>
</tr>
<tr>
<td>Accounts Rec. -Trade</td>
<td>5</td>
<td>(3)</td>
</tr>
<tr>
<td>&quot; &quot; -Other</td>
<td>7</td>
<td>(4)</td>
</tr>
<tr>
<td>Notes Rec. - Trade</td>
<td>9</td>
<td>(5)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Omissions</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts Payable - Trade</td>
<td>65</td>
<td>(37)</td>
</tr>
<tr>
<td>Mortgage Payable</td>
<td>80</td>
<td>(38)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Omissions</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common Capital Stock</td>
<td>125</td>
<td>(61)</td>
</tr>
<tr>
<td>1st Pfd Cum. 6% Stock</td>
<td>126</td>
<td>(62)</td>
</tr>
<tr>
<td>2d Pfd. 6% Stock</td>
<td>127</td>
<td>(63)</td>
</tr>
<tr>
<td>Capital Surplus</td>
<td>128</td>
<td>(64)</td>
</tr>
<tr>
<td>Earned Surplus</td>
<td>129</td>
<td>(65)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Omissions</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales - Rug Dept</td>
<td>149</td>
<td></td>
</tr>
<tr>
<td>Sales - Furniture Dept.</td>
<td>153</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Omissions</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purchases - Rug Dept.</td>
<td>196</td>
<td></td>
</tr>
<tr>
<td>Purchases - Furniture Dept.</td>
<td>203</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Omissions</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

To Balance Profit and Loss for 1929

Total this page 4

| Total Page 1 | 323687.40 | 103507.43 | 354907.30 | 108404.35 |
| " 2 | 253176.30 | | 249134.60 |
| " 3 | 204677.83 | 7099.60 | 209768.01 |
| Grand Total | 567161.56 | 567161.56 | 567306.96 | 567306.96 |
The Watjen Company  
Work Sheet for the Year Ending December 31, 1929  

<table>
<thead>
<tr>
<th>Auditor’s Adjustments</th>
<th>1929 Balance Sheet</th>
<th>1929 Profit and Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr.</td>
<td>Cr.</td>
<td>Dr.</td>
</tr>
<tr>
<td>(12) 1709.30</td>
<td>25018.37</td>
<td>56785.54</td>
</tr>
<tr>
<td>(24) 11576.00</td>
<td>1506.80</td>
<td></td>
</tr>
</tbody>
</table>

---

**OMISSIONS**

---

**(Top Portion of Page 1)**

---

**OMISSIONS**

---

**Bottom Portion of Page 1**

---

**OMISSIONS**

---

**Mid-Portion of Page 2**

---

**OMISSIONS**

---

**Top Portion of Page 2**

---

**OMISSIONS**

---

**Last Portion of Page 4**

---

**OMISSIONS**

---

<p>| | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>10370.49</td>
<td>12530.47</td>
<td>23037.39</td>
<td>23037.39</td>
<td></td>
</tr>
<tr>
<td>22506.60</td>
<td>17642.18</td>
<td>215678.43</td>
<td>367244.95</td>
<td></td>
</tr>
<tr>
<td>16003.91</td>
<td>14762.21</td>
<td>1209.60</td>
<td>97302.45</td>
<td></td>
</tr>
<tr>
<td>15330.93</td>
<td>13077.07</td>
<td>7803.20</td>
<td>246905.11</td>
<td></td>
</tr>
<tr>
<td>58011.93</td>
<td>58011.93</td>
<td>245519.02</td>
<td>367244.95</td>
<td></td>
</tr>
</tbody>
</table>

---
AUDITOR'S ADJUSTING ENTRIES (FOR PLATE 11) PLATE 12

F. Stacey

The Watjen Company
Adjusting Entries
Audit for the Year Ending December 31, 1929

Work Sheet
Analysis Sheet
No. No. No. Dr. Cr.

(10)
198 # Purchases - Rug Dept.
65 BB2 Accounts Payable - Trade (M.R. Smith)

To include Vo.#1-673 in 1929 purchases being
dated 12/26/29. Goods were received on
12/31/29 per Receiving Record - page 614 line
18. Due to an unexplainable slip-up, the
voucher was not recorded until Jan. 1930.
The goods were entered on 12/31/29 on
perpetual inventory card #6,503A

(11)
203 # Purchases - Furniture Dept.
206 # Purchases - Glassware Dept.

To correct an error in distribution in the
V. Register on page 171, Vo.#781. The
figure was placed in the Glassware column
whereas it should have been in the Furniture column.

--- Omissions --- Omissions ---

(24)
5 C1 Accounts Receivable - Trade
149 # Sales - Rug Dept.

To take up 1929 sales recorded in the Sales
Book (page 909) in 1930. These items could
not have been included in the inventory
because they were shipped Dec. 31st as per
Shipping Record (page 712), whereas the
inventory was taken on Jan. 1, 1930.
Mr. Peterson $700.00 Page 909 Ins. #2175
Mrs. Rose 10878.00 " " 2176
Total $11578.00

86. Explanation and Comments. - Every adjustment that the auditor makes
on his Adjusting Entries sheet should be indexed both to the Trial Balance
Work Sheet and to the particular Analysis Sheets concerned, and vice-versa.
The most important point for the auditor to watch in preparing the
adjusting entries is to make certain that his explanations are adequate.
Poor and inadequate explanations have caused auditors a tremendous amount
of annoyance, worry, and difficulty. No explanation can be too clear.
The reader should note that not all of the auditor's adjusting entries
will necessarily be adopted by the client, hence the auditor's certificate
may not read that the balance sheet and/or profit and loss statement are in
agreement with the books of account. This is NOT an important consideration
however. Moreover, the auditor will very likely have certain adjustments
which he will not ask the client to make; e.g. an adjustment transferring the
small "normal" credit balances in the individual accounts receivable in the
Customers' Ledger to individual accounts payable in the Creditors' Ledger.
A SCHEDULE PLATE 13

Eddy and Wood, Inc.
Furniture and Fixtures
Audit for the Year Ending April 30, 1930

<table>
<thead>
<tr>
<th>Date</th>
<th>Ref.</th>
<th>Creditor</th>
<th>Explanation</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1929</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4/30</td>
<td></td>
<td>Balance per G/L and per our audit report</td>
<td>14329.18</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5/17</td>
<td>V114</td>
<td>Warren Bros.</td>
<td>14 chairs</td>
<td>120.00</td>
<td></td>
</tr>
<tr>
<td>8/14</td>
<td>V748</td>
<td>Osborne &amp; Williams</td>
<td>1 desk lamp</td>
<td>34.19</td>
<td></td>
</tr>
<tr>
<td>4/3</td>
<td></td>
<td>Burroughs adding machine retired #68143291</td>
<td>410.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>J326 (New machine purchased. $50 allowance)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>A. Rec. 50</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>R. Depr 360</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>410</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Balance per G/L</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>14483.37</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>410.00</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>410.00</td>
<td></td>
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<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>14073.37</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Adjustment #18, Burroughs adding machine expensed in account #168 V1986
Final balance per G/L and our audit report 14568.37
To B/S

88. Explanation and Comments.— As can be seen by an examination of the various plates shown herein, there is no particular form which an analysis schedule should take. There is always plenty of scope for ingenuity.

The essential qualities of a good schedule are clearness, completeness, and brevity.

A schedule should be headed up with the name of the place being audited, the name of the account, etc. being analyzed, and the length of the audit period. The one who prepares the schedule should also sign his name (or initials), and the date on which the work was done. (This may just as well be done on the schedule in addition to putting them on the audit program.)

Note that the auditor took his opening balance from the work sheet (or audit report) of last period in order to prove that the books had not been altered since then.
general ledger. This is not a radical procedure at all when one stops to remember that in drawing up the various schedules which analyze the balance sheet accounts, the auditor does the equivalent of checking the postings, and footing the accounts. For example, in analyzing the Furniture and Fixtures account, the auditor will trace each entry in the account back into a book of original entry in order to get the number, etc., of the supporting voucher. Furthermore, he will add his analysis schedule to see that its balance agrees with that of the ledger account. In short, to repeat, he has checked the postings and footed the account.

In many detailed audits all of the profit and loss accounts in the general ledger are checked. However, it is very common indeed for the auditor to rely on a test check of these ledger postings. Likewise, in a detailed audit, the entries in the customers' and in the creditors' ledgers are usually tested somewhat extensively. A number of accounts should be selected, some at random and some with a purpose in mind, (such as large accounts, overdue accounts, accounts with credit balances, irregular accounts, etc.) for a complete test. That is, all of the entries therein should be checked back to books of original entry. In addition to this checking, some other items should be traced from books of original entry into the ledger accounts.

90. Confirmations. Just as soon as the auditor knows definitely what he wants to confirm, he should prepare and send out the confirmation letters (Plates 35, 36 and 64) so that he may have the replies in hand before he finishes the audit.

Many auditors are so lax in this matter that some of the replies are not received until after the report has been mailed to the client. If such a confirmation letter should fail to agree with the auditor's figures, the auditor would certainly be in a very tight place.

As to a stock method of remedying such an awkward situation, there is none. Each particular case will require a different handling. But one thing can be foretold with certainty. The penalty of losing one's auditing reputation in the community will be exacted, even though money damages are not involved.

On the other hand, the inexperienced auditor may send out his confirmation letters too soon. Further auditing may reveal questions that ought to have been asked. Of course, they can always be asked, but a series of requests will not impress the receiver (such as a banker) as being the work of an auditor who knows his business.

As the reputation (if true and merited) of an auditor is his chief asset, it behooves an aspiring senior auditor to pay attention to the impressions he gives of himself to others.

91. Minutes. As a rule the minutes of the board of directors, of the special committees, and of the stockholders will be abstracted by the senior because of their extreme importance.

If it is a first audit, the minutes of the opening sessions ought to be reviewed as a valuable means of getting acquainted with the purposes and founders of the business. In fact, if it is possible or at all feasible, all of the minutes since the organization date, ought to be scrutinized rather thoroughly. In any event, the minutes for the period under audit must be read in detail, and adequate notes must be taken.

Among the more important things which are often found in the directors' minutes of a business concern are as follows: election of the officers; the amount of salaries to be received by each executive; the authorization

See Appendix C, Sec. 7 -#2
of the purchase of any property (either tangible or intangible) for stock; authorization of the valuation of such property; the planning of bond and stock issues; declaration of dividends; appropriations of surplus; authorization of major additions and betterments; authorization of contracts for the acquisition of other corporations or interests therein; authorization of special bonuses; authorizations to settle suits in litigation; authorizations for the sale of plant property; authorization for the making of contracts for large purchase commitments; authorizations to start court action on infringements of patent or other rights; authorizations for the settling or contesting of additional tax assessments; authorization for the retirement of a stock issue, and so on.

In the case of universities, hospitals, and similar institutions, the directors' minutes will acknowledge gifts, bequests, etc., and give a brief excerpt of the specific purposes of the donations. In this way the auditor can verify the amount recorded in the cash book, and see to it that the funds are applied as their donors requested.

The minutes of special committees are often just as important as those of the board of directors, but some auditors fail to see it that way. If such auditors should ever be required to testify before a court on this matter, there is no doubt but what the auditors would be charged with gross negligence. That is, in the writer's opinion it is not optional for an auditor to review the minutes of special committees. They must be examined.

The minutes of the stockholders will show the election of the directors, the changes in the by-laws, the authorization to dissolve, the authorization to consolidate, the acceptance or rejection of the directors' plans to issue additional stock, and other basic matters in respect to which the decision is solely with the stockholders.

92. See Plate 14.

93. See Plate 15.

94. The Charter.—It is important for the auditor to ask for, and examine the charter in order to see that the business is really a corporation. Some individuals, it must be confessed, are not aware of the fact that it is necessary to get a charter from the state in order to be incorporated. Again, as the charter shows the powers of the business, the amount of stock authorized, etc., this document must be examined,—and the earlier the better.

95. By-Laws.—As the by-laws give the duties of the various officers, the auditor must make an abstract of them for his working papers so as to be in a position to know who has the right to take charge of the security transactions, who has the power to sign checks, who has the power to sign contracts, who has power to sign notes and drafts, and so on.1

Of course, as these powers are often altered from time to time, the auditor must look through the Minutes for these changes.

96. Capital Stock.—At an early date, the provisions of the different classes of capital stock should be drawn off on working papers. For example, if there are several classes of preferred stock, their respective rights will have to be clearly analyzed for otherwise the auditor will not know if the provisions thereof have been lived up to. This investigation is absolutely necessary since the auditor owes this duty to the stockholder; even if he were engaged direct by the directors or officers.

1In practice the fact that "K" signs the checks is taken by the auditor as evidence, without referring to the by-laws, that "K" is authorized to do so; and so on.
EXCERPTS FROM DIRECTORS' MINUTES  PLATE 14

Crosby and Wright
Directors' Minutes
Audit for the Six Months Ended April 30, 1930

Checked To
By________________

PLANT E WATER TOWER
W.S. 11/17/29 Accepted the bid made by Osborne & Pratt to build a new water
tower for $26147.00 on the roof of building AFB-5 at Plant E

COMMON DIVIDEND #48
W.S. 12/4/29 Declared quarterly dividend of 4% to stockholders of record
as of 12/31/29, payable 1/15/30

Payroll p.147
PERSONNEL EXPERT
KM Authorized a personnel manager at not more than $5000 per annum.

Omissions

Payroll
MR. KEOUGH RETIRED
p.179 Authorized the retirement of Mr. R.M. Keough, chief dyer, age 70, 45
W.S. years service, at pension of $240 per month for life starting 12/1/29

Payroll
OFFICERS ELECTED FOR 1930
p.316 President -R.M.Salibury $4000 Treas. -M.Wilson $18000
W.S. V.Pres. S. Salisbury $18000 Sec'y-R.Cochrane $18000
Gen. Manager - R.E.Jordan $72000

CONTINGENCY RESERVE CLOSED OUT TO SURPLUS
DD-5 Authorized the transfer of the Contingency Reserve of $50000 back
P.T into Earned Surplus.

4/15/30 None of the actions taken at this meeting concern us.

RIGHTS ON COMMON STOCK

4/30/30 As of 6/30/30 rights are to be issued to common stockholders
in the ratio of one right for each five shares held. One right and
$100 are required for each new share of common stock.

92. Explanation and Comments.- This plate is from a series of pages of
excerpts of Directors' Minutes of a single audit.

Only those transactions which have a bearing on the accounts or
position of the company are abstracted.

Note that a brief heading is given to each excerpt.

The initials under the "Checked To:" column mean that these persons
(auditors) have verified these items in the financial records. Thus Walter
Sullivan (W.S.) identified the cooling tower authorization with audit
schedule K2, which is entitled, "Additions to Buildings."

When there is a meeting but nothing of importance to the auditor
occurs, he should nevertheless, note the meeting and that fact. If no
reference is made to it, some one (or even the auditor himself at a later
date) may wonder if he overlooked that meeting.
Directors Elected

R. Williams, Peter Lang, S. Lang, M. Langen, N. Warren, T. Simpson, M. Marsters

Audit Report

Our 1928 audit report is read and accepted

Auditors Elected

E.W. & Co. are retained as the 1930 auditors

Common Stock Increased

12/17/29 Authorized the issuing of $250,000 ($50 par) of additional common stock through own efforts.

Pension Fund

Voted to request the Board of Directors to consider the matter of establishing a pension fund, and the retirement of aged employees of long service.

Combination with H.F. Grebe, Inc.

Motion to consolidate with H.F. Grebe, Inc. was defeated.

93. Explanation and Comments.—This plate shows the nature of items to be abstracted from the stockholders' minutes. Note the different type of function exercised by the stockholders from that of the board of directors (Plate 14).
Moreover, without an analysis of the provisions of all of the classes of capital stock, the auditor would be negligent in giving an unqualified certificate reading, "And, I Hereby Certify, that in my opinion the above balance sheet is a true and correct presentation of the financial condition of the Gooch and Helliwell Cotton Corporation as at February 28, 1930."

For example, a provision in the preferred stock might show that the dividend liability to the common stockholders is illegal because the net quick assets are below 110% of the outstanding preferred stock.

97. See Plate 16.

98. See Plate 17.

101. See Plate 20.

102. Contracts.— Many contracts which the client has entered into will not concern the auditor. But if, for example, a contract has been made between the president and the board of directors for a salary of $35,000 for the next five years, the auditor will note this fact in his working papers and check the president’s salary against this figure.

Again, if there is a future contract for the purchase of $1,500,000 worth of raw materials, that fact deserves the auditor’s closest attention as to its bearing upon the financial condition of the company. (A full discussion of purchase commitments is taken up under that heading in the chapter on inventories (section 255)).

Again, if the corporation had let a contract for a new building costing $750,000 that fact would also interest the auditor because it means that the financial structure of the business is going to change. Perhaps this outlay on plant will not strain the current position of the business; on the other hand, it may damage the current ratio considerably. At any rate, it is a change, the effect of which is important enough to warrant making a note of it either on the balance sheet or in the report.

In brief, all contracts of any size must be very carefully read and excerpts must be drawn off on to the working papers. If the auditor overlooks these documents, he is incompetent. Not every contract will require a notation on the balance sheet or a comment in the report, but many of them will doubtlessly be commented on in this manner. Contracts often change the whole color of a statement which has been drawn up merely on the basis of the book accounts.

103. Partnership Agreements.—If the client is a partnership, the senior himself ought to make the abstract of the partnership agreement. Often he will find therein a paragraph devoted to each of the following matters: the powers and duties of the several partners; the arrangement as to partners' salaries, if any; the interest, if any, to be allowed on capital accounts or charged on drawing accounts; the percent division of profit and loss; the provision for drawings, if any; and such other matters as the auditor must know about before he can set forth the final equities of the partners in the business.

On many occasions the auditor will find that no written partnership agreement exists. If so, the auditor can give no better piece of constructive advice than to convince the partners that prudence demands that there be a written agreement.
97. Explanation and Comments.—This plate is introduced to show the complexity of some preferred stock issues, and to prove that unless the auditor examines the various capital stock provisions and sees that they are carried out, he is grossly negligent in certifying that he is presenting a true and correct exhibit of the state of the company's affairs.

Warren, Hasking & Crosby
7% Preferred Stock Provisions
Audit for the Six Months Ending June 30, 1928
Richards 7-8-28
Sheet 1
Schedule 15

Authorized $3,000,000  Par $100  Issued $2,000,000  Unissued $1,000,000
7% cumulative  Participating same ratio as common
Dividends Payable Quarterly Jan. 1, April 1, July 1, Oct. 1

Preferred As to Assets.—In the event of dissolution the stock is entitled to $115 per share and accumulative dividends before any distribution may be made on any other class of stock.

Sinking Fund.—10% of the annual net profits remaining after the payment of all taxes and 7% dividends on this stock. Payments to be made annually, the first one to start with the year ended Dec. 31, 1924. The auditors are to determine the figure. The fund is to purchase and retire the stock at not more than $110 per share and accrued dividends. Any unexpended funds can not be invested; they must be banked.

Callable.—The stock is callable by lot in whole or in part for the fund at any dividend date at $110 per share and accrued dividends on 30 days' notice.

New Stock.—This issue may not be increased without 75% affirmative vote.
The $1,000,000 unissued stock may be issued only (1) when the corporation's consolidated net assets (depreciation deducted, and not including patents, trademarks or goodwill, but including the proceeds of this $1,000,000) are at least twice the par value of the total issued stock (including this $1,000,000) and (2) when the corporation's average annual net earnings (as certified to by the auditors) for the last five fiscal years preceding such issue shall have equaled at least twice the annual dividend requirements of this outstanding stock (including the $1,000,000 proposed to be issued)

Cash Dividends.—No cash dividends may be paid on common
(1) Except out of profits earned after Dec. 31, 1923
(2) Which will reduce the net quick assets (to be defined by the auditors) below 110% of the preferred stock then outstanding.
(3) While any sinking fund payment on preferred is in arrears.
(4) Until the current quarterly dividend and all accumulated dividends on the preferred is paid.

Omissions

Funded Debt.—No mortgage or funded debt or stock having a priority over or equality with this stock is to be issued except on consent of 75% of the preferred stockholders. The Corporation may however acquire additional property subject to existing or purchase-money mortgages or liens.

Voting.—No voting power except if eight quarterly dividends are in arrears. It then has the sole voting power until only four quarterly dividends are in arrears at which time it has equal voting power per share with the common stock until all arrears are fully paid up.

Auditors.—Annual audit by C.P.A. selected by common stockholders.
Authorised $20,000,000 Issued and Outstanding $15,000,000
8% Sinking fund convertible gold bonds
Dated Jan. 1, 1920 Due Jan. 1, 1970 Interest Jan. 1 and July 1
Guaranty Trust Company of Wichita, California is the Trustee.
Coupon bonds $1000, $500, and $100 denominations - Can be registered as to principal only in respect to the $1000 denominations.

Mortgage.- No additional mortgage or pledge of corporations' property can be made beyond the $15,000,000 1st mortgage now existing unless the net earnings are equal to at least three times the total interest charges including interest on the bonds proposed to be issued, and then at not more than 50% of the cost of the new plant additions made after January 1, 1920. See also NET ASSETS, below.

Notes.- No additional notes or other evidences of indebtedness, other than current accounts, acceptances, etc. or not more than one year's maturity incurred in the ordinary conduct of business, can be issued.

Convertible.- The bonds are convertible at par with adjustment of interest and dividends at the option of the holder at any time prior to maturity or redemption upon 30 days notice to corporation in Class B Common Stock.

Sinking Fund.- 20% of the net income remaining after the payment of all taxes and interest on the 1st mortgage bonds and on these bonds (with a minimum retirement per annum of 1/50 of the bonds outstanding) is to be used to call and retire these bonds at not more than 107 prior to January 1, 1940, and not more than 106 during the next 20 years, and at not more than 101 during the remaining years, plus accrued interest. The first sinking fund payment to be based on the fiscal year ended October 31, 1920.

Callable.- The bonds are callable by lot as a whole or in part on any interest date and on 30 days notice at not more than 107 prior to January 1, 1940, and at not more than 105 during the next 20 years, and at not more than 101 during the remaining years, plus accrued interest.

Net Assets.- The total net assets shall equal 350 per cent of the total fixed debt of the corporation. The Plant Properties must be at least 200% of the total fixed debt. See MORTGAGE, above.

Current Assets.- The current assets must be at least 200% of the current liabilities before and after any dividends may be paid on either the preferred or on the common stock.

Explanation and Comments.- This plate is introduced (1) to show the complexity of some bond provisions, and (2) to prove to the reader that unless an auditor examines the bond indentures and sees that they are carried out, he is grossly negligent in certifying that he is presenting a true and correct view of the financial condition of the corporation.
EXPLANATION OF PLATE 18
AN INDEXED BALANCE SHEET

THE SEYWARD CORPORATION
Balance Sheet - December 31, 1929 - 1930

99. Explanation and Comments.— Quite often the auditor's working papers are indexed (as here) to the completed final Balance Sheet in addition to the Work Sheet.

Under another common method of indexing, the Balance Sheet is prepared on the basis of the client's figures. By the use of additional adjustment columns, these amounts are brought into agreement with the auditor's working papers. When this procedure is adopted, the working papers will not be indexed to the Work Sheet.

An outline of such a Balance Sheet is as follows:

<table>
<thead>
<tr>
<th></th>
<th>1929</th>
<th>1930</th>
<th>Auditor's adjustments</th>
<th>1930</th>
</tr>
</thead>
<tbody>
<tr>
<td>final PROPERTY AND PLANT per client</td>
<td>1,129,604.53</td>
<td>2,208,523.14 (12)</td>
<td>60,146.19</td>
<td>(15) 33,633.11#</td>
</tr>
</tbody>
</table>

The following are the analyses of Exhibits A2, A3, and A4.

**EARNED SURPLUS**

<table>
<thead>
<tr>
<th></th>
<th>1930</th>
<th>Exhibit A2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance January 1, 1930</td>
<td>$640,429.15</td>
<td></td>
</tr>
<tr>
<td>Net Income - Exhibit B</td>
<td>$981,941.11</td>
<td></td>
</tr>
</tbody>
</table>

Less—Appropriation to Sinking Fund Reserve $40,000.00
Appropriation to Fire Insurance Reserve $50,000.00
Dividends - 7% on Preferred $8 on common $160,000.00

Balance December 31, 1930 $1,219,370.26

**APPROPRIATED EARNED SURPLUS**

<table>
<thead>
<tr>
<th></th>
<th>1930</th>
<th>Exhibit A3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance, Jan. 1</td>
<td>$140,000.00</td>
<td>$320,000.00</td>
</tr>
<tr>
<td>Appropriation</td>
<td>$100,000.00</td>
<td>$100,000.00</td>
</tr>
<tr>
<td>Obsolete Inventories</td>
<td>$14,000.00</td>
<td>$14,000.00</td>
</tr>
<tr>
<td>Balance, Dec. 31</td>
<td>$100,381.76</td>
<td>$396,000.00</td>
</tr>
</tbody>
</table>

**CAPITAL SURPLUS**

<table>
<thead>
<tr>
<th></th>
<th>1930</th>
<th>Exhibit A4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Appraisal of Plant</td>
<td>$498,612.49</td>
<td>$247,689.04</td>
</tr>
<tr>
<td>Revaluation of Goodwill, etc.</td>
<td>$28,311.09#</td>
<td>$2,912.90#</td>
</tr>
<tr>
<td>Total</td>
<td>$746,301.53</td>
<td>$31,228.99#</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>1930</th>
<th>Exhibit A4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance, January 1</td>
<td>$470,301.40</td>
<td>$244,776.14</td>
</tr>
<tr>
<td>Depreciation of Appreciation</td>
<td>$715,077.54</td>
<td></td>
</tr>
</tbody>
</table>
### The Seward Corporation

**Balance Sheet—December 31, 1929-1930**

(Subject to the "Auditors' Certificate" and the "Comments" in the attached Report)

#### Assets

<table>
<thead>
<tr>
<th>Dec. 31, 1929</th>
<th>Dec. 31, 1930</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>PROPERTY AND PLANT</strong></td>
<td><strong>PROPERTY AND PLANT</strong></td>
</tr>
<tr>
<td>Land</td>
<td>Land</td>
</tr>
<tr>
<td>304436.00</td>
<td>304436.00</td>
</tr>
<tr>
<td>Buildings</td>
<td>Buildings</td>
</tr>
<tr>
<td>1129604.53</td>
<td>901612.27</td>
</tr>
<tr>
<td>Machinery and Equipment</td>
<td>1017629.93</td>
</tr>
<tr>
<td>2981637.41</td>
<td>5187837.49</td>
</tr>
<tr>
<td>Fixtures</td>
<td>24720.01</td>
</tr>
<tr>
<td>20611.51</td>
<td>21762.20</td>
</tr>
<tr>
<td>46482.21</td>
<td>46482.21</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>Total</strong></td>
</tr>
<tr>
<td>4456446.57</td>
<td>4872027.25</td>
</tr>
<tr>
<td><strong>GOODWILL PATENTS and TRADEMARK</strong></td>
<td><strong>GOODWILL PATENTS and TRADEMARK</strong></td>
</tr>
<tr>
<td>300000.00</td>
<td>304000.49</td>
</tr>
<tr>
<td><strong>INVESTMENTS in the BECK CORPORATION:</strong></td>
<td><strong>INVESTMENTS in the BECK CORPORATION:</strong></td>
</tr>
<tr>
<td>Common Stock (Par $500,000; Book value $550,000)</td>
<td>580000.00</td>
</tr>
<tr>
<td>First Mortgage 7% Bonds (Due 1940)</td>
<td>113000.00</td>
</tr>
<tr>
<td><strong>FIRE INSURANCE FUND</strong> (Market $151,000) (And Policies $55,000)</td>
<td>143012.79</td>
</tr>
<tr>
<td><strong>SPECIAL DEPOSITS with TRUSTEES:</strong></td>
<td><strong>SPECIAL DEPOSITS with TRUSTEES:</strong></td>
</tr>
<tr>
<td>Guaranty Trust Company, Detroit</td>
<td>5869.14</td>
</tr>
<tr>
<td>Sinking Fund Cash</td>
<td>397604.87</td>
</tr>
<tr>
<td>4287.12</td>
<td>245817.25</td>
</tr>
<tr>
<td>Sinking Fund Investments (Market $240,680.25)</td>
<td>245817.25</td>
</tr>
<tr>
<td><strong>Equitable Trust Company, New York:</strong></td>
<td><strong>Equitable Trust Company, New York:</strong></td>
</tr>
<tr>
<td>Contract Guaranty Deposit—Cash</td>
<td>130000.00</td>
</tr>
<tr>
<td>494621.00</td>
<td>361686.39</td>
</tr>
<tr>
<td><strong>CURRENT ASSETS:</strong></td>
<td><strong>CURRENT ASSETS:</strong></td>
</tr>
<tr>
<td>Cash-General</td>
<td>1145460.23</td>
</tr>
<tr>
<td>Cash on Deposit for Payment of Dividends</td>
<td>115000.00</td>
</tr>
<tr>
<td>Notes Receivable—Trade, Less Reserve 57629.12</td>
<td>115000.00</td>
</tr>
<tr>
<td>Accounts &quot; &quot; &quot; &quot;</td>
<td>236814.17</td>
</tr>
<tr>
<td>Inventories (At Cost or Market) 5</td>
<td>344443.29</td>
</tr>
<tr>
<td>Finished Goods</td>
<td>267189.45</td>
</tr>
<tr>
<td>Work-in-Progress</td>
<td>157012.78</td>
</tr>
<tr>
<td>Materials and Supplies</td>
<td>181193.45</td>
</tr>
<tr>
<td>Advances on Raw Materials:</td>
<td>605395.68</td>
</tr>
<tr>
<td>Contracted For (Market $890,000)</td>
<td>865300.00</td>
</tr>
<tr>
<td>Due on Contract</td>
<td>452406.09</td>
</tr>
<tr>
<td>Liberty Bonds (1st 3 1/2; Due 1932-47)</td>
<td>412893.91</td>
</tr>
<tr>
<td>(Par 90,000—Market $874,98)</td>
<td>86540.50</td>
</tr>
<tr>
<td>Accrued Interest Receivable</td>
<td>17651.12</td>
</tr>
<tr>
<td>Prepaid Expenses</td>
<td>42107.45</td>
</tr>
<tr>
<td>Deferred Charges to Operations:</td>
<td>42107.45</td>
</tr>
<tr>
<td>Unamortized Discount and Expense on Bonds</td>
<td>25612.49</td>
</tr>
<tr>
<td>Deferred Advertising Expenditures</td>
<td>11321.47</td>
</tr>
<tr>
<td>Experimental Expenditures</td>
<td>6614.55</td>
</tr>
<tr>
<td><strong>TOTAL ASSETS</strong></td>
<td>9214625.82</td>
</tr>
</tbody>
</table>

---

1. Replacement value determined by THE PIT APPRAISAL CO. of PROVIDENCE, R.I. as at Jan. 1, 1929, plus additions since at cost.
2. As appraised by the Corporation as of Jan. 1, 1929, plus net additions.
3. Taken and priced by the management, and subjected to a critical analysis for substantial accuracy by ourselves.
### LIABILITIES and CAPITAL

#### 8-33

**Dec. 31, 1929**

<table>
<thead>
<tr>
<th>LIABILITIES and CAPITAL</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>20,000,000.00 <strong>AA</strong></td>
<td>FIRST MORTGAGE 6% GOLD BONDS (Due 1956):</td>
</tr>
<tr>
<td>20,000,000.00</td>
<td>(Authorized and Issued)</td>
</tr>
<tr>
<td>(60,000,000.00)</td>
<td>Less-In Sinking Fund 71,000,000.00</td>
</tr>
<tr>
<td>In Treasury (Pledged) 80,000.00</td>
<td>79,000,000.00 121,000,000.00</td>
</tr>
</tbody>
</table>

| 32,000,000.00 | CONTRACT OF PURCHASE - WAREHOUSE: |
| 24,000,000.00 | Payable at rate of $36,000 per annum |

<table>
<thead>
<tr>
<th>CURRENT LIABILITIES:</th>
</tr>
</thead>
<tbody>
<tr>
<td>50,000.00 <strong>CC</strong></td>
</tr>
<tr>
<td>4,569,065.05 <strong>DD</strong></td>
</tr>
<tr>
<td>21,061,124.12 <strong>EE</strong></td>
</tr>
<tr>
<td>51,000.00 <strong>FF</strong></td>
</tr>
<tr>
<td><strong>GG</strong></td>
</tr>
<tr>
<td>35,000.00</td>
</tr>
<tr>
<td>60,000.00</td>
</tr>
<tr>
<td>51,612,614.61 <strong>HH</strong></td>
</tr>
<tr>
<td>21,791,511.17 <strong>II</strong></td>
</tr>
<tr>
<td><strong>JJ</strong></td>
</tr>
<tr>
<td>40,011,450.00</td>
</tr>
</tbody>
</table>

#### CONTINGENCIES:

1. The Company has a contingent liability as guarantor of the principal and interest of $500,000 first mortgage bonds of the Beck Corporation.
2. The Company has undetermined liabilities on account of unreported drafts drawn by its Asiatic agents for purchases of raw materials under letters of credit the unissued balances of which total $253,187.92.
3. The Company has a contingent liability of $201,609.54 on account of notes and acceptances receivable discounted.

#### CAPITAL

**CAPITAL STOCK:**

| 10,000,000.00 **KK** | 7% Preferred (Non-Cum) (Par $100) 10,000,000.00 |
| (Authorized 15,000 Sh) |
| 15,326,124.00 **LL** | Common (Auth. 30,000 No Par Shares) 15,326,124.00 25,326,124.00 |
| (Issued 20,000 Shares) |

<table>
<thead>
<tr>
<th><strong>SURPLUS:</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Earned:</strong></td>
</tr>
<tr>
<td>64,042,915.15 <strong>MM</strong></td>
</tr>
<tr>
<td>11,660,000.00 <strong>NN</strong></td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
</tbody>
</table>

| **74,630,153.63 **OO** | Capital (Exhibit A-4) 71,507,754.54 31,448,295.56 56,774,415.66 |
| **90,804,876.68** | TOTAL LIABILITIES and CAPITAL 92,146,254.82 |

(This is the equity side of the balance sheet given on Plate 18.)

(This balance sheet is NOT to be taken as a model. However, in most respects it is good.)
A SCHEDULE ON MEMOS  PLATE 19

Bury & Morcross, Inc.
Memo - Voucher Register
Nov. 30, 1930

Missings Vouchers

<table>
<thead>
<tr>
<th>No.</th>
<th>Quantity</th>
<th>Status</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1318</td>
<td>2817</td>
<td>5115</td>
<td>6285</td>
</tr>
<tr>
<td>1394</td>
<td>2901</td>
<td>5524</td>
<td>6992</td>
</tr>
<tr>
<td>1402</td>
<td>2902</td>
<td>5596</td>
<td>12189</td>
</tr>
<tr>
<td>1708</td>
<td></td>
<td>5832</td>
<td></td>
</tr>
</tbody>
</table>

Found by file clerk

Errors in Distribution

<table>
<thead>
<tr>
<th>Is</th>
<th>Should be</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vo. #1186 Machinery</td>
<td>Repairs to Machinery</td>
</tr>
<tr>
<td>1199 Stores - Acct. #14 Stores - Acct. #17</td>
<td></td>
</tr>
<tr>
<td>2012 Adm. Expense #113 Selling Expense #115</td>
<td></td>
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</table>

Results

<table>
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<tr>
<th>Vo. #1186 Machinery</th>
<th>Repairs to Machinery</th>
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</thead>
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<tr>
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<td>Machinery</td>
</tr>
<tr>
<td>Repairs to Machinery</td>
<td></td>
</tr>
<tr>
<td>896.21 Taken up</td>
<td></td>
</tr>
<tr>
<td>1467.57 in Adj.</td>
<td></td>
</tr>
<tr>
<td>954.24 #24</td>
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</tr>
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Omissions

November Vouchers Entered in December

<table>
<thead>
<tr>
<th># Vo. #187</th>
<th>11/28</th>
<th>Stores - Acct. #12</th>
</tr>
</thead>
<tbody>
<tr>
<td>#284</td>
<td></td>
<td></td>
</tr>
<tr>
<td>566</td>
<td>11/29</td>
<td>Factory Exp. - Acct. #11</td>
</tr>
<tr>
<td>591</td>
<td>11/30</td>
<td>Selling Exp. - Acct. #15</td>
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<tr>
<td>#187 on page 45 and #591</td>
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</table>

Amount

<table>
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<tr>
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<th>11/28</th>
<th>Stores - Acct. #12</th>
</tr>
</thead>
<tbody>
<tr>
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<td></td>
</tr>
<tr>
<td>566</td>
<td>11/29</td>
<td>Factory Exp. - Acct. #11</td>
</tr>
<tr>
<td>591</td>
<td>11/30</td>
<td>Selling Exp. - Acct. #15</td>
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Amount

<table>
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<tr>
<th># Vo. #187</th>
<th>11/28</th>
<th>Stores - Acct. #12</th>
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</thead>
<tbody>
<tr>
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<td></td>
<td></td>
</tr>
<tr>
<td>566</td>
<td>11/29</td>
<td>Factory Exp. - Acct. #11</td>
</tr>
<tr>
<td>591</td>
<td>11/30</td>
<td>Selling Exp. - Acct. #15</td>
</tr>
</tbody>
</table>

Omissions

100. Explanations and Comments.- The junior auditor should realize immediately that when a new piece of work is started, a new MEMO-SHEET should be headed up. Nothing impedes the progress of the work any more than when unrelated memorandum have been written on the same sheet.

Observe that an important part of a MEMO-SHEET is the section devoted to RESULTS. The findings, criticisms, and suggestions of the one who has done the actual auditing work are stated on the left hand side of the sheet. These are then reviewed by the senior in charge of the audit. If a suggestion is not adopted the word "PASS" will be written opposite it; if it is adopted and results in an auditor's adjustment, for example, the adjustment number will be given, and so on. In any case, at the close of the audit, no suggestion, etc. will have been made without there appears in the RESULTS section a notation of the disposition made of it by the senior in charge.
A SCHEDULE ON AGENDA  PLATE 20

Baker
Snow & Snow, Inc.
Agenda
B/S Audit for the Six Months Ended June 30, 1930  Schedule 15

<table>
<thead>
<tr>
<th>Results</th>
<th>Checked By</th>
</tr>
</thead>
<tbody>
<tr>
<td>#20</td>
<td>Omissions</td>
</tr>
<tr>
<td>Are there any goods out on consignment with T.T. Amborn (or others) this time?</td>
<td>No</td>
</tr>
<tr>
<td>#21</td>
<td>Omissions</td>
</tr>
<tr>
<td>Don't forget to check the sales contracts.</td>
<td>Done</td>
</tr>
</tbody>
</table>

| #28     | Omissions  |
| Beginning this year the Company has employed a Transfer Agent and a Registrar. | (MM1) | E.W. |
| (MM2)    | E.W.       |
| Be sure to get their certificates. |

| #29     | Omissions  |
| Discuss with A. Goldsmith the possibility of showing the Treasury Stock as a deduction of Cap. Stock B/B from capital stock outstanding rather than Outstanding as an asset. The amount is very sizable this year. |
| Reduction |
| of B/S |
| |

| #35     | Omissions  |
| What is the status of the claim for the refund on the 1925 federal income tax? | See DD3 | E.C.W. |

| #36     | Omissions  |
| Analyze for our working papers the contract made with The White Machine Corp. for the 75 new looms for Dept. DF5A | (17) | R.M. |

101. Explanation and Comments.- As the senior gets deeper and deeper into the audit, there will usually occur to him from day to day a number of different things to be looked into or done, and so on. These matters are written down immediately as it is futile for him to attempt to carry them in his mind if the audit is of any magnitude at all.

Note that there is a space devoted to the RESULTS, and one to the initials of the person who arrived at them. The importance of having these two facts upon such schedules as this can not be overemphasized.

Ordinarily it is better to confine the comments to the left half of the sheet so that the results may also be given ample room.
If the agreement is in writing, the partnership has a better lease on life since there is then a definite statement on what the partners agreed to. Often a partnership comes to grief because one partner or group of partners says, "We agreed thus and so," whereas the other partners deny it. Both sides may be stating their honest opinions as to what they believed was decided among them, but as there is nothing in writing to which to refer, ill will arises even though they patch up their quarrel. How much more sensible and business like it would have been to have drawn up a written agreement at the formation of the partnership! To be certain, a partner might be mistaken in his idea as to what is in the written agreement, or as to what certain words therein mean. But even so, the interpretation by a confidential neutral party could be secured, whose decision should be satisfactory to all.

Again, no matter how much faith one has in his partner or partners, a written agreement should be entered into as a personal protection against the failure of one or more partners to justify the confidence placed in him. Cashiers and others do not resent being bonded, neither should partners resent the idea of a written agreement. It is absolutely no reflection on their honesty; it is simply a procedure which long experience has shown to be advisable.

If the auditor cannot persuade the partners to make a written agreement, he ought himself to set down in his working papers the answers to such questions as were necessary for him to ask in order to set out the respective interests of the partners. Moreover, in such cases the auditor should also provide places for the signatures of the partners at the end of the audit reports. If he does so, he will be adopting an excellent method of protecting the interests of each partner, and of preventing misunderstandings, since it is unlikely that any partner will sign the reports if he isn't satisfied with their accuracy.

104. Wills.—If the audit is for an estate, the auditor will need the deceased's will. Formerly an auditor deemed it sufficient if he audited the books and records and set forth in the exhibits the status of the accounts as he found them. But to-day, leading auditors would not consider that sufficient. They would ask for the will in order to see if the provisions thereof had been carried out. For example, formerly if an audited account called for $60,000 par value of Robertson Manufacturing Co. common stock, it was sufficient if the auditor accounted for that amount; but to-day, the auditor would want to know that that type of investment did not violate any provisions of the will.

Again, in the past an auditor would have performed his duty if he showed in his exhibit that Mrs. Parker Townsend received $50,000 from the estate as a bequest, but a modern auditor would also examine the will to satisfy himself that such was the provision for Mrs. Townsend.

105. Mortgages.—Likewise, an auditor will know much better where he is at, if he analyzes the mortgage indentures before he gets deep into the details of the audit. As the making of a correct analysis of mortgage

The greatest damage done by errors arising from oral (rather than written) orders or agreements is NOT the loss incurred through goods being processed incorrectly by reason of the misunderstanding, etc., etc., but rather the friction which such mistakes and misunderstandings engender among the executives. No organization can long succeed if its executives harbor ill-will, one towards the other; and it is oral orders and the like which are one of the chief causes thereof. To repeat, then, ALL orders or agreements should be in writing.
indentures is often difficult, as is this whole matter of seeing that the provisions of these important instruments are complied with, the senior ought to do this work himself.

ADDENDUM

The following case (from the American Accountant) shows that auditor's working papers are his sole property and must remain in his possession.

Supreme Judicial Court of Massachusetts
260 Mass 453
Ipswich Mills v. William Dillon and Another

Suffolk, Argued March 8, 1927
Opinion filed July 5, 1927
Present: Rugg, C.J., Braley, Pierce, Carroll and Waitt, JJ.

Accountant, Ownership of letters, work sheets, and memoranda.
Agency, Independent contractor.

Reservation and report by Weed, J., of a suit in equity heard by him in the Superior Court.

Carroll, J. The question involved in this suit in equity is the ownership of certain papers. The plaintiff is a manufacturer of hosiery. The defendants are accountants, father and son, who have been partners since January 1, 1921. In 1912 or 1913 the father, and later the firm, were employed by the plaintiff as accountants to make an annual audit, to prepare tax returns, and to perform services on matters of bookkeeping, cost accounting and statements for banks. This employment continued until December, 1925. In 1922 or 1923 the defendants were employed to conduct a Federal tax case before the bureau of internal revenue as attorneys for the plaintiff. While a Federal revenue agent was making an examination of the plaintiff's returns for the years 1922, 1923, 1924, he was sent by the plaintiff to the defendants to examine certain papers in their possession relating to the plaintiff's affairs, more particularly the defendants' "work sheets" relating to the revaluation of the plant assets and to certain adjusted inventories developed in their work on the tax case. The defendants refused the revenue agent access to these papers. On January 6, 1926, the plaintiff demanded of the defendants "all papers in your possession belonging to Ipswich Mills." No papers were delivered and this suit was instituted.

Papers Produced at Trial

All papers involved which were in the defendants' possession were produced by them at the trial. They were examined by the parties, grouped, initialed and impounded, awaiting the final decision of the case. Group A consisted of papers that originated in the plaintiff's office or in the office of its selling agents, or of some one associated with them, including papers relating to the 1917 Federal tax return of the plaintiff. The defendants conceded that the plaintiff is the owner of these papers in Group A, and entitled to possession of them. Group B included a copy of the amended Federal tax return of the plaintiff for the year 1918, and certain papers (not work sheets) relating thereto. In Group C there were copies of the plaintiff's tentative and amended tax return for 1919 with work sheets and correspondence in connection therewith. In Group D were papers and work sheets of the revaluation of the plaintiff's plant assets. The
papers in Group E were the defendants' work sheets of their July, 1922, report. Group F included papers, reports, returns, copies, work sheets, data, correspondence and memoranda respecting the tax case, together with some letters originating in the plaintiff's office.

Work Sheets Defined

It was found by the trial judge that "work sheets" meant papers on which original compilations, computations and analyses are made by accountants, which later are gathered together in a summary form and the figures rendered in a schedule, exhibit, report or return upon which the accountant is working. The judge ruled that the plaintiff was the owner of the papers in groups B, C, D and E, and entitled to the immediate possession of them, the defendants being entitled to take and preserve such photostatic copies as they desired. With reference to the papers initialed F, the judge ruled that the parties were jointly interested in these particular papers, with the right in the plaintiff to take them temporarily from the defendants. An order for a decree was made. The case was then reported to this court.

Concerning the papers marked F, which consist of "copy of amended Federal tax return of the plaintiff for 1918 and certain papers (not work sheets) relating thereto," the judge found "the defendants were under employ as accountants, --auditing, checking up and verifying, and making a research for the original costs of the plaintiff's plant assets then in use and applying depreciation figures decided upon by the directors with respect to the different classes of property. It was work of a character requiring accounting skill and experience, and good judgment in reaching sound and dependable conclusions where original entries were obscure or vouchers missing. It was fully paid for by the plaintiff." We assume that the original tax return was delivered to the plaintiff and the copy of this return retained by the defendants. The defendants were not the agents or servants of the plaintiff, they were independent contractors. In the making of the documents and papers and in collecting the information involved in them, the defendants were independent accountants engaged in their own occupation. See Pearl v. West End Street Railway, 176 Mass. 177, 179; Leverone v. Arancio, 179 Mass. 439, 443. They had the right to make and retain copies of the tax return. It might be necessary to have possession of the copies if the accuracy of their work was questioned. There was nothing in the contract of employment which required the defendants to surrender this copy and in the absence of such an agreement they could not be compelled to surrender it. The other papers relating to the Federal tax return of 1918, mentioned in Group F, we understand are office copies of letters sent by the defendants. The defendants could retain copies of these letters as well as copies of the schedules which are indicated by the evidence as being a part of the "papers -- -- -- relating thereto." This copy of the return and the papers relating thereto may have contained information of importance to the plaintiff. The right of the plaintiff to restrain its publication is not before us. Even if it be assumed that the defendants could be enjoined from the publication of the contents of these papers, the title to them was in the defendants.

Ruling as to Letters

Group C consisted of (1) carbon copies of letters from the defendants to the plaintiff; (2) original letters from the plaintiff to the defendants; (3) original letters to the defendants from the plaintiff's attorneys; and (4) carbon copies of letters from the defendants to the collector of internal revenue.
The carbon copies of the defendants' letters to the plaintiff were the property of the defendants. The plaintiff did not own these copies and was not entitled to their possession. The contract of employment did not require the defendants to furnish these copies to the plaintiff.

The original letters from the plaintiff to the defendants belonged to the defendants. They were the recipients, and therefore owned them. It was decided in Baker v. Libbie, 210 Mass. 599, 606, after an exhaustive review of the authorities, that as a general rule the publication of letters may be restrained by the author, but in the absence of some special arrangement the recipient of the letter is the owner. "The author parts with the physical and material elements which are conveyed by and in the envelope. These are given to the receiver. The paper upon which the letter is written belongs to the receiver. Oliver v. Oliver, 11 C.B. (N.S.) 129, Grisby v. Breckinridge, 2 Bush, 460, 466. Pope v. Curl, 2 Ark. 341. Werckmeister v. American Lithographic Co., 142 Fed. Rep. 827, 830. A duty of preservation would impose an unreasonable burden in most instances. It is obvious that no such obligations rest upon the recipient, and he may destroy or keep at pleasure." The same principle is applicable to the letters sent from the plaintiff's attorneys to the defendants. As the defendants were the receivers of these letters, they were the property of the defendants.

Tax Letters Owned by Defendants

The carbon copies of the defendants' letters to the collector of internal revenue did not belong to the plaintiff. Whatever right it may have to examine these copies, or take copies of them, which point we are not called upon to decide, the defendants' copies did not belong to the plaintiff; they were owned by the defendants. The fact that the copies of these letters concern the plaintiff is not a sufficient reason for depriving the defendants of their property. In writing the letters the defendants were not the plaintiff's servants. In Group C there are copies of Federal tax returns. These, as we understand from the record, were the defendants' office copies. The record shows that copies of all returns and schedules prepared by the defendants for the plaintiff were sent to the plaintiff. Even if the plaintiff has a right to require further copies, a question not involved in this suit, it has no right to demand of the defendants the surrender of these office copies. They were the property of the defendants.

Ruling as to Work Sheets

The work sheets, as defined by the trial judge, were the defendants' property. They were made by them while engaged in their own business. The paper on which the computations were made belonged to them. They were not employed to make these sheets. The sheets were merely the means by which the work for which the defendants were employed might be accomplished. The title to the work sheets remained in the defendants after the computations were made. In the absence of an agreement that these sheets were to belong to the plaintiff, or were to be held for it, they were owned by the defendants. It may be that these papers contained information confidential in its nature and of importance to the plaintiff; but the defendants did not receive this information as the plaintiff's servants. It has been held that plans prepared by an architect employed for that purpose belong to the one for whom they are made. Walsh v. St. Louis Exposition & Music Hall Association, 101 Mo. 554, 555, Gibbon v. Pease, (1905) 1 K.B. 810. See Knats v. Pelby, 20 Pick, 65, 66. But it has never been decided so far as we know
that the preliminary plans and sketches of an architect belong to the person by whom the architect is employed, see in this connection Rutan v. Collidge, 241 Mass. 564; nor has it been held so far as we are aware that the preliminary sketches and drawings of an artist employed to paint a portrait belong to the sitter; or that memoranda made by a physician of his examination of a patent, or the notes and records of a lawyer, his preliminary drafts of legal documents or his minutes of testimony, belong respectively to the patient or client. See Anonymous Case, 31 Maine 590; In re Wheeler v. Ch. D. 97. As to property rights in a negative where a photograph is taken for pay in the usual course, see Ewens v. Cooke, (1908) 2 K.B. 227, 238; Pollard v. Photographic Co., 40 Ch. D. 345. The interest of the plaintiff in the information collected and copied by the defendants and the confidential nature of this information do not give title to the plaintiff of the defendants' working papers. They were made by the defendants solely for their own assistance in preparing the tax returns.

Same Ruling on Tax Papers

With reference to Group F, the letters addressed to the defendants, copies of letters written by the defendants, copies of returns furnished to the plaintiff, and work sheets relating to the tax case, are the sole property of the defendants, and this is true of the papers and reports collected by the defendants in the preparation of the tax case. The plaintiff is not jointly interested with the defendants in these documents. We do not understand that any of these reports, papers and returns were property of the plaintiff which had been placed in the defendants' custody by the plaintiff or merely delivered to the defendants. If there are any papers belonging to the plaintiff which were lent to the defendants, the plaintiff is entitled to them, but as we construe the record, the papers referred to in Group F were gathered and collected by the defendants in the course of their business and were not papers of the plaintiff placed by it in the defendants' possession.

No Right Given to Client

On the record of the evidence disclosed in this case, the defendants were under no legal obligation to surrender their working sheets or other papers to the plaintiff. The testimony of Leonard and Dillon does not prove that the defendants gave the plaintiff any right or title in them. It is apparent that at one time papers in the possession of the defendants, including their working papers, were turned over to the plaintiff for which receipts were given by the plaintiff to the defendants. These papers were again returned to the defendants. The plaintiff contends that by this transaction the plaintiff's rights of property and possession of all these papers were settled. Dillon testified that these papers were merely lent to the plaintiff. An investigation of the letters and receipts, and an examination of the record, do not satisfy us that the defendants in placing these documents in the possession of the plaintiff intended to part with their title and property in them.

It follows that the papers in Group A belong to the plaintiff. The other papers and documents belong to the defendants. A decree is to be entered for the plaintiff, directing that the plaintiff is the owner and entitled to immediate possession of the documents described in Group A.

Ordered accordingly.

The case of HERBERT ALFRED BURLEIGH v. INGRAM CLARK, Lim.
(Decided by Joyce, J., in the Chancery Division, on April 2nd 1901.)
Held that an Accountant has a Lien on certain Account Book for Professional Charges.

"Mr. Lawrance said he had a Motion in the case of Herbert Alfred Burleigh, of Park Row, Bristol v. Ingram Clark, Lim., booksellers and stationers, of Bristol, against the Auditor of the defendant company for an order upon him to hand over the account books of the company to the receiver appointed in a debenture-holder's action. The motion raised a very nice point, and one as to which, as far as he knew, there was no authority whatever — namely, whether the Auditor of a company had a lien on the books of the company for his fees. The receiver (Mr. Frederick Jenkins, F.C.A.), was appointed on the 8th of February last in the action by Mr. Burleigh on behalf of himself and other first debenture-holders for £7,000, and Mr. W. Grimes, A.C.A., the Auditor, was requested to go into the accounts. He now took the view that he had a lien on the books of the company for work done, and he refused to deliver up the books except on payment by the receiver of his account, 3157. The way in which he got possession of the books was this. He asked leave of the directors and the secretary to take away the books to his own office, as he said the company's office was small and inconvenient for him, and he could do the work better in his own office.

"Mr. Christopher Jones, for the accountant, said if the money was brought into Court he would hand over the books at once.

"Mr. Lawrance said that was just what he contended the Auditor was not entitled to.

"Mr. James pointed out that Mr. Grimes had done accountant's work to the books, as well as Auditor's work.

"Mr. Lawrance admitted that some work had been done on the books, as distinguished from work done in respect of the books, and there might be a distinction. He did not think his Lordship at present had got the materials for saying how much was actually done on the books, and how much done in the books. He contended that the Auditor had no lien for any part of the work. If he had, then there must be some inquiry. He thought if there was such a thing as an Auditor's lien on the books he worked upon, it must have been tried on before, but he could not find any record.

"Joyce, J., said he had no evidence here as to the terms upon which the Auditor was employed. There might be some resolution of the board, and it was very material to know on what terms he was employed. He might have been employed as accountant, as well as Auditor.

"Mr. James said there was the evidence of Mr. Grimes himself that he was asked by the board of directors to do this accountant's work.

"Mr. Lawrance contended that the company, by allowing the Auditor to take away the books for his own convenience, conferred on him no right to retain them. He was appointed Auditor in the usual way, yearly. He admitted Mr. Grimes had bought a Shareholders' Register, an important book, for the company, and that the receiver had not yet paid him the price, 315., but the receiver would see that that was paid.

"Mr. James, in opposing the application, said it might be that work done as an accountant and work done as an Auditor stood on different footings, but he contended, in any event, the Auditor had a lien. The bulk of the work was done as an accountant, and so far as that branch of the work went he clearly had a lien on the authorities. The right of an
Auditor was, no doubt, somewhat different, but even in that case he submitted there was a lien.

"Joyce, J., said, apart from other matters, it was clear the Auditor had no right to keep the Shareholders' Register, as that was a book which the company must keep for public inspection, and he must therefore give it up. That was not an account book. As to the articles of association, he could not see that the article relating to the Auditor gave him any lien whatever on the books. At present he was of opinion that no book of the company ought to leave the company's office.

"Mr. James said if these books had to be re-bound the binder would have a lien on them for his work.

"Joyce, J., said he did not know, but he thought if a parish register had to be re-bound it could not be retained.

"Joyce, J., asked Mr. Lawrence whether, if the Auditor would return the books at once, the receiver would be willing to give the Auditor a personal undertaking to pay whatever it might be found he was entitled to. Of course, he did not say that the Auditor was entitled to a lien.

"Mr. Lawrence consulted his clients, and said they were willing to give that undertaking.

"Joyce, J., said: Very well! This was obviously an urgent matter, because the company must have its books, and this arrangement would settle the matter temporarily. If the books were handed over and the undertaking given, he would postpone his decision as to the law until the first day of next sittings, because he wished to look at the documents, as this was a novel point."

JUDGMENT

"His Lordship delivered judgment on the 18th inst. He said that the affidavits filed showed that the respondent claimed a lien, not as Auditor, but as accountant. In his opinion, the question of an Auditor's lien did not arise, and, had it done so, he considered that an Auditor had no such lien; but that point he did not now decide. In respect of the Share Register, the accountant had no possible lien on that, but he held that he was entitled to a lien on such books only as he had actually worked upon, in respect of his proper remuneration for work upon those books only. If the parties did not agree upon the sum, there must be an inquiry. Each side would pay its own costs."—Acct. L.R., 1901, p. 65)
REVIEW QUESTIONS

1. Why should an auditor get a list of the accounting records and the names of the clerks who run them?
2. What was the main decision of the Ipswich Mills v Dillon case?
3. What is a natural business year? What are its advantages to the client? To the auditor?
4. Define the term "current assets".
5. What use will an auditor have for signatures of officials and chief clerks? Be definite.
6. What is an audit program? Give several reasons why it is used.
7. What is meant by a system of internal check?
8. Should an internal auditing force be separate, or a part of the whole accounting department?
9. Differentiate between a preliminary audit and a monthly audit.
10. Do you approve of standard audit forms? Give reasons for your answer.
11. Bring out in a paragraph or two the essential differences in the work sheets of plates 9, 10 and 11.
12. Must all cash be deposited daily and all payments be made by check under a good "cash system"?
13. What advantages came from vacations and rotation of work?
14. Why does an auditor ask to see the charter? The by-laws?
15. If you knew of the existence of another auditor's report, would you ask for it or simply ignore it? Why?
16. Why is an internal auditing force apt to become ineffective? In what ways?
17. How are insurance policies useful in detecting liens?
18. What would you do if a partnership had not drawn articles of partnership and refused to do so?
19. Why is it an invariable rule in many auditing firms that a junior shall not state his views to a client?
20. Name at least seven underlying principles of a balance sheet audit.
21. What benefit would you as an auditor expect to get from making a tour of the client's plant?
22. What is a letter of introduction?
23. What is a confirmation? Name three cases where one might be used.
24. Why would an auditor have to read a trust indenture of a bond issue?
25. What is a plant ledger? Of what use is it?
26. Give as many reasons as possible why working papers must be prepared.
27. In preparing adjusting entries what is the most important point for the auditor to keep in mind?
28. Why does a competent auditor abstract the minute books at his earliest convenience?
29. Why is it permissible to complete a balance sheet audit without checking the general or personal ledger postings?
30. What is your opinion of the following: "Ordinarily, the Auditor would have no duty to inquire into the work of a predecessor, but it will always be necessary for him to see that the opening entries of the period under review do in fact correspond with the last Balance Sheet. From the point of view of professional etiquette, he would probably consider it necessary to communicate with such predecessor and to ascertain, if possible, the reasons for the change. He might also inquire, directly or indirectly, as to the audit work previously done, to ascertain whether such work has left open any loopholes for fraud which he himself will regard it necessary to close. . . Should the Auditor find that such previous work has been so negligently performed as to permit of a loss to the Company being incurred in the period under review, he should, of course, report on the matter to the directors and to the members, so as to guard himself in the future." - Taylor & Perry (p.151)
CHAPTER 9
SYSTEM OF INTERNAL CHECK

106. General Discussion.

107. Outline of, and Comments on a System.

108. Explanation of Plate 21.
   PLATE 21 — A House Voucher.

109. Explanation of Plate 22.
   PLATE 22 — A Form of Voucher Check (1st type)

110. Explanation of Plate 23.
   PLATE 23 — A Form of Voucher Check (2d type)

111. Explanation of Plate 24.
   PLATE 24 — A Form of Voucher Check (3d type)

112. Explanation of Plate 25.
   PLATE 25 — A Form of Journal Voucher, and Journal Voucher Summary.

113. Explanation of Plate 26.
   PLATE 26 — A Form of Trade Acceptance.

114. Explanation of Plate 27.
   PLATE 27 — A Type of Note Receivable Register.

115. Explanation of Plate 28.
   PLATE 28 — A Form of Plant Ledger Card.

116. Explanation of Plate 29.
   PLATE 29 — A Page of Notes on a Client’s System of Internal Check.

Review Questions.

106. General Discussion.—As has been emphasized previously (sections 28 and 81), no auditor can draw up a good audit program unless he first acquaints himself with the system of internal check. Accordingly, the senior auditor must ascertain as early as possible if there is a good system in operation, for upon his findings depends the extent of the detailed auditing that will be necessary.

A good system of internal check "implies that the accounting records, methods and details generally, of an establishment are so laid out that no part of the accounts or procedure is under the absolute and independent control of any one person; that, on the contrary, the work of one employee is complementary to that of another, and that a continuous audit is made of the details of the business by having controlling accounts wherever possible. Moreover, "the first aim of a good system of internal check is to fix responsibility for particular acts, defaults, or omissions on definite persons."

107. Outline of, and Comments on a System.—To be more specific, a good system of internal check is indicated, in part, in the following paragraphs.

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1See Appendix C, Sec. 4, "Questionnaire Re System of Internal Check."
2However good the system of internal check may SEEM to be, the auditor must not place full reliance in it to the exclusion of all vouching, etc., for some auditing is ALWAYS necessary at every point. The purpose, therefore, of the auditor’s inspection is to ascertain (1) the weaknesses of the system, and (2) whether or not such checks as exist are actually being used. With this information in hand, the auditor can cover the deficiencies with the requisite detailed auditing. See also section 29, note #1.

Montgomery, p. 67.

4Taylor & Perry.
Incoming Mail.—The incoming mail should be placed under the control of a responsible officer, say the cashier. His aides should open and sort the mail, and, in the case of receipts of cash, a triplicate record thereof should be made. One copy should be retained, the second copy should be sent to the chief in charge of the personal ledgers, and the third copy should be sent to the clerk keeping the cash book. This person will record only the daily totals of the sheets as there is no necessity for copying this record into the cash book. The checks should be immediately stamped: FOR DEPOSIT ONLY with name of bank.

Deposit Slips.—In conjunction with the above, the cashier will make up the deposit slip and deposit the money personally (if feasible). A stamped duplicate deposit slip should be secured from the bank.

Separate Functions.—Furthermore, the cashier must be denied access to the cash book, to the personal ledgers, and to the monthly customers' statements. Similarly, the cash book clerk and the personal ledger clerks must not have access to any other records than their own. Where possible, salesmen should not collect money.

Summary.—By adopting the above procedure many manipulations, practiced in businesses where one clerk has charge of the cash, records it in the cash book, and in the accounts receivable ledgers, are absolutely cut off because no one person has access to other records required to "balance up his manipulation".

Deposits.—All money received must be deposited regularly. Some poorly organized businesses make payments out of the cash receipts. If this is done, it is exceedingly hard for an auditor to check up the cash unless the cash book has columns for "cash" and "bank". Even so, the record is clumsy. Moreover, a receipt for the expenditure is usually lacking unless checks are used.

If the receipts are not deposited regularly, the way is often open for various kinds of manipulations. For example, if the business is a small one so that of necessity the cashier also writes up the cash book, he could withhold some receipts for personal use provided he replaced them before the end of the fiscal period.

Cash Sales.—Cash sales should be protected by having cash registers, or by having one or more cashier cages.
A cash register not only provides a safer place for the money than a till, but, since a clerk will hesitate to ring up the incorrect amount before the customer's eyes, it also records the amount of money to be accounted for at the end of the day.

By having one or more cashier's cages, the cash is not only protected, but the correctness of making change is also insured, since the cashier is a person skilled in handling money. If a clerk has to wait upon the exacting 

For the cashier's chief aide.

This deposit slip is given to the cashier, thus assuring him that his aide has deposited the money. If no slip is required, a theft by this aide would not be caught promptly. "Salesmen only to sell, packers to pack, and central cashiers to take the money, in a departmental store."

(a) Receipts
demands of customers and then make change, and so on, she is apt to make costly errors either in short changing a customer, who may then be lost, or of under charging a customer, which is a pleasant way of going bankrupt.

Moreover, by subdividing the work in this manner sales clerks can give their whole attention to waiting on customers. As business is now largely a matter of service, this procedure of having separate clerks as cashiers, and as salesmen should recommend itself to progressive salesmen managers.

(b) Payments

Signatures.—Checks should be signed by at least two persons neither of whom has written the check. The adoption of this method of internal check will prevent both errors and fraud.

As a rule, the chief accountant should sign the check as well as the treasurer. The accountant’s signature means that he has reviewed the voucher being paid and is satisfied with its propriety and correctness. The treasurer, as the chief-in-charge of the funds of the business, must necessarily sign as supervisor of all disbursements. Checks should read: Not Negotiable - A/C Payee Only.

On occasions, the treasurer or chief accountant may sign up a number of checks at a time if he expects to be absent. This is a bad practice since it abandons the protection contemplated by requiring two signatures. The situation is easily provided for by appointing some one to take the place of the absentee in this respect. If the bank is properly notified of the temporary substitution of persons, the checks will be honored as usual and at the same time two persons will actually (not nominally) have approved the expenditures.

Vouchers.—No payment should be made without a supporting voucher which has been approved. Generally an approved voucher is stamped with an approval imprint, the different sections of which (such as for the receipt of goods, the correctness of the unit price, the correctness of the extensions and additions, and so on) must be initialled by the clerk doing that work.

If the expenditure is one such that no voucher will be received from the payee, a House Voucher (Plate 16) (which is a form printed in advance) should be filled in and approved in the regular manner. All vouchers should be stamped PAID so as to prevent duplicate payment thereof either through error or fraud. The stamp will usually provide a place for the check number, and possibly the date.

Again, all vouchers must be presented to the treasurer for inspection at the time when he is to sign the checks. Very often officials fail to insist on this important precaution because of the rush of business. But someday the chief accountant, or other person, may pick an opportune moment (such as that when the treasurer is in a rush to keep an appointment with the directors) to have the treasurer sign a check for a fraudulent purpose. The chief accountant feels safe in approaching the treasurer in this manner because the custom of presenting an approved voucher for every check to be signed, has long since been discarded.

Checks.—All payments should be made by check except those which are more easily handled by the use of a petty cash fund.

See Appendix C, Sec. 8-#1. In a large business it is advisable to have checks of two colors. One color is for all checks under a certain amount, say $5,000, and the other color is for all sums over this amount. Checks of the first color may be signed by the accountant and the treasurer, whereas the others should be signed by the president and the treasurer.
An endorsed check acts as a receipt whenever it is clear that the payment was made in reference to some particular liability. For this purpose voucher checks are being used with great satisfaction. One type of voucher check (Plate 20) has a detachable section the size of the check itself. On this part is listed the items which the check covers. Another type of voucher check (Plate 19) provides on the face of the check a space for showing the invoices being paid. On the whole, the writer prefers the latter form, as it is the more convenient.

Void Checks.—All checks ought to be numbered by the printer so that all of them may be accounted for. Spoiled checks must never be destroyed; they ought to be pasted to the check stub or otherwise preserved. If only one-half of a check is retained, it must be that portion showing the number.

These suggestions above are two simple precautions which auditors have found to be effective in reducing thefts. As fraud is often made easier by allowing the defrauder access to blank checks which are not accounted for, the numbering of checks cuts off this avenue of wrong doing.

No check should be used out of order.

Currency Checks.—The issuing of currency checks (i.e., checks made out to cash) should be discouraged. If cash is wanted for the payroll, it should not be made payable to payroll but to the paymaster. Of course, the purpose of the check will be shown on its face, in the usual manner of showing what any voucher check is drawn for. By making the check payable to a particular person, no other party can cash it if it is lost or stolen. During a rush, for illustration, a person who is known to be an employee of the business, might get by with the check at the bank with the explanation that he is to get the payroll during the sickness of the paymaster. As the check is payable to the order of payroll, the defrauder is not frustrated as he would be if the check were payable to the paymaster.

Reconciliations.—The bank statements should be called for by some one other than the cashier, treasurer, or cash-book clerk. This person should foot the cash-book etc., and reconcile it to the bank statement. In this manner many forms of cash fraud would be easily detected. Moreover, as the law requires a bank customer to review the checks and statements promptly if he is to hold the bank for any errors therein, the client who follows this procedure of checking the bank statements promptly is conducting his financial affairs effectively at this point.

Petty Cash.—As small amounts can not be conveniently paid by check, the adoption of the policy of making all payments by check is thwarted at this point. But if a petty cash fund is established and replenished by check, no serious breach in the system will have been made.

The simplest method of maintaining the fund is undoubtedly the best one. Under this plan each expenditure is backed by a signed petty cash voucher. All of these vouchers should be numbered by the printer. Each voucher can thus be accounted for as being used or spoiled.

Whenever the fund gets low, the petty cashier will present his vouchers to the "approval clerk" for reimbursement. Each voucher will then be examined and okayed like any other group of bills, except that the

1If the checks are not numbered by the printer, the clerk must be forbidden to take checks from the back of the check book to replace those which have been spoiled. 2The approval clerk will find it best to examine and okay the vouchers the day after they arise; otherwise it is exceedingly difficult to check some vouchers a week or two after their origin.
signature of the payee is required on each petty voucher.
In due course, the approved voucher (with its enclosed petty cash vouchers) will pass through the treasurer's department, the check being made out to the petty cashier who is then in a position to reimburse himself.

Payroll.-- Time clocks and accompanying in-and-out cards should always be used in a business of any size. The person in charge of these cards should show them each day to the department foremen for their oral approval. Where there is a cost system, these cards are a valuable check against the total time recorded on the individual job tickets.

The payroll sheets ought to be prepared in triplicate from these approved time cards by a person (or group of persons) who is not permitted to fill the pay envelopes. Payroll sheet #1 should be sent direct to the paymaster, sheet #2 should be sent direct to the department heads, and sheet #3 should be enclosed in a voucher jacket to go through the customary routine of approval and entry on the books of account.

After the payroll check has been cashed by the paymaster, the pay envelopes should be filled by persons who did not work upon the payroll computations, if this is at all feasible.

The paymaster and his assistant will then pay off the employees in the presence of the department heads. These bosses will note on their own payroll sheets the names of those employees who were absent.

Unclaimed, i.e., unpaid, wages should be paid by the paymaster only upon the presentation of a printed voucher properly signed by the department head as well as by the employee.

At regular intervals some one in the treasurer's department should collect the payroll sheets from the department heads and foot them. The total payroll should then be checked against the amount drawn on the payroll check. And finally, these sheets should be checked against the Back Pay vouchers and the unclaimed pay envelopes on file in the payroll department.

Naturally, the above outline is not adapted to every business, but it does illustrate the point that no one should control enough steps in the payroll process to be able to cover up fraud.

Thus, for example, the common method of padding the payroll with the names of workers who were never employed, is impossible under the above system except through the connivance of the time clock keeper, a department head, and an outsider. The department head has nothing to do with the payroll make up as it is prepared from the time cards. As the time-clock keeper should be made to watch the employees as they punch their 'time' in... and out, no boss could make out a false card and record the time thereon without the time-clock keeper's consent. Then too, the time-clock keeper could not make a false one himself because each boss has to sign the in-and-out time-cards, when completed for the week, before they will be accepted by the payroll department.

But, if the time-clock keeper and a boss got together, they could with the aid of a third person perpetrate fraud. The false time card would go through without detection, and eventually the pay envelope would be taken back by the paymaster as an unclaimed wage. The boss would then sign the back pay voucher, and the third party would sign, and present it to the paymaster for payment. However, as each fraud would require a third party, the likelihood of its being done repeatedly is negligible.

Again, the scheme whereby a high official, such as the treasurer, inserts additional names or raises amounts or totals after the approved payroll sheet comes to him, so that he may pocket the excess money after he has cashed the check, is destroyed. In the illustration given, it should be noted that the paymaster cashed the check, is destroyed. In the illustration given, it should be noted that the paymaster cashed the check...
Although most who they would pocketed
be emphasized and upheld by the treasurer because otherwise it will fall
rapidly into disuse.

The chief accountant should not disclose to these clerks the balance at
which they must arrive in order to come into agreement with his controlling
accounts. It has been known, for example, for an incompetent clerk, or one
who is going to leave soon, to say that her ledger agreed with the figure
given to her by the chief accountant, whereas the ledger was actually in
bad shape.

As to the monthly statements, these must be sent out direct to the
customers by those who prepare them without the intervention of anyone in
the accounting department or of anyone who opens the incoming mail.

Any allowance or large discount should be okayed by the sales manager.
In many cases, especially where the accounting office was small, the book-
keeper has pocketed money which he was able to cover up by passing a credit
to a customer's account for discount or allowance allowed, when in reality
none whatever was taken by the customer.

The same sort of manipulation has been worked through the bad debts
reserve. A bookkeeper might take a certain sum of cash for which, of course,
he would be obliged to pass a credit to the customer's account. He would do
this by writing off the account to the bad debts reserve because this pro-
cedure was not apt to arouse suspicion.

The Journal.—To prevent such manipulations as these just mentioned,
the journal entries should be supported by journal vouchers (Plate 22)
which must be made out in duplicate and signed by a high official as well as
by the chief accountant. The duplicate must be retained by the high
official for later use by the auditor, because instances are known where
additions have been made to the voucher after it has been approved by the
high official. Moreover, such a procedure is not merely useful to prevent
fraud. It attaches responsibility for the entry to the person who author-
ized it, and it prevents misunderstandings, because it is written.

Circularization of Accounts Receivable.—Although most businesses do
not do it, the writer recommends that each business circularize its trade
debtors by placing on the monthly statements in large type a request to
communicate direct to the collection department if there is a misstatement
of the account.

Shipping Records.—Accurate and full shipping records should always
be maintained. As usual, the installation of such records is not chiefly
to aid the auditor to detect fraud or to accomplish his work thoroughly,
although those are very important considerations, but rather to put the
client on a sound business basis. For example, if customer K is on the

1 "Unused check, order, counterfoil receipt and similar books to be under
the direct control of a responsible official and be properly stored and
recorded as issued."
the telephone inquiring if his goods were shipped last Monday, the answer, "Yes", or "No" can be given immediately if good shipping records are kept. But if it is otherwise, the customer's business may be lost by the exasperating delay required in trying to determine if the goods were shipped and when. As a rule, as much time is spent in straightening out such matters as would be spent in the keeping of a model shipping record.

Then too, the auditor can use this record to detect fraud and errors. If, for example, a sale is not recorded in the sales book, the money may be easily abstracted when the customer sends it in, because there is no need of passing a credit to the customer's account.

Ordinarily an auditor, or anyone else, would not detect this kind of fraud except by checking the shipping record against the sales book to see that a sale was recorded for each shipment.

Moreover, the auditor will use the shipping record to see that the sales book has been cut off at the proper point since there is a strong tendency, especially if it is suggested by the manager, for the bookkeeper to allow a part of January shipments to be treated as December sales.

Returned Shipping Record.— A Returned Shipping Record should also be kept distinct by itself. This record is necessary in order to grant credit memos promptly. Nothing is quite as exasperating to a customer as to find that the place where he bought the goods has no record of ever having received those items which were returned to it for credit.

Moreover, such a record is invaluable in auditing the correctness of the Returned Sales book. Sometimes a defrauder will pass a credit to a customer's account through the returned sales book never dreaming that the auditor would check that book against the returned shipping record.

If credit memos are granted before the returned goods are received, the Record is needed at the year end in order to include in the inventory the goods-in-transit.

Credit Limit.— The ledger sheets should show the credit limit allowed each customer. Before an order is started en route to be filled, it ought first to go to the accounts receivable ledger clerk. She will see if it and the existing ledger balance exceed the credit limit.

Of course, if there is a credit manager, he alone will have knowledge of the line of credit granted to each customer. Also in that case, the orders will come to him for approval and not to the personal ledger clerk. The only part that this clerk will have in the matter is to give the credit manager the account balance whenever he calls for it.

Bad Debts.— Whether or not there is a collection department, someone should be given the job of following up delinquent accounts.

As an aid in this matter, the person in charge ought to take these accounts out of the personal ledger into a special ledger for his own use, so that he may write down in the account the complete history of all his efforts to collect it.

Notes Receivable.— If the notes and acceptance (Plate 27) receivable are many, a notes receivable register (Plate 24) is an invaluable aid in keeping track of them. As many of these notes may be discounted, renewed, or dishonored, the problem of keeping those notes straight will

1"Cash, stores, and other items should be checked without notice at irregular dates." — Taylor & Perry.
often be a perplexing one. If the advantages of a register are not secured, the average bookkeeper may not be able to handle the situation. If it is customary for partial payments to be received on the notes, a record of these transactions must be made on the back of the notes by their custodian upon his personal verification of the cash received per the cash book. Also, at regular intervals this custodian ought to advise the makers of the notes as to the balances of the notes, just as customers are advised as to the balances of their accounts. Care should be taken that the note custodian is not also the cashier. And, the note custodian must himself verify in the cash book the cash received from the note. For otherwise the cashier on pocketing the money could tell him (the custodian) to credit such Garrn such a note. Of course, the cashier will also have to credit the note account in some manner in order to make it have the proper balance, but that may be done by one of a number of clever manipulations such as simply putting a credit direct in the note account and a debit direct in an expense account, without making any entry in a book of original entry.

Freight F.O.B.Shipper's Plant.--- A clerk should be given the duty of seeing that the freight charges are billed to the customers whenever the terms are F.O.B. vendor's plant. Such a clerk is practically required whenever the business has a large number of instances where the terms are F.O.B. shipper's plant, freight to be prepaid and added to the invoice. In these cases the auditor might well ascertain by personal examination if the customer is figuring his discount on the gross billing instead of upon the gross billing for the merchandise only, i.e. no discount is permissible upon the freight.

The writer knows of an instance of this kind where the discounts erroneously taken on prepaid freight ran into substantial sums. Fortunately for the vendor, the situation was limited to a few customers who gladly made up the difference when shown their error.

Sales Invoices.---Sales invoices ought to receive as careful a checking before being sent out as that given to purchase invoices before being passed for payment. This means that an approval stamp can be used to advantage on each duplicate sales invoice. This approval stamp should be initialed for correctness in such matters as filled by, unit price, extensions and additions, checked to salesman's order book, terms, freight, shipped by, shipment date, etc. Only after the invoice has been thoroughly checked in this manner should the original be forwarded to the customer.

As many annoyances and losses of customers arise either from inaccurate billing or shipping, the seller can well afford to have a good system of internal check at this point despite its additional clerical cost.

Securities.---As a rule not less than two persons should be together whenever the securities are handled. That is, one person should never be allowed to control the securities at any point. Many instances are on record where a chief executive having control of the securities has pledged them as security against personal loans. It

---This is not necessary if the custodian personally verified the balance due on the note by direct confirmation with the maker of the note.

---Where possible stock should be billed to departments and branches at selling prices in order to maintain a good check on inventories thereof.
is possible to do this without being detected by using a power of attorney for the endorsement rather than by making the endorsement on the back of the security itself. Of course, before the auditor makes his appearance, the official must redeem the securities and destroy the power of attorney. All securities (that permit it) must be endorsed in the name of the client so that if they are lost or stolen, they cannot be negotiated. Never leave the securities endorsed in blank.

Authorization of Capital Expenditures.--- Major capital expenditures ought to be authorized by the board of directors, or by a special committee appointed by them for that purpose. A record should be kept of the expenditures on each authorization so that the outcome may be reported back to the committee. Any large extra amount needed to complete a job must, of course, be also authorized by the directors.

Care of Tools.--- In the best managed businesses there is a tool house placed under lock and key, and put under the care of a tool-keeper. Each workman is given a number of brass checks bearing the same number. These are charged up to him. Whenever he wants a tool, he gives the tool-keeper a check for it. The tool-keeper hangs this check in front of the bin from which the tool was taken. As each tool is carefully stored in a bin of its own with its own name plate outside, the tool-keeper can tell what tools are out and who has them. Moreover, thefts of tools are reduced to a minimum as each tool is strictly accounted for.

As a part of the scheme, there is placed in each department a complete catalogue listing each tool and its bin location. This plan, by showing each workman (provided there is no planning department) what tools are available, permits him to go at his work with the proper equipment. Moreover, the catalogue keeps the tool-keeper straight as to where the tools are located. Then too, he can not say, as a lazy tool-keeper will often do, "Sorry, but we don't have that tool."

Before a tool is returned to its bin, the tool-keeper must see that it is in good shape to be used again. If he doesn't know, he must ask the workman who returns it. If it is in poor shape, say a saw is dull, the tool-keeper must send it directly to the repair shop.

Property Ledger.--- Property ledgers ought to be kept, similar to the one shown in Plate 25. The advantages which flow from such a careful record are important, whereas the amount of clerical work involved is largely overstated. Depreciation can be much more accurately computed because it is possible to check the physical condition of each unit against the accumulated depreciation reserve on its card.\(^1\) Too often a depreciation rate is set and then forgotten. Such a haphazard method naturally results in wide discrepancies between the physical depreciation and the book reserve account.\(^1\)

A property ledger is also useful in showing the repair costs of a unit. This bit of information is very valuable to a live plant manager, as for example, as a basis for comparing the cost and efficiency of machines of different makes. Moreover, such records are invaluable in case of a large damaging fire.

Finally, such records are the boon friend of the cost accountant

\(^1\)This does not mean that the book reserve is a measure of the physical depreciation. However, a comparison of the two is often very helpful in checking the depreciation rate.
of the business because they yield reliable figures.

Notes Payable.—All notes payable for extraordinary large sums ought to be authorized by a committee from the board of directors, and, there should be not less than two signatures to each note. This sort of precaution is necessary because instances are known where an executive, having sole authority to sign notes, has issued company notes for funds which were then diverted to personal uses. Of course, the executive had to meet these notes at maturity out of personal funds; so the business lost nothing. But the point is, the executive had absolutely no right to use the business’s credit for his own benefit. More specifically, the business could be held on these notes because the officer was held out to third parties, the banks, as having the right to borrow in the name of the company.

Furthermore, there should be a note payable book with each note numbered by the printer. Of course, as each note must be accounted for as used or voided, the above manipulation just referred to would be impossible. Finally,—all notes payable must be preserved for inspection by the auditor.

Purchases.—This topic will be covered by a number of comments and suggestions in lieu of a discussion thereof.

(1) A book should be devoted to keeping a record of all purchase commitments.

(2) All contracts should be written so as to comply with the statute of frauds.

(3) There should be a purchasing agent through whom all purchases must be placed. There should be such a person in every business even though he is given other duties to perform.

(4) All requests for purchases must be written and signed. They should be made out on printed forms provided each department head. These forms should be numbered by the printer, and hence they must be accounted for as used or voided.

Written requisitions avoided the errors, delays and disputes generally experienced when oral requests are permitted. Moreover, as the requisitions are signed, responsibility is definitely fixed.

(5) Purchase orders must be written and signed by the purchasing agent on printed forms. These forms should be numbered by the printer and should be accounted for either as used or voided.

(6) Both purchase requisitions and purchase orders should be issued in at least duplicate. (More copies may be necessary according to the system used.) For example, the head of the department (or the balance-of-stores clerk) will want to retain a copy of the purchase requisition which he sent to the purchasing agent. And the purchasing agent will need to retain a copy of the purchase order which he sent out to the creditor.

(7) All purchase invoices ought to bear an approval stamp covering the correctness of such matters as: receipt of goods, quality, unit price, extensions and additions, terms, freight deductions, expense distribution by, entered by, etc., before it is entered in the voucher register.

Each person performing any work on a purchase invoice must initial therefor so that responsibility or credit may be attached to that person.

(8) Some person should be assigned the job of seeing that all allowable freight charges are actually taken off the creditor’s bill. This

As a result of the 1930 -1933 depression, depreciation charges are being scrutinized by management as never before (e.g. the recapitalization plans of Studebaker, Graham Paige, and others, whereby the value of the property accounts is being greatly reduced in order to get a lower depreciation charge).
feature is essential whenever many goods are bought f.o.b. destination, freight being paid and deducted by the purchaser.

(9) All monthly statements from creditors must be preserved for the auditors.

(10) All vouchers should be approved for payment by some official, such as the chief accountant, after which they should be sent with the countersigned checks to the comptroller for final approval and payment (second signature).

Receiving Record.—A receiving record must be carefully kept with full details if it is to be useful on all occasions. The value of such a record to the client is so obvious that no time will be spent in developing the subject other than to emphasize the necessity of its being complete and legible.

An auditor makes use of this record to see that for each receipt of goods the liability therefor has been taken up on the books of account. Moreover, it is a very useful record in deciding what purchase invoices go into this period's voucher register, and what purchase invoices must be withheld for entry in the subsequent period.

Loans to Employees and Officials.—Ordinarily, loans to employees and officials should be frowned on. At times it may be legitimate to make a loan to an employee, as, for example, in a case of real trouble so that he will not have to deal with a loan "shark". Such a loan is indeed a real service to the employee and a legitimate use of the business's money since it builds up an invaluable goodwill within the organization. But the customer of allowing an employee to get at will an advance against his week's wages should never be countenanced. It is a general nuisance, and there is, in reality, no good reason for its existence. If anything, it creates in an employee the habit of spending before the money is in hand.

Loans to officials are very hard to justify. It takes hours, in fact, to think of a single legitimate reason why the funds of the business should be diverted into this channel. Of course, it is as common a situation as where an official uses the company's car indiscriminately for his own personal use. But in neither case is the official acting "above board"—he is simply "getting away with it" because there is no one higher up to rebuke him.

Inventories.—This topic will be covered by a number of comments and suggestions in lieu of a discussion thereof.

(1) Most inventories should be kept under the control of a storeskeeper. The storage room should be enclosed and put under lock and key. There should be ample storage space, and the bins should be adapted or adaptable to the commodities they are to hold. Each bin should have a designation, and a catalogue thereof ought to be prepared so that if the stores-keeper's memory fails him, or if he should be sick or should withdraw, there will be no delay in locating in the stores-room whatever is wanted.

(2) No goods should be issued without a requisition. These forms generally show (when completed) the requisition number, the department in which it arose, the department head's signature, the date, the description of the items wanted, the job to be charged, the unit cost price, the total cost, the name of the person who filled the order, the inventory account to be credited, and so on, in further detail depending on the system used. The duplicate is kept by the department head who issued the requisition.

(3) Bin tags are a great help in keeping the system in good running
order. As the tag shows the "ins" and "outs", of the goods, the tag balance must tally with the actual number of physical items in the bin.

(4) Stock records which keep track of each item by quantity and cost are generally worth their trouble. As the goods are accounted for accurately, shortages and thefts are minimized. But more important than this, is their use in connection with monthly profit and loss statements.

In order to draw up a profit and loss statement, the inventories must be known. Since the cost and confusion of taking frequent physical inventories is prohibitive, monthly profit and loss statements are forgone by most businesses. But where there are stock records, the inventories can be drawn off without much trouble. Moreover, the operations in the factory are not disturbed to any considerable extent since the book records can be checked piecemeal during the whole year against the physical items in the storehouse, etc.

In brief, stock records permit the preparation of monthly profit and loss statements which are invaluable in themselves. Moreover, the cost of maintaining such records is more than offset by the reduction of shortages and thefts, and by not having to suspend business operations to take a complete inventory.

(5) As inferred above, all stock records must be checked and corrected to the physical goods. Even so, this work is not as burdensome as ordinary inventory taking since it can be done piecemeal. As a rule, the goods called for by an inventory card should be checked when they are at a minimum balance.

(6) Goods received on consignment should be accounted for as carefully as any other goods, but they must be excluded from the inventory.

(7) Goods sent out on consignment ought not to be billed and recorded as sales. Memorandum accounts should be used. If the consigned items are such that they could not be identified from similar goods, they should be marked, for otherwise they could not be recovered in case the consignee went bankrupt. Merely to secure the consignee's promise to keep the goods segregated is not sufficient protection because the promise is easily broken, especially whenever the consignee is ignorant of the legal aspect of the situation.

Miscellaneous.—

(1) Even though it is not required by law, there should be a transfer journal and a stock ledger whenever the business transfers its own stock. These records keep the stock transactions distinct and in good order so that each transfer or new issue can be easily traced from beginning to end.

(2) Employees in positions of trust should be adequately bonded. Moreover this provision covers everyone having charge of money, or securities, or goods, etc. No one, from the clerks to the highest officials, should be exempted. No sentimental reason whatever, such as, "he has been with us for years and we would trust him with our lives", should be allowed to displace sound business judgment on this matter.¹

(3) Branch accounts should be controlled by the main office to as great an extent as is feasible. For example, if all branch sales are made payable only to the main office, and if all branch expenses, except petty cash disbursements, are paid by the main office, two important steps will have been taken to secure adequate control over the branch accounts.

(4) All vouchers, requisitions, orders, invoices, and the like, should come from the printers in at least duplicate, and numbered. The person who originates a requisition or order, for illustration, should

¹See Appendix C, Sec. 7-#1
retain a copy of it. The numbering of checks, petty cash vouchers, invoices, requisitions, orders, etc. is invaluable as a means of accounting for "everything", whether it be from the angle of detecting fraud or from the angle of checking up on the completeness of a record.

(5) Vacations should be enforced not only as a means of detecting fraud but also as a means of creating goodwill and an energetic group of workers. That is, a vacation should not be looked upon by the management as a gift to its employees, but rather as a scientific way of securing more efficient and greater production per dollar of wage expense. In most instances some one or more persons will have to take care of the absentee's work. If there is error or fraud in his records, it will most likely show up at this time. Curiously enough, it does seem as if an error will pick this inopportune time (from the absentee's point of view) in which to make its appearance. This rule should be enforced even in the case of a high official, for there are many instances where fraud has been detected during his absence which never would have been caught otherwise. It may be, for example, that a letter from a bank to the absentee treasurer will be opened (as it is company business) revealing that certain notes payable of the company will not be renewed, whereas actually the company never knew it had such notes outstanding. In such a case, the treasurer would very likely be discharged for borrowing funds for personal use on the company's notes.

(6) There should be written, not oral, instructions at all points, because written instructions reduce errors from misunderstandings, and, the blame or credit connected with a certain transaction can be attached to a definite person because of his signature on the document. (7) A clerk's work should be varied as much as possible. If this is done, it should be obvious that errors and fraud will often show up (it always does whenever a different person is set to work on someone else's records). Moreover, in case of a clerk's sickness or dismissal, there will then be no section of the work which can not be promptly handled by some clerk on hand who has handled it before.

(8) A book should be devoted to keeping a record of all special claims whatsoever that are made against the business.

(9) The general ledger should have a controlling account for each subsidiary ledger.

(10) The balances in each sub-ledger should be drawn off monthly by some one not connected with the ledgers and agreed with the general ledger controlling accounts.

(11) The cost system, if any, should tie-in with the general ledger accounts.

106 See Plate 21
109. See Plate 22
110. See Plate 23
111. See Plate 24
112. See Plate 25
113. See Plate 26
114. See Plate 27
115. See Plate 28
116. See Plate 29
A HOUSE VOUCHER

WATKINS AND BURY
House Voucher

**Explanation and Comments.**—A house voucher is simply a voucher form, printed by the business for those rare instances where it is impossible to get a voucher. The one who makes the purchase fills it in and signs it, and then has it countersigned by "someone higher up". As no payment should ever be made without a supporting voucher, a house voucher is a necessity in maintaining the system.

---

VO. No. _49_  Charge
Acct. No. _62_  Date _9/16/29_

Purpose: Entertainment of various buyers during June, July and August. 300.00

Countersigned by S. Shawcross  
Vice. Pres.  

By K. Whipple  
Pres.
EXPLANATION OF PLATE 22
A FORM OF VOUCHER CHECK (1st type)

109. Explanation and Comments.--- This type of voucher check is of ordinary check size. It has on its face a space for listing the invoices that are being paid, less the cash discounts and other deductions, such as freight.

Note that the voucher number (here #711) is always given on voucher checks.

A FORM OF VOUCHER CHECK (1st type) PLATE 22

<table>
<thead>
<tr>
<th>Date</th>
<th>Invoices</th>
<th>Amt.</th>
<th>Discount</th>
<th>Net</th>
<th>Deductions</th>
<th>Pay to the order of</th>
<th>The Hawkins Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td>4/25</td>
<td>#7613</td>
<td>500.00</td>
<td>10.00</td>
<td>490.00</td>
<td></td>
<td>R.T. Thomas Company</td>
<td>$574.79</td>
</tr>
<tr>
<td>4/7</td>
<td>#8132</td>
<td>100.00</td>
<td></td>
<td>100.00</td>
<td></td>
<td>79/100</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Less freight (bill enclosed)</td>
<td>15.21</td>
<td></td>
<td>590.00</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>574.79</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Central Falls, N.H. May 3, 1930

By _ K.P. Ryan _ __________ Treas.
By Mark Heseltine __________ Auditor
A FORM OF VOUCHER CHECK (2d type)  PLATE 23

110. Explanation and Comments.—This type of voucher is, in the writer's opinion, somewhat less effective than the one shown in plate 22 because it will not show in detail the invoices it pays for, when it returns from the bank. (It is to be observed that the creditor is instructed to detach for his own use the flap which gives this information.) However, the details can be readily ascertained from the voucher (here #147) which it pays.

<table>
<thead>
<tr>
<th>Date</th>
<th>Invoice #</th>
<th>Amount</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>4/25</td>
<td>#7613</td>
<td>$500.00</td>
<td>$490.00</td>
</tr>
<tr>
<td>4/7</td>
<td>#8132</td>
<td>100.00</td>
<td>100.00</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>590.00</td>
</tr>
<tr>
<td></td>
<td>Less Freight (Bill Enclosed)</td>
<td></td>
<td>15.21</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>574.79</td>
</tr>
</tbody>
</table>

Detach Before Depositing

DETACH HERE

Voucher No. 147

FIRST NATIONAL BANK

Central Falls, N.H.  May 31, 1930

Pay to the order of  R.T. Thomas Co.

Five Hundred Seventy-Four and 79/100 Dollars

The Hemphill Corporation

By  K.P. Ryan  Treas.

By Mark Hesseltine  Auditor

(If desired, the writing on the flap can be placed vertically.)

(Note that the flap is exactly the same size as the check itself.)

(The signatures would be in writing on real checks.)
A FORM OF VOUCHER CHECK (2d type) PLATE 24

THE HOLT MANUFACTURING CORPORATION


Pay to the order of Ross M.P. Hadley          $ 75.19

Seventy five and 19/100- ------------------------ Dollars

To Chase City Bank

THE HOLT MANUFACTURING CORPORATION

By K. S. Wilkinson  ----------------- Treas.

By J. Perregaux  ----------------- Auditor

Fold Here

---Back face when folded--front face when opened---

---Back face when folded--front face when opened---

---Back face when folded--front face when opened---

Explanation and Comments.—This type of voucher check consists, when folded, of a check face in front, and an endorsement face in back. In the inside are listed the invoices being paid, and their distribution.

It should be noted that whenever the distribution is by account number, no private information is made public; but whenever the accounts are designated by name, this type of voucher check is apt to reveal to the public, matters that should be kept confidential.
EXPLANATION OF PLATE 25

A FORM OF JOURNAL VOUCHER AND JOURNAL VOUCHER SUMMARY

112. Explanation and Comments.-- Part (a) is a Journal Voucher in completed form, whereas part (b) is the Journal Voucher Summary into which an abstract of each voucher is entered.

The postings to all general ledger accounts, (except accounts receivable, notes receivable, and accounts payable), and the postings to all personal ledger accounts are made direct from the journal voucher. The postings to the accounts receivable, notes receivable and accounts payable in the general ledger are made from the journal voucher summary by using the monthly totals.

Note that the voucher is ruled to prevent making additions to it after it has been approved. This method of preventing fraud is, however, entirely ineffective especially in the case of alterations (not additions).

The better method of preventing alterations is for the treasurer (or other person)\(^1\) to keep a duplicate of each journal voucher, which the auditor will use in vouching postings to the general ledgers, and in vouching the abstract entries in the journal summary.

The auditor must never use the original journal vouchers, as these may have been altered. If, on the other hand, the treasurer's vouchers have been altered, they will not check into the ledgers or into the journal summary.

\(^1\)I.R. each person who originates an entry keeps the carbon copy.
A FORM OF JOURNAL VOUCHER AND JOURNAL VOUCHER SUMMARY  PLATE 25  9-19

Part (a)

Journal Voucher  NO 49  Date 5/6/29

<table>
<thead>
<tr>
<th>Entry</th>
<th>G</th>
<th>P</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>L</td>
<td>L</td>
</tr>
</tbody>
</table>

Reserve for Bad Debts
Acct. Rec. - R.C. Morrison

To write off the balance of
Morrison's account, due 12/6/28

By W.F. Frost, Accountant
Approved
By  C.M. Simpson, Tres.

Part (b)

JOURNAL VOUCHER SUMMARY

Month of  May  1929

<table>
<thead>
<tr>
<th>Voucher No</th>
<th>Debits</th>
<th>Credits</th>
</tr>
</thead>
<tbody>
<tr>
<td>49</td>
<td>15.10</td>
<td></td>
</tr>
<tr>
<td>50</td>
<td></td>
<td>181.14</td>
</tr>
<tr>
<td>51</td>
<td></td>
<td>62.70</td>
</tr>
<tr>
<td></td>
<td>Omissions</td>
<td>Omissions</td>
</tr>
<tr>
<td>Total</td>
<td>1247.19 4871.15 8107.00 147.15 1070.01</td>
<td>4195.15 8651.37 455.46</td>
</tr>
</tbody>
</table>

G.L.
Posting  #  18  20  42  #  18  20  42
113. Explanation and Comments.— Note that in this trade acceptance the Rayon Manufacturing Corporation drew on The William Henry Company in favor of themselves; i.e., The William Henry Company owed the Rayon Manufacturing Corporation. See also plate 4.

A trade acceptance is much more negotiable than a note because under the rules of the Federal Reserve System, a member bank may rediscount this type of paper at the district Federal Reserve Bank, provided the acceptance meets certain restrictions as to wording, futurity of the maturity date, etc. Ordinary notes are not acceptable for rediscount because they do not show (or can not show) that they arose out of the type of business transaction required by the Federal Reserve law.

The sentence, "The drawee may accept this bill payable at any bank, banker, or trust company in the United States which he may designate," is designed to give the note negotiability it might not otherwise have under the laws of certain states.

The wording, "The obligation of the acceptor hereof arises out of the purchases of goods from the drawer," is an essential part of the instrument if it is to be eligible for rediscount with a Federal Reserve Bank because it affirms that the note arose from one of the types of business transactions which the Federal Reserve System was designed to aid.

"The advantage arising from the substitution of the trade acceptance for the open book account will accrue not only to the seller but to the buyer and the banker as well. The chief advantages may be briefly stated as follows:

To the seller—

1. Completion of the transaction upon acceptance of the draft, and the implied acknowledgment by the buyer of the correctness of the account, thus avoiding or reducing the evils of extensions, counter claims, unearned discounts, return of goods, etc.

2. Elimination of the costly and inconvertible open book account and the substitution of an instrument of credit readily and economically negotiable.

3. Automatic provision of funds necessary to finance each account, thus releasing the seller's own capital for use in the upbuilding of his business in other ways.

4. Substitution for the practice of borrowing on accounts receivable or on single-name paper of the sound practice of discounting double-name paper convertible at will into cash at much better rates.

To the buyer—

1. Improvement of business standing and credit by giving the seller a negotiable evidence of indebtedness with a fixed maturity.

2. Enhancement of credit standing with sellers, by furnishing a means of liquidating sales at preferential discount rates, entitling the acceptor to the best prices and service.

3. Assumption by the buyer of an obligation which must be met at maturity will tend to check the pernicious habit of over buying.

During the depression year 1932 a vigorous campaign was initiated to increase the use of trade acceptances. "Du Pont" was one of the leaders in this drive.
EXPLANATION OF PLATE 26
(Continuation)

4. Improvement of buyer's credit, not a reflection upon it, for the acceptance shows on its face that the obligation is made for the purchase of goods. The use of the trade acceptance need not interfere in any way with legitimate cash discounts.

To the banker—

1. Increase in volume of double-name paper, representing current business transactions and not past due accounts, offered for discount in place of single-name paper which is less liquid and often does not represent a commercial transaction at all.

2. Trade acceptances discounted and held by the bank furnish additional reserve, for they are readily redisccontable at the Federal reserve banks at preferential rates.

3. A customer who habitually settles his accounts by trade acceptances is less likely to sell his book accounts, or to borrow through brokers, or to apply to a competitor bank for credit, for his bank if a member of the Federal reserve system can furnish him ample accommodation.

4. The bank is primarily a dealer in credit, and the acceptance system will aid greatly in keeping the credit system sound.

The benefits attending the wide use of the trade acceptance cannot fail to be felt directly or indirectly by the entire business public. A stronger sense of responsibility toward commercial obligations; a check upon over buying and over selling; better system in financial arrangements; closer relationship between buyer and seller; reduction of losses from bad debts, of collection expenses, of the abuses of unwarranted discounts, and of the need for borrowing through brokers or on open accounts; the substitution of liquid, double-name paper, based upon actual current commercial transactions, for the "frozen" credit of book accounts; and the release for business requirements of a vast volume of working capital heretofore tied up for indeterminate periods on the books of manufacturers, jobbers and banks — these advantages will inure to the benefit of the general public, affording an additional safeguard against those periods of business depression which so often in the past have resulted from or have been intensified by the lack of a system of liquid commercial credits."  

1 J.T. Holdsworth p. 112
A FORM OF TRADE ACCEPTANCE

Pawtucket, Me. __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ __ ___
EXPLANATION OF PLATE 28

A FORM OF PLANT LEDGER CARD

115. Explanation and Comments.—This plate is adapted from a form of plant ledger card designed by the U. S. Chamber of Commerce.

Where there is a plant ledger card for each machine or group of identical machines, depreciation can be much more accurately computed because it is possible to check the physical condition of each unit (or group) against the accumulated depreciation reserve on the ledger card.

Of course, there is no direct relationship whatever between the operating efficiency of a unit and its depreciation reserve. Therefore, if the depreciation reserve of a $1000 unit had a credit balance of $500, that fact would not mean that the accountant would expect to find the machine operating at fifty percent efficiency.

On the other hand it is very easy to discern many cases where one can say with assuredty, "This machine will be out of operation long before the proper reserve has been provided unless we increase the depreciation rate right away".

Plant ledgers are very useful in comparing operating costs of different makes of machines, and in showing the annoyance and cost thereof due to being tied up for repairs. Two additional columns could profitably be added to the card; namely, Repair Costs and Hours in Repair.

In the case of large destructive fires, Plant ledgers are invaluable to the business man in presenting and maintaining his claims for assets damaged or destroyed.

Finally, a cost accountant always welcomes a plant ledger as a boon friend because it yields reliable figures for his costs.

In this exhibit a 50 horse power steam engine with a useful life of 15 years was bought from Evans and Clark on order #5906. The manufacturer, the Brighton Engine Company, numbered it B93217. The engine was placed in the Trimming Department after being assigned the plant number S (steam) E (engine) --T (trimming) 1799 which was stamped on a metal plate and attached to the engine for identification.

The history of the engine is as follows:

1921.—The machine was bought on January 7 at an invoice cost of $2500.00. The freight cost another $15.00 and the installation costs came to a total of $185.00. These three costs amount to a grand total of $2700.00.

As a rough estimate of the scrap value is placed at $150.00, the depreciable value was $2550.00 ($2700 - $150). And, on this basis of $2550.00, the annual depreciation charge was set at $170.00 (i.e. $2550 divided by 15 (years)).

The depreciation charge of $170 was entered in January for the year 1921.

1922.—After the depreciation charge of $170 was entered for 1922, the reserve for depreciation stood at $340.00, and the remaining asset value at $2210.00 ($2700 (cost) - $150 (scrap) - $340 (depreciation reserve)).

1923.—During this year another $170.00 was charged off for depreciation, and as a lubricator costing $150.00 was attached to the machine in October, the values at the end of the year were as follows: total cost ($2850.00) - scrap value ($150.00) equals depreciable value ($2700.00) - reserve ($310.00) equals remaining value ($2190.00).

1924.—The depreciation charge for this year was $182.50 computed as follows: $2190.00 (remaining value) divided by 12 (remaining life in years).
1925.-- On July 12th a piston was replaced at a cost of $300.00. As this was an extraordinary repair, it was a proper charge to the reserve. Moreover, as the new piston will prolong the life of an engine, it was estimated to have a life of twelve years as at 12/31/25.

The depreciation charge of $182.50 was entered as usual on January 1 so that at December 31 the values were as follows: total cost ($2850.00) minus scrap value ($150.00) equals depreciable value ($2700.00) minus reserve ($575.00) equals remaining value ($2125.00).

1926.--The annual depreciation was entered at $177.08; i.e. ($2125 (remaining value) divided by 12 (remaining life)).

As the machine was sold for $2000.00 on December 10, the journal entry was as follows:

<table>
<thead>
<tr>
<th>Cash</th>
<th>2000.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reserve for Depreciation-Machinery</td>
<td>752.08</td>
</tr>
<tr>
<td>Profit and Loss on Retirement of Plant Assets Machinery</td>
<td>97.92</td>
</tr>
<tr>
<td></td>
<td>2850.00</td>
</tr>
</tbody>
</table>
### Table: Plant Ledger Card

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Remarks</th>
<th>Ref.</th>
<th>Total Cost</th>
<th>Scrap Value</th>
<th>Deprec. Value</th>
<th>Annual Reserve</th>
<th>Remaining Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1921</td>
<td>Jan. 7 O.H.B. Engine Invoice V731</td>
<td></td>
<td>2500.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Freight V729</td>
<td></td>
<td>15.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Installation R741</td>
<td></td>
<td>185.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Jan. 1921 Deprec. Charge</td>
<td></td>
<td></td>
<td></td>
<td>170.00</td>
<td>170.00</td>
<td>2350.00</td>
<td></td>
</tr>
<tr>
<td>&quot; 1922 &quot; &quot;</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>170.00</td>
<td>340.00</td>
<td>2210.00</td>
<td></td>
</tr>
<tr>
<td>&quot; 1923 &quot; &quot;</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>170.00</td>
<td>510.00</td>
<td>2040.00</td>
<td></td>
</tr>
<tr>
<td>Oct. 9 Lubricator</td>
<td>Installed Invoice V791</td>
<td></td>
<td>100.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Installation R799</td>
<td></td>
<td>45.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Freight V661</td>
<td></td>
<td>4.00</td>
<td></td>
<td>150.00</td>
<td>150.00</td>
<td>0</td>
<td>150.00</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td></td>
<td></td>
<td>2850.00</td>
<td>150.00</td>
<td>2700.00</td>
<td>510.00</td>
<td>2190.00</td>
</tr>
<tr>
<td></td>
<td>Jan. 1924 Deprec. Charge</td>
<td></td>
<td></td>
<td></td>
<td>182.50</td>
<td>875.00</td>
<td>1825.00</td>
<td></td>
</tr>
<tr>
<td>&quot; 1925 &quot; &quot;</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>182.50</td>
<td>875.00</td>
<td>1825.00</td>
<td></td>
</tr>
<tr>
<td>July 12 Piston</td>
<td>Replaced Invoice V907</td>
<td></td>
<td></td>
<td>(260.00)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Installation R99</td>
<td></td>
<td></td>
<td>(30.00)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Freight V1009</td>
<td></td>
<td></td>
<td>(10.02)</td>
<td></td>
<td></td>
<td></td>
<td>300.00</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td></td>
<td></td>
<td>2850.00</td>
<td>150.00</td>
<td>2700.00</td>
<td>575.00</td>
<td>2125.00</td>
</tr>
<tr>
<td></td>
<td>Jan. 1925 Deprec. Charge</td>
<td></td>
<td></td>
<td></td>
<td>177.08</td>
<td>752.08</td>
<td>1947.02</td>
<td></td>
</tr>
<tr>
<td>Dec. 10 Engine Sold</td>
<td>$2000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Loss $97.92</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

1. This plate is adapted from a form of plant ledger suggested by the U.S. Chamber of Commerce.

2. A full year's depreciation was taken on the opening balance irrespective of any changes during the year. The most common method, however, is to take a full year's depreciation on the opening balance plus (or minus) a half year's depreciation on the net additions for the year.

3. The reason for charging the new piston to the reserve was doubtless due to the fact that there was no way of ascertaining the portion of the original total machine cost represented by the old piston. The correct procedure is to charge a costly new part to the asset account, the old part being charged to the reserve with a corresponding credit to the asset account. Sometimes a profit or loss on retirement is involved too.

4. In most instances the effect of any scrap value upon the depreciation charge is ignored. As this procedure is conservative, auditors do not attempt to correct it unless the sum involved is very significant.
114. Explanation and Comments.-- It should be noted that in an actual Register the various column headings follow one another from left to right. In this plate they are placed in five groups under each other merely for editing convenience. By means of several short insert sheets, the size of the Register can be kept normal.

A Register is recommended as a practical necessity whenever the number of notes on hand at one time is continually, say, 50 and over.

E - Endorser, or endorsee  A - Acceptor
P - Payee        M - Maker  D - Drawer
Incl'd - Included in the face

On July 21 Holden & Arkwright drew on S. Lewis & Sons for $2347.91 in favor of K.P. Eddy.

Note that notes received from officers are charged to the "Notes Receivable - Officers" account.

The Register should also contain space for REMARKS. Thus the comments upon these notes might have been:

(1) Dishonored 8/2/29 First Nat'1, Providence 12/17/29 Written Off
(2) Paid
(3) Discounted 9/8/29 First Nat'1 City
(4) Renewed for 30 days
(5) Paid
Notes Receivable Register---Holden & Arkwright, Inc.

<table>
<thead>
<tr>
<th>Date Rec'd</th>
<th>Dated</th>
<th>Acceptor or Endorser</th>
<th>Endorsee or Payee</th>
<th>Maker or Drawer</th>
<th>Notes Receivable</th>
<th>Sundry Amount</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1929</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>July 4</td>
<td>July 2</td>
<td>Ourselves</td>
<td>P.T. Gooch</td>
<td>M</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>7</td>
<td>W.F. French(payee) E</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>20</td>
<td>17</td>
<td>W.R. Crawford E</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>21</td>
<td>20</td>
<td>P.T. Ewing A</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>28</td>
<td>21</td>
<td>S.Lewis &amp; Sons</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Omissions</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Where Payable

<table>
<thead>
<tr>
<th>Where Payable</th>
<th>Interest Rate %</th>
<th>Year</th>
<th>Month</th>
</tr>
</thead>
<tbody>
<tr>
<td>First Nat'l of Providence, Mass.</td>
<td>6</td>
<td>1929</td>
<td>Jan.</td>
</tr>
<tr>
<td>State St. Trust Co.</td>
<td>6</td>
<td>1929</td>
<td>Feb.</td>
</tr>
<tr>
<td>Their Office</td>
<td>6</td>
<td>1929</td>
<td>Mar.</td>
</tr>
<tr>
<td>First Nat'l, New Orleans, La.</td>
<td>6</td>
<td>1930</td>
<td>Apr.</td>
</tr>
<tr>
<td>R.I. Hospital Trust Co.</td>
<td>6</td>
<td>1929</td>
<td>May.</td>
</tr>
</tbody>
</table>

Omissions


Notes Accounts Debited

<table>
<thead>
<tr>
<th>Notes Receivable</th>
<th>Sundry</th>
<th>Amount</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>546.29</td>
<td></td>
<td></td>
<td>107</td>
<td></td>
</tr>
<tr>
<td>531.65</td>
<td></td>
<td></td>
<td>109</td>
<td></td>
</tr>
<tr>
<td>100.00</td>
<td></td>
<td></td>
<td>102</td>
<td></td>
</tr>
<tr>
<td>179.15</td>
<td></td>
<td></td>
<td>111</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Acc'tPay-K.P.Eddy</td>
<td>2349.71</td>
<td>201</td>
<td>176</td>
<td></td>
</tr>
<tr>
<td>Notes Rec.' Officers</td>
<td>5000.00</td>
<td>30</td>
<td></td>
<td>176</td>
</tr>
<tr>
<td>Omissions</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Total 1357.39

Omissions

Total 5349.71

Omissions

Acct Rec'ed | Name | Sundry | Amount | Date Paid |
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>546.29</td>
<td>P.T. Gooch</td>
<td></td>
<td>53</td>
<td>8/6/29</td>
</tr>
<tr>
<td>531.65</td>
<td>W.R. Crawford</td>
<td></td>
<td></td>
<td>8/20/29</td>
</tr>
<tr>
<td>100.00</td>
<td>R. Hadley, Inc.</td>
<td></td>
<td></td>
<td>10/21/29</td>
</tr>
<tr>
<td>179.15</td>
<td>P.T. Ewing</td>
<td></td>
<td>53</td>
<td>8/6/29</td>
</tr>
<tr>
<td>2349.71</td>
<td>S.Lewis &amp; Sons</td>
<td></td>
<td></td>
<td>8/20/29</td>
</tr>
<tr>
<td>3706.57</td>
<td></td>
<td></td>
<td>3000.00</td>
<td></td>
</tr>
<tr>
<td>Omissions</td>
<td></td>
<td></td>
<td>3000.52</td>
<td></td>
</tr>
</tbody>
</table>

For compactness columns to the right have been placed below.
The portion of the incoming mail containing money is handed over to Miss Crawford, the cash book clerk, but as she is not allowed to have access to the personal ledgers or to the monthly customers' statements, there is ample protection against fraud and error.

Beginning this year, Miss Curtis is banking the money. She is also calling for the bank statements, and is reconciling Miss Crawford's cash books to the bank statements.

We instructed Miss Curtis to foot all of the columns, to check the forwards, and to crossfoot the totals at the end of the month. We also showed Miss Curtis how to trace the book receipts into the bank statements, how to examine the checks, and how to draw up a bank reconciliation of her own.

Mr. Hadley, the treasurer, was pleased, it will be remembered, with our suggestion on this matter of having Miss Curtis review Miss Crawford's work.

We established a petty cash fund on the impress basis last year. Miss Holt was put in charge of it. Mrs. Wilkinson was assigned the task of okaying the vouchers before they are accepted for reimbursement by Mr. Hadley. Cash receipts are deposited intact and regularly. All items received after 1 P.M. are recorded as of the following day, since the deposit slips can not otherwise be prepared in time for banking on the same day.

The checks are signed by Mr. Cushman, chief accountant, and by Mr. Hadley, treasurer. Last period we were able to show Mr. Hadley the danger of his signing ahead of time. Mr. Hadley does not sign (now) the checks unless he has an approved voucher before him.

116. Explanation and Comments.—This exhibit illustrates a page of the type of information which the working papers should contain on the client's system of internal check.

The reason why these facts are recorded in the working papers is because the senior who regularly conducts the audit may fall sick, or leave the employ of the auditing firm. Or, the resident manager or partner of the auditing firm may want to see if the work done, as called for on the audit program, is sufficient or superfluous in the light of the system of internal check described in the working papers.

Successful auditing, it is repeated, can never be accomplished without an intimate knowledge of the client's system of internal check.

A number of paragraphs in the text are devoted to a consideration of what constitutes a good system of internal check.
1. State a good system of internal check on cash receipts received by mail. Be specific. Give adequate treatment to the topic.
2. Do you agree with Montgomery's ideas on page 88 which start with, "The attitude of the lender --- --- --- --- --- appropriate titles."
3. Describe fully and clearly the operation of an imprest petty cash fund.
4. Write several paragraphs giving your idea of a good system of internal check for purchases.
5. Would you expect to uncover in a balance sheet audit as of April 30, 1927 a theft of cash from securities sold in January 1927?
6. Should the cashier have access to the personal ledgers? Give reasons for your answer.
7. Define a junior, semisenior, senior, supervising senior, resident manager, junior partner, and senior partner.
8. Draw up a complete list of questions which you would ask about conditions surrounding cash in order to determine if the system of internal check is completed.
9. Why might an auditor send in writing to the client, the limitations and scope of a balance sheet audit?
10. Give a paragraph embodying the essentials of careful maintenance of stock records.
11. Company's A's net account receivable balance was stated at $587,642.19 in the ledger. An analysis of this account disclosed that $1,409,427.83 worth of accounts had been sold to a discount company which retained a 20% margin. Show how you would set forth this situation on a balance sheet.
12. Why should an office force be kept ignorant of the amount of testing which the auditor does?
13. What is meant by the expression "an examination of the essential features of the accounts"?
14. Is it necessary to foot all of the general ledger? If not, why not?
15. What is the function of a transfer agent?
16. Give some practical suggestions about "testing".
17. If an auditor finds that the data supporting an entry is in order is that sufficient?
18. Why is it advisable to have a duplicate voucher for every journal entry?
19. Draw up a plant ledger card and fill it in. Also give on a separate sheet the same thing in the form of a composition.
20. If an office force should "lie down on the job" whenever the boss is out, should the auditor call the client's attention to this fact?
21. Give a description of a well organized tool room.
22. To what extent would you audit the General Journal? Why?
23. How would you safeguard the securities?
24. How can the bad debt reserve be used to cover up fraud?
25. How would you safeguard the make-up and the payment of the payroll?
26. Draw up, without reference to your text, a Notes Receivable Register, and make 10 different entries therein.
27. What would you do if a clerk told you that the voucher you wanted was missing?
28. What records are required for the proper recording of transfers in capital stock?
29. What is the function of a registrar?
30. State the types of entries to be found in the General Journal when there are a large number of books of original entry.

32. Write several paragraphs on the topic, "Trade Acceptances".

33. If an auditor discovers fraud, what is it necessary for him to do before following up his discoveries?

34. Give several reasons for checking the shipping record against the sales book.

35. In a paragraph or two, explain the differences in the voucher checks of plates 19, 20 and 21. What one do you prefer? Why?
CHAPTER 10
OTHER ESSENTIAL PRINCIPLES OF AUDITING

117. The Check, and the Analysis Methods of Auditing.
119. Analyzing Ledger Accounts.
120. Postings.       121. Footings.        122. Ticking.
123. Explanation of Plate 30.

PLATE 30—A System of Check Marks.

124. Purchase Vouchers.
125. Sales Invoices.
126. Division of the Work.

Review Questions.

117. The Check, and the Analysis Methods of Auditing—The term, check

"The difference between the 'checking' and the 'analysis' method of auditing may be brought out most clearly perhaps by explaining the auditing procedure in each case. The 'checking' method involves the verification of entries in books of original entry, in the order in which they occur, by reference to supporting papers, such as checks and approved creditors' invoices and journal entries. Having verified the propriety and correctness of the entries in the books of original entry, the auditor then proceeds to check the footings and also the posting of those entries to the ledger. That done, he then checks the footings of the ledger accounts and the abstraction of balances, to prove the correctness of ledger balances. In short, the checking method proceeds from the foundation up.

"The 'analysis' method involves the analysis of ledger accounts; that is to say, the auditor will begin with a certain ledger account and verify the entries therein by tracing them to books of original entry and thence to supporting documents. If all ledger accounts were thus analyzed, the auditor would cover exactly the same ground as he would if he used the checking system and checked all the entries, the only difference being that he would go 'down' instead of 'up'.

"The same ground would not be covered, however, by the two methods if only tests were made. For example, one auditor might check the voucher register and the postings thereof for the months of January and February and the cash books for the months of May and June, and not verify all of the entries which the auditor would verify if he completely analyzed six or seven accounts. In the second case, the auditor might verify certain entries in the voucher register for months subsequent to February and in the cash book certain entries prior to May. On the other hand he might verify some of the voucher register entries for January and February and some of the cash book entries for May and June, but he probably would not verify them all.

"If the auditor uses the checking method exclusively, he is likely, in the mass of detail, to be blind to the significance of certain entries, which a critical examination of a given ledger account would reveal, such as expense items which do not appear normal in comparison with those of other months.

"If the auditor uses the analysis method exclusively and does not analyze all accounts, he will verify certain scattered entries in the books of original entry, and he will not be so likely to uncover frauds as if he checked all of the entries even for only part of the period, because he runs a greater risk of missing the fraudulent entries." (Boll-Powellson, "Answers to Questions")
method, is applied to the procedure of going over the route taken in building up the records, whereas the term, analysis method, is given to the procedure of working backwards from the end to the beginning. Thus, for example, if an auditor works from a ledger amount back into a book of original entry, and thence back to a voucher, he is using the analysis method of auditing. But, on the other hand, if he checks a sales invoice into the sales book and then checks the posting into the accounts receivable ledger, the auditor is using the check method of procedure.

Unfortunately, many auditors do not use both methods of procedure as often as they should. There is hardly any lengthy piece of work but what should be subjected to these two kinds of tests because each method serves important and distinct purposes which are to be elaborated herein-after along with several other matters.

116. Testing Books of Original Entry.1--If about one-third of the entries in a book of original entry are going to be examined, as in a detailed audit, the auditor may choose to verify four months' transactions. But if he does so, his plans are inefficient. On the other hand, if he audits the final month's entries completely, and then audits the major

1"In deciding upon the number of entries to be tested, consideration must be given to the conditions of office management and accounting control. The auditor should not arbitrarily say to himself, 'I will verify such-and-such a percentage of the total number of entries." Study of the situation might convince him that the cash was loosely handled, in that there was no internal check on the receipts recorded by the cashier and in that the cashier also kept the books. Under such conditions the auditor might find it advisable to check practically all of the cash records, and pay much less attention to other records, such as the voucher register and the sales journal, provided the office check on purchases and expense bills and on the shipment of merchandise was pretty well established. In other words, the auditor should think of his audit in sections and decide upon the percentage in each section that ought to be tested.

'Under ordinary circumstances it is thought that from twenty to forty percent of the entries in general ledger accounts should be verified in detail. An auditor may ordinarily select from a year's work one to four months' entries in the original records for verification in detail according to the 'checking method', but should not choose consecutive months. That is to say, he may check the cash books for January, May, November and December and the register and sales journal and other books for the same months (or any other four months). If that is done, about 33 1/3% of the entries in books of original entry will have been verified, if transactions for the twelve months of the year number approximately the same each month. After the posting of the entries verified have been checked to the ledger, the auditor can determine approximately the proportion which they bear to the total number of general ledger entries, and if the percentage is too low, he may raise the percentage by auditing according to the analysis method. Even if the percentage is high, however, the auditor should not neglect to make tests by the analysis method.

"It must be remembered that when any given month has been chosen for a test it must be completely tested. Often times an auditor is tempted to 'pass up' an entry because it seems difficult to get any real information about it. The journal may be vague, or the supporting papers and clerks may report that they cannot find them. The auditor may ease his conscience in not 'running down' the item by saying 'it is only a test anyway,' but this is dangerous practice."--Ibid.
items for the other eleven months, his auditing is much more effective, although he will probably have checked only the equivalent of four months' transactions.

This latter plan calls for the use of both the check method, and the test method of auditing. The check method will be used in auditing the final month's transactions. For example, if we take the voucher register as an illustration of the book of original entry, the vouchers, on being pulled from the files and arranged in order by the client's clerk, will be checked into the register. But the rest of the auditing for the other eleven months will be by the test method. That is, the auditor will run over all of the entries in the register until a major item appears. He will then stop at this point to secure and examine the supporting voucher, after which he will proceed to the next major item.

Before leaving the subject, the writer wishes to point out that the last month of a period is the most important month to be audited, except possibly the first month of the next period. If, for illustration, an auditor verified the sales book for the month of December on a calendar year audit, he kills two birds with the one stone. He not only tests a complete month for errors and fraud, but he also determines at the same time that the sales have been "cut off" at the proper point as between this period and the next one. If, however, the month of June were examined, nothing whatever would be accomplished on this very important point of the proper "cut off" as between periods.

Again, it must be emphasized that the auditor must see a voucher or document, if in his opinion there should be one, for every entry in the book of original entry for the month audited in detail. In fact, if necessary, the auditor should write personally for a duplicate. However, there is usually on hand some other independent source of verification. The only precaution that the auditor should take in these matters is to see that he is not making a mountain out of a molehill. For example, if the writer found a voucher for a January advertisement, none for the same advertisement in February, one for it in March and the other months of the year, he would accept the entry for February as being correct if he were shown the cancelled check therefor.

But, on the other hand, insistence on seeing a voucher for every entry in that specially selected month for detailed auditing must not be abated one iota if the auditor can see no good reason for the client's laxity. It may well be that the only thing of importance to develop in the whole audit might be at this very point where the client has no voucher to support the entry. Take, for illustration, the case of Auditor F, who was told that the missing voucher for an entry was only a bank charge slip for something or other that was too small to be remembered. To the ordinary auditor this explanation would have been sufficient as the voucher was charged to General Expense. But Auditor F insisted on getting a duplicate charge slip from the bank, which he found to be for warehouse rent. On pressing forward his inquiry, F found that the bank had in its own name at a public warehouse $700,000.00 worth of merchandise which the client had contracted to take as it needed it. That is, the client had had the bank accept drafts against the bill of lading for these goods. Obviously, although the legal title of the merchandise was with the bank, some mention of this extremely important matter had to be made on the client's balance sheet, since the client

1 The first month is the most important on the Voucher Register, for example, whereas the last month is it in the Sales Book. This is because present expenses are apt to be entered as of the first of the next period whereas the sales of the next period are apt to be entered as of the present period.
was bound by contract to take the goods even though the bottom dropped out of the market.

Finally, the receiving and shipping records should be vouched against the sales, purchases, returned sales, and returned purchase books, and against any other books of original entry that ought to be checked to these original and independent sources.

119. Analyzing Ledger Accounts.—In analyzing accounts, the analysis method of auditing is often used. Take, for example, the land account. After checking the opening balance in the account to the opening entry on the schedule for land, the auditor takes each significant entry in the account (whether debit or credit) and traces it back to its book of original entry. As the supporting vouchers, documents, etc. are designated in books of original entry, the auditor’s next step is to examine these vouchers in proof of the correctness of the entry. Thus, in brief, since the auditor worked from the end, (the ledger account) back to the beginning (the vouchers), he used the analysis method of procedure.

120. Postings.—As a rule, the checking of postings requires two persons if maximum efficiency is desired,—one person calling to the other.

Both the analysis method and the check method or procedure should be used in checking postings, especially whenever all of the postings are not covered. If, however, all of the postings are to be checked, it makes no difference whether one calls from the books of original entry into the ledgers, or vice versa. In either case the person receiving the "calls" must review his book before leaving it to see that all of the entries therein have been ticked.

Many leading auditors do not check every entry in the general ledger; and practically no one ever checks every entry in the personal ledgers. On occasions, every entry in both general and personal ledgers might have to be checked, but that may be regarded as the rare exception, and not the rule. For example, in ascertaining the extent of fraud known to exist or whenever there is a totally inadequate system of internal check, it might be necessary to tick every entry.

Ordinarily then, to repeat, there are many audits where only a few entries in a ledger are checked. In such instances both the analysis and the check method of procedure should be used in checking the postings. The check method will be used in pushing through to completion, the results of one’s detailed examination of a record. If, for illustration, an auditor has vouched and footed the check register for December, he must go one step farther and check the December postings into the general ledger.

Unfortunately, the check method of procedure does not uncover certain kinds of manipulation which the analysis method may reveal. If, for illustration, a defrauder were to pocket $250 received on a customer’s account, he could put a debit of that amount direct into an expense account.

It should be kept in mind that in preparing the various analysis sheets the auditor does the equivalent of checking postings, hence there is little need to go over the ground again by making the checking of the postings a distinct job in itself. For example, consider the method used in analyzing the Machinery account. An amount in the ledger is traced to the Voucher Register to obtain the voucher number, after which the voucher itself is secured in order to ascertain the nature of the capital addition. Hence, if the checking of postings is undertaken as a separate job, attention should be confined to the accounts which have not been analyzed.
account and a credit direct into the Accounts Receivable controlling account. No amount of posting less than a complete job would ordinarily catch this manipulation. This is so because there is nothing to attract suspicion to these two items since there would be many other unchecked entries. But by using the analysis method of checking postings, the auditor does stand a chance of detecting this fraud. As he moves about in the ledger, calling the debits and credits back to the books of original entry, the auditor may happen to call this false credit in the Accounts Receivable account, or this false debit in the expense account, with the result that since it cannot be found in a book or original entry, the fraud will be disclosed.

121. Footings.—Whenever a complete section, i.e. a page or an account, either in a book of original entry or in a ledger, has been audited, it should then be completely footed. In books of original entry, this includes, of course, the checking of the forwards to see that they are correct in amount and that they got the proper columns on the next page, together (if the section is a complete month) with the crosfooting of the totals at the end of the month.

In addition to this, on a detailed audit the footings for the other months of the period under examination should be tested, a page here and there, always including the last page of each month and the crosfooting of the monthly totals. As to the general ledger, these accounts should be footed and the balance proven, to about the same extent as the proportion of postings checked.

In verifying footings, short cuts are often permissible. In many records, such as sales book for example, it is not necessary to foot the cents, and, in footing inventories, the auditor may properly start in with the hundred dollar column. No negligence or danger is involved in this procedure as long as the auditor remains alert throughout this dulling job. For example, if fraud by over-footing inventories is being undertaken, it will generally be nothing short of an overstatement of a hundred dollars at a time, as any lesser amount would not be worth the trouble. Again, if the clerical errors in the inventory are less than one hundred dollars, they are generally too small in the aggregate for the auditor to take cognizance of.

Of course, no clerk in the client's employ should be allowed to act on the same principles as the auditor. Ty her, a five cent mistake in adding may be a just cause for a reprimand, but it is a microscopic matter to the auditor as far as requiring an adjustment.

In regard to the use of computing machines by auditors, the writer feels that it is no disgrace to use them, but rather a mark of efficiency, provided always that the auditor can quickly and correctly perform mentally all ordinary mathematical processes, and provided that he doesn't run to an adding machine to total a single column of say fifteen figures. In brief, as long as the auditor uses common sense in selecting what should be done mentally and what should be done by machine, there is no reason why computing machines cannot be used extensively. In fact, some auditing firms employ adding machine operators.

122. Ticking.—(Plate 30)—In the writer's opinion, an item in a book of original entry should be ticked whenever it is vouched, or when-

1The comments made above in note 1 also apply to footings since the auditor by footing his schedules does the equivalent of footing the ledger account of which the schedule is a duplicate.

2An auditor should not accept as conclusive proof the client's adding machine tapes as these can be easily falsified.
ever it is posted. Likewise, the voucher, or the entry in the ledger account should also be ticked at the same time. Many auditors do not do this ticking, and even scorn it as being a relic of the dim past. These auditors either do not think that the ticking is necessary, or they do not do it because they feel that it discloses to the office force the extent of their auditing.

The writer's position is this. If ticks are not used, there is a possibility that in the monotony and size of the work of vouching, or checking postings, the same item may be used twice. Suppose, for example, that there are five $150 items in the advertising account for the month of March, and that it takes two days to check the March postings. Is it not clear that ticks would be advantageous in keeping track of the $150 entries which had been used? Moreover, ticks show exactly what has been done so that if the work has to be dropped hurriedly for a week or more, or if the client has to use the books or sheets for a day or two, it can be picked up readily without loss of time. Thus in checking inventories, for example, the writer finds the use of ticks to be a great aid in keeping straight what has and what hasn't been done.

Ordinarily the writer adopts this method: If a whole section is to be checked, such as a month's vouchers to the Voucher Register, the items and vouchers are ticked lightly in pencil so that the ticks in the register (not on the vouchers) can be erased. This section is then noted on the audit program. But whenever scattered special items are ticked (as in a test in a detailed audit), the ticks are not erased and hence the items are not recorded on the audit program, because they are too numerous to mention. This procedure does not disclose to the office clerks the extent of the auditor's checking, but the audit program does have it for the auditor.

Again,—the monotony of checking vouchers, or of checking postings should be relieved by having first one person and then the other do the calling, and by substituting different work at intervals in order to get the benefit of a change of work.

Finally, it should be clear that if the auditor takes the precaution to keep the books and records under his physical control until a section is completed and recorded on the audit program, he is adopting a procedure of preventing error and fraud that outweighs any system of ticking however adequate. 3 In all cases the auditor should make certain that he can

1 Ticking is always a great help when the audit is a "continuous" one.

2 Many times, however, he does not use it, unless the client is one who objects to check marks, or is otherwise finicky.

3 "As far as is practical each section of the work taken up should be completed and definitely cleared to a certain point. The habit of leaving loose ends is all too common; it is a dangerous practice opening opportunities for eventually overlooking or forgetting points of vital consequence, or for inviting the making of fraudulent alterations. Many cases have been encountered where Ledger balances were checked one day and footed the next in which, during the interim between the two operations, the checked figures were altered; had the accounts been footed immediately after checking, these alterations could not have been of any effect. Again, under no circumstances should pencil figures be accepted unless the auditor elects to ink them himself (a questionable practice since it opens a possibility of the auditor being accused as a party to a fraud). It seems far better to raise vigorous objection to pencil entries and footings, and insist that all such be inked in prior to commencing work on the books proper; Ledger account balances should be noted at the side of the sheet or in the explanation space, preferably in ink of a color different from that used in the body of the Ledger."—Bennett (p.43)
have the book for the time necessary to audit a complete section of it. If the
book must be given up, the auditor must take off the totals on to his
pad.

123. See Plate 30.

124. Purchase Vouchers.—The first thing on a voucher that should
have the auditor's attention is the name of debtor shown thereon. As it is
possible that two companies may have names approximately the same, care
must be exercised to see that no one else's bills are paid. But more
important than this, is the possibility of an officer having his personal
bills paid by the business. To be certain, bills rendered in the name of
an officer or salesman, are often proper charges to the business. But the
point is that the auditor must examine these bills more carefully than the
others. And, if he is in doubt as to their propriety as charges against
the business, he must get the approval of someone "higher up", even if it
has to be the board of directors.

Bills marked "duplicate" should be scrutinized with great care lest
the same debt be paid for twice. Ordinarily it is sufficient for the
auditor to scan the other paid vouchers in that particular creditor's
file (for a reasonable period in the past) in order to satisfy himself
that the original bill is really missing.

The date of the voucher should receive the auditor's attention be-
cause a bill might get paid twice, or a defrauder might remove an old
bill from its voucher jacket and pass it through again for second pay-
ment. As the old date might be changed to a current one, the auditor
should be alert to detect erasures.

An excellent method to forestall such a manipulation is to have a
routine procedure which requires that all bills be stamped "PAID", and
show the check number and the date. Some businesses perforate their
paid invoices.

After this has been done, the auditor should examine the bill to
see, as evidenced by various initials, that it has gone through the
regular routine of checking the correctness of the quantities, the unit
prices, the extensions, the footings, the terms, the distribution, the
approval for payment, and so on. In the most up-to-date businesses a
rubber stamp is used for this purpose. But in other less efficient or
smaller businesses a single initial may stand for the approval of all
these matters.

Next, the auditor must examine the nature of the items purchased,
both to see if the distribution is correct, and to satisfy himself that
the expenditure was a proper one. For example, in auditing a manufactur-
ing plant an auditor found a voucher made out to the client; it bore a
current date; it also showed evidences of having passed through the
office routine, and yet it was for a necklace. Obviously, the auditor
had detected a case of fraud. But, as a matter of fact, it wasn't fraud
in this case since the auditor found on presenting the matter to the
accountant that it was a gift by the company to the winner of the girls'
race in a recent office outing.

If the voucher system is the type where several bills are enclosed
in a single voucher jacket, the auditor must examine each bill in the
manner just described above. If he has done this intelligently, the
auditor should be in a position to know if his impressions coincide
roughly with the distribution and total on the voucher jacket. If his
impressions do coincide, then the auditor may pass the voucher, if the
other matters were satisfactory. But if his impressions vary widely
from the facts on the voucher jacket, the auditor must again review the
EXPLANATION OF PLATE 30

A SYSTEM OF CHECK MARKS

HOLT, HELLWELL AND COMPANY
Certified Public Accountants
Pawtucket, Connecticut

System of Check Marks

123. Explanation and Comments.—This exhibit outlines a complete system of check marks.

As stated in the text, the writer uses small light check marks made with black lead whenever they are to be erased, and with blue lead whenever they are to remain on the books or records. By using ticks, the auditor is prevented from using the same item twice, whether it be an entry, a check, a document, a voucher, or a security. Moreover, the ticks show exactly what has been done, so that if the work must be dropped hurriedly for a period, it can be picked up without loss of time. If a whole section is ticked, that fact should be noted on the audit program, and at the same time the light lead pencil ticks must be erased, thus concealing from the office force the extent of the auditor's examination. Whenever special items are ticked with blue pencil, the marks are not erased because it is desirable to have somewhere a record of what was done. As it is too difficult to record those numerous special items on the audit program, the books and records must retain the evidence.

---

1 This procedure is optional.
Beginning January 1, 1930, the following system of ticking client's books must be used by all staff members. Care must be taken to make the marks very small and very neat because many bookkeepers take considerable pride in the neatness of their records, and so must we too.

Each staff member must provide himself with a blue Eversharp pencil. Red will be used in 1931 and green in 1932.

1. Voucher Register:

A blue tick (v) to the right of a total in the vouchers payable column of a voucher register will indicate that the amount and the distribution are correct. Whenever a single item in a distribution column is checked (v), this will mean that that item only has been verified.

```
EXAMPLE

<table>
<thead>
<tr>
<th>Total</th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
</tr>
</thead>
<tbody>
<tr>
<td>500.00</td>
<td>100.00</td>
<td>20.00</td>
<td>V</td>
<td>380.00</td>
</tr>
<tr>
<td>72.00V</td>
<td>30.00</td>
<td>10.00</td>
<td>20.00</td>
<td>12.00</td>
</tr>
</tbody>
</table>
```

2. Vouchers:

After a voucher has been compared with its entry in the Voucher Register, it must be cancelled with our audit stamp.

If only a single item on the voucher was inspected that item must be ticked (v), for otherwise the inference is that the whole makeup of the voucher was examined and found to be correct.

3. Footings:

A blue tick (v) below the total of a column of figures means that the footing is correct.

```
EXAMPLE

$149.17
20.33
$169.50
v
```
4. Cross-footings:

A blue tick (✓) to the right of a total figure which has been distributed, indicated that the cross addition is correct.

**EXAMPLE**

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>70.00</td>
<td>10.00</td>
<td>20.00</td>
</tr>
<tr>
<td></td>
<td>65.00</td>
<td>19.00</td>
<td>65.00</td>
</tr>
<tr>
<td></td>
<td>29.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>164.00</td>
<td>✓</td>
<td>29.00</td>
<td>50.00</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>105.00</td>
</tr>
</tbody>
</table>

5. Check Register:

A small blue tick (c) to the right of an entry in the cash column indicates that it was compared with its cancelled check.

**EXAMPLE**

<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
<th>C</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>116.00</td>
<td>10.00</td>
<td>43.00</td>
<td>169.00</td>
</tr>
</tbody>
</table>

6. Cancelled Checks:

After a check has been compared with its entry in the Check Register, it must be cancelled with our audit stamp.

7. Amounts Check To Some Other Place.

A blue tick (v) to the right of a figure means that it has been checked to some place else, such as into a ledger or on to the next page. The particular situation will indicate its nature as, for example, whether it has been posted, or whether it has been forwarded to the next page, or to a summary.

**EXAMPLE**

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>Omissions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>716.00</td>
<td>16.00</td>
<td>500.00</td>
<td>200.00v</td>
</tr>
<tr>
<td></td>
<td>v</td>
<td>v</td>
<td>v</td>
<td>v</td>
</tr>
</tbody>
</table>
8. Amounts Checked From Some Other Place:

A blue tick (v) to the left of a figure means that it has been checked from some other place. Such a mark in a ledger account indicates that this posting has been checked from a book of original entry. If the mark is to the left of a figure in an inventory summary sheet, for illustration, it means that that figure has been checked from its supporting source somewhere in the mass of inventory sheets. Again, for example, if the "brought forward" figures at the top of a page bear this mark, it means that these figures have been verified from the figures at the bottom of the prior page.

**EXAMPLE**

<table>
<thead>
<tr>
<th>Total</th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>$42.00</td>
<td>$17.00</td>
<td>$15.00</td>
<td>$10.00</td>
</tr>
</tbody>
</table>

9. Items Verified:

If any item, other than those in the Voucher Register, is verified in any manner against some document or other source, it must be ticked with a blue (v) above the figure.

**EXAMPLE**

170.50

10. SUMMARIES:

Whenever the summary of a miscellaneous column is verified a blue tick (v) must be placed below each item.

**EXAMPLE**

<table>
<thead>
<tr>
<th>Miscellaneous</th>
<th>G.L.</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Furniture</td>
<td></td>
<td>17.80</td>
</tr>
<tr>
<td>Land</td>
<td></td>
<td>1500.00</td>
</tr>
<tr>
<td>Furniture</td>
<td></td>
<td>129.17</td>
</tr>
<tr>
<td>Machinery</td>
<td></td>
<td>520.00</td>
</tr>
<tr>
<td>Machinery</td>
<td></td>
<td>500.00</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2666.97</td>
</tr>
</tbody>
</table>

| Land          | 7   | 1500.00 |
| Machinery     | 12  | 1020.00 |
| Furniture     | 15  | 146.97  |
|               |     | 2666.97 |
11. Audit Stamp:

F.T. Clarkson & Co.
14
C. P. A.

Each staff member has been provided with an audit stamp having a different number (here 14). By this means each one will be held accountable for the accuracy of his work. Allow no one to use your audit stamp. This request also applies to a fellow staff member.

Make certain that your stamp pad is blue. It must be wet enough to give good results but not wet enough to blot.

Do not place the impression on top of a figure because that makes it (the figure) unreadable. If possible, choose the same location to stamp each voucher, or check, and so on. Do not do your stamping haphazardly. Never stamp the impression upside down.

Do not use the audit stamp on securities or documents etc. that are likely to be submitted for verification at subsequent auditing periods because the impressions will disfigure them.

Use the audit stamp on:

(1) Cancelled checks after they have been used to vouch the check register.
(2) Bank statements whenever they have been used.
(3) Vouchers after they have been used to verify the Voucher Register entries.
(4) Records whenever it is desirable to show the point up to which the audit has been carried.
(5) Cancelled notes payable, etc. after they have been used to vouch the cash book entries.
(6) Petty cash vouchers after they have been verified.

12. Incorrect Entries.

Whenever an entry is wrong, place a blue (x) in the position of the tick that would have been used had the entry been correct, or to prevent confusion, the correct tick should be placed above the (x). Thus (x) beside a figure in the Cash Payments book would mean that the check did not check with the entry.

13. Use of Ink on Working Papers:

(a) Prepare all preliminary papers, e.g. analyses, in pencil.
(b) Prepare all summaries in ink.

1 The writer has worked for a national firm which requires all papers to be written in ink. Here the qualities of legibility and permanence were the paramount considerations. Erasures were not encouraged, the mistakes being crossed out; hence neatness of appearance was not of particular import. Undoubtedly the use of pencil makes for speed, convenience in making changes through erasures, and neatness of appearance. Some firms and seniors consider the latter important lest the schedules come under the observation of the client.
nature and amounts of the items. In addition, every now and then the auditor should actually figure on paper the exact distributions and the exact amount of a few vouchers.

Whenever the voucher is a "house voucher", as in the case of pay-rolls, too much care cannot be taken in ascertaining its correctness. Naturally, in such instances, the auditor must get back of the voucher to the original basic documents such as the time cards, and so on, if his auditing is to be the least bit effective.

At times a paid check is a sufficient voucher as in the case of one made payable to an office clerk for her weekly salary. But on other occasions, it is entirely insufficient as when the check is made payable to a garage. In such a case a duplicate bill should be sent for by the auditor personally if the file clerk states that the original is missing.

125. Sales Invoices.—In his examination of the sales invoices, the auditor should account for them by number.

Although it is not the auditor's duty to test the accuracy of the unit prices, the extensions, and the footings, he must see that these duplicate invoices have been initialed in proof of the correctness of these and other matters as called for by the office routine of checking sales invoices.

In a detailed audit the auditor should check, every now and then, a sales invoice against the salesmen's order book to see that it has been properly filled, and against the shipping record to see that it has been shipped. Moreover, such testing proves that the sales are not fictitious.

On rare occasions the auditor may also check a few invoices as to the correctness of the unit prices, the extensions, and the additions. As a rule it is an utter waste of time to do so, but on occasions luck favors the auditor by disclosing to him an error or two of importance.

126. Division of the Work.—In every accounting firm of large size, there will be many distinct grades of people; senior partners, junior partners, branch managers, report supervisor, seniors, semiseniors, juniors, adding machine operators, bookkeepers, telephone operators, private secretaries, stenographers, typists, file clerks, and office boys.

At the top of the organization, then, are the senior and junior partners. Obviously, this distinction is not one of age but rather one of rank. As a rule, the partners will be in charge of offices located in the various cities, but this is not always so. In many instances the branch managers are not partners in any sense of the word, and yet they are distinct from and decidedly above the seniors. They seldom if ever work directly on any audit engagement, and they are responsible only to the partners or to a partner.

In general the next lower level of employee is the senior. Exceptions to this are to be found in very large accounting organizations where "the tax expert", the final authority on all tax matters, or the report supervisor, to whom all reports must be submitted for revision, or the work procedure manager, who interviews new prospective clients and who also assigns and controls the work given to seniors, are usually men advanced from senior positions into these specialized functions. In fact, it often happens that some of these three grades of men in the main office are higher in rank than some managers of the smaller branch offices.

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1 In some organizations there are supervising seniors and in-charge seniors. The former supervise and control a number of engagements each of which is headed up by an in-charge senior; hence a group of in-charge seniors will be responsible to a single supervising senior.
The senior is the one who is directly responsible for the correct execution of the engagement. Of course, some audits are large enough to engage the attention of several seniors, or the client may request the services of several seniors, or several seniors may be placed on the job to get the work completed at the earliest moment possible, and so on. In such cases, one senior will be placed in command and held responsible for the work of all,—seniors, semiseniors, and juniors.

But ordinarily only one senior will be on an engagement of even large proportions. All contracts with the executives of the business on ordinary matters will be through the senior, i.e., the semisemior and juniors are not allowed to interview an executive, or comment to executives or others upon their findings. For example, if an employee or an executive should ask a semisemior to suggest improvements in the columnarization of the Voucher Register, the semisemior must explain that he will be glad to do so on the senior’s approval, but that otherwise the rules of the auditing firm strictly forbid it.

The senior will, of course, draw up the audit program, and parcel the work out to the semisemiors and juniors. In this connection, the senior will ordinarily indicate how he wishes the schedules to be drawn up and possibly the methods to be pursued in achieving the results. He must watch the progress of the work, and review each schedule with the one who submits it, so that he may feel assured that it has been properly executed.

As a rule, the senior will read all of the important documents such as the directors’ minutes, the stockholders’ minutes, the special committee’s minutes, the charter, the capital stock provisions, the partnership agreement, the will of an estate, the indenture of a mortgage, the terms of a leasehold, the provisions of a franchise, and so on.

Also, the senior will draw up all of the adjustments even though most of them will have been suggested to him in the first place by the semisemiors and juniors. Moreover, the senior will very likely handle personally the tax accrual computations, and such other very important and specialized matters as are necessitated as a result of his examination of the aforesaid documents.

Finally, the senior will write the report which, in the case of the larger auditing firms, will be re-worked by the report supervisor, and in the case of smaller organizations by the branch manager, or partner.

The semisemiors will probably be assigned the drawing off of the trial balance of the general ledger, the working up of most of the schedules, the counting of cash, negotiable instruments and securities, and the execution of similar work. Of course, whenever the cash, negotiable instruments and securities are the principal assets, the senior must always assist in the verification thereof.

The work of the junior is largely confined to routine matters requiring but little technical skill and experience. However, that is not to say that very important errors are not disclosed by juniors. Indeed, since their work of adding, checking computations and vouching, is mainly on primary data—vouchers, receiving records, time cards, requisitions, inventory tags and sheets, paid checks, shipping records, and so on,—juniors may uncover just as many important errors or fraud as do the semisemiors or seniors. In brief, alert juniors are very essential to

"A junior should ask no question of the client’s staff. He should report only to his senior, and use discretion as to matters taken up with him. Be slow in reporting errors; think before jumping at conclusions."—Bennet (p. 24).

Furthermore, the junior should not answer any questions put to him by the client. He must politely refer the client to the senior for the answer thereon.
the successful completion of an audit, albeit the technical knowledge required of them is elementary.

One example will be sufficient to show the importance of careful work by juniors. On one audit that the writer knows of, a junior observed, while checking the vouchers to the Voucher Register, that the cash discount was being taken on the gross bill less the freight allowance instead of on the gross bill. Thus, although the bills were f.o.b. client's place of business, the client's clerk would compute the discount as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bill</td>
<td>$14407.29</td>
</tr>
<tr>
<td>Freight paid by client and allowed by the vendor</td>
<td>601.18</td>
</tr>
<tr>
<td>2% discount</td>
<td>276.12</td>
</tr>
<tr>
<td>Check for</td>
<td>$13529.99</td>
</tr>
<tr>
<td>The correct computation should have been:</td>
<td></td>
</tr>
<tr>
<td>Bill</td>
<td>$14407.29</td>
</tr>
<tr>
<td>Freight paid by client and allowed by the vendor</td>
<td>601.18</td>
</tr>
<tr>
<td>2% discount (on full amount of the bill)</td>
<td>288.15</td>
</tr>
<tr>
<td>Check for</td>
<td>$13517.96</td>
</tr>
</tbody>
</table>

As these errors involved a very large number of important invoices and extended over a period of several years, the client retrieved a rather significant sum.

Finally, the lowest paid types of employee are the clerks, switchboard operator, typists, stenographers, file clerks, and the like, depending on the size of the office.

**REVIEW QUESTIONS**

1. Outline the personnel of a large auditing firm.
2. What are the advantages of using tick marks?
3. What short cut in footing may be properly taken?
4. Outline the type of work performed by various grades of auditors.
5. Explain the difference between the check method, and the analysis method of auditing.
6. How does an auditor examine a voucher?
7. What are some of the principles to be observed in testing books of original entry?
127. Definition of Current Assets. A rough but working definition of current assets is that they consist of liabilities that will mature within a specified period of time. The reader's attention is diverted at this point to five paramount considerations which the auditor must bear in mind during his audit of the assets: (1) "Too much emphasis cannot be placed upon the need for a careful consideration of circumstances calling for the differentiation between capital and revenue charges." On some engagements, however, the auditor may find that the client has a working rule whereby all expenditures costing less than a certain amount are to be expensed though they are true capital expenditures. Although this procedure is theoretically incorrect, its adoption is recommended. (2) One of the largest problems facing the auditor in his verification of the assets is the problem of valuation. This task is practically omnipresent whether the asset be cash (e.g., foreign bank balances), accounts receivable, notes receivable, securities, plant properties, etc. Therefore, the auditor should not adopt the client's valuation unless it is in substantial agreement with his own independent conclusions. This word of caution is nowhere needed more than in the case of ascertaining the proper rates of depreciation. Many auditors are prone to adopt the client's rates because of the universally recognized difficulty of the problem. (3) The assets must belong to the client. (There are important exceptions to this rule, as where the title to machinery is still in the name of the seller-manufacturer until the purchase money notes are paid off. Although it is probably proper to show merely the net equity of the client in the machinery, the better procedure is to present the machinery gross less depreciation as a pledged asset, and the notes payable as a secured liability. (4) The assets must be on hand or otherwise properly accounted for. (5) All assets belonging to the client must (omissions are permitted at the auditor's discretion) be taken up on the books. Sometimes the client intentionally omits certain assets. Thus prepaid interest and/or accrued interest receivable are often intentionally omitted. The auditor should mention this fact in his certificate. On other occasions, the omission of assets is sanctioned by a Board of Directors who are desirous of creating or increasing a secret reserve. Finally, certain types of fraud are accomplished in this manner. As Bennet says (p. 32), "Certain employees may be interested vitally to have the records hold as few charges against the asset accounts as possible; (2) The persons, or someone behind them, may desire the spreading of a rumor of coming disaster so that an interest in the concern may be secured at moderate cost. (b) Other persons, individually responsible for property as represented in the accounts kept by the, may desire to show as small an amount of property in their charge as possible so that
a current asset is: A current asset is one which in the REGULAR COURSE of business will and/or can be readily and conveniently converted into cash within, say, one year from the date of the balance sheet. Furthermore, this cash must be available, if needed, to discharge a current liability. As with other rules, there are legitimate exceptions to it. Nevertheless, the above rule does give the gist of the matter.

128. Cash.—Cash should be thought of as those items which are usually accepted for deposit by banks. Besides checks, bills, and coins, the terms includes, among other things, demand certificates of deposit, matured time certificates of deposit, money orders, bank checks, bond coupons, and foreign currency (converted at proper rates). Postdated checks, checks drawn on insolvent customers, checks returned because of insufficient funds, checks drawn on closed banks, and so on, are not cash.

If any cash is not available for the payment of a current liability, it is not properly listed among the current assets. But if, for example, there is a cash fund (even though it is a specific one) which can be used to extinguish the dividends payable account, it is a current asset. On the other hand, if there is a cash fund which must be used to pay off a bond liability maturing more than a year hence, it is a fixed asset.

Cash items, such as postage stamps, expense vouchers, I.O.U.s, etc. may be treated as cash if they are insignificant. However, if the amount of these cash items is considerable, they must be placed under proper captions. Thus the stamps may be classified as office supplies under the main caption of PREPAID ASSETS. The expense vouchers will be charged to various profit and loss accounts.

129. Notes Receivable.—The term notes receivable is reserved for unmatured notes received from customers for sales and "on account"; therefore, all other notes must be carefully classified and segregated according to their individual nature and according to their maturity dates.

As trade acceptances are more liquid than ordinary notes (because they can be rediscounted at the federal reserve banks under certain conditions), they are generally set out separately as, Trade Acceptances.

130. Accounts Receivable.—The caption accounts receivable (as a current asset) means that the accounts are due from the trade for sales, and are collectible within the credit terms granted, or have been reduced to a collectible amount by a reserve for doubtful accounts.

Installment accounts are current even though the maturity date is more than a year hence provided these are the regular installment terms of the trade in general. Moreover, installment accounts ought always to be shown separately.

Accounts and notes receivable of stockholders, employees, officers, and the like, are current if they are to be received within a year, but they must be separated from other types of receivables. Likewise, charges to customers for returnable containers, claims of all sorts, deposits, subscriptions receivable, advances on purchase commitments, etc. must be weeded out of accounts receivable and classified according to their individual nature, i.e. either as current or as fixed assets.

131. Inventories.—Inventories of raw materials, scrap, operating (cont'd) they can make way with portions of it from time to time: (1) Accounts and notes receivable, The smaller the amounts thereof, the less will be the accountability for collections. (2) Goods. The smaller the amounts thereof, the more may be appropriated to personal use."
Supplies, ordinary repair parts, goods in process, and finished goods are current assets if they are saleable, or as useable within a reasonable period,—otherwise they are fixed assets. Thus a very large over supply of a raw material may be a fixed asset. Likewise, spare machines, dynamos, and the like, are fixed assets and not repair parts.

Inventories of office supplies are usually classified as deferred charges to operations (prepaid assets).

132. Advances on Purchase Contracts.—Advances on raw material commitments etc. are current assets because they will be soon liquidated by the receipt of raw materials. They should be listed, therefore, directly after the inventories.

133. Temporary Investments.—Temporary investments are current assets if we mean by temporary that the investments are likely to be (or can be) turned into cash in the near future,—not that the maturity dates of the investments are near at hand. Moreover, such cash must be available, if needed, for the discharging of a current liability. And finally, these investments must also be readily marketable.

134. Accrued Income.—Accrued income is, of course, income that is earned but not yet due. Ordinarily it is a current asset even though it may be computed on a fixed asset. Thus bond interest receivable is usually a current asset (but this is not true if it is on a sinking fund) even though bonds are among the fixed investments.

135. See Plates 31 and 32.
EXPLANATION OF PLATES 31 AND 32

THE CURRENT ASSET SECTION OF A BALANCE SHEET

135. Explanation and Comments.— This exhibit (Plate 31) shows a characteristic make-up of the current asset section of a balance sheet. It is not often that the cash is given in as much detail as shown here.

Note that the reserve is made to apply to the notes as well as to the accounts.

Items 13, 14, and 15 are to indicate that there are many other items not shown herein which can be properly classified as current. The numbers must, of course, be omitted on a balance sheet presentation.

The chief difference between plates 31 and 32 is that the PREPAID ASSETS are included in the latter as a part of the current assets. As a rule, bankers and creditmen are not in favor of this. However, textbook writers and many balance sheets, sanctioned by leading auditors, favor, or at least allow, this location in the balance sheet for the prepaid items. The writer agrees with the position taken by the former group.

Note that the accrued interest on the Sinking Fund Securities has been treated as a current asset. This is the correct procedure only when the Sinking Fund will not get this interest.

Finally, note that the Dividends on Securities have been taken up. This is permissible only if they have been declared, i.e. they should not ordinarily be anticipated, however certain their receipt may seem to be.

---

See Appendix C, Sec. 14 #9
CURRENT ASSETS:

(1) Cash:
- Cash in current Bank Accounts and on Hand $xx
- Cash Items xx
- Cash on Deposit to Pay Current Interest Coupons and Dividends xx
- Cash Funds Available for Current Obligations $xx

(2) Notes Receivable - Customers $xx

(3) Trade Acceptances $xx

(4) Installment Account Receivable - Customers $xx

(5) Accounts Receivable - Customers xx

Less - Reserve for Bad Debts $xx

(6) Inventories (at "cost or Market"):
- Finished Goods on Consignment $xx
- Finished Goods on Hand xx
- Goods-in-process xx
- Raw Materials xx
- Operating and Maintenance Supplies² xx

Total $xx

(7) Advances on Raw Material Commitments (see footnote) $xx

(8) Temporary Investments (at "Cost or Market") $xx

(9) Due from Subscribers to Capital Stock $xx

(10) Due from Officers and Employees³ $xx

(11) Claims (detail if large) $xx

(12) Accrued Income (detail if large) $xx

(13) Etc. (Be specific) $xx

(14) " " 

(15) " " 

Total Current Assets $xx

1 Note that these are given separately.
² The writer favors separating the supplies from the raw materials.
³ These items must all be due within one year.
⁴ Of course, these numbers are NOT a part of the balance sheet.
### Current Asset Section of a Balance Sheet

**Assets**

**Current**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash - Current Funds</td>
<td>$xx</td>
</tr>
<tr>
<td>Cash on Deposit for Payment of Matured Debt and Interest</td>
<td>xx</td>
</tr>
<tr>
<td>Cash on Deposit to Pay Interest and Dividends</td>
<td>$xx</td>
</tr>
<tr>
<td>Trade Notes (Schedule #1)</td>
<td>$xx</td>
</tr>
<tr>
<td>Trade Acceptances</td>
<td>xx</td>
</tr>
<tr>
<td>Customers' Accounts</td>
<td>$xx</td>
</tr>
<tr>
<td>Installment Accounts Receivable</td>
<td>xx</td>
</tr>
<tr>
<td>General Accounts Receivable and Accrued Interest</td>
<td>xx</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>xx</td>
</tr>
<tr>
<td><strong>Less Allowances:</strong></td>
<td></td>
</tr>
<tr>
<td>Discounts</td>
<td>$xx</td>
</tr>
<tr>
<td>Doubtful Accounts</td>
<td>xx</td>
</tr>
<tr>
<td>Other</td>
<td>xx</td>
</tr>
<tr>
<td>Accounts Receivable - Officers and Employees</td>
<td>xx</td>
</tr>
</tbody>
</table>

**Inventories as Taken and Valued by the Company:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Finished Goods (at market less 10%)</td>
<td>$xx</td>
</tr>
<tr>
<td>Consigned Goods</td>
<td>xx</td>
</tr>
<tr>
<td>Work-in-Progress (at &quot;cost or market&quot;)</td>
<td>xx</td>
</tr>
<tr>
<td>Materials and Supplies (at &quot;cost or market&quot;)</td>
<td>xx</td>
</tr>
<tr>
<td>Marketable Securities at &quot;Cost or Market&quot; (Schedule #2)</td>
<td>xx</td>
</tr>
<tr>
<td>United States Liberty Loan Bonds, Less Collections</td>
<td>xx</td>
</tr>
<tr>
<td>thereon from Employees (not market)</td>
<td>$xxx</td>
</tr>
</tbody>
</table>

**Accrued Interest Receivable:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>On Sinking Fund Securities</td>
<td>$xx</td>
</tr>
<tr>
<td>On Notes Receivable</td>
<td>xx</td>
</tr>
<tr>
<td>Interest and Dividends on Securities</td>
<td>xx</td>
</tr>
</tbody>
</table>

**Prepaid Assets:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salesmen's Working Funds</td>
<td>$xx</td>
</tr>
<tr>
<td>Interest</td>
<td>xx</td>
</tr>
<tr>
<td>Insurance</td>
<td>xx</td>
</tr>
<tr>
<td>Rent</td>
<td>xx</td>
</tr>
<tr>
<td>Taxes</td>
<td>xx</td>
</tr>
</tbody>
</table>

1. *(Where definite funds, such as those here, have been set aside against specific liabilities, it is permissible, in fact preferable because of the better current ratio, to deduct the liability from the asset. Thus: Cash on Hand and in Banks Government Securities at "Cost or Market": xx Cash on Deposit to Pay Interest and Dividends $20,000.00 Less - Accrued Interest and Dividends Payable 20,000.00)*

Although not commonly done, the same method is applicable to the whole of the sinking fund; i.e., it may be deducted from the bond liability.

It is generally considered better to separate raw materials from supplies.
REVIEW QUESTIONS

1. Define the term, Temporary Investments.
2. Where would you place the prepaid assets on the balance sheet?
3. Define the term, Accounts Receivable.
4. What is meant by the term, Cash?
5. What is your definition of Current Assets?
6. What cash may be classified as current?
7. What inventories must not be classified as current?
8. Why are advances on purchase contracts a current asset?
9. What is your opinion of the following procedure? Why?
   Profit and Loss Deductions.¹
   Losses in Exchange, including unrealized loss arising from
   conversion of net current assets in Foreign Countries at prevailing
   rates of exchange on December 31, 1931 — — — — — — $1,578,971.32
   Write down from cost to December 31, 1931 market prices
   of Raw Materials on Hand, on Commitment, and Material
   Content of Unfinished and Finished Goods on Hand —— 4,426,194.79

136. The Objectives of a Complete Cash Verification.

137. Methods Employed to Obtain These Objectives.


139. Miscellaneous Comments.

140. Petty Cash.

141. Explanation of Plate 33.

PLATE 33—A Reconciliation of Cash Book Receipts and Payments with Bank Deposits and Charges.

142. Explanation of Plate 34.

PLATE 34—A Completed Cash Confirmation Form.

143. Explanation of Plates 35 and 36.

PLATE 35—A Letter Request for Confirmation of Bank Balance.

PLATE 36—A Reply to a Request for Confirmation.

144. Explanation of Plate 37.

PLATE 37—A Bank Reconciliation (1st type).

145. Explanation of Plate 38.

PLATE 38—A Bank Reconciliation (2nd type).

146. Explanation of Plate 39.

PLATE 39—A Bank Reconciliation (3rd type).

147. Explanation of Plate 40.

PLATE 40—A Summary of Bank Reconciliations.

148. Explanation of Plate 41.

PLATE 41—A Petty Cash Count.

149. Explanation of Plate 42.

PLATE 42—A Petty Cash Fund Reconciliation.

150. Explanation of Plate 43.

PLATE 43—A Letter on a Branch Petty Cash Fund.

151. Explanation of Plate 44.

PLATE 44—A Form of Certificate of Deposit.

152. Explanation of Plate 45.

PLATE 45—A Reconciliation of Receipts and Payments.

153. Explanation of Plate 46.

PLATE 46—An Audit Program of Cash on a Detailed Audit.

Review Questions.

136. The Objectives of a Complete Cash Verification.—A complete verification of cash covers at least the following scope:

1. Determination of the correctness of the cash book balance at the beginning date of the audit period.

In a detailed cash audit, the auditor must see that the opening book balance is in agreement with the opening bank balance per the bank statement, but, of course, it is not necessary for him to show that the balance should have been more.

For example, if a beginning cash book balance was stated as $1000.00, whereas the adjusted bank balance was actually $1150.00, the cashier could abstract $150.00 of receipts during the period under audit and still have his final cash book balance agree with the final adjusted bank balance. Obviously, the auditor would be expected to uncover this theft in a complete verification of cash.

As stated hereinafter, it is VERY important to verify the deposits in transit and the checks outstanding as of the beginning of the period.
On the other hand, if an opening cash book balance of $4500.00 agreed with the adjusted bank balance, the auditor is not required to prove, for example, that the opening balance should have been more than $4500.00. To prove this would require an examination prior to the scope of the audit.

2. -- Determination that the bookkeeper has recorded all of the cash which he has received during the period.

This objective represents an ideal to be striven for, as obviously, it cannot be attained except in rare instances. Nevertheless, by judicious testing and scrutinizing, an auditor can often approximate the goal with reasonable certainty.

Take, for example, the case of Mr. B who makes good on an old debt which Mr. F has already charged off his books as being worthless. If F's cashier makes no record of the receipt of this cash from B, he can pocket this sum with little fear of being detected.

Even though this is so, it is quite evident that such limitations as these are not a reasonable basis for an auditor to reject the whole project of seeing if all receipts have been recorded.

A further consideration of the problem involved will show that in accomplishing this second objective it is necessary to audit many underlying records, and accounts other than the cash account. Without an analysis of the investments account, for instance, it is impossible to know what interest and/or dividends should have been received. So also, unless the sales records are audited, there is no certainty that all cash sales have been recorded or that all amounts (accounts receivable) to be received in the future have been included.

Clearly, then, to ascertain that the bookkeeper has recorded all of the cash which he has received during the period is a rather large and difficult task. And, although in some instances, because of the nature of the business and/or the records kept, it is impossible for an auditor to attain this objective, nevertheless the conscientious auditor always does whatever he can, however little that may be.

In a balance sheet audit, therefore, the auditor often does but very little (if anything) on this second objective of a cash verification because it involves the detailed auditing of accounts and records totally outside of the scope of this type of audit. As a matter of fact, the auditor is often instructed even in a detailed audit to accept, as is, the receipts of cash as recorded. In this case the auditor's duty is to see that it has been deposited regularly.

In brief, the auditor must often protect himself and inform his client of the scope of the audit in respect to cash, by stating that "all recorded cash was traced into the depositaries, and in addition tests were made which indicated that all receipts have been recorded."

3. -- Determination that the receipts have been properly recorded.

This means that the auditor must satisfy himself that the entries are in accordance with sound accounting principles and that they have been made without clerical error. For example, if a receipt "on account" is credited to notes receivable it is an error of principle. Likewise, if a receipt is entered in the wrong column in the cash book it is an error of principle.

Again, consider the difficulty of the auditor's knowing and proving what donations have been received, what money has been found on inmates at the time of imprisonment (prisons), what money has been received from sales of scrap, what money has been received from church members on their subscriptions, what money has been received from sales of farm produce, etc., etc., depending upon the type of client.
clerical error. The catching of both types of errors falls clearly within the scope of a complete cash verification.

4.—Determination that the discounts allowed are proper.

5.—Determination that the receipts have been deposited regularly if the routine of the business provides for it.

Included in this objective is the detecting of overlappings and withholdings both of which terms are explained in section 137.

6.—Determination that the receipts were received within the period.\(^1\)

7.—Determination that all checks have been recorded.

8.—Determination that the payments have been properly recorded in accordance with sound accounting principles.

This objective is the same as item 3 above.

9.—Determination that the expenditures have been properly incurred.

To accomplish this objective the auditor ought to see without exception an approved voucher\(^2\) for each check. Where the cash book contains the debit distributions this verification of checks against vouchers is very simple. But when ever a voucher register is used, the auditor must correlate it with the cash payments book. One common method of doing this is to check an audited section of the cash payments book into the voucher register for correctness of name and amount. These items, which are thus ticked off in the register, must then be checked against approved vouchers. In all of this procedure careful attention must be paid to all detailed particulars both on the checks and on the vouchers. Of course, mere approval is not final if the payments are fraudulent as where an official has approved a personal bill as an expense of the company.

10.—Determination that the payments were made within the period.

11.—Determination that the cash book balance at the end of the period is in accordance with the recorded (or adjusted) receipts and disbursements.

12.—Determination that there was on hand, in banks or otherwise properly accounted for, cash to the amount of the correct cash book balance.

13.—Determination that the cash was subject to check and free to be applied at will (such as against present or future current liabilities).

137. Methods Employed to Obtain These Objectives.— Common methods which are employed to accomplish the ten (10) objectives just outlined are as follows:

(2) Receipts

1.—Verify the opening book balance against the bank statement.

\(^1\)See Appendix C, Sec. 14-#16. \(^2\)However, the mistake must not be made of accepting an approved voucher as conclusive proof that the expenditure was properly incurred. The voucher may be for an ultra-vires purpose, or the approval on a voucher may be by the very official who is having his personal bills paid by the corporation.
The procedure required to reconcile a book balance to a bank balance is elaborated in this section under "Balances".

2.--Compare the totals of each day's receipts per cash book with the daily bank deposits per bank statements.

The purpose of this procedure is to indicate to the auditor that the cash is being deposited promptly and regularly in accordance with the routine requirements of the business. This step is good as far as it goes, but it is valueless unless combined with step 3.1

3.--Compare the DETAILS of the SIGNED duplicate deposit slips with the DETAILS of the cash book for at least the last few days of the period and for a few days selected at random, such as at the first of the next period.

Where this is feasible (and it generally is), it is an excellent check on overlapping, on withholdings, and sometimes on kiting. The auditor may use the duplicate deposit slips except when he is suspicious of fraud. In this case the deposit slips at the bank should be obtained.

OVERLAPPING—Suppose B, the cashier takes $50 from the cash sales. In addition, suppose that he covers himself by crediting C's check for $75 (received on account) as only $25 to C. Later, being obliged to show C's account credited with the $50 shortage, B enters D's check for $125 as a credit to C for $50 and to D $75. This is called overlapping.

If the auditor follows the plan suggested in item 2 above he will find everything in order. But if he also compares the details of the deposit slips against the details of the cash book he will detect the overlapping, because he will find a check for $75 whereas the cash book calls for a $25 check. And later he will also find a check for $125, whereas the cash book calls for two checks, one for $50 and another for $75.

It is to be understood that the above case is stated in the most elementary manner possible, whereas actual cases of it are often very complicated and involved (though the defrauder often never intended to let it become so involved). A secret record may be necessary to keep himself straight.

WHITHTOLDINGS.—Suppose B, the cashier, pockets $125, although he gives C proper credit for it on the date on which it is received. Then suppose that B makes the shortage good by depositing the $125 just before the end of the audit period.

In this case both the methods suggested in 2 and 3 above would detect this irregularity because neither the total of the daily deposits nor the details of the deposit slips would agree with the cash book entries.

KITING.—Suppose B, the cashier, draws a check on Bank C and deposits it late on the last day of the period under audit in Bank D to cover a shortage there. Bank D's balance will then be correct and so will Bank C's (i.e. apparently so) because Bank C will not record the check as a charge against Cashier B until it comes through the clearing house which will be at least a day later—the time depending on how far apart banks D and C are. Of course it is to be understood that B, the cashier, has not entered the check on C in the cash book until after the audit date.2

1See Appendix C, Sec. 7#3; Sec.8-#4. 2Another type of kiting is as follows, supposing the shortage to be $1015.50. A check for $507.75 is drawn on Bank K and deposited in Bank M at the close of banking hours on the last day of the fiscal period. A similar check is drawn on Bank M for deposit in Bank K. The checks, of course, are not entered until the
If now, the auditor compares the deposit slips with the cash book he may in certain rare cases note that the kited check is on a local bank whereas the customer, whose shortage is being covered, is known to be in business in a distant city. This difference is not conclusive evidence, to be sure, but it offers a reasonable starting point for further investigation. Of course, the best method to catch kiting is for the auditor to reconcile the bank accounts as of a date (after the audit date) of his own choosing.

4.—Test the cash discounts allowed against the time of payment and against checks received from customer.

5.—Reconcile the book receipts with the bank deposits in totals.
Under this method of procedure (Plate 33) the auditor takes the cash book receipts by months (with or without being footed) and with certain adjustments such as for intransits and the like brings them into agreement with the bank deposits per bank statements.
Of course if the cash book is not footed, the "proof" is not a proof as it is subject to errors (despite the implicit faith with which many auditors use it) inasmuch as the cash receipts column, for example, may be underfooted, etc. to agree with the money deposited.

6.—Foot, check forwards as to amount and proper column, and crossfoot the monthly totals.
    Auditors are at variance as to the amount of footing which is necessary. For example, some feel that there is no substitute for it, and hence foot everything in sight. Others feel that it is only necessary to foot those months which are vouched in detail. Still others would foot only the debit columns of the receipts book and the credit columns of the payments book.
    The writer feels that in a complete cash verification all of the columns should be footed but that in a detailed audit or in a balance sheet audit the tests may be limited to the debit receipt columns (cash and discount columns) of all months other than those particular months selected for critical auditing, all of whose columns should be footed and crossfooted. The same procedure is recommended for the payments book.

7.—Check the postings into the general ledger and into the personal ledger.
    As a rule in a complete cash verification, the posting will be done completely in respect to the general ledger, but only as a very limited test into the personal ledgers. A good plan is to cover a different portion of the personal ledgers at each audit. The method of checking from the personal ledgers into cash book is more difficult than the reverse method, but it often finds errors and fraud that could not otherwise be detected. Always use BOTH the check and analysis methods.
    As noted before, some auditors do not check any postings whatever on a balance sheet audit. In a detailed audit, these auditors would limit the posting to tests. Review section #89.
(cont'd) next period, when they are entered as bank transfers. Thus the cash balance at the end of the fiscal period is in agreement with the Cash Book balance. Thereafter, the cash balance is less than the book balance by the amount of $1015.50 shortage. This is a usable procedure when the shortage exceeds either individual bank balance.
(b) Disbursements

1. -- Compare the checks with the cash book entries in respect to date, name of payee and amount.

In regard to the date, the auditor ought to protect himself by including it in his inspection of checks for there is a possibility that an old check might be used in an attempt to cover up a shortage. For example, the cashier may re-enter in the voucher register the old voucher, or a duplicate. Then, with the old check entered in the cash book in payment of it, the effect would be to cover up a shortage to this extent.

To be sure, other lines of auditing may uncover this fraud, but the point is that the auditor can not afford to pass up this simple method of catching it. Then again, the competent auditor purposely uses methods which overlap one another so that he often covers the same ground twice but from an entirely different approach. To the novice this may appear to be incompetency and waste, but checking is such a dulling process and fraud is so often well covered up, that the writer holds, with many others, that this charge is unjustifiable.

As stated in item 9 of Objectives of a Cash Verification, the writer expects the auditor to correlate the cash book and the voucher register in respect to the name of payee, amount, proper voucher, etc. 3

2. -- Examine the check for forgery of the maker's signature, endorsements, and evidence of passing through the bank. Also compare the wording of the amount and the figures.

As a part of the working papers, the auditor should have the signature of all persons who are authorized to sign in various capacities. With this information on hand, it is surprising how often the alert auditor will catch forgeries if there are any.

In cases where returned canceled checks have been signed by only one person whereas there are places for two signatures, the auditor should have the second person sign them. The bank may be willing to take a chance and cash the check without the second endorsement, but the auditor need not pass it as O.K. and therefore should not take a chance.

In regard to endorsements, the auditor, of course, can not tell whether it is a forgery or not, but he can tell whether there is an endorsement or not, and whether or not it corresponds with the name of the payee. Also, if there is more than one endorsement, it is a thing that an auditor should examine into further because ordinarily a business deposits its checks (that is, there is but one endorsement and generally it reads "for deposit only") 3.

Cases of fraud where the defrauder has forged the name of the payee

---

3 Checks drawn to the order of employees, cash, bearer, etc. must be carefully investigated. 2When private accounts are paid through the business in order that the individual may secure the discount allowed the business, or for other reasons, great care must be taken to see that the purchases are charged to the individual's personal account. This is often quite a task, when the partners of a partnership, or the officers of a close corporation, pass numerous personal transactions through the concern's books of account. In regard to traveling salesmen's commissions and expenses, the auditor may not, most likely will not, be able to find satisfactory vouchers for all expenses. His duty under such circumstances is to state the condition in his audit report, leaving the question of the desirability of a stricter accounting to the management. 5Even if, in the case of double endorsement, the auditor feels that there is no fraud in the client's office, he may feel it advisable to have the client write to the payee if it is not depositing these checks. The fraud may exist there.
and then endorsed his own name have been found only in this manner. Moreover, as courts have held that the maker may be responsible for failing to detect forged endorsements that are so obviously forgeries, or are so unusual as to arouse the suspicions of a reasonably prudent business man, it behooves the business man and the auditor to cover this point.

(By evidences of passing through a bank is meant the bank perforation, clearing house stamp, etc.) (For cancelling a perforation is better than a stamp.)

3.--Account for all check numbers.

The auditor, by taking this step for whatever period he is testing the cash disbursements, covers several angles of possible fraud.

(If the checks are not numbered, he should strongly recommend their being numbered by the printer). (In such cases check the checks to the bank statement.)

If a cashier were to mark a check stub void without presenting the voided check to the auditor, the way is open for its possible misuse. So also if a schemer attaches to the voided check stubs only one half of the check, he can secure a complete check by voiding two checks, one of which he will divide in half to be pasted to the two check stubs. In both of these cases the auditor covers the situation by accounting for the numbers either as on hand, voided, or outstanding.

Or again, if a check is not entered in the cash book and if it is destroyed when it returns from the bank, the auditor should detect it by accounting for numbers. Here again the point is not that other avenues of approach will fail to uncover this fraud, but that the auditor can ill afford to overlook such a simple effective test for uncovering it as accounting for check numbers.

4.—Scan the check book for checks abstracted out of order.

It is not expected that the auditor will minutely examine each and every unused check book page by page. On the other hand if a few minutes examination in this direction should disclose that checks have been abstracted out of order, the auditor will feel well repaid even though the cashier is able to justify his faulty procedure.

5.—Foot, check forwards as to amount and proper columns, and crossfoot the monthly totals.

6.—Reconcile the book disbursements with the bank charges per bank statements in totals (Plate 33).

7.—Check the postings into the general ledger and into the personal ledgers (see item 6 under Receipts).

1"Bank officials became suspicious when they noticed that tens of thousands (reported to total $213,000) were being added to Lewis' account weekly, which therefore had maintained an average of about $100. They noticed that all Lewis' deposits were checks signed by the City Treasurer and made out to one grocery firm (non-existent). Lewis' name was the second endorsement on these checks."—The Detroit News (June 9, 1931)

2"The endorsements of the payees can not be known to the auditor, but responsibility rests on the banks through which check has been passed and for that reason the auditor should see that each check bears the endorsement of some bank".—F.W. Thornton.
1. — Cash negotiable instruments ought to be accounted for as of the same day.

If the auditor fails to account simultaneously for the cash and negotiable instruments he may not find that the bank shortage was made up by getting a loan against securities, which were immediately regained so as to be on hand for inspection the next day. For instance, cashier B, being short $15,000, pledger $20,000 in securities against a loan of $15,000. This was done on December 30th so as to have the cash for the auditor, who came on January 1st for the cash count and bank reconciliation. After the auditor went, the cashier repaid the loan and regained the securities so that they would be on hand for the auditor when he came to complete the audit in February, including the security count.

As there are other manipulations of the same sort too numerous to detail, the auditor must take this precaution of reconciling cash and negotiable instruments simultaneously. He should also be especially on guard whenever an instrument shows the client's endorsement thereon, for such endorsement is reasonable ground for supposing that it was negotiated and regained.

2. — All cash funds and negotiable items must be brought together and at one time, or if impracticable, similar safeguards (such as sealing, or using a staff member at each location of cash or securities) should be devised to prevent the manipulation of the cash and/or securities.

Many cases are known where shortages have been covered up by using the cash in one fund to make good temporarily the shortage in another fund. Thus, B was the bookkeeper for several estates which kept large sums of cash on hand. The auditor in failing to account for the funds of all estates at once, or of sealing the deposit boxes of the other estates, unwittingly permitted B to make good a large shortage by borrowing temporarily from the other funds. (All estates were to be audited.)

In instances where the person has funds not recorded on the books, these also must be counted, for otherwise a shortage could exist without being detected. Obviously, this procedure is not always practical.

In regard to marking securities etc. upon inspection, the writer feels that despite some auditors disdain of it, it is advisable to make some sort of a new distinctive tick in a new place. Of course, the use of an audit stamp is totally out of the question because it would disfigure the securities which remained on hand for several audits. Where securities are likely to be on hand and unused for long periods, the

If feasible, the auditor may count the cash and negotiable securities as of the close of business on the last day of the fiscal year, or on the morning following, as this involves the least possible work of auditing these assets. However, this plan is rarely possible because there are not enough men in an auditing firm to send one or more to each client, or the distances involved are too great, etc. Moreover, in the writer's opinion, the additional work arising from making the examination and count as of a later date is not lost notion by any means. If fraud is undertaken, the trap can be very artfully set as of the audit date, whereas this is entirely impossible if the auditor chooses the date of reconciliation independently without notifying the clerk or officer. Then too, this "extra work" can be counted as so much accomplished in the way of detailed auditing, a certain amount of which is always done even in so-called balance sheet audits. See also item 6.
auditor may find it expedient to place them in a sealed envelope. If broken open, the reason therefor must be valid.

3.—A representative of the client must always be present, and often a receipt should be obtained that the items were returned. Some auditors fail to take this essential precaution; but should they some day get into the unfortunate situation of being themselves charged by the defrauder with his shortage of securities or cash, they will rue their negligence in this matter. The above statement is not fanciful, but is based upon actual facts.

4.—Verify bank balances and items in transit by independent confirmation direct from the bank.

This procedure is common to all auditors so that many of them have printed forms (Plate 36). Naturally, other information is requested on the same form, so as to keep the correspondence and the annoyance thereof at a legitimate minimum.

The auditor's chief concern ought to be to reread the form before personally mailing it to the bank. Some auditors do not take this precaution. But suppose that the client never sends the form to the bank, but substitutes a letter requesting only the bank balance. Some may say that since the lower half of the form would not be returned to the auditor, this is prima facie evidence of fraud. However, as a matter of fact, it isn't, because many banks use their own letterheads in replying so as to have a memorandum of this correspondence.

If the deposit is on hand, the auditor should compare it item by item (in so far as possible) with the cash receipts book. Special care should be taken to see that checks representing transfers between banks, etc. have been entered in the cash payments book. If possible, the auditor should bank the deposit himself. Finally, the auditor should carefully examine all returned N.G. checks, lest the deposit in transit contain a bogus check.

5.—When the audit takes place after the audit date, the two balances (one as of the audit date and the other as of the day of actual auditing) and their intervening transactions, must be audited in as much detail as that used in auditing the transactions within the period.

This requirement is always necessary where the receipts are not deposited regularly, for then the cash book balance will consist of cash on hand and cash in bank (Plate 37). There is no way of proving what cash was on hand at the audit date (unless the auditor made a special visit to count it then), unless the transactions are followed through as of the date of actual cash count.

1It is sometimes stated that the person in charge of the cash and/or securities should do the actual counting under the eye of the auditor because the person in charge is generally skilled in handling money and/or securities; and (2) the auditor thereby prevents the defrauder from charging him with the theft. The writer has never done this, but has often called upon the person in charge (who must always be present during the count) to prepare a reconciliation of the petty cash fund in the presence of the writer when the component parts thereof were a labyrinth.

2Of course, the auditor can advise the client to deposit all cash balances on the last day of the fiscal period, and then replenish the cash by checks drawn as of the next day. This procedure should also be followed by the petty cashier if the petty cash fund is not run on the imprest system.
Then again, even though the receipts are deposited regularly, the auditor will not be making a "tight" audit unless he covers this intervening ground between the dates. One simple case will make this point clear. Suppose B is short in his securities at June 30th, and that he purchases them back on July 1st.

On this basis, the auditor will find that the cash as at June 30th is in order, and that the securities as of the day of his count, say July 16th, are on hand, because the security account will not be charged with the July 1st purchase (the check being omitted from the cash book until the auditor leaves).

But if the two balances and the intervening transactions were audited, and they should be, the auditor would not have been fooled.

6.—The auditor should select his own date for reconciling the cash in addition to the verification as of the audit date.

The writer is inclined to consider this procedure as more important than any other single procedure, because it is impossible to say what are the intricacies that a clever schemer can devise if he knows the date at which the reconciliation is to be made. But if the auditor chooses his own date, the defrauder cannot possibly set a trap as at that date. Therefore, this second reconciliation automatically voids many otherwise feasible schemes of fraud (such as kiting and the case mentioned in item 5 above).

7.—Deposits in transit and all items making up the reconciliation should be verified.

In the case of a deposit in transit, the auditor should make certain that it was deposited, and that none of the items came back N.G. (no good) without good reason. The acceptance of bank statements or signed duplicate deposit slips, as proof of the deposit in transit, is proper. The better way, however, is to include it in the bank confirmation request.

If items come back N.G. (no good), the auditor must satisfy himself that it is not a mere bogus check thrown into the deposit in an attempt to conceal a shortage of that amount. N.F.S. checks (not sufficient funds) must also be adjusted. In short, charge slips in statements after the close of the period must be very carefully examined. They may disclose fraud. Also, it should be seen that they often affect not only the cash balance but also the collectibility of the item which they were supposed to have paid.

8.—Examine carefully (at a late date) the outstanding checks, as to date of bank perforation, amount, name of payee, date, signature of maker, endorsements, and so on.

As one of the major classes of items in a bank reconciliation is checks outstanding, the auditor cannot subject these checks to too severe an examination. In fact, if an auditor is obliged to leave before the

1 Normally at the end of a month as this makes for convenience, but banks will furnish statements as of any date. If not, the checks when they come in at the end of the month can be sorted as to those which were cashed by the date selected.
outstanding checks are returned by the bank, he should make it a point (if feasible) to drop in again to cover this feature.

Checks which are unduly long outstanding should be acted upon. The auditor should call for the voucher it pays. If sizable in amount, he should correspond with the creditor. Perhaps this correspondence will show that the reason for its not being cashed is that there is a still larger amount in dispute which is not recorded at all in the client’s books. If the outstanding check is small, it may be advisable to write it off as “Other Income,” especially if the statute of limitations is applicable.

138. Classification of Cash in the Balance Sheet.—The proper subdivision of cash as between current and fixed, and pledged and unpledged, is a major duty of an auditor. Thus, for example, cash funds devoted to the future purchase of fixed assets, or to the retirement of fixed liabilities, are fixed,—not current. So also are balances in closed banks. Deposits made as guarantees are both fixed and pledged. In some instances minimum balances not withdrawable should be considered as fixed.

139. Miscellaneous Comments.—Foreign balances should be converted at the current rate of exchange if the cash is a current asset. If it is not a current asset, an average exchange rate is proper. The amount of the bank balance must, of course, be confirmed direct by the auditor.

In some instances, when manipulation of current ratios is being attempted, checks drawn but not sent out must be added back to the cash and to the accounts payable, because the cash is actually under control to the client. Likewise, cash received in “January” but recorded as of “December” may also require adjustment.

Bank overdrafts may be deducted from other cash balances only if, as a matter of fact, these balances can be transferred to make up the overdraft. Usually an overdraft in a foreign bank, or in a bank of a subsidiary (consolidated statement being prepared), is a liability. Special deposits must be confirmed by direct correspondence. Moreover, the auditor would do well to ascertain that the holders are reliable parties. Finally, the contract under which the cash is held should be read, and any adjustments, such as interest, should be taken up. The reason why the deposit is necessary may be of paramount interest to the auditor.

Under these circumstances, the auditor should see that there is a genuine voucher for each outstanding check, or where the payment is on account, the balance of the account (on the client’s books) should be seen to be in agreement with the creditor’s monthly statement. Of course, if the check is dated as of the last day or two of the audit period, the creditor’s statement may not show that the check has been received. In this case the audit the auditor can do is to see that there are previous “payments on account”, rather than “payments for individual vouchers”.

See also Plate 46 for a complete audit program. If the debt is not outlawed a stop payment order should be forwarded to the bank, whereupon cash can be debited and accounts payable credited.

“It is the exception when any portion of cash does not constitute a current asset. Such an exception would occur in a case of funds obtained from the sale of securities or from long term borrowings, for use in capital expenditures, or where a part of the total cash has been earmarked for investment in an insurance-reserve fund, even though there be no legal bar to its employment for the liquidation of any debt. In other words cash which constitutes a current asset should be restricted to cash which is wholly free for and intended for use in operating purposes. To adopt
auditor.

Time certificates of deposits should be stated separately, but demand certificates may be called cash.

Before leaving this topic, the student should have clearly in mind that we have been emphasizing and discussing the objectives and methods of a COMPLETE cash verification. In a strict balance sheet audit, the auditor need make only a thorough bank reconciliation. And in a detailed audit the auditor may not test more than three or four months' entries and postings (except to the personal ledger where a test of half a month would be sufficient in many cases). However, the system of internal check on cash is generally such that even in a balance sheet audit, the auditor will feel that it is necessary to audit at least the December entries and postings. Or the client will probably deem it desirable to have this auditing done.

Finally, the auditor should endeavor to see if the cash is being employed effectively. Sometimes cash discounts are neglected; sometimes sinking funds are invested in outside securities yielding less interest than is being paid on outstanding bonds payable which could be called in or purchased on the market at an appreciable net saving in interest.

140. Petty Cash.—In accounting for the petty cash fund, the auditor may not resort to trying to take the cashier by surprise. No rule can be stated on this point,—it is a matter for individual judgment. If the auditor arrives totally unexpectedly, a surprise audit of the fund may be worth while, even though it be in the middle of things. If, on the other hand, the auditor's appearance is expected, little is apt to be gained by counting the fund until the close of the day. At this time the day's duties are not pressing, so that the cashier is less apt to become upset at the auditor's presence.

The auditor should prepare a schedule of petty cash (Plate 41), showing when, where, and at what time, it was counted. The names of the auditor and of the cashier, who must be present during the count, should also appear on the schedule. A full description of everything seen should be given. Cash in rolls need not be counted coin by coin. If desirable, a knife slit can be made up the side of several rolls as a test of their genuineness. Checks should be listed with full particulars. If suspicious of fraud, the auditor might try to identify the checks against items in cash receipts book. In any case, the auditor would do (cont'd) this theory in practice would admittedly be difficult and would meet much opposition by those who lay great stress on the ability to show a high current ratio regardless of its accuracy. Further, in the absence of an actual appropriation of the amount which is to be used for capital investment or for reserve-fund purposes, it may be impossible to determine accurately what part of the cash will be available for operating purposes and what will not. Consequently, I see no reason to avoid considering all cash as a current asset in the absence of a definite appropriation for non-operating purposes"—A. Herrick, The Journal of Accountancy, Jan. 1932 (p.54). (Do you concur?) Sometimes an auditor will call on his client at the audit date for the counting of Petty Cash and negotiable instruments, and then return later at his "customary time" to complete the engagement. That is, customers' checks cashed by the defrauder through the petty cash fund. Of course, when the auditor is suspicious of fraud he should or rather must, make a second petty cash count at a later date of his own choosing. Personal checks given by employees as security for advances made to them should be taken to the bank for certification.
well to insist on the checks being deposited so that he may detect any worthless decoys among them. (Cashiers have been known to "throw in" a fictitious check to cover a shortage). As to vouchers, these also should be listed in full detail. The auditor can show these to the proper authority for approval, or he may merely see that these were included in the batch presented at the next reimbursement. 1 All I.O.U's should be okayed by someone in authority.

As a general rule, the auditor makes no attempt to separate the fund, as at the audit date, into cash, expenses, receivables (I.O.U's), etc., for the purpose of adjusting entries, unless the amounts are significant. All that an auditor would probably do is to ask the cashier to make it a point in the future to cash the checks, collect on the I.O.U's, and present the expense vouchers for reimbursement as at the audit date.

Often times working funds may be located at distant points. If they are insignificant in amount, the auditor will generally require only a detailed statement of their contents as at the audit date. The statement will generally be signed by a person in authority other than the one in charge of the fund. But distant bank balances, if a part of the fund, are generally checked up independently by the auditor. 4 If a large working fund is too distant for the auditor to examine personally, he will have to qualify his balance sheet in this respect.

141. See Plate 33. 142. See Plate 34.
143. See Plates 35 and 36. 144. See Plate 37.
145. See Plate 38. 146. See Plate 39.
147. See Plate 40. 148. See Plate 41.
149. See Plate 42. 150. See Plate 43.
151. See Plate 44. 152. See Plate 45.
153. See Plate 46.

1 The vouchers in the next one or two reimbursements should be reviewed for the purpose of ascertaining if any IMPORTANT expenses of the period under audit are included therein. 2 If the I.O.U's were given by those in highest authority, the auditor may deem it advisable, under some circumstances, to mention the fact to the Board of Directors via a comment in the audit report. 3 If a petty cash fund is cut a few cents, and the auditor is satisfied that the difference is the result of honest mistakes in making change etc., this fact should never be mentioned either orally to the head of department, or much less in the audit report to the Board of Directors. To do so is to make one's self appear ridiculous and incompetent. In fact, this lack of judgment, even in such a minor matter, may cause the client to wonder if he (it) has selected the "right" auditor; and yet how many auditors still look upon the correction and reporting of such items as AUDITING. 4 The auditor should have the branch manager (i.e. NOT the one in charge of the distant fund) send in a copy of the bank reconciliation and the outstanding checks as soon as they are returned by the bank. The auditor, himself, will verify the bank balance by direct correspondence to the bank. 5 If the auditor finds that the amount of cash on hand, or in a fund, is increasing beyond proper proportions, he should comment on it in his report.
### A Reconciliation of Cash Book Receipts and Payments with Bank Deposits and Charges

#### Arthur Brooks & Co.

Reconciliation of Book Receipts and Payments with Bank Deposits and Charges

December 31, 1929

<table>
<thead>
<tr>
<th># Footed and vouched to Bank Statements or to cancelled checks</th>
<th># Book</th>
<th>Bank</th>
<th># Book</th>
<th>Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan</td>
<td>10609.30</td>
<td>10381.16</td>
<td>8495.15</td>
<td>8312.48</td>
</tr>
<tr>
<td>Feb</td>
<td>12398.75</td>
<td>12177.48</td>
<td>14169.87</td>
<td>13949.17</td>
</tr>
<tr>
<td>Mar</td>
<td>14687.67</td>
<td>14516.05</td>
<td>15107.17</td>
<td>15316.54</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>OMISSIONS</th>
<th>OMISSIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec</td>
<td>15009.19</td>
</tr>
</tbody>
</table>

Interest for Dec 1928 on books Jan 1929

<table>
<thead>
<tr>
<th></th>
<th>1929</th>
<th>1920</th>
</tr>
</thead>
<tbody>
<tr>
<td>&quot;</td>
<td>43.16</td>
<td>56.12R</td>
</tr>
</tbody>
</table>

Deposit-in-transit at Dec.31,1928

| "       | 765.94R |

Bank charge on Dec. 13 in error of 6.17

| "       | 6.17R |

Checks outstanding Dec.31,1928

| "       | 1743.19R |

Total 151306.69 151306.69 141562.78 141562.78

R (Red)

<table>
<thead>
<tr>
<th>PARTIAL CHECK PROOF</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Book balance Jan 1929</td>
<td>79324.12</td>
</tr>
<tr>
<td>Book receipts as above</td>
<td>151306.69 ***</td>
</tr>
<tr>
<td>Total</td>
<td>230630.81</td>
</tr>
<tr>
<td>Book Payments as above</td>
<td>141562.78 ***</td>
</tr>
<tr>
<td>&quot; balance 12/31/29 per G/L</td>
<td>89068.03</td>
</tr>
<tr>
<td>To A</td>
<td></td>
</tr>
</tbody>
</table>

141. Explanation and Comments:—Auditors often prepare this reconciliation schedule in order to see that all of the receipts went into the bank, and that all of the payments were made by check.

Some auditors prepare this schedule from the monthly totals of the cash books without their having been footed. But, if the totals are not proved, the schedule is not a proof. For example, the total of the cash column in the receipts book might be understated in order to agree with the actual deposits made.

The general method for getting the total charges (which might be some thousands of checks) from the bank statements is not to add the individual charges, i.e., checks and slips, but to make use of the balances given on the statement:

**EXAMPLE:**

- Balance per bank statement Oct. 1

  - 411400.16

- ADD Total deposits per bank statement

  - 121367.12

  - Total

  - 532767.28

- DEDUCT- Balance per bank statement Oct. 31

  - 212142.19

- Charges for the month

  - 320625.09
Dear Sirs:

Please verify the attached certificate in respect to The Amesbury Manufacturing Corporation. A stamped envelope is enclosed.

Cordially yours,

Greene and Post

By J.R. Moffit

--- DETACH HERE ---

CERTIFICATE

Messrs. Greene and Post,
110 Ramsdale Ave.,
Podunk, Pa.

Dear Sirs:

At the close of business on Jan 18, 1930 the balance subject to check to the credit of The Amesbury Manufacturing Corp. was $50906.50 (12/21/29) - A5-a $45360.90 (1/18/30) - A4-a. Deposits were made on 1/2/30 and 1/19/30 in the amount of $13456.17 $14979.20 - A5-a A4-a.

At the close of business on 12/21/29 and 1/18/30 said Corporation was contingently liable or directly indebted to us as endorser, maker, guarantor, etc. on loans, notes receivable discounted, notes payable, contracts, etc. ONLY as follows:

<table>
<thead>
<tr>
<th>Description of Obligation</th>
<th>Dated Principal</th>
<th>Maturity Rate</th>
<th>Other Details</th>
<th>Collateral</th>
</tr>
</thead>
<tbody>
<tr>
<td>Notes Payable 11/23/29 $50000</td>
<td>1/23/30</td>
<td>5</td>
<td>$10000 (Par) Pfd Stock</td>
<td>Ross Mfg Co</td>
</tr>
<tr>
<td>&quot; 12/17/29 $10000</td>
<td>2/17/30</td>
<td>5</td>
<td></td>
<td>BB-2</td>
</tr>
<tr>
<td>Notes Rec. Disc. $45367.19 (D-5)</td>
<td></td>
<td></td>
<td></td>
<td>BB-2</td>
</tr>
<tr>
<td>Notes Payable - Same as above - No change since 12/31/29</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Very truly yours,

By E.K. Cooper

Title Auditor

142. Explanation and Comments. — The reader should note that the auditor is confirming the bank balances, etc. as of two dates; namely, Dec. 31, 1929 and Jan. 18, 1930. This latter date is evidently the date of the actual auditing. It may be stated here that some auditors prefer to send two blanks (one for each of the two dates) feeling that it is less confusing to the bank. Also, some auditors fill in the blank spaces themselves, whereas other auditors prefer to have the bank do it.

The writer customarily sends two blanks with the spaces filled in, because this reduces the bank's work (a favor to the client and to the auditor) to a minimum. Theoretically the best method is to leave the spaces blank.

Note how carefully the form has been checked into the schedules which it verifies. The best procedure is to show that this has been done by noting the schedule number to which the amount has been checked.

Finally, note that the form states: "the balance SUBJECT TO CHECK to the".
Messrs. Hadley and Gooch,
420 R.I. Trust Bldg.,
Orchard City, Ind.

Dear Sirs:

We are pleased to answer the request of January 27, 1930, concerning Jordan & Clarkson as follows:

To A (1) $147329.73-Balance at close of business December 31, 1929
(2) $12347.61- Deposited on January 2, 1930
(3) (a) Notes Payable to us: $50000--12/7/29--60 days at 5 1/4% To BB
$170000--11/1/29--90 days at 5 1/4% To BB
(b) Collateral: $85000(Par) Pfd Stock of Calder & Holt, Inc. To BB
(c) No other direct or indirect liabilities.

Yours truly,
Third National Bank
By M. Freeman
Auditor

M.F./P.S.

143. Explanation and Comments.—Plate 36 is the bank’s reply to Plate 35. Often times an auditor will prefer to dictate a letter to a bank rather than use a form. This is especially true whenever the information will not fit readily into the printed form.
The Radley Corporation
Cash in Bank—Industrial Trust, Pensgrove, Ill.
Audit for the Year Ending December 31, 1929
Schedule A

Balance per bank statement and certificate attached 12/31/29 (A-1) 185,130.27
ADD: Deposit-in-Transit per " " 10,220.21
175,361.38
DEDUCT:
Interest for Dec. 1929 entered in cash book in Jan. 3014.02 ADJ. #3
Checks Outstanding: No. 1107 517.01
8 1003.28
9 8646.59
15 10117.13 23,296.03
Balance per General Ledger 12/31/29 173,0313.35
ADJ. #3 3014.02 Interest
173,3327.37 To B/S

AUDIT PROCEDURE

Receipts
The receipts for Nov and Dec were traced by daily totals into bank statements. The details of the cash book receipts for Dec 28, 29, 30, 31 were checked into the duplicate deposit slips. The receipts were footed, forwards checked, and monthly totals crossfooted for Nov and Dec. Postings to the General Ledger for Nov and Dec were checked, and to the Personal Ledger for Dec 16-31 incl. The book receipts for Jan. 1-10, 1930 were checked into a bank statement secured 2/13/30; and to signed duplicate deposit slips for Jan. 1-31 incl., 1930.

Payments
Checks were vouched to the Cash Book for Nov and Dec. Signatures, check numbers, amounts, payees, endorsers, etc., were accounted for. Checks outstanding 12/31/29 were examined in detail on 2/13/30 and compared with the cash book including this schedule of outstanding. They were properly perforated as of 1930. The cash book was footed, forwards were checked and the monthly totals were crossfooted for Nov and Dec. Postings were checked to G/L for Nov and Dec and to P/L for Dec. 16-31 incl.

145. Explanation and Comments.—As this schedule was prepared on January 1, 1930 (see the date under auditor Mason's name in the upper right hand corner), only one reconciliation was necessary (see plate 39). That is, as the audit date and the day of the actual auditing of cash were one and the same, a second proof or reconciliation of cash was not necessary.

Observe that a bank certificate (not shown) is mentioned in the proof, and that it has been indexed A-1, since it supports schedule A.

Note also that a clear outline of the audit procedure taken is a part of every well drawn up schedule. Some auditors, however, omit this feature on the analysis sheet relying on the main audit program for this information. This outline is obviously too wordy.

From the description of the procedure, the writer would say that the auditors were making a balance sheet audit, and, owing to the lack of a sufficient system of internal check on cash, it was tested two months.
12-18

EXPLANATION OF PLATE 37

A BANK RECONCILIATION (1st type)

GOOCH AND HOLT INC.

Bank and Cash Reconciliation, Cash Count, Etc. 5/27/29 and 4/30/29
Audit for the Year Ending April 30, 1929

144. Explanation and Comments.—This plate will require the reader's closest attention as there are "five points" involved. It should be understood that the receipts are not deposited regularly; in fact, some of the receipts are expended without ever going to the bank. Furthermore, the cash payments book has only one column for cash and checks combined.

As a result of this situation, the auditor is faced with the problem of ascertaining if there really was $823.12 on hand on April 30. The cash ($100,010.10), said to be in the bank at that date, can be proved, of course, by the ordinary type of bank reconciliation (section D).

Part A of the plate shows that on May 27 (the date on which the cash was audited) the cash book was balanced at $62,496.48 of which $2,187.36 was cash on hand, being proved by actual count by the auditor on May 27 (Part B). As a result, the bank balance had to be $60,309.12. This was proved by the auditor in Part C from a certificate secured from the bank.

From this point the auditor added to the book balance the payments ($41,324.19) made between April 30 and May 27. These had to be divided by the auditor into cash payments ($781.09) and check payments ($40,543.10). The payments were vouched against cancelled checks and vouchers. Moreover, the deposits ($842.12) for the same period as per the bank statement had to be taken into consideration.

To the total thus secured, the receipts for the period (which were footed) were subtracted, giving the book balance ($100,833.22) as at April 30, consisting of the cash on hand ($823.12) and the cash in bank ($100,010.10).

In brief, section A proved that there was $823.12 on hand on April 30. That is, as all of the other figures in the proof were proved either by count, or by bank statements, or by bank reconciliations, the cash on hand figure ($823.12) was established independently of the bookkeeper.
A BANK RECONCILIATION (1st type) PLATE 37

Gooch and Holt, Inc.
Bank and Cash Reconciliations, Cash Count, and Reconciliations
Audit for the Year Ending April 30, 1929

Exhibit A-1

<table>
<thead>
<tr>
<th>Bank and Cash Reconciliation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance 5/27/29</td>
</tr>
<tr>
<td>62496.48</td>
</tr>
<tr>
<td>### Payments 4/30/29-5/27/29</td>
</tr>
<tr>
<td>### Deposits 4/30/29-5/27/29</td>
</tr>
<tr>
<td>Total</td>
</tr>
<tr>
<td>Balance 4/30/29</td>
</tr>
<tr>
<td>100833.22K</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cash Count 8:30 A.M. Miss K. Ross</th>
</tr>
</thead>
<tbody>
<tr>
<td>35.00</td>
</tr>
<tr>
<td>2.00</td>
</tr>
<tr>
<td>1.00</td>
</tr>
<tr>
<td>.25</td>
</tr>
<tr>
<td>.10</td>
</tr>
<tr>
<td>.05</td>
</tr>
<tr>
<td>.01</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Bank Reconciliation 5/27/29</th>
</tr>
</thead>
<tbody>
<tr>
<td>ZZ Checks Outstanding No. 6117</td>
</tr>
<tr>
<td>6</td>
</tr>
<tr>
<td>9</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Adjusted Bank Balance 5/27/29</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank Balance 4/30/29 per Bk. Certificate &amp; Statement (A1-b)</td>
</tr>
<tr>
<td>Add Deposit-In-Transit (Verfied)</td>
</tr>
<tr>
<td>ZZ Deduct- Checks Outstanding No. 6079</td>
</tr>
<tr>
<td>60</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Adjusted Bank Balance 4/30/29</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash on Hand (As proved above)</td>
</tr>
<tr>
<td>Cash Book Balance 4/30/29</td>
</tr>
</tbody>
</table>

Note: We found that the cash receipts were not only not deposited regularly but were also paid out without ever being deposited. We have instructed them as to the proper methods of handling cash, which methods they were pleased to adopt including an imprest fund of $2000.

ZZ-Examined Z-Certificates attached herein. ###-Footed and vouched with cancelled checks, bank statement, or vouchers, as the case may be. Books were footed and posted to G/L for March and April.

R-(Red)
A BANK RECONCILIATION (3d type) PLATE 39

The Clarkson Corporation

Reconciliations 1/27/30 and 12/31/29 Second Nat'l Bank

Audit for the Year Ending Dec.31,1929

(A)

Reconciliation from 1/27/30 to 12/31/29

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bal. per bank statement and certificate attached 1/27/30 (A-1)</td>
<td>$5937.11</td>
</tr>
<tr>
<td>Add-deposit in transit 1/27/30 See certificate (A-1)</td>
<td>$937.40</td>
</tr>
<tr>
<td>Deduct:</td>
<td></td>
</tr>
<tr>
<td>Interest for Jan.1930 not entered in Cash Book as yet</td>
<td>$12.35</td>
</tr>
<tr>
<td>Checks outstanding</td>
<td></td>
</tr>
<tr>
<td>#701</td>
<td>$10.19</td>
</tr>
<tr>
<td>710</td>
<td>$107.50</td>
</tr>
<tr>
<td>711</td>
<td>$13.21</td>
</tr>
<tr>
<td>Balance per Cash Book at 1/27/30</td>
<td>$62542.51</td>
</tr>
<tr>
<td>Add-disbursements 12/31/29 to 1/27/30 incl. per Cash Book</td>
<td>$14374.20</td>
</tr>
<tr>
<td>(#) Deduct-receipts 12/30/29 to 1/27/30 incl. pet Cash Book</td>
<td>$76755.46</td>
</tr>
<tr>
<td>Balance per G/L 12/31/29</td>
<td>$56348.16</td>
</tr>
</tbody>
</table>

Audit Procedure

The bank statement at 1/27/30 was secured personally.

(¶) Verified by footing and checked into bank statement.

# Vouched with checks or vouchers and footed.

¶ Verified on Feb. 2, 1930. Checks were perforated after 1/27/30

--- Omissions ---

Reconciliation 12/31/29

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance per bank statement and certificate attached 12/31/29 (A-1)</td>
<td>$55073.12</td>
</tr>
<tr>
<td>Add-deposit in transit 12/31/29 See certificate (A-1)</td>
<td>$1307.29</td>
</tr>
<tr>
<td>Deduct: Dec. Interest entered in C/B in Jan.1930 (verified)</td>
<td>$11.25</td>
</tr>
<tr>
<td>Checks outstanding</td>
<td></td>
</tr>
<tr>
<td>#691</td>
<td>$10.00</td>
</tr>
<tr>
<td>692</td>
<td>$11.00</td>
</tr>
<tr>
<td>Balance per G/L 12/31/29</td>
<td>$56348.16</td>
</tr>
</tbody>
</table>

Audit Procedure

The receipts and disbursements were footed, forwarded, and crossfooted for Dec.1929. All postings to G/L were checked. The daily receipts per C/B for Dec. were checked by daily totals into the bank statement. The individual receipts for Dec. 29, 30, 31, 1929 and Jan. 2, 3, 4, 1930 were checked in detail to the signed duplicate deposit slips. Checks for Dec. were vouched to C/B and to V. Register.

¶ Verified per bank statement of 1/27/30

146. Explanation and Comments.--- As the auditor did not reconcile the cash until Jan.27,1930, two reconciliations (1/27/30 and 12/31/29) were necessary (See section 137 under balances).

The reader should study how the auditor worked back from Jan. 27, to Dec. 31, and particularly how he audited the transactions intervening between the two dates. Observe that a schedule always ends (if feasible) as of the audit date, no matter on what date the work is done.

Note that symbols are used to index items in the proof section to the explanation thereof in the audit procedure section.

From the reading of the audit procedure, the writer would say that the auditors were making a balance sheet audit, and in addition felt the need of auditing one month's cash transactions.
A PETTY CASH FUND RECONCILIATION PLATE 42

CUSHMAN & CRAWFORD SPOOL CORPORATION

Petty Cash Fund
December 31, 1929

<table>
<thead>
<tr>
<th>#</th>
<th>Balance 2/19/30 (A4-a)</th>
<th>(A4-a) 2857.81</th>
</tr>
</thead>
<tbody>
<tr>
<td>(x) Add</td>
<td>January payments</td>
<td>408.19</td>
</tr>
<tr>
<td></td>
<td>February 2 to the 18th incl.</td>
<td>327.43</td>
</tr>
<tr>
<td></td>
<td></td>
<td>3593.43</td>
</tr>
<tr>
<td>(x) Deduct</td>
<td>January receipts</td>
<td>1007.93</td>
</tr>
<tr>
<td></td>
<td>February &quot; to the 18th incl.</td>
<td>986.89 1994.82</td>
</tr>
<tr>
<td></td>
<td>Balance 12/31/29</td>
<td>1598.61</td>
</tr>
</tbody>
</table>

(Audt Procedure)

(x) The receipts and disbursements in the Petty Cash Book were footed. The disbursements were checked against receipted vouchers. The receipts were also checked out as far as possible.

# See schedule A4-a for the composition of the $2,857.81 balance at 2/19/30

149. Explanation and Comments.—This exhibit illustrates the point that whenever the petty cash fund varies in amount from day to day, it is necessary for the auditor to work the balance ($2857.81) at the date of count (2-19-30) back to the balance ($1598.61) at the audit date (12-31-29).

Note that is is customary to have every schedule end with the balance as at the audit date.
A SUMMARY OF BANK RECONCILIATIONS PLATE 40

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>First Nat'l of Rochester N.Y.</td>
<td>35329.34</td>
<td>1334.60</td>
<td></td>
<td>Deposit of 12/24/29 by the bank as Should be $1334.07</td>
</tr>
<tr>
<td>Irving Bk. Millville, N.Y.</td>
<td>10407.20</td>
<td></td>
<td>30000.00</td>
<td></td>
</tr>
<tr>
<td>Blackstone Bk. City</td>
<td>79377.65</td>
<td></td>
<td>30000.00</td>
<td></td>
</tr>
<tr>
<td>Industrial Trust Co. City</td>
<td>216309.78</td>
<td>29324.30</td>
<td></td>
<td>Foreign collection NOT in Cash Book 1930</td>
</tr>
<tr>
<td>City Trust Co. City</td>
<td>50000.00</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wauregan Bk. Dayton, N.Y.</td>
<td>12307.60</td>
<td>510.63</td>
<td></td>
<td>Check #1748 deduct-bank as $14.83 be $12.90</td>
</tr>
<tr>
<td>First Nat'l Bk. Albion N.Y.</td>
<td>16309.20</td>
<td>125.73</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Chace Bk. Watertown N.Y.</td>
<td>6702.40</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>427743.17</td>
<td>31295.26</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

147. Explanation and Comments.—This schedule is the type which has to be prepared whenever there is only one cash account ($402,713.75) (Col.10) in the general ledger for the several banks combined.

Note that a special column (#3) is devoted to seeing that the bank transfers-in-transit cancel one another.

The reader should also observe that small adjustments (Columns 5 and 8) which overlap one period into the other, etc. are not generally the subject matter of an auditor's adjustment,—hence the notation 'Not Taken Up" or "Pass".

Column 11 gives the schedules (A-1 to A-8) from which these figures (Schedule A) were taken.

The auditor separated the cash into two parts—Guarantee Deposit, and Cash-in-Banks—because the guarantee deposit is a fixed asset, and also subject to a lien.

In the writer's opinion the auditor should have indicated by special tick marks, such as those given in Plate 30, that the columns have been footed and crossfooted.
<table>
<thead>
<tr>
<th></th>
<th>(5)</th>
<th>(6)</th>
<th>(7)</th>
<th>(8)</th>
<th>(9)</th>
<th>(10)</th>
<th>(11)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total Checks</td>
<td>Bank int.</td>
<td>Total Cash Book Analysis</td>
<td>of Col. out-</td>
<td>taken up Col.</td>
<td>Balance Sheet</td>
<td></td>
</tr>
<tr>
<td>Amount</td>
<td>1-5 incl. standing in 1930</td>
<td>7&amp;8</td>
<td>Col. 6 less 9 No.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>credited</td>
<td>9.63R</td>
<td>36654.31</td>
<td>576.34</td>
<td>17.78</td>
<td>594.12</td>
<td>36060.19</td>
<td>A-1</td>
</tr>
<tr>
<td>$1343.70</td>
<td>40407.20</td>
<td>10.91</td>
<td>10.91</td>
<td>40396.29</td>
<td>A-2</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>49377.65</td>
<td>3487.63</td>
<td>29.42</td>
<td>3517.05</td>
<td>45860.60</td>
<td>A-3</td>
<td></td>
</tr>
<tr>
<td>charges</td>
<td>1.50</td>
<td>245635.56</td>
<td>51709.24</td>
<td>51.29</td>
<td>51760.53</td>
<td>193875.05</td>
<td>A-4</td>
</tr>
<tr>
<td>until</td>
<td>50000.00</td>
<td>50000.00</td>
<td>A-5</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ed by the 1.93</td>
<td>12818.23</td>
<td>329.47</td>
<td>7.32</td>
<td>336.79</td>
<td>12481.44</td>
<td>A-6</td>
<td></td>
</tr>
<tr>
<td>Should</td>
<td>15436.86</td>
<td>79.30</td>
<td>10.02</td>
<td>89.32</td>
<td>15347.54</td>
<td>A-7</td>
<td></td>
</tr>
<tr>
<td></td>
<td>8702.40</td>
<td>9.76</td>
<td>9.76</td>
<td>8692.64</td>
<td>A-8</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

6.20R 459032.23 56181.98 136.50 56318.48 402713.75

Pass | Pass | To B/S

H.B. | HB

**BALANCE SHEET PRESENTATION**

Guarantee Deposit on Contracts-In-Process 50000.00 (A fixed asset subject to a lien)

Cash in Banks 352713.75

Total 402713.75

**AUDIT PROCEDURE**

For verification procedure see individual reconciliations A-1 to A-8 inclusive.
EXPLANATION OF PLATE 41

A PETTY CASH COUNT

THE ROBINSON COMPANY
Petty Cash Count
Audit For the Year Ending Dec. 31, 1929

146. Explanation and Comments.—In a petty cash count schedule, the auditor shows the time of day, the date, and the name of the cashier, who must watch the count so that if a shortage develops the blame can not be thrust upon the auditor.

The reader should observe the detail in which the composition of the fund is given.

Note that the auditor had the checks ($11.01) deposited on the next day in order to satisfy himself that none of them were bogus. Sometimes a shortage is made ostensibly good by throwing into the fund a bogus check.

Note also that the auditor made certain that the vouchers which he saw on January 30 were included in those presented on February 15 to the Approval Clerk for reimbursement. This procedure is an excellent one for detecting bogus vouchers.

An auditor should always review the first reimbursement after the audit date, in order to see if there are important vouchers belonging to the period under audit. Observe that this auditor found $120.49 in 1929 vouchers, but that he did not think it worth while to make an adjustment for them.

If some of the wage and salary checks are cashed through the petty cash fund, the practice should be abandoned unless it is absolutely necessary to continue it. More convenience is NOT a sound reason for continuing this service. It has happened all too frequently that such a procedure has resulted in checks (usually other than salary checks) being cashed fraudulently by means of a "double endorsement", i.e. (supposedly) of the payee and that of the defrauder. In such instances the bank is not to blame for cashing these irregularly endorsed checks inasmuch as the practice of allowing "double endorsement" is known by it to be allowed by the corporation.

Checks on hand should be traced to the cash book to see if they are customers' checks.

Postdated checks should not be treated as cash, but as what they really are, i.e., loans, accounts receivable, etc.

Before reporting a difference in funds, the auditor should give the custodian an opportunity to explain the discrepancy. If this is not done, the auditor may find that he has been too hasty in criticizing a situation fully justified under the circumstances. In fact it may be that the auditor is wholly at fault inasmuch as he has misunderstood what has been told him previously or what he should have known would exist.

Whenever the fund is on the imprest system, it is sufficient for the auditor to count the fund as of any date without working it back to the audit date. But not so with a fund whose amount changes from time to time.

In a strict balance sheet audit a mere counting of the fund is sufficient. Therefore, this auditor's program was expanded at this point. (One month's examination (December) can hardly be called a detailed audit.)

"All cash held by the cashier and his assistants should be counted at the same time as the cash shown by the cash book and ledger even though it includes funds not carried on the general books; thus, unclaimed wages, Christmas Club money, money of athletic associations and other similar funds that may be held."—F.W. Thornton.
# A PETTY CASH COUNT  PLATE 41

The Robinson Company  
Petty Cash Count  
Dec. 31, 1929  
Schedule A-2

Time - 9:10 A.M. Jan. 30, 1930 in the presence of Miss M. Robinson, Cashier

<table>
<thead>
<tr>
<th>Bank Balance - no checks outstanding</th>
<th>(A2-a) 200.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>$20.00 5 100.00</td>
<td></td>
</tr>
<tr>
<td>10.00 3 30.00</td>
<td></td>
</tr>
<tr>
<td>5.00 7 35.00</td>
<td></td>
</tr>
<tr>
<td>2.00 20 40.00</td>
<td></td>
</tr>
<tr>
<td>1.00 35 35.00</td>
<td></td>
</tr>
<tr>
<td>.50 17 8.50</td>
<td></td>
</tr>
<tr>
<td>.25 23 5.75</td>
<td></td>
</tr>
<tr>
<td>.10 18 1.80</td>
<td></td>
</tr>
<tr>
<td>.01 33 .33</td>
<td></td>
</tr>
<tr>
<td><strong>Rolls $2.00 (nickles) - 3</strong></td>
<td></td>
</tr>
<tr>
<td>.50 (cents) - 6</td>
<td>3.00 265.36</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Checks</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Date</td>
<td>Maker</td>
</tr>
<tr>
<td>1/21/30</td>
<td>F. Jones</td>
</tr>
<tr>
<td>1/20/30</td>
<td>S. Somers</td>
</tr>
<tr>
<td></td>
<td>M. Robinson</td>
</tr>
<tr>
<td>1/21/30</td>
<td>R. Monton</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Vouchers</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Date</td>
<td>For</td>
<td>Signed?</td>
</tr>
<tr>
<td>1/15</td>
<td>Stamps</td>
<td>Yes</td>
</tr>
<tr>
<td>1/18</td>
<td>Express-in</td>
<td>&quot;</td>
</tr>
<tr>
<td>1/18</td>
<td>Stamps</td>
<td>3.11</td>
</tr>
<tr>
<td>Balance per G/L 1/30/30 and 12/31/29</td>
<td>23.61 500.00 (To A)</td>
<td></td>
</tr>
</tbody>
</table>

**Audit Procedure**

1. The checks were deposited (by request) 2/1/30, the stamped duplicate deposit slip being accepted as evidence thereof as the amount was small.  
2. On 2/15/30 the vouchers were included among those submitted to the treasurer for reimbursement.  
3. An analysis of the vouchers submitted at 1/14/30 for reimbursement showed expenses of $120.49 applicable to 1929. This has not been taken up as an adjustment, but the matter was taken up with Miss Robinson who promises "to do better next time".  
4. The vouchers for Dec. were reviewed for possible irregularities, and the totals agreed with the totals on Voucher #7182 of 12/14/29 and on Voucher #9558 of 12/27/29.
EXPLANATION OF PLATE 43

A LETTER ON A BRANCH PETTY CASH FUND

THORNLEY, MAC MILLAN AND BROOKS, INC.
Pawtucket, Maine

150. Explanation and Comments.--This exhibit represents the sort of letter that is often secured from a branch manager as to the composition of the Petty Cash Fund as at the audit date.

Note that an adjustment entry (#27) has been outlined by the auditor at the bottom of the letter. Of course, this adjustment will also be found on the Auditor's Adjustments Schedule.

In cases such as this where there are small funds at distant points, or the client has an adequate number of traveling auditors, the auditor is not required to go to these places (here Charleston, Vt.) to verify the funds, but confirmation letters showing the composition of the funds should always be secured from the BRANCH MANAGERS,--not from the ones in direct charge of the funds. The signature of the person designated by the manager to count the fund should appear on the certificate too. When the fund is large, the certificate is distinctly unsatisfactory, hence the auditor MUST set forth the method of verification in his report.

It should be observed that if part of the fund is in the bank, it should be verified by an independent bank certificate. Furthermore, branch vouchers representing expenditures, or otherwise, should be charged to expense, asset or other accounts and credited to the fund, NOT to accounts payable. This is also true of branch vouchers which are among the open items in the Voucher Register at the main office, awaiting a check to be drawn for their reimbursement. The main office should not call them vouchers payable.

Again, cash in transit, representing reimbursing checks in the mail, should be verified against the outstanding checks at the main office.

Ordinarily, it is best for the branch to deposit intact in the bank (subject to check by the main office alone) the monies received on accounts receivable, etc..

Finally, it is repeated that it is advisable to review branch reports and vouchers for a brief period after the audit date for the purpose of seeing if any sizable items relate to the period under audit.
THORNLEY, MAC MILLAN AND BROOKS, INC.
Pawtucket, Maine

Sanborn
1-12-30
Schedule (A6-a)

Charleston Branch -Vt.

January 9, 1930

Messrs. Williams and Williams,
Certified Public Accountants,
Bangor, N.Y.

Dear Sirs:

As at December 31, 1929 the composition of our cash fund was as follows:

Cash 201.05
Checks 209.07
Vouchers for -(x) office supplies 467.12
Freight & Express -In 114.95
" " -Out 7.81
$1000.00
(To A-5)

(x) These supplies were received on December 28th, and hence have been included in the December 31st office supplies inventory.

PTT/PS

(Cordially yours,
Thornley, MacMillan and Brooks, Inc.
By P.T. Thornley)

(Adj. Entry #27)

Office Supplies expense 467.12
Freight and express-in 114.95
" " " -out 7.81

Petty Cash - Charleston Branch 589.88
EXPLANATION OF PLATE 45

A RECONCILIATION OF RECEIPTS AND PAYMENTS

THE HADLEY PLATE GLASS WORKS, INC.
Reconciliation of "Book Receipts with Bank Deposits",
and of "Book Payments with Bank Charges".
Audit for the Year Ended Dec. 31, 1931

152. Explanation and Comments.—This form is not as common as that
in Plate 33, but it is somewhat better in that it will detect monthly
manipulations that might "wash out" during the year. Thus, if a book-
keeper were to personally use $500 of January's receipts and put it back
during the year, Plate 33 would not develop that fact, whereas this form
would.

Of course, this form requires that the auditor prove the respective
in-transit deposits, outstanding checks, etc. at the end of each month;
 È.£., prove the monthly bank reconciliations. Hence, on a balance sheet
audit, an auditor will often PROVE the receipts section of this form,
since the interest and the deposits in transit are usually readily veri-
ified, but take for granted that the client's lists of outstanding checks
are correct. This latter is done, then, merely for what it MAY disclose,—
NOT as a "tight" proof.

The facts on which this plate is drawn up are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Per Books</th>
<th>Per Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance Dec. 31</td>
<td>4,689.19</td>
<td>4,915.32</td>
</tr>
<tr>
<td>January Receipts</td>
<td>14,811.23</td>
<td>15,025.60</td>
</tr>
<tr>
<td>Total</td>
<td>19,500.42</td>
<td>19,941.12</td>
</tr>
<tr>
<td>January Payments</td>
<td>12,665.31</td>
<td>13,268.46</td>
</tr>
<tr>
<td>Balance January 31</td>
<td>6,935.11</td>
<td>6,677.67</td>
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<tr>
<td>February Receipts</td>
<td>15,814.35</td>
<td>15,992.15</td>
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<td>Total</td>
<td>22,749.46</td>
<td>22,669.80</td>
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<td>Balance February 28</td>
<td>3,838.41</td>
<td>3,728.34</td>
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RECONCILIATIONS

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The Hadley Plate Glass Works, Inc.
Reconciliation of Book Receipts with Bank Deposits and of Book Payments with Bank Charges

Audit for the Year Ended Dec. 31, 1931

(RIGHT HALF)

## PAYMENTS

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A FORM OF CERTIFICATE OF DEPOSIT  PLATE 44

THE SLATER NATIONAL BANK

NO. 617

Worcester, Mass.  Sept. 18, 1929  

NOT  = = Philip K. Holt  = = = = = = = = = = = = has deposited with this bank

SUBJECT = = = = Fifty Thousand = = = = = = = = = = = = = = Dollar = ($50000.00)

payable to the order of = = = = = = = = = = = = = = = = = = = = = = = = = = = = = =

on the return of this TIME CERTIFICATE OF DEPOSIT properly endorsed

with interest at the rate of 4 1/2 _ per cent per annum if left six

__months, interest to cease at maturity. The Bank reserves the

right to require two (2) weeks notice of withdrawal.

CHECK  = = = = = S. Mac Intosh  = = = = = = = = = = Ass. Cashier

P. P. Schroeder  = = = = = = = = = = = = = = = = = = = = = = = = = = = = = = = = = = = = = =

Cashier

151. Explanation and Comments.—A certificate of deposit is simply

a receipt for having deposited "so much" money at interest in the bank

specified.

Time certificates of deposit are not considered to be cash, but

demand certificates are. Time certificates are a separate item of current

assets.
153. Explanation and Comments.—This schedule is given in order that the reader may see more readily the differences between a complete verification, a verification on a detailed audit, and a verification on a balance sheet audit.

Note that even in a detailed audit the checking of postings to the personal ledgers (Receipts - 9; Payments - 7) is generally very limited in scope.

Item 8 under Payments will be completed by auditing these entries in the Voucher Register against their vouchers.

Note also that two reconciliations were made because the auditing took place on June 25, whereas the audit date was May 31.

This and the following audit programs are intended to be summaries of desirable procedures to be taken on most detailed audit. Study and master them most carefully as they represent in summary form the sum and substance of the text material.
(14) Cash Receipts:

(1) Test the receipt of interest and dividends from securities for June 1929, and Feb. and April 1930.

(2) Test the correctness of all discounts granted during Nov. 1929. Check these against customers' checks per deposit slips. Have treasurer C X differences.

(3) Check out all of the transfers of funds between banks during the whole year and particularly in May. Each receipt must be entered as a payment in the same period.

(4) Compare each total of daily receipts per Cash Book with each total of daily deposits per Bank Statement for June 1929 and April, May and June 25, 1930.

(5) Check the details of each signed duplicate deposit slip against the details of the Cash Book for May 28 -31, 1930 to see that checks deposited are those that were received.

(6) Reconcile the total receipts per Cash Book for the year with the total deposits per Bank Statements.

(7) Foot all columns, check forwards, and crossfoot at end of month for June 1929 and April, May and June 25, 1930. Foot Cash and Discount columns for entire year.

(8) Check all the postings to the G/L for June 1929 and April, May and June 25, 1930. Post cash for entire year.

(9) Check all the postings to the personal subsidiary ledgers for May 1930.

(10) Verify the footings of the duplicate deposit slips for May 28-31, 1930, and June 1-2, incl. 1930.

(11) See that the receipts have been properly cut off at May 31, 1930. All items called In Transit must be in the bank on June 1, 1930.

(12) Compare Record of Cash Sales with entries in the Cash Book for May and June 1930.

(13) Test the correctness of the discounts granted against the receipts for the month. Should be much less than 2%. If nearly 2% or over investigate. Entire year.


(15) Stamp all bank statements examined.

(16) As you go along check to schedules sums found to apply to: Notes and loans payable, notes and accounts receivable discounted, Stock issues, bond issues, sales of securities.

Columns for August through May inclusive have been omitted.
(15) Cash Payments

(1) Vouch the checks for June 1929, and April, May, and June 25, 1930.

(2) Examine these checks in all particulars: date, signature, endorsement, date of bank perforation, amount. If not banked by payee, examine the endorsements for fraud.

(3) Account for check numbers for entire year.

(4) Foot all columns, check forwards, and crossfoot at end of month for June 1929, and April, May and June 25, 1930. Foot Cash and Discount columns for entire year.

(5) Reconcile the total payments per the Cash Book for the year with the total charges per the bank statements.

(6) Check all postings to the G/L for June 1929 and April, May and June 25, 1930. Post Cash for entire year.

(7) Check all postings to the personal ledgers for May 1930.

(8) Check the payments for June 1929, and April, May and June 25, 1930 into the Voucher Register for name of payee and amount. See also under V. Register (41) where these items are to be checked against vouchers. Be watchful of same voucher being used twice.

(9) See that the payments have been properly cut off at May 31, 1930. Were checks mailed in May or were some held over into June? How soon in June are the next checks drawn?

(10) Check payments on notes payable against the cancelled notes. Also see that Cash was Received previously when note is dated.

(11) "Verify all checks returned uncashed by payees or cancelled by the client by examination and comparison with entries (in red).

(12) Run through and list the Notes and Loans Receivable; the Sinking Fund Payments; the Dividend Payments; the B. Interest Payments; and the Securities Purchased.

(13) Check to these respective schedules.

(14) Stamp all checks examined.

(15) Make a list of all checks with more than the payee's signature as endorsement. See #2 above. (Reader's note: This would be a 12 column sheet for the months June 1929 to May 1930 inclusive. The same thing applies to all of the sheets comprising this Plate)

(16) Investigate cases where voided checks are not on hand.

(17) Examine bank perforation date of all cancelled checks for last month (May). Do same for checks outstanding at May 31 when they come in later.

(18) Check bank statement against cancelled checks for May.

(19) Outstanding checks, issued prior to month of reconciliation, must be traced back into previous reconciliations.
(20) Examine into all payments in the Miscellaneous column which are not supported by proper vouchers. Check Postings to General Ledger.

(16) Balance.

(1) Make TVC complete and thorough bank reconciliations as at May 31, 1930 and as at June 25, 1930.

(2) Investigate against approved vouchers all checks of long outstanding, say three months and over. Issue stop payments if necessary and issue new checks. Mark clearly those ECW payable to branches, affiliates and/or subsidiaried.

(3) Verify all cash in transit. Watch out for kiting.

(4) Confirm the bank balances and the in-transits at 5/31 and 6/25 by direct correspondence with banks. See §14 also. Are the bank balances excessive?

(5) See that all outstanding checks are thoroughly examined for irregularities as soon as they are returned by the bank. (Number, Date, Payee, Maker, Endorsements, Perforation.)

(6) Do the same as in §5 for those not seen on last ECW audit.

(7) Count the cash on hand in presence of official or employee. Prepare schedules of it. Bring all funds together.

(8) Determine if the checks in §7 are bona fide. Check into Cash Receipts for "lapping." Company checks must be in the Cash Payments Book. Have the checks deposited yourself. Are any returned NG?

(9) See that the cash in transit from branches have not been duplicated (counted or included twice).

(10) Treat overdrafts as liabilities IF the other banks can not be drawn on to cover these sums.

(11) Verify the funds at Toledo by certificate from the branch manager, Mr. R. Foley. The funds at Cleveland and Chicago have been counted by representatives from our offices in those two cities as of 5/31 and 6/25/30.

(12) Trace deposits in transit at May 31, 1930 and June 25, 1930 into subsequent Bank Statements.

(13) If you have any Certificates of Deposit, ascertain if they are being used as collateral security.

(14) Is the cash balance restricted by liens or offsets, etc.? What is the minimum balance to be maintained against the Notes Payable-Banks? Confirm also with bank if there are any other funds.

(15) Stamp all checks and bank statements examined with our audit stamp.

(16) Be certain to make a bank reconciliation as of the beginning of the period, May 31, 1929. Check to the general ledger.

(17) Cash and negotiable instruments and securities must be accounted for as of and on the same day and hour. Bring together in one place if possible, or seal, etc.
(18) Account for any funds on hand not called for on the books.

(19) If a deposit is on hand, compare it by items with C.R. Book. See #8 above.

(20) Are those handling cash and/or securities bonded?

(17) Petty Cash at New York

(1) Prepare in full detail a schedule showing the cash and the cash memoranda.

(2) State the date, hour and place of the count.

(3) Who was the client's representative? Be certain that he is present throughout.

(4) Did you count the cash, or did the client's representative count it?

(5) Get the signature of the client's representative on your Petty Cash schedule showing that you returned the fund intact.

(6) Are the vouchers signed by the payees?

(7) Have the vouchers approved by Miss Manson. (She is the P. Cashier)

(8) Examine the vouchers yourself for genuineness.

(9) Deposit or have deposited all checks in the fund.

(10) Make list of necessary adjustments.

(11) Examine first reimbursement after May 31, 1930 for vouchers belonging to this period.

(12) Check the vouchers for June 1929 and May 1930 for genuineness. Check distribution too.

(13) Foot the Cash column and check the crossfootings at the end of the month for June 1929 and May 1930.

(14) Check the postings from the Petty Cash book into the G/L for June 1929 and May 1930.

(15) Check the Petty Cash account in the G/L to see that the amount has not been changed. If changed, show all the details.

(16) Stamp all vouchers examined.

(17) Have proper official approve the I.O.U.s, advances and like "cash" items.

(18) See that checks drawn to order of P.Cash or for cash purposes are entered in cash Disbursements Book for period under audit.

(19) Have any items deposited here or as General Cash been subsequently returned as valueless? Give details.
REVIEW QUESTIONS

1. How would you determine that the cash receipts have been deposited regularly?
2. Draw up a request to be sent to a bank.
3. What do we mean by kiting? Give an illustration.
4. How would you convert foreign balances?
5. What is meant by auditing from the trial balance?
6. What inspection would you give a check before passing it as O.K.?
7. Give a brief discussion of some problems involved in setting forth cash on the balance sheet.
8. Why must cash and negotiable securities be accounted for as of the same date? Give an illustration to prove your point.
9. Why should numbers on checks be accounted for?
10. Why are confirmations of cash balances necessary?
11. How should spoiled checks be handled?
12. Outline a plan for catching kiting.
13. Draw up a schedule of reconciliation where there is only one cash account for several banks combined.
14. Why should the details of the deposit slips for the last few days of an audit period be compared with the details of the cash book?
15. Give an illustration of overlapping.
16. Why is it necessary to close the cash book on time?
17. Give an illustration of kiting.
18. Outline a plan for catching overlapping.
19. How would you correlate the cash book and the voucher register?
20. Draw up a completed schedule as of a date later than the audit date for reconciling cash when the balance consists of cash on hand and cash in bank.
21. Is it necessary to examine endorsements on a check? Why do you take your position in this matter?
22. Would you count cash and securities while alone? Give reasons for your answer.
23. You enter upon your audit of cash on February 21 for the year ended January 31. At what point (date) would you close your audit? Why?
24. What are the several objectives of a complete cash verification?
25. Would you release any cash or security before you had completed the whole count?
26. Draw up a schedule of a Petty Cash count.
27. In a complete cash verification why is it necessary to check the opening cash book balance against bank statements?
28. Draw up a schedule showing the reconciliation of the cash book receipts with the bank deposits, etc.
29. Draw up a cash audit program for use on a balance sheet audit.
30. How would you treat bank overdrafts in your balance sheet arrangement?
31. Why is it difficult to determine that all cash that has been received has been recorded?
32. To what extent is it necessary to foot a cash book in a complete cash verification? In a detailed audit? In a balance sheet audit?
33. Why is it permissible to accept a letter from a branch manager as to the composition of his cashier's petty cash fund?
34. When would you recommend a complete cash verification?
35. Give a list of the different kinds of items that an auditor might find that a bookkeeper had wrongly included as cash.
36. How would you treat these items (35) on the balance sheet?
37. Define cash.
38. Draw up an audit program for a complete verification of cash.
39. Draw up an audit program on cash for use on a detailed audit.
40. On an audit of a partnership, you ascertain that a substantial cash investment made by a partner just before the audit date was withdrawn shortly thereafter. What, if anything, would you do about it?

41. Is it common for businesses to omit the last month's bank interest, or must the auditor insist on taking up all assets?

42. What test should the auditor make for those outstanding checks which do not come back before he leaves?

43. How and when should long outstanding checks be "written back" into the accounts? What notification should be given to the bank?

44. On a balance sheet audit, you find that there has not been a bank reconciliation for seven months. Must you start in where the client left off? If not, why not, and how should you proceed to make your reconciliation? Assume that two of the outstanding checks are five months old. All others are one month old.

45. How might an auditor catch the inclusion of some of the next period's receipts within the present period? How might an auditor catch checks dated in the present period but not mailed until several days later? Why would a client adopt the above policy of entering receipts and payments in the wrong period? What adjusting entries are necessary?

46. Why should the balance of the check book, if any, be compared with the cash book balance? Would you audit the check book also?

47. During the audit of a partnership, a senior finds that one of the partner's accounts was credited and the cash account debited for a substantial sum, the money being, as he ascertains, a personal loan by a bank to the partner as an individual. The senior believes that the credit should have been to NOTES PAYABLE-BANKS. Is he correct? Why?

48. On an audit you discover a secret fund, now $1,000, in the treasurer's control which is not on the books. You are permitted to audit the fund against vouchers and cancelled checks (which you find to be for corporate purposes), but are requested to omit it from the balance sheet because the management uses the fund for purposes which it does not care to have the accounting force or others aware of. What position on the omission of the $1,000 would you take? What would your position be if you were not allowed to audit the account?

49. Why should the auditor insist that checks found in the Petty Cash Fund be cashed by him or evidenced by a signed duplicate deposit slip?

50. How would you handle outstanding certified checks in a bank reconciliation?

51. Why should an auditor be wary of two or more endorsements on a cancelled check?

52. Name several reasons why a bank might enclose a charge voucher in the bank statement.

53. May matured bond coupons be treated as cash?

54. What indications of fraud do you find in the following problem #1?

55. B, an auditor, maintains that it is not necessary to foot the cash book if the following steps are taken to ascertain the final bank balance. Is he right? See Problem #2.

(a) Ascertain as in (1) the total deposits and withdrawals per the BANK STATEMENTS

(b) Reconcile the bank and the book balance as in (2) (if this has not already been done) as at the first of the period.

(c) Reconcile as in (3) the bank and the book balance as at the
55. (Continuation) close of the period.

(d) Ascertain as in (4) the final book balance by adding the BANK
DEPOSITS and WITHDRAWALS, as computed in (1), to the opening BOOK
BALANCE, taking into consideration the adjustments appearing in reconciliations (2), and (3).

56. How would an auditor be likely to find the following case of fraud? The defrauder takes $1000 in cash and to offset it draws a check of the same amount to a creditor, charging it to an expense account. Of course, the check is not mailed, but is placed among the cancelled checks of that month when they are returned by the bank.

57. How would an auditor be likely to find the following case of fraud? The defrauder draws up a fictitious check and then cashes it. In due course the check is returned by the bank with the notation NO FUNDS, whereupon the defrauder charges the check to the Reserve for Bad Debts.

58. What evidence of fraud is there in problem #3 below?

59. After the close of business on January 3, the auditor started on the reconciliation of general cash and petty cash. After checking the December checks to the Cash Books, he prepared the Bank Reconciliation shown in (1). He then counted the Petty Cash of $337.06 and verified and worked the reconciliation back to December 31 as in (2). What fraud should the auditor have uncovered? How? See Problem #4 where the records are shown running into January.

60. What error did the auditor fall into in problem #5 below?

61. Take the specific procedure Audit Program (Plate 46) for Mathews, Saunders, & Phelps, Inc., and translate it into a general procedure audit program.
**PROBLEM 1 - #1**

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<td>Jan. 2</td>
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<tbody>
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<td>Jan. 6</td>
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<tr>
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<td>Jan. 7</td>
<td>S1 1,407.16</td>
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<tr>
<td>9   25,607.76</td>
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<td>12-43</td>
</tr>
<tr>
<td>Jan. 8</td>
<td>S1 19,709.42</td>
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<td>Jan. 8</td>
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PROBLEM 1 - #4 (Continuation)

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Adding Machine Tape List

<table>
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<td>8881.83</td>
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Total, O.K. per controlling account

ACCOUNTS RECEIVABLE LEDGER J-Z (Problem 1, cont'd)

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<td>10</td>
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<td>13</td>
<td>S1</td>
<td>768.92</td>
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<td>26</td>
<td>S1</td>
<td>3,071.18</td>
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<td>22,146.98</td>
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SUMMER T

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<th>Corresponding Amount</th>
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WILLIAMS S

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SEITZEN P

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<td>407.09</td>
<td>C1</td>
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<tr>
<td>25</td>
<td>S1</td>
<td>98.16</td>
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MARCH S

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<th>Corresponding Amount</th>
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<td>1,776.64</td>
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<td>405.15</td>
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Adding Machine Tape List

<table>
<thead>
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<th>Description</th>
<th>Amount</th>
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<tbody>
<tr>
<td>3,071.18</td>
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<td>1,987.42</td>
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<td>99.16</td>
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From the foregoing, ascertain what manipulations have been made, if any, and make a report thereon such as you would render to a client.
**Problem 2 - #1**

**Abstract of Cash Receipts Book**

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<tr>
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<tbody>
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<td>Balance - Jan. 1</td>
<td>3662.14</td>
<td>3862.14</td>
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<tr>
<td>Sundry</td>
<td>632.05</td>
<td>632.05</td>
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</tr>
<tr>
<td>Bank Interest</td>
<td>3.65</td>
<td>3.65</td>
<td></td>
</tr>
<tr>
<td>Cash Sales</td>
<td>4695.21</td>
<td>4695.21</td>
<td></td>
</tr>
<tr>
<td>On Account</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>15961.66</td>
<td>267.31</td>
<td>17219.17</td>
</tr>
<tr>
<td></td>
<td>25144.91</td>
<td>267.31</td>
<td>4497.64</td>
</tr>
</tbody>
</table>

| Balance - Feb. 1     | 5781.29          | 5781.29 |
| Sundry               | 8.15             | 8.15   |
| Bank Interest        | 4.95             | 4.95   |
| Cash Sales           | 2166.31          | 2166.31 |
| On Account           |                  |       |
| Total                | 15412.98         | 298.67 | 15711.65 |
|                      | 22393.69         | 298.67 | 5794.40  |

| Balance - March 1    | 3100.65          | 3100.65 |
| Sundry               | 1000.00          | 1000.00|
| Bank Interest        | 3.05             | 3.05   |
| Cash Sales           | 4600.01          | 4600.01|
| On Account           |                  |       |
| Total                | 14961.61         | 109.96 | 15151.57 |
|                      | 23665.32         | 109.96 | 4103.70  |

| Balance - April 1    | 2996.24          | 2996.24|
| Cash Sales           | 3691.27          | 3691.27|
| On Account           | 16912.45         | 17208.59|
| Total                | 23509.96         | 17208.59|
|                      | 29879.24         |       |

| Balance - May 1      | 549.61           | 549.61 |
| Cash Sales           | 5991.07          | 5991.07|
| On Account           | 12563.12         | 12863.20|
|                      | 19193.80         | 12863.20|
|                      | 5991.07          |       |

| Balance - June 1     | 2651.84          | 2651.84|
| Sundry               | 3691.25          | 3691.25|
| Bank Interest        | 6.63             | 6.63   |
| Cash Sales           | 14961.35         | 14961.35 |
| On Account           | 25814.63         | 26227.25 |
|                      | 47025.90         | 26227.25 |
|                      | 512.62           |       |
|                      | 26227.25         |       |
|                      | 14961.35         |       |
|                      | 6349.92          |       |
### ABSTRACT OF CASH PAYMENTS BOOK

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<th>Vouchers Dis-Payable</th>
<th>Cash</th>
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<td>Misc.</td>
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<tr>
<td>First National</td>
<td>1-17</td>
<td>18.19</td>
</tr>
<tr>
<td>Slater Trust</td>
<td>1-14</td>
<td>3997.94</td>
</tr>
<tr>
<td>Industrial Trust</td>
<td>1-6</td>
<td>4001.07</td>
</tr>
<tr>
<td>R.I. Hospital Trust</td>
<td>1-4</td>
<td>2748.61</td>
</tr>
<tr>
<td>Old Stone Bank</td>
<td>1-40</td>
<td>5390.93</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td>4019.26</td>
</tr>
</tbody>
</table>

| First National | 18-27 | 6291.63 | 110.54 | 6181.29 |
| Slater Trust     | 15-19 | 7869.72 | 89.62 | 7780.10 |
| Old Stone Bank    | 41-45 | 6331.65 |      | 6331.65 |
| **Total**         |      | 6331.65 | 14161.55 | 200.16 | 20293.04 |

| First National | 28-56 | 7876.27 | 65.78 | 7810.49 |
| Industrial Trust | 7-20 | 9111.01 | 95.84 | 9015.17 |
| R.I. Hospital Trust | 5-9 | 3901.07 | 47.65 | 3853.42 |
| **Total**         |      | 20888.35 | 209.27 | 20679.08 |

| First National | 57-63 | 351.86 | 9423.42 | 159.86 | 9615.42 |
| Industrial Trust | 21-25 | 6884.32 | 66.65 | 6815.47 |
| R.I. Hospital Trust | 10-15 | 6642.30 | 32.84 | 6609.46 |
| **Total**         |      | 351.86 | 22950.04 | 211.55 | 23040.35 |

| Old Stone Bank    | 46-48 | 6060.57 | 181.42 | 5869.15 |
| R.I. Hospital Trust | 16-24 | 7995.61 | 108.19 | 7887.42 |
| First National    | 64-67 | 2784.39 |      | 2784.39 |
| **Total**         |      | 2784.39 | 14047.18 | 289.61 | 16541.96 |

| Shawmut National | 1-5  | 2614.18 |      | 2614.18 |
| Slater Trust     | 20-24 | 6007.52 | 112.87 | 5994.65 |
| Industrial Trust | 26-35 | 7158.91 | 49.86 | 7109.05 |
| R.I. Hospital Trust | 25-31 | 6554.61 |      | 6554.61 |
| Old Stone Bank    | 49-52 | 4465.75 | 135.68 | 4329.87 |
| Amburn National   | 1-9  | 5169.09 | 62.14 | 5106.95 |
| First National    | 69-73 | 7525.35 |      | 7525.35 |
| **Total**         |      | 17694.14 | 22601.27 | 360.27 | 40134.66 |
PROBLEM-2 - #3

(1) Abstract of Bank Statements

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<tr>
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<th>Withdrawals</th>
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<td>Bal. Jan. 1</td>
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<td>Jan.</td>
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<td>Feb.</td>
<td>20,066.69</td>
<td>20,564.67</td>
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<tr>
<td>March</td>
<td>21,706.84</td>
<td>20,703.72</td>
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<tr>
<td>April</td>
<td>17,188.63</td>
<td>18,644.19</td>
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<tr>
<td>May</td>
<td>40,067.69</td>
<td>44,374.06</td>
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<tr>
<td>June</td>
<td>136,667.95</td>
<td>144,061.81</td>
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Bal. Dec. 31 | 5,193.66 |

(2) Bank Reconciliation Jan. 1

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<td>Balance per books</td>
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(3) Bank Reconciliation Dec. 31

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<td>Balance per books</td>
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</table>

(4) Reconciliation of Receipts and Payments

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<td>Deposits per bank statements</td>
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<tr>
<td>Less - Checks Paid per bank statement</td>
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<tr>
<td>Checks outstanding Dec. 31</td>
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<tr>
<td>Total</td>
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<tr>
<td>Checks outstanding Jan. 1</td>
<td>99.20</td>
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<tr>
<td>Balance per books Dec. 31</td>
<td>6,891.24</td>
</tr>
</tbody>
</table>

An auditor made the above reconciliations which balanced out at the amount per the CASH account in the general ledger. What error, if any, did he fall into by taking the figures from the bank statements instead of footing the cash books?
**PROBLEM - 3**

**CASH RECEIPTS BOOK**

Month of January  
Terms 1/10 n/30

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<th>P</th>
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<td>1089.17</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Scholtze, E.</td>
<td>12</td>
<td>654.32</td>
<td>654.32</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Oldrich, S.</td>
<td>14</td>
<td>1084.36</td>
<td>10.95</td>
<td>1095.31</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash Sales</td>
<td>X</td>
<td>3817.69</td>
<td>3817.69</td>
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</tbody>
</table>

**DEPOSIT SLIPS**

<table>
<thead>
<tr>
<th>Jan. 1</th>
<th>Jan. 2</th>
<th>Jan. 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bills</td>
<td>910.00</td>
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<tr>
<td>Currency</td>
<td>1,076.03</td>
<td>1,498.49</td>
</tr>
<tr>
<td>Checks</td>
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<td></td>
</tr>
<tr>
<td>Slater</td>
<td>508.12</td>
<td>1,615.04</td>
</tr>
<tr>
<td>New York</td>
<td>1,597.98</td>
<td>307.70</td>
</tr>
<tr>
<td>St. Louis</td>
<td>16.15</td>
<td>8,026.55</td>
</tr>
<tr>
<td>Industrial</td>
<td>409.73</td>
<td></td>
</tr>
<tr>
<td>R.I. Hospital</td>
<td>1,676.15</td>
<td>571.05</td>
</tr>
<tr>
<td>Philadelphia</td>
<td>1,680.85</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>7,973.71</td>
<td>16,231.89</td>
</tr>
</tbody>
</table>

What evidence, if any, of manipulation do you find in the foregoing problem?
BANK STATEMENT

<table>
<thead>
<tr>
<th>Date</th>
<th>Deposit</th>
<th>Checks</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>1,205.82</td>
<td>75.16</td>
</tr>
<tr>
<td>2</td>
<td>1,469.32</td>
<td>517.12</td>
</tr>
<tr>
<td>3</td>
<td>718.18</td>
<td>186.55</td>
</tr>
<tr>
<td>4</td>
<td>200.00</td>
<td></td>
</tr>
</tbody>
</table>

(1) Bank Reconciliation

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec. 31 Balance as per Bank Statement</td>
<td>1,466.55</td>
</tr>
<tr>
<td>Deduct - check outstanding at Dec. 31</td>
<td>75.16</td>
</tr>
<tr>
<td>Balance per books</td>
<td></td>
</tr>
<tr>
<td>Receipts</td>
<td>7,892.43</td>
</tr>
<tr>
<td>Payments</td>
<td>6,501.04</td>
</tr>
</tbody>
</table>

(2) Petty Cash Reconciliation

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan. 3 Balance per Petty Cash Count</td>
<td>477.06</td>
</tr>
<tr>
<td>(Actual Count)</td>
<td></td>
</tr>
<tr>
<td>Add - Payments 1-3 verified and footed</td>
<td>112.05</td>
</tr>
<tr>
<td>Deduct - Receipts 1-3 verified and footed</td>
<td>31.30</td>
</tr>
<tr>
<td>Dec. 31 Balance as per P.C.Book</td>
<td>489.12</td>
</tr>
</tbody>
</table>

In the December bank statement the following cancelled checks were found:

<table>
<thead>
<tr>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1,597.98</td>
</tr>
<tr>
<td>102.76</td>
</tr>
<tr>
<td>309.14</td>
</tr>
<tr>
<td>650.41</td>
</tr>
<tr>
<td>765.23</td>
</tr>
<tr>
<td>591.42</td>
</tr>
<tr>
<td>100.00</td>
</tr>
<tr>
<td>999.76</td>
</tr>
<tr>
<td>514.14</td>
</tr>
<tr>
<td>681.05</td>
</tr>
<tr>
<td>103.97</td>
</tr>
</tbody>
</table>
### CASH RECEIPTS BOOK

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<thead>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td>1,454.23</td>
<td>14.69</td>
<td>1,468.92</td>
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</tr>
<tr>
<td>2</td>
<td></td>
<td>515.00</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8</td>
<td></td>
<td>1,397.87</td>
<td>12.16</td>
<td>1,410.03</td>
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</tr>
<tr>
<td>16</td>
<td></td>
<td>950.17</td>
<td></td>
<td>950.17</td>
<td></td>
</tr>
<tr>
<td>17</td>
<td></td>
<td>1,070.08</td>
<td></td>
<td>1,070.08</td>
<td></td>
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<tr>
<td>21</td>
<td></td>
<td>63.61</td>
<td></td>
<td>63.61</td>
<td></td>
</tr>
<tr>
<td>28</td>
<td></td>
<td>1,177.45</td>
<td>11.89</td>
<td>1,189.34</td>
<td></td>
</tr>
<tr>
<td>30</td>
<td></td>
<td>500.00</td>
<td></td>
<td></td>
<td>500.00</td>
</tr>
<tr>
<td>31</td>
<td></td>
<td>765.82</td>
<td>36.74</td>
<td>765.62</td>
<td>1,015.00</td>
</tr>
<tr>
<td>Jan. 1</td>
<td></td>
<td>1,205.02</td>
<td>12.16</td>
<td>1,218.00</td>
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</tr>
<tr>
<td>2</td>
<td></td>
<td>1,469.32</td>
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<td>1,469.32</td>
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</tr>
<tr>
<td>4</td>
<td></td>
<td>718.18</td>
<td></td>
<td>718.18</td>
<td></td>
</tr>
</tbody>
</table>

### CASH PAYMENT BOOK

<table>
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<tr>
<th>V. Payable</th>
<th>Discount</th>
<th>Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec. 1</td>
<td>1,614.12</td>
<td>15.14</td>
</tr>
<tr>
<td>3</td>
<td>309.14</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>102.76</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>650.41</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>765.23</td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>591.42</td>
<td></td>
</tr>
<tr>
<td>12 Petty Cash</td>
<td>100.00</td>
<td></td>
</tr>
<tr>
<td>17 Total</td>
<td>1,009.06</td>
<td>10.10</td>
</tr>
<tr>
<td>26</td>
<td>514.14</td>
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<tr>
<td>29</td>
<td>691.05</td>
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<tr>
<td>30</td>
<td>105.02</td>
<td>1.05</td>
</tr>
<tr>
<td>31</td>
<td>75.16</td>
<td></td>
</tr>
<tr>
<td>Jan. 1</td>
<td>517.12</td>
<td>5.19</td>
</tr>
<tr>
<td>2</td>
<td>61.99</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>186.65</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>165.15</td>
<td></td>
</tr>
<tr>
<td>6 Petty Cash</td>
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<td></td>
</tr>
<tr>
<td></td>
<td>6,525.33</td>
<td>27.29</td>
</tr>
</tbody>
</table>

### PETTY CASH BOOK

<table>
<thead>
<tr>
<th>Dec. 1 Balance</th>
<th>750.12</th>
<th>1 Sundry</th>
<th>32.16</th>
</tr>
</thead>
<tbody>
<tr>
<td>12 General Cash</td>
<td>100.00</td>
<td>6 &quot;</td>
<td>186.92</td>
</tr>
<tr>
<td>16 Sundry</td>
<td>256.12</td>
<td>12 &quot;</td>
<td>348.15</td>
</tr>
<tr>
<td></td>
<td></td>
<td>16 &quot;</td>
<td>81.19</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>457.82</td>
</tr>
<tr>
<td></td>
<td>1,106.24</td>
<td></td>
<td>1,106.24</td>
</tr>
<tr>
<td>Jan. 1 Balance</td>
<td>457.82</td>
<td>2 Sundry</td>
<td>112.05</td>
</tr>
<tr>
<td>2 Sundry</td>
<td>15.12</td>
<td>4 Sundry</td>
<td>71.63</td>
</tr>
<tr>
<td>3</td>
<td>16.12</td>
<td>5 Sundry</td>
<td>5.06</td>
</tr>
<tr>
<td>6</td>
<td></td>
<td></td>
<td>200.00</td>
</tr>
</tbody>
</table>

Note that this Petty Cash fund is NOT on an imprest basis where the balance remains constant. A constant fund is preferable to a fluctuating fund.

Checks drawn on General Cash to the order of Petty Cash are cashed on the days shown on the bank statements.
**PROBLEM #5**

### Cash Receipts Book

<table>
<thead>
<tr>
<th>Date</th>
<th>Cash</th>
<th>Discount</th>
<th>Acct. Rec.</th>
<th>Misc.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec. 1 - 31</td>
<td>45,914.50</td>
<td>586.91</td>
<td>45,360.32</td>
<td>632.09</td>
</tr>
<tr>
<td>Jan. 1</td>
<td>25,618.19</td>
<td>412.10</td>
<td>25,526.14</td>
<td>510.15</td>
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<tr>
<td></td>
<td>673.02</td>
<td></td>
<td></td>
<td>673.02</td>
</tr>
<tr>
<td>15</td>
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<td></td>
<td>1,000.00</td>
<td></td>
</tr>
<tr>
<td>21</td>
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<td>1,121.51</td>
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<tr>
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<td>125.62</td>
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</tr>
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<td>31</td>
<td>5,610.54</td>
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</tr>
<tr>
<td></td>
<td>250.02</td>
<td></td>
<td>250.02</td>
<td></td>
</tr>
<tr>
<td></td>
<td>185.19</td>
<td></td>
<td></td>
<td>185.19</td>
</tr>
<tr>
<td></td>
<td><strong>1,176.12</strong></td>
<td></td>
<td><strong>1,176.12</strong></td>
<td></td>
</tr>
</tbody>
</table>

### Cash Payments Book

<table>
<thead>
<tr>
<th>Date</th>
<th>Vouchers</th>
<th>Discount</th>
<th>Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec. 1-27</td>
<td>28,196.32</td>
<td>261.96</td>
<td>27,914.36</td>
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<td>5.12</td>
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<td>16.59</td>
<td></td>
<td>16.59</td>
</tr>
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<td>.16</td>
<td>18.14</td>
</tr>
<tr>
<td></td>
<td>150.45</td>
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<td>156.07</td>
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<td>37</td>
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<td>.05</td>
<td>5.12</td>
</tr>
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<td>6.12</td>
</tr>
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<td>16.59</td>
</tr>
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<td>24.69</td>
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<td>5.16</td>
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<td>15.05</td>
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<td>46</td>
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<td>4.22</td>
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</table>

### Cash Payments Book

<table>
<thead>
<tr>
<th>Date</th>
<th>Vouchers</th>
<th>Discount</th>
<th>Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan. 1</td>
<td>16.05</td>
<td>.16</td>
<td>15.89</td>
</tr>
<tr>
<td>9</td>
<td>6.81</td>
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<td>6.81</td>
</tr>
<tr>
<td>10</td>
<td>15.49</td>
<td>.15</td>
<td>15.34</td>
</tr>
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<td>11</td>
<td>7.09</td>
<td></td>
<td>7.09</td>
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<tr>
<td>12</td>
<td>147.67</td>
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<td>147.67</td>
</tr>
<tr>
<td>13</td>
<td>99.99</td>
<td>1.00</td>
<td>98.99</td>
</tr>
<tr>
<td>14</td>
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<td>17.12</td>
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</tr>
<tr>
<td>16</td>
<td>18.52</td>
<td>.19</td>
<td>18.33</td>
</tr>
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<td>17</td>
<td>6.31</td>
<td></td>
<td>6.31</td>
</tr>
<tr>
<td>18</td>
<td>4.98</td>
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<td>4.98</td>
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<tr>
<td>19</td>
<td>113.67</td>
<td>1.14</td>
<td>112.53</td>
</tr>
<tr>
<td>20</td>
<td>115.94</td>
<td>1.16</td>
<td>114.78</td>
</tr>
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<td>21</td>
<td>1,176.86</td>
<td>11.77</td>
<td>1,165.09</td>
</tr>
<tr>
<td>22</td>
<td>2,103.91</td>
<td>21.04</td>
<td>2,082.87</td>
</tr>
</tbody>
</table>
PROBLEM #5 (Continuation)

Cash Payments Book
(Continuation)

The December 31 balance per the Bank Statement was $12,107.10 and the
auditor found the following cancelled checks therein:

\[
\begin{array}{cccccccc}
27,914.22 & 4.22 & 18.14 & 156.67 & 9.76 & 6.12 & 5,634.51 \\
8.61 & 1.10 & 5.10 & 5.16 & 9.88 & 24.69 & 8.88 \\
\end{array}
\]

Auditor's Reconciliation

Balance per Bank Statement Dec. 31  $12,107.10
Less checks outstanding
5.12  225.61
16.59  15.65
7.63
Balance per books Dec. 31  $11,836.30

January Bank Statement

<table>
<thead>
<tr>
<th>Jan. 1 Balance</th>
<th>Checks</th>
<th>Deposits</th>
</tr>
</thead>
<tbody>
<tr>
<td>1,165.09</td>
<td>25,618.19</td>
<td></td>
</tr>
<tr>
<td>15.89</td>
<td>673.02</td>
<td></td>
</tr>
<tr>
<td>17.12</td>
<td>1,000.00</td>
<td></td>
</tr>
<tr>
<td>7.09</td>
<td>986.33</td>
<td></td>
</tr>
<tr>
<td>18.33</td>
<td>1,121.51</td>
<td></td>
</tr>
<tr>
<td>4.98</td>
<td>682.56</td>
<td></td>
</tr>
<tr>
<td>1.10</td>
<td>5,810.54</td>
<td></td>
</tr>
<tr>
<td>98.99</td>
<td>250.02</td>
<td></td>
</tr>
<tr>
<td>147.67</td>
<td>185.19</td>
<td></td>
</tr>
<tr>
<td>112.56</td>
<td>1,176.12</td>
<td></td>
</tr>
<tr>
<td>8.61</td>
<td>6.31</td>
<td></td>
</tr>
<tr>
<td>Jan. 31 Balance</td>
<td>$46,006.87</td>
<td></td>
</tr>
</tbody>
</table>

What evidence, if any, of manipulation do you find in the foregoing problem?
CHAPTER 13
CASH FRAUDS

154. General Discussion.
155. Some Common Methods of Cash Frauds.
156. Some Common Methods of Preventing Cash Frauds.

Review Questions

154. General Discussion.— At the outset, the reader should realize that cash fraud is only one type of fraud for which the auditor must be alert. Manipulation of accounts, and security and merchandise frauds, for example, are very common indeed.

Again,—the reader should realize that the detection of fraud is a very minor objective in a balance sheet audit, and of only equal importance with other objectives in a detailed audit. For this reason an auditor should make certain, by discussion, that the client realizes the position taken by modern auditors on the importance of detecting fraud. In addition to this, the prudent auditor always explains in his report the extent of the responsibility assumed at this point.

The modern point of view is that the auditor has more important work to do than to detect fraud. Moreover, the fee for having an auditor check "everything in sight" is too costly in relation to the results accomplished. Then too, the auditing which is necessary to accomplish the other objectives is also reasonably adequate to disclose any fraud not too ingeniously laid. Finally, if in addition to the ordinary auditing a proper system of internal check is installed together with the bonding of all employees and owners who are in a position to defraud the business, there is adequate protection against fraud.

155. Some Common Methods of Cash Frauds.—

(1) By Kiting—(This has been explained previously)
(2) A personal account may be credited direct and another personal account may be debited direct for the amount of the money pocketed. The account debited will have to be taken care of later, of course.
(3) Receipts from miscellaneous items, such as sales of scrap, recovery of bud debts written off, and so on, may be pocketed without record. This type of fraud is extremely hard to detect because it is "smokeless"; that is, it leaves no trail.
(4) Unrecorded receipts from cash sales may be stolen.
(5) Credit sales may not be recorded. If so, the cash can be pocketed when received.
(6) A discount granted to a customer may be increased when recorded in the cash book. For example, B may send in $980 to cancel a debt of $1000 less 2% discount. If the bookkeeper records the cash as $960 and the discount as $40 with a credit to accounts receivable of $1000, he is in a position to steal $20. A discount may be allowed when none was taken.
(7) A receipt from a customer may be entered correctly, but the footing of the cash column will be understated and that of the discount column will be overstated the same amount.
(8) The cash receipts book may show that a customer took a discount (even though late in paying) whereas in fact the full amount was paid.
13-2

(9) The opening book balance may be understated.

(10) A dummy forged check may be placed among the cancelled checks (offsetting a theft of receipts) to support a disbursement entry, whereas the check did not go through the bank. Sometimes an old cancelled check (and an old cancelled voucher) is used to support the disbursement entry.

(11) Checks outstanding may not all be listed, or if listed, not footed properly.

(12) Signatures and endorsements on checks, etc., may be forged.

(13) A payment to a creditor may be entered correctly, but the footing of the cash column be overstated and that of the discount column will be understated to the same extent.

(14) A credit may be made direct in the accounts receivable control account and a debit direct to an expense account in the general ledger for the amount of the theft.

(15) Cash may be received personally upon the unauthorized issuing of notes, stock certificates, and the like.

(16) By Lapping—(This has been explained previously)

(17) Collusion with creditors whereby goods are received for without being received, or the vouchers are raised after being approved.

(18) Petty cash may be tampered with by raising amounts on vouchers, making false signatures, using an old paid voucher, and so on.

(19) Payrolls may be padded with false names, extra hours, higher rates, overfootings, and so on ad infinitum, with or without collusion of several persons.

(20) A fraudulent check may be issued but not recorded. If so the column footings will be overstated. The check itself will be destroyed when returned.

(21) A sale may be entered in the sales book but not included in the column totals. As there will be no debit to accounts receivable and no credit to sales for this item, the manipulator can take the money when the customer sends it in.

(22) Checks may be raised when returned from the bank in order to correspond with fraudulent cash book entries.

(23) Checks may be recorded in the name of a false payee, endorsed in that name, and then endorsed by the defrauder.

156. Some Common Methods of Preventing Cash Frauds—

(2) Someone other than the cashier should call for the bank statements and reconcile them with the cash book. This implies that the cash book will be footed, checks and deposits will be vouched and examined in the same detail as an auditor would do it in a complete cash verification audit. In addition to preventing and detecting fraud, this routine is that which courts generally require of a plaintiff who is suing a bank for improper payments on forged checks, and the like.

(b) The cashier should not have access to the personal ledgers, or to the customers' statements.

(c) Checks should bear two signatures. The practice of one of two persons signing checks ahead should be reduced to an absolute minimum.

(d) All vouchers (not merely the voucher jacket) when paid, should be stamped "paid" so as to hinder the reusing of old vouchers. The stamp on voucher jackets should bear the check number.

(e) All transactions (not only cash) should be substantiated by numbered vouchers to be accounted for later. This precaution should be taken because many cash frauds involve the manipulation of other records.

(f) All spoiled checks should be preserved.
(g) All credits to customers' accounts for sales allowances, bad debts, returned goods, etc. should be approved by someone in authority.
(h) Complete receiving and shipping records should be maintained.
(i) Salesmen's expense vouchers should be approved by someone in authority.
(j) The petty cash fund should be operated on the imprest system with numbered vouchers to be accounted for. Each voucher should be written in ink. Before being reimbursed the vouchers should be approved.
(k) Cash sales should be controlled by using cashiers' stations, numbered slips (to be accounted for), cash registers, etc.
(l) All cash receipts should be deposited promptly by the person responsible for the opening of the incoming mail.
(m) All incoming mail should be opened by a responsible person under the treasurer. Cash receipts may be listed in triplicate, one to go to the treasurer, one to the cashier, and one to the customer's ledger clerk.
(n) All remittance checks should be immediately stamped, "For Deposit Only".
(o) If salesmen are allowed to collect debts, precaution must be taken to issue receipts DIRECT to the payer by SOMEONE OTHER THAN the salesmen.
(p) The cashier must not have custody of the notes receivable, etc.
(q) Checks must not be made to Cash, or to Bearer, or to Payroll.
(r) The preparation and payment of the payrolls must be surrounded by a very careful system of "checks and balances"; i.e., no one person should be permitted to carry out several operations.¹

¹See Appendix C, Sec. 7 – #6; Sec. 8 – #2, #5, #6; Sec. 9 – #1.
REVIEW QUESTIONS

1. Why is it wise to forbid the cash book clerk access to either the personal ledgers, or to the monthly statements?
2. Of what value are cash stations and cash registers in preventing cash fraud?
3. What is the value of keeping the petty cash funds on the imprest system over no system at all?
4. What is a House Voucher? Give a full explanation.
5. How would you detect the type of fraud stated in item 3, section 151.
6. Give a definite illustration (using names and amounts) of the type of fraud given in item 7.
7. How would you proceed to catch fraudulent overstatements of cash discounts allowed?
8. How will an auditor catch the type of fraud given in item 9, section 151. Be definite.
9. How might an auditor catch the type of fraud given in item 11, section 151. Be definite.
10. Give five additional types of cash fraud not given in the text.
11. Illustrate a case of kiting on a single bank.
12. To what extent is the petty cash audited on a balance sheet audit?
13. How would an auditor be apt to catch the type of fraud given in item 10? Be definite.
14. Which type of cash fraud is, in your opinion, the hardest kind to detect?
15. Treasurer X, one of the signers of all checks, is to leave on a month's vacation. Devise a plan whereby he will not have to sign checks ahead.
16. Why should all spoiled checks be preserved?
17. What use does an auditor make of the shipping record? The receiving record?
18. If the auditor does not arrive at the audit date, why should he examine the first batch of petty cash vouchers turned in by the cashier for cash replenishment.
19. When might a second petty cash count be made, even though the first one checked out correctly?
20. Distinguish between kiting by using ONE check and by using TWO checks? When would the defrauder be forced to use the latter method?
21. Is a bank statement or a pass-book satisfactory evidence of the cash balance? Why?
CHAPTER 14

THE VERIFICATION OF NOTES RECEIVABLE

157. General Discussion.
158. Explanation of Plate 47.
   PLATE 47 - A Form of Promissory Note.
159. Explanation of Plate 48.
   PLATE 48 - A Form of Trade Acceptance.
160. The Date to Audit.
161. The Schedule.
162. Explanation of Plate 49.
   PLATE 49 - A Note Receivable Schedule (1st type).
163. Explanation of Plate 50.
   PLATE 50 - A Note Receivable Schedule (2nd type)
164. Explanation of Plate 51.
   PLATE 51 - A Note Receivable Schedule (3rd type).
165. Checking the Notes to the Schedule.
166. Auditing the Account.
167. Ageing the Notes.
168. Payments after the Audit Date.
169. Signatures.
170. Confirmation of Notes.
171. Contingent Liability on Notes.
172. Collateral Notes.
173. Notes of Officers, etc.
174. Notes Representing Loans.
175. Notes of Affiliated Interests.
176. Large Notes.
177. Testing Through to the Interest Account.
178. Simultaneous Notes and Cash Verification.
179. Renewals.
180. Explanation of Plate 52.
   PLATE 52 - A Form of Domestic Bank Acceptance.
181. Explanation of Plate 53.
   PLATE 53 - Several Forms of Drafts.
182. Explanation of Plate 54.
   PLATE 54 - A Form of Three Party Draft.
183. Explanation of Plate 55.
   PLATE 55 - An Audit Program for Notes Receivable.
184. Explanation of Plate 56.
   PLATE 56 - A Form of Foreign Bank Acceptance.

Review Questions.

157. General Discussion. -- Before outlining some of the more common methods of auditing notes and acceptances receivable, the writer desires to make several miscellaneous comments. A promissory note (Plate 47) and/or a trade acceptance (Plate 48) are generally more liquid than an account. To illustrate, it certainly is much easier and cheaper to discount a trade acceptance (or note) than it is to sell an account receivable. And again, a note (or acceptance) is a better evidence of a debt than a book account, because the burden of proof in litigation over the denial of a note receivable is on the hands of the maker, whereas in the case of an open account the burden of proof of its existence rests with the creditor. But, although a note (or acceptance) is generally more liquid than an account, the auditor (an analyst) should always bear in mind that certain types of businesses rarely ever take notes directly on merchandise sales, and that notes of other businesses often represent ¹See Appendix C, Sec. 6-#2. ²Notes are commonly taken by concerns handling items of large value, such as pianos, farm implements, etc., or where the retailer (or wholesaler) as to grant long credit terms, such as in the case of dental supply houses. Thus an auditor would expect to find many trade notes in the hands of a manufacturer of farm implements, but
nothing but overdue accounts placed in writing for additional security, and possibly for interest. Clearly then, the auditor should approach his task of auditing the notes with definite knowledge as to which two types of notes, fresh debts or renewals, are before him.

As to trade acceptances (Plate 48), the auditor also needs to keep in mind that even they do not always represent original transactions.

Of the two (notes and acceptances), acceptances are certainly the more preferable when drawn up within the law of the Federal Reserve Act. They are then preferred by member reserve banks, being acceptable for rediscount at the district Federal Reserve Bank.\footnote{1}

158. See Plate 47.

159. See Plate 48.

160. The Date to Audit.--- Naturally, the easiest and in some respects the most satisfactory procedure is for the auditor to be on hand to account for the notes and acceptances as at the audit date. Not only is there less work involved, but certain facts may be "caught" only as at that date. For example, some notes receivable pledged at the audit date, may be returned (due to the maturity of the liability secured thereby) soon after that time. As at the audit date, the auditor will catch this fact because of the absence of the notes; but if he audits at a later date, he may not detect this fact especially if the note payable did not bear a recital of the collateral, and if the pledged notes were made negotiable by power of attorney rather than by endorsement.

Moreover, as just mentioned, whenever the auditor examines the notes receivable later than the audit date, he must cover the intervening transactions (between the audit date and the date of auditing) in order (as explained in section 137) that he may feel certain that the notes and the cash have not been manipulated, or substituted one for the other. So also, the reader should recall that as a part of this procedure, the cash should be reconciled as of this same date.

161. The Schedule.--- Perhaps the first thing (after reviewing the system of internal check, the methods of billing and handling invoices, the credit terms, etc.) that the auditor will do in connection with notes and acceptances receivable is to prepare a schedule of them, or have it done by the client.\footnote{2} As shown by plates 49, 50 and 51, auditors have devised a multiplicity of forms on notes receivable. The contents of each one is, of course, wholly based upon the necessities of the particular audit. However, the most common headings for columns are as follows: Dated, Maker, Drawer, Acceptor, Payee, Endorser, Amount, Collateral, Partial Payments; Account (cont'd) would be surprised if he found many in the hands of a city department store. In the writer's opinion, the auditor would do well to counsel his client to give and get trade acceptances in lieu of accounts. The acceptances can be readily discounted at the bank enabling the client to conduct its business with less capital. Thus the function of granting credit to businesses is passed on to banks where it properly belongs. Moreover, the financial position of the client is immeasurably improved, as what would have been accounts is now either current acceptances or cash (if discounted). Finally, the loss on bad debts is considerably less since the acceptor will hesitate to dishonor the acceptance, seeing that it will ruin his credit standing in the eyes of the bank which is making the collection for the payee. The best procedure is to ask the client to prepare a COMPLETE list of ALL KINDS of negotiable instruments. It is reiterated at this point that all partial collections should be endorsed on the back of the notes. Moreover, the cashier must NEVER be the one authorized to
Credited (source), Location, Time, Due Date, Interest Rate, Accrued Interest, Prepaid Interest, Interest Earned, Interest Collected, How Verified, Remarks.

Whenever the transactions are few, the schedule may show all of the notes for the entire period, including a full accounting for the interest thereon (Plate 51). But other than in limited instances, this plan is rarely followed. Even in a complete detailed audit, good accounting procedure permits testing, albeit it must be rather extensive. So then, the majority of note schedules will show only the composition of the audit balance, with or without the intervening transactions (between the audit date and the date of auditing) (Plate 49) depending upon the date when the actual auditing is done.

162. See Plate 49. 163. See Plate 50.

164. See Plate 51.

165. Checking the Notes to the Schedule.---After the schedule has been worked up from the ledger account and/or notes receivable register, the auditor is then ready to examine and vouch the notes against it. In all cases where there is a considerable volume of notes, a register (Plate 27) is indispensable. If the client hasn't one, the auditor should make the client familiar with its advantages.1

166. Auditing the Account.2---In studying the note schedules, the reader should observe that one of the principal columns in a note schedule is the one headed "Account Credited"; i.e., the source of the note. By ascertaining from the book entries what accounts (or account) were credited when the note account was debited, the auditor is auditing the account, an important procedure which some auditors totally overlook.

It is not sufficient for the auditor to merely inspect such and such an amount of notes whose total dollar value agrees with the general ledger figure. For example, to use an extreme case, it is possible for an auditor to see notes to the amount of the balance in the general ledger account (cont'd) make these indorsements. The note custodian himself (or his aide) should see that an entry has been made in the Cash Receipts Book for the amount of the collection, and at least once a month, he should personally see that the balance of the Notes Receivable account agrees with the notes in his possession. 1In some instances the Notes Receivable Register is only a memo record; i.e., it is not a book of original entry, hence no posting is made from it. Each note is first entered in the General Journal, and then a second record of it is made in the Register.

2"Account analysis seems to have five definite objects:
(1) To prove additions of the General Ledger accounts. If an account is analyzed and the items therein are grouped according to the various classes of things they represent, and group totals added, the account is proved without the necessity of footing.
(2) To see that nothing has been buried which has no right to be there.
(3) To determine that the components have been posted to the correct account. An error here may be due to the fact that the bookkeeper has slipped in applying accounting principles, that he is ignorant of what the proper treatment should be, or that he has unintentionally made a posting to one account when he meant to make it to another.
(4) To ascertain that the proper distinction has been made between capital and revenue; primarily, that expenses have not been capitalized.
(5) To see that assets have not been written off the books when they should have been retained." ---Bennett (p.106)
159. Explanation and Comments.—In this type of trade acceptance, note that the acceptance is written across the face of the instrument on the lines provided therefor (See also Plate 26).

Let us suppose the acceptance arose as follows. The Jordan & Marsh Co. of Central Falls, R.I. sells The Wilson Corporation of Pawtucket, Mass. an invoice of goods worth $780.47. As the Jordan & Marsh Co. wishes to get its money quickly, or as it desires The Wilson Corporation's promise to pay for the goods on a specified date, it draws up a trade acceptance.

When Jordan & Marsh Co. leaves the goods at the Central Falls freight office, it will get a bill-of-lading (a receipt) from the railroad. A bill-of-lading is, therefore, a written statement showing that goods have been received, to whom they are to go, by whom they are shipped, and who is entitled to them.

Jordan & Marsh Co. will thereafter deposit the bill-of-lading and the trade acceptance at its bank in Central Falls. This bank will then forward these two documents to some bank in Pawtucket. The Pawtucket bank will take the trade acceptance and bill-of-lading to The Wilson Corporation for acceptance. If The Wilson Corporation accepts (signs) the trade acceptance, the bill-of-lading will be handed over to it, and then only. The accepted trade acceptance is, of course, taken back to the bank by the messenger and returned to the Central Falls bank, and by them to Jordan & Marsh Co.

As The Wilson Corporation is now in possession of the bill-of-lading, it can get the goods at the freight office in Pawtucket on presenting this document. On the other hand, The Jordan & Marsh Co. can get its money by discounting the accepted trade acceptance as soon as it gets back from the bank in Pawtucket.

("Mr. French: Do bankers consider that a (foreign) draft, which is purely a medium of collection, should be washed back into accounts receivable and aged accordingly, or should be shown on the statement as a draft on sight, or sixty days, or what have you, depending on how far away the customers are? . . . . . Mr. Gray: But the seller here has simply drawn a draft and has not changed in form. It is an accounts receivable, in my opinion, until the party at the other end has accepted the draft payable at a certain time.") —"RELATIONS BETWEEN ACCOUNTANTS AND BANKERS", N.Y.S.S. of C.P.A., November 1931, (p. 44)
Central Falls, R.I.       August 17, 1930       No. 17618
City of Drawer       Date

On September 3, 1930       Pay to the order of Ourselves
Date of Maturity

Seven Hundred Eighty and 47/100       Dollars $760.47

The obligation of the acceptor hereof arises out of the purchase of goods
from the drawer. The drawee may accept this bill payable at any bank, banker,
trust company in the United States which he may designate.

To The Wilson Corporation       ————
Name of Drawee

1718 Gooding St.       ————
Street Address

Pawtucket, Mass.       ————
City of Drawee

—— Jordan & Marsh Co.       ————
Signature of Drawer

By __ M. S. Jordan       ————
Treas.

When/if the above draft is accepted by the Wilson Corporation,
the following stamp will be impressed vertically across the face of the
draft, thus converting it into an acceptance.

ACCEPTED

Date August 19, 1930       ————
Payable at State Street Bank       ————
Location Pawtucket, Mass.       ————
Acceptor The Wilson Corporation       ————
By __ Fred Wilson       ————
Treas.
EXPLANATION OF PLATE 47

A FORM OF PROMISSORY NOTE

158. Explanation and Comments.—A promissory note is a written promise to pay a sum certain in money to the payee (creditor) on demand, or at the end of a definite time. The payee, by endorsing it, may make it payable to a third party, and he in turn may transfer it to a fourth party, and so on.

This type of paper, when endorsed, can be readily discounted at the bank; but, of course, it is not acceptable as a trade acceptance (which is acceptable for rediscount at the district Federal Reserve Bank if it complies with the provisions of the Federal Reserve Act).

Note that Wightman & Bros. have adopted the excellent plan of requiring two signatures to their notes. This procedure is a good check against errors and fraud.

$1467.16

Pawtucket, R.I. July 17, 1930

five months __ After date ___ Promise to pay to the order of

_The Winchester Paper Company__________________________

One thousand four hundred sixty seven and 16/100 ________ Dollars

at __ The Third National Bank, Pawtucket, R.I.__________

Without Defalcation. Value Received. No.614 With interest at ___%____

E. Wightman & Bros.

Approved __Ruth Wightman___ Treas. By __Everett Wightman__ Pres.
# A NOTE RECEIVABLE SCHEDULE (1st type) PLATE 49

## The Regan Corporation
### Notes and Acceptances Receivable
#### Dec. 31, 1929

<table>
<thead>
<tr>
<th>Dated</th>
<th>Due</th>
<th>Interest Rate</th>
<th>Maker or Acceptor</th>
<th>Verified Source</th>
<th>T</th>
<th>General Ledger</th>
<th>General Ledger</th>
<th>Balance</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>11/29</td>
<td>1/30</td>
<td>6%</td>
<td>A B Smith</td>
<td>Acct Rec</td>
<td>N</td>
<td>350.29#</td>
<td>350.29</td>
<td></td>
<td></td>
</tr>
<tr>
<td>11/29</td>
<td>1/30</td>
<td>6%</td>
<td>F Smiley</td>
<td>Mdse</td>
<td>N</td>
<td>1705.00#</td>
<td>1705.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12/29</td>
<td>1/18</td>
<td>6%</td>
<td>R W Talcott Corp</td>
<td>&quot;</td>
<td>A</td>
<td>118.37#</td>
<td>118.37</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12/29</td>
<td>1/18</td>
<td>6%</td>
<td>S Stacey Company</td>
<td>Note Renewal</td>
<td>N</td>
<td>355.29#</td>
<td>355.29</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12/29</td>
<td>1/20</td>
<td>6%</td>
<td>F Stearns &amp; Son</td>
<td>Acct Rec</td>
<td>N</td>
<td>1472.83</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12/29</td>
<td>1/20</td>
<td>6%</td>
<td>S &amp; S Kearns Co.</td>
<td>Mdse</td>
<td>N</td>
<td>3540.28</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12/29</td>
<td>1/20</td>
<td>6%</td>
<td>S Curtis &amp; Bros.</td>
<td>&quot;</td>
<td>N</td>
<td>500.00#</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12/29</td>
<td>1/20</td>
<td>6%</td>
<td>R W Francis Corp.</td>
<td>&quot;</td>
<td>N</td>
<td>1179.37#</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance per G/L</td>
<td>1/27/30</td>
<td>RECIPES in CASH BOOK</td>
<td></td>
<td></td>
<td></td>
<td>9530.43</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

## AUDIT PROCEDURE

1. All of the notes composing the balance at 1/27/30 were on hand and inspected in the presence of Mr. Ross Hadley, Tress.

2. Notes on hand at 12/31/29 but paid up since were traced into Cash Book.

3. The Note Register did not show any notes under at 12/31/29 nor did any correspondence with banks reveal any. We were informed that no notes were pledged at 12/31/29.

4. The account was analyzed from Nov. through to 1/27/30.

5. 2/2/30 The note of F Stearns & Son was not paid. An allowance of 70% was set up in adjustment #16 under Accounts Receivable at 12/31/29.

6. # 2/2/30 These notes were received in cash to date.

## Explanation and Comments

This exhibit shows that the notes and acceptances were all accounted for as of the same date (1/27/30) as the cash count. Note that the General ledger balance at 12/31/29 was obtained by taking into consideration the notes paid up in cash after that date. The reader should also observe that the auditor intends to show in his report the amount of notes paid up in cash up to 2/28/30 at which time, presumably, he had finished the audit. Such information is, of course, the best sort of proof that these notes were good. In this connection, note that on 2/2/30 Stearn's note was not met, and, as this note arose from an old account in existence at 12/31/29, the auditor provided a reserve of 70% against it (as at 12/31/29) in adjustment #16. There was some hope of collecting a part of it.
### A Note Receivable Schedule (2d Type)

**The Holt Mfg. Corp.**

**Notes Receivable**

**December 31, 1929**

<table>
<thead>
<tr>
<th>Dated</th>
<th>Due</th>
<th>Maker or Acceptor</th>
<th>Verified</th>
<th>Source</th>
<th>G/L Balance</th>
<th>G/L Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>10/30/29</td>
<td>1/30/30</td>
<td>N H/J Jackson Company</td>
<td>Loan to Sub. Co.</td>
<td>10000.00</td>
<td>10000.00X</td>
<td>12/31/29</td>
</tr>
<tr>
<td>11/27/29</td>
<td>2/27/30</td>
<td>S Wilson &amp; Son</td>
<td>M/a</td>
<td>15329.42</td>
<td>15329.42X</td>
<td>12/31/29</td>
</tr>
<tr>
<td>12/21/29</td>
<td>2/21/30</td>
<td>A F Franklin Bros.</td>
<td>Due 10/21/29 (M) Renewal</td>
<td>1547.62</td>
<td>1547.62X</td>
<td>12/31/29</td>
</tr>
<tr>
<td>12/26/29</td>
<td>2/26/30</td>
<td>M S Banter Corp.</td>
<td>M/a</td>
<td>3429.60</td>
<td>3429.60X</td>
<td>12/31/29</td>
</tr>
<tr>
<td>12/30/29</td>
<td>1/30/30</td>
<td>M Parker Co.</td>
<td>M/a</td>
<td>1720.30</td>
<td>1720.30X</td>
<td>12/31/29</td>
</tr>
<tr>
<td>1/7/30</td>
<td>2/7/30</td>
<td>N S F Norman Mfg Corp</td>
<td>&quot;</td>
<td>325.47</td>
<td>325.47X</td>
<td>12/31/29</td>
</tr>
<tr>
<td>1/9/30</td>
<td>2/9/30</td>
<td>Wilson &amp; Wilson</td>
<td>&quot;</td>
<td>129.57</td>
<td>129.57X</td>
<td>12/31/29</td>
</tr>
<tr>
<td>1/22/30</td>
<td>2/22/30</td>
<td>Proctor and Armour Inc</td>
<td>&quot;</td>
<td>986.45</td>
<td>986.45X</td>
<td>12/31/29</td>
</tr>
<tr>
<td>(K) 1/28/30</td>
<td>3/28/30</td>
<td>N Stapleton &amp; Smith Co</td>
<td>Due 1/28/30</td>
<td>557.60</td>
<td>557.60X</td>
<td>12/31/29</td>
</tr>
</tbody>
</table>

**Verified Receipts on Notes as per Cash Book 12/31/29 to 1/28/30**

- 11/8/29 1/8/30 6 A Parker & Norman Inc M/a 63529.30X
- 12/4/29 1/4/30 6 A Worcester Perkins & Holt " 4203.31X
- 12/27/29 1/27/30 A Smedley Bros. " 3475.52X

**Verified Renewals 12/31/29 to 1/28/30**

- (K) 12/27/29 12/31/29 A Stapleton & Smith Co M/a 557.60X

**N** Note Receivable

**A** Acceptance Receivable

| X | Received in cash by 3/30/30 For this reason the items of $1547.62, $676.30, and $557.60 do not need any reserve at 12/31/29. |

| M | The original acceptance was taken direct for merchandise on 10/21/29 |

| # | The balance has been outstanding since 10/29/29 |

All of the items in the 1/28/30 balance were inspected except for the $10000 note which was held and confirmed by the Slater Bank (C-1) and the item of $1720.30 which was out for collection. See confirmation (C-3). The note transactions intervening between 12/31/29 and 1/28/30 were checked from books of original entry into the General Ledger. The cash was checked into the bank statement.
Accrued
Int. Rec.
12/31/29
163.38

NOTES DISCOUNTED AT 12/31/29

86.87
12/22/29 1/22/30 6 A F F Foster
11/7/29 1/7/30 6 N P M Martins & Co
2.56
Total 15956.96 (C-2)
1.71
Show the above on the balance sheet as a foot-note.
.19
Verified by correspondence with the Industrial Trust Co. as per schedule C-2
.29

BALANCE SHEET PRESENTATION

Loan to Subsidiary — Pledged C-1 10000.00
Notes receivable — Trade 17626.02
Acceptances 19626.95
Total 47252.97

56.96
19.27

271.57 Balance per G/L is $ 270.00 PASS HF

163. Explanation and Comments-- This exhibit shows that the auditor verified the manner in which each note arose. From such an inquiry he learns a great deal that he would otherwise miss. For example, he feels more certain, after this inquiry, that the notes are not bogus, and that he is also seeing the particular notes called for by the books of account. But far more important, perhaps, is the fact that he learns the history of each note such as: this one is a renewal; this one is in payment of an old account; this one — — — — — etc.
Evidently the auditor accounted for the cash and securities on 1/28/30. The general ledger balance of notes at 12/31/29 was secured by adding the notes paid up since in cash, plus the renewals. Note that the accrued interest receivable at 12/31/29 was computed one this schedule, and that the auditor did not try to change the error of $1.57.
The reader ought also to observe that on a well executed exhibit there will be a summary of complete information for use in drawing up the balance sheet presentation.
<table>
<thead>
<tr>
<th>Dated</th>
<th>Int. Due</th>
<th>Rate</th>
<th>Maker or Acceptor</th>
<th>Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/25/28</td>
<td>6</td>
<td>12/24/30</td>
<td>M F Worcester (President)</td>
<td>Loan</td>
</tr>
<tr>
<td>12/6/28</td>
<td>6</td>
<td>1/5/29</td>
<td>F K Arnold &amp; Son</td>
<td>(X) Renewal</td>
</tr>
<tr>
<td>11/3/28</td>
<td>6</td>
<td>1/2/29</td>
<td>Cushman Bros. Inc.</td>
<td>Merchandise</td>
</tr>
<tr>
<td>1/17/29</td>
<td>6</td>
<td>2/16/29</td>
<td>Wightman and Crawford</td>
<td>&quot;</td>
</tr>
<tr>
<td>1/14/29</td>
<td>6</td>
<td>3/15/29</td>
<td>M N Koechling</td>
<td>&quot;</td>
</tr>
<tr>
<td>3/3/29</td>
<td>6</td>
<td>5/2/29</td>
<td>MacLean Sons</td>
<td>&quot;</td>
</tr>
<tr>
<td>6/26/29</td>
<td>6</td>
<td>6/27/29</td>
<td>The Jordan Company</td>
<td>&quot;</td>
</tr>
<tr>
<td>6/15/29</td>
<td>X</td>
<td>8/14/29</td>
<td>Gooch &amp; Gooch</td>
<td>&quot;</td>
</tr>
<tr>
<td>7/12/29</td>
<td>X</td>
<td>8/11/29</td>
<td>The Hazel Mfg. Co.</td>
<td>&quot;</td>
</tr>
<tr>
<td>9/29/29</td>
<td>6</td>
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<td>Thornley &amp; Crawford</td>
<td>&quot;</td>
</tr>
<tr>
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<td>6</td>
<td>12/1/29</td>
<td>N N Smith Sons</td>
<td>&quot;</td>
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<tr>
<td>11/16/29</td>
<td>6</td>
<td>1/14/30</td>
<td>John R Roper</td>
<td>&quot;</td>
</tr>
<tr>
<td>11/28/29</td>
<td>6</td>
<td>1/26/30</td>
<td>Seth Holden</td>
<td>&quot;</td>
</tr>
<tr>
<td>12/26/29</td>
<td>6</td>
<td>2/24/30</td>
<td>( # ) George B Parker (Treasurer)</td>
<td>Loan</td>
</tr>
</tbody>
</table>

A Acceptances  
N Notes  
(X) First note taken for merchandise on 11/6/28  
(#) 6% interest in the face of this note

164. *Explanation and Comments.*— This exhibit shows all of the entries in the general ledger account for the entire year, together with a full accounting for all of the interest. Naturally, this type of schedule is rarely developed except when the items are very few. Even in a complete audit, all of the interest would not be accounted for, because frequent testing is held to be sufficient except where there are suspicions of irregularities, etc.

Note that the auditor passed over the error of not deferring the $4.58 interest received in advance.

Also note that the audit procedure is not given on the schedule, the reader being referred to the audit program for it.

Finally, note that when there is no interest rate, it is better to indicate it than to leave the space blank, for the latter might occur through error on notes that do bear interest.
<table>
<thead>
<tr>
<th>Amount</th>
<th>C collected</th>
<th>D discounted</th>
<th>Out.-</th>
<th>Int.</th>
<th>Int.</th>
<th>Int.</th>
<th>Accrued</th>
<th>Interest Received in</th>
<th>Interest Rec'd in</th>
<th>Balance 12/31/29</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>stand-</td>
<td></td>
<td></td>
<td></td>
<td>in 12/31/29</td>
<td>12/31/29</td>
<td>1929</td>
<td>12/31/29</td>
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<td>3.00</td>
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<td>5.00</td>
<td></td>
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<tr>
<td>6500.00</td>
<td>C</td>
<td></td>
<td>27.08</td>
<td>5.42</td>
<td>32.50</td>
<td></td>
<td></td>
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<tr>
<td>1300.00</td>
<td>C</td>
<td></td>
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<td></td>
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<td></td>
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<tr>
<td>Balance 12/31/29</td>
<td>7387.85</td>
<td>42.65</td>
<td>507.20</td>
<td>520.85</td>
<td>28.56</td>
<td>4.58</td>
<td></td>
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<td></td>
</tr>
</tbody>
</table>

BALANCE SHEET PRESENTATION

| Notes and Acceptances Receivable | 3862.85 |
| Notes Receivable—Officers | 3505.00 |
| Per Books | 7387.85 |

See Audit Program for the audit procedure

(Student's Note: Observe that the auditor is in error in using the caption "Notes and Acceptances Receivable". There aren't any acceptances in the final 12/31/29 balance.)
without seeing those actually called for by the books. But the procedure just mentioned (auditing the account) covers this point, because the auditor knows from his analysis of the account whose notes he ought to see. Moreover, this procedure reveals the history of a note. For example, the analysis may show the note to be a renewal, or a receipt in full of an old account, or the acknowledgement of a loan, etc. This sort of information is invaluable to the auditor in properly evaluating the notes as to collectability. It is also vital information in classifying the notes on the balance sheet as current or fixed, or as trade, officers, affiliated interests, loans, etc.

167. Aging the Notes.--In checking this "Account Creditos" column, the auditor can also age the notes by obtaining the original dates of the renewed notes, or of the account receivable balances paid off by the notes (Plates 50 and 51). In doing so he may find, for illustration, that F. Co's note renewed one dated three months earlier, and that this note in turn was taken on an account balance that was then overdue one month. Clearly then, the auditor needs to trace the notes back to their very source as a basis for setting up the proper reserve for bad debts. Moreover, the auditor should investigate the client's previous experience with the maker, and also his rating.

168. Payments After the Audit Date.--Another valuable piece of information on collectibility can be developed for the report on the schedule by noting the cash received after the audit date on the notes composing the audit balance. The auditor, by waiting until just before his departure to get these figures, is thus able to show that such and such notes were good without any question whatsoever. What more definite and important information about the notes could the report possible contain?

169. Signatures.--One of the prime essentials in the checking of the notes to the schedules is to make certain that the notes are negotiable by the client. Cases have often been met where the notes (with payees other than the client) did not have the proper, or in fact any, endorsement.

In respect to all signatures (maker's, acceptor's, endorser's), the auditor is naturally not in a position to pass upon them. Nevertheless, he should look at them lest for some reason or other the forgery (if any) be so clumsy that any reasonably prudent person would know that something was wrong. Of course, the auditor ought always to prepare (or check if prepared by the client) his schedule from the general ledger account so as to know before hand whose notes, (and hence whose signatures), he ought to have presented to him for inspection.

Furthermore, the auditor should see if the notes have been endorsed by the client. If so, the auditor should assume, until the client proves otherwise, that the notes were pledged at the audit date or were used to make good a cash shortage.

170. Confirmation of Notes.--In tallying the notes, the auditor will customarily find that most of them are on hand, but that others are

Although it is possible for a note to be a mere dummy (as the auditor does not know the maker's signature), the auditor does not ordinarily confirm notes receivable by direct correspondence (1) unless it is unusual to accept notes in the client's line of business (2) unless they are overdue (3) unless they are exceptionally large (4) unless they are due from officers, employees or affiliates (5) unless the client is a loan company, in which case at least a test must be made, or (6) unless
out for collection, or in hands of attorneys for prosecution, or with certain holders as collateral, or have been paid up in cash or renewed and so on.

Obviously, those in existence, but not on hand, are subject to personal confirmation. If the holder is a collection attorney, the auditor should have in mind the possible necessity of creating a reserve for the note. Where notes in existence are not on hand, nor discounted, nor out for collection, nor with attorneys, the auditor should always assume, until proven otherwise, that such notes are being held as collateral. Clearly, the setting forth of such a lien on notes is a major function of an auditor, requiring that such notes be separately stated and distinctly labelled.

771. Contingent Liability on Notes.—One of the every day experiences of the auditor is to find that some of the client’s notes and acceptances have been discounted. As a matter of good business, this policy of discounting notes and acceptances is generally to be recommended, although some few business men regard it as a sign of weakness. The writer feels that it is the function of banks, not the business man, to extend credit. Moreover, fewer notes will go bad because the maker will think twice before dishonoring a note whose collector is a local bank. Many a person has ruined his future credit at banks by having dishonored his trade notes.

Of course, the auditor is interested in only those discounted notes and acceptances which have not yet matured. Such receivables constitute what is known as a contingent liability. The contingency in this particular case is that if the maker (or acceptor) fails to meet his obligation when due, the client, because of his endorsement of the note (or acceptance), will have to reimburse the banker. Of course, the client, on getting the dishonored note, may be eventually able to collect, so that a loss is not always suffered. Nevertheless, enough total or partial losses of this kind are borne yearly by businesses as to make it extremely important that the auditor cover and report upon this point. Notes said to be discounted Without Recourse must be verified independently, because it is a rare occasion to find anyone who will discount a note under these terms.

If a note receivable register is in use, those under discount at the audit date can be readily ascertained by reviewing the “How Disposed” and “Maturity” columns. If only a ledger account exists, the information will have to be secured by an analysis of it. In such cases, the auditor will find it profitable to persuade the client’s accountant to use a Notes Receivable Discounted account.

After having ascertained a list of the notes and acceptances under discount, and having secured the assurance of the client that no others exist, the auditor will proceed to get an independent check of it by personally communicating with those through whom they have been discounted. A question on this point should also be included on each and (cont’d) the system of internal check is very poor, etc. The auditor relies on such corroborative evidence as (1) receipt and payment of previous notes by the same maker (2) payment of the note before the auditor leaves (3) receipt of interest on it (4) receipt of partial payments (5) statement of the notes included on the monthly statement of the account (6) system of internal check (7) shipping records (8) collateral held, and so on. However, if the client does not object to circulating the makers of the notes receivable the auditor is NEGLIGENT (in the writer’s opinion) if he fails to do so.
every confirmation form sent out, even though the records do not show any notes as having been discounted by the particular bank to whom the form is being sent.

In setting forth this important information on the balance sheet, auditors use many methods in order to satisfy the various whims of their clients. For example, a simple one is merely to make a note of the fact on the balance sheet, as, "Note: As of the audit date there was $75000 worth of Notes Receivable under discount." A second simple method is as follows:

<table>
<thead>
<tr>
<th>Notes Receivable</th>
<th>$190,617.12</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loss - Notes Receivable Discounted 1</td>
<td>75,015.87</td>
</tr>
</tbody>
</table>

A third method is to show the notes receivable gross (i.e. including those under discount) on the asset side, and the amount of the discounted notes as a liability.

If notes or acceptances are sold with a guarantee, the contingent liability is about the same as if they had been discounted.

In computing the number of days of accounts and notes receivable outstanding (i.e. uncollected), it seems to the writer that a great mistake is made by not including in the computation those notes and acceptances under discount. Since discounted notes are certain not "collected", the fact that they are merely discounted does not take them out of the computation. For example, the collections of Company A with $50,000 worth of notes under discount are certainly not in better shape than those of Company B with $50,000 of uncollected notes; despite the fact that Company A's notes receivable account may have a zero balance.

In reviewing notes and accounts for possible bad debts, those under discount must be reviewed. Many auditors "forget" to do this.

The accrued interest on discounted notes is not often set up.

172. Collateral Notes.—In examining collateral notes, the auditor must always find out why the collateral was necessary, because such notes are the exception and not the rule. In all cases, for example, the auditor must account for the collateral, taking special care to see that it is endorsed or accompanied by a power of attorney, or otherwise made negotiable in case of default on the note. One further step ought also to be taken; namely, to ascertain, if possible, some idea of the worth of the collateral. Some collaterals have turned out to be good fodder for waste baskets. On special occasions, or in special businesses, or banks, the auditor may deem it advisable to personally confirm the collateral, at least by tests, with its owners.

In classifying collateral notes as a separate note receivable item on the balance sheet, the term "collateral notes receivable" is sufficient to denote that they are secured. Rarely ever is the nature and amount of the collateral stated upon the balance sheet, but the report will usually contain the full details thereof.

173. Notes of Officers, etc.—Notes representing loans (and other items) to officers, stockholders, employees, etc. must be stated separately on the balance sheet. Ordinary trade notes are excepted.

Bankers always want to be informed as to whether or not the notes have been discounted through the client's banks, or through outside agencies such as a discount or finance company. When collateral is held by a client without there being any independent source on hand to show the auditor the nature and amount thereof, he must confirm it, and of course the note also by direct correspondence.

Where the value of the collateral can be ascertained and/or where the nature of the collateral can be given concisely, the auditor should do so parenthetically.
This separation is always made in certified statements because the term "Notes Receivable" means notes unmatured, free from liens, and arising from trade. A further substantial reason for separating such items is that many notes falling in this group are practically nothing but unsecured borrowings by those in power. This sort of information is always demanded by the banker and credit man as a prime essential in forming an opinion about the strength of character of the officer personnel of a business. And when the notes are sizable, as they often are, the current position of the business is probably less liquid than if the notes were due from businesses.

Of course, all of these notes must also be classified either as current, or as fixed—as the facts may warrant. Thus a $500 note due from an employee (who was loaned the money to meet hospital bills—a proper loan made to create goodwill among the organization) who is paying it back at the rate of $10 a month, say, is NOT a current asset. They must also be verified by direct correspondence.

174. Notes Representing Loans.—Notes representing loans to other businesses must be stated as a separate item on the balance sheet, because it is not the function of an ordinary business to loan money. Care must also be taken to ascertain the proper classification as current or fixed. If fixed, its classification is generally under investments. The notes must be verified by direct correspondence.

175. Notes of Affiliates and Subsidiaries.—Notes of affiliated interests, whether representing loans or trade receivables, are always stated separately from other loans or trade notes.

At times these notes cannot be pressed for collection to the same extent as are those of ordinary outside customers, because to do so would be equivalent to collecting from one's self. For example, suppose A Company owns B Company and has large trade receivables due from B Company. If, now, times are bad, it may be that A Company cannot collect from B Company without ruining it, which of course A will not do. How different the case would be if B Company were an outsider! Furthermore, those persons making use of the balance sheet desire to know the full extent of the interest of the client in other businesses, particularly as these advances by way of loans and trade credits are generally sizable and often approach in amount the value of the investment in the subcompany's stock.

Again, consider the case of a parent company which, finding itself in December with too heavy an inventory of finished foods, makes heavy sales to the subsidiary in return for notes receivable. Is it not clear that these notes are not notes but inventories; as would be shown if a consolidated balance sheet were prepared? How important, then, that notes of subsidiaries and affiliated interests be stated separately on the balance sheet. In short, accounts and notes receivable due from subsidiaries are not accounts and notes, but rather some other asset which they represent. This fact is clearly shown when a consolidated balance sheet is prepared, for these receivables are automatically cancelled out against the corresponding payables on books of the respective subsidiaries.

It must also be remembered that a note receivable due from a subsidiary is after all NOT a note receivable, for, in a consolidated balance sheet the receivable of the parent company is cancelled against the subsidiary's payable. Hence, for example, it is often true that a note receivable due from a subsidiary (or vice versa) is really machinery at inter-company SALES PRICES. This is obviously an altogether different asset than a "genuine" note receivable due from a totally outside customer.
Here again, some of the notes may be properly classified as current, whereas others must assuredly be stated as fixed under Investments. In ascertaining these evaluations, the auditor generally analyzes the statements of the subsidiary. Thus if the note receivable arose from a loan of money to the subsidiary which in turn uses it to purchase machinery, the likelihood is that the current ratio, as per the balance sheet of the subsidiary, will definitely show that there is no possibility of the subsidiary meeting the notes when they come due.

Where feasible, as with affiliates and subsidiaries for example, the notes and acceptances on hand should be confirmed. But ordinarily an auditor is satisfied with the inspection of a note and an examination of the book entry. In fact, unless he is suspicious that a note is bogus, he generally conforms to the client's desire that no confirmation be made, lest it tend to upset or annoy a customer.

In cases where there are large notes, or notes of affiliated interests, to repeat, the auditor should secure a personal confirmation. In the first instance, the importance of the note fully warrants the independent confirmation, and, in the second case, the client's objection (disgusting at times because so groundless) is no longer valid, for there is no danger of losing the trade of an affiliated interest because of the supposed annoyance at the request for confirmation.

176. Large Notes.— If a note is of large amount in comparison with the other notes, it must be named separately in the report, and, if extremely sizable, good practice warrants its being set forth on the balance sheet. The reason for this procedure is that a canon of good auditing procedure is that all unusual items, including those of large amount, must be clearly reflected, for otherwise an essential fact has been concealed.

If the client objects to the auditor's methods, the very reason for his objection is prima facie evidence that such a note has an essential bearing upon the status of the business. Therefore, if an auditor fails to separate such notes, he must be exceedingly well prepared to justify his unusual position. Suppose, for example, that the sum of forty trade notes amounts to $125,000, of which one note is for $80,000. Is it not clear that here is a situation whose complexion depends upon a single note? How important, then, is that the auditor's report sets forth this fact in detail? And, in such a case the auditor should look up the credit rating of this customer of the client.

177. Testing Through the Interest Account.— In balance sheet audits, the interest account is often checked against the note account, not
only to verify the correctness of the item of Accrued Interest Receivable, but also to prove from this angle that no note has been omitted from its account.

178. Simultaneous Notes and Cash Verifications.—As stated under cash, all negotiable items ought to be accounted for in the presence of a representative of the client, and at the same time as the accounting for cash. For example, if an auditor were to count securities, notes, etc. as of December 31, and reconcile the cash later as of, say, January 9, a schemer could cash or pledge some of the audited notes after December 31 in order to secure for deposit on January 9 (or any date after December 31) the cash he is short. Obviously, a reconciliation of cash and a count of securities simultaneously, or with the use of other safeguards, such as sealing, etc., would disclose such a manipulation as just explained.

If a note (or security) bears the client's endorsement, it is essential for the auditor to be on guard, as it strongly suggests that the note was borrowed upon, and then released upon the loan's being paid up. A full and satisfactory explanation of it should be secured from the person in charge.

No negotiable item should be released, after it has been seen, until the whole verification of cash, negotiable instruments, and stamps, has been completed AND found to be in accord with the records.

179. Renewals.—In examining an old note which has been renewed, the auditor should ascertain if the accommodation endorser, if any, has also renewed its guarantee, for one must remember that it is released (on its pledge to meet the payment if the instrument is not paid by its maker (or acceptor) as soon as the original maturity date expires. Hence, to repeat, the auditor must make inquiry on this point, lest his client consider the guarantee to be good until payment is received.

180. See Plate 52.
181. See Plate 53.
182. See Plate 54.
183. See Plate 55.
184. See Plate 56.
A FORM OF DOMESTIC BANK ACCEPTANCE PLATE 52

No. 62  Austin, Texas  July 19, 1929  $ 13445.00

Three Months  After  Sight
Pay to the order of MacMillan Bag Company
Thirteen thousand four hundred forty-five  Dollars
To The Third National Bank Charge to Wightman Bros.
Low Ave at Warren Ave  7 Myrtle St.
Cambridge  Cambridge
Massachusetts  Massachusetts

Date July 27, 1929
Bank The Third National Bank
Location Cambridge, Mass.
By F.K. Walker, Cashier

180. — Explanation and Comments. — The transaction giving rise to this acceptance was as follows: Wightman Bros. of Cambridge, Mass., having bought some bags from the MacMillan Bag Company of Austin, Texas, arranged with The Third National Bank to accept the draft in exchange for the bills of lading, which will give Wightman Bros. the title to the goods at the freight yards.

After the bank has accepted the draft, it is responsible for its payment on October 27, 1929. But as Wightman Bros. have agreed to place funds in the bank by that date to meet the draft, the bank merely expects to extend the use of its credit to Wightman Bros., for which, of course, a fee is charged.

On receipt of the bank acceptance, the MacMillan Bag Company at Austin, Texas will either hold it until maturity or discount it at some local bank. The acceptance is, of course, readily discounted because it is the debt of a bank, The Third National Bank.

1Sometimes, however, the bank will not release the title to the buyer except in piecemeal quantities in proportion to the amounts paid upon the acceptance.
A FORM OF THREE PARTY DRAFT PLATE 54

No. 45 Pawtucket, R.I.       June 12, 1929   $ 500.00

--Two months--       AFTER Date

Pay to the order of William N. Halliwell

-- FIVE HUNDRED -- DOLLARS

Drawn By E. Wilson, Inc.  
E. Wilson, Treas.

To Peter Hobson, Inc.

79079, Eddy St.

111 Hendricks Street

Providence, R.I.

Cranston, Ark.

Date: June 12, 1929

Payable at The Rice Street Trust Company

Accepted by Peter Hobson, Inc.

182. Explanation and Comments. - In this draft E. Wilson, Inc. drew on Peter Hobson, Inc. in favor of William N. Halliwell, i.e., Peter Hobson, Inc. owed E. Wilson, Inc. which in turn owed William N. Halliwell. On receipt of this draft from E. Wilson, Inc., William N. Halliwell will look to Peter Hobson, Inc. to pay it on August 12, 1929 at The Rice Street Trust Company.
161. Explanation and Comments.—A draft is like a trade acceptance, except that a draft does not have to arise out of a purchase of goods from the drawer. It may, for example, arise from a loan of money by the drawer. A trade acceptance, on the contrary, by stating on its fact that it arises out of a purchase of goods from the drawer, must arise in that way only.

The advantages of a commercial draft are said to be these:

(1) If the draft accompanies a bill-of-lading, the purchaser must pay for the goods (i.e. the draft) before he receives them (i.e. the bill-of-lading).

(2) If an account is overdue, a draft sent to the debtor's bank is very apt to be accepted because a refusal to accept will destroy the debtor's credit standing at his bank.

(3) The drawee can secure his money immediately by discounting the draft provided, of course, his (the drawee's) credit is good at his own bank.

(4) The burden of proof is upon the payee, if he denies his liability on the accepted draft, because his signature appears thereon as acceptor. If it were an open account, the burden of proof of the existence of debt, in case of dispute, would be upon the vendor.

(a) Sight Draft.—A sight draft is payable on presentation. For this reason the ACCEPTED section is not filled out. Ewing and Eddy would probably deposit the draft with its local bank. This bank would then forward it to a correspondent bank in Detroit. This Detroit bank in turn will send a messenger to Oldrich & Hobson Bros., who will give him a check made payable to the account of Ewing & Eddy, if they (O.& H. Bros) "accept" the draft. The Detroit bank will forward the check with bill for collection fees to the local bank. This Rochester bank will then credit the check to Ewing & Eddy's account, and charge them with all the collection fees.

(b) Time Draft.—As this draft was seen on August 9, 1930, it is payable on October 9, 1930, i.e. two months after sight.

When the Detroit, La. bank messenger was sent on August 9 to Oldrich & Hobson Bros., his duty was to get the ACCEPTED section filled out. No money exchanged hands at that time. Of course, as in all other cases, Oldrich & Hobson Bros. did not have to accept the draft if they did not want to do so.

By October 9, 1930 Oldrich & Hobson must have their check at The R. I. Trust Company of Detroit, Louisiana, payable to The State Trust Company of Rochester, Conn. for the account of Ewing & Eddy, and drawn for the principal and two months interest at 6% per annum.

The remaining procedure is like in (a) above.

(c) Time Draft.—As this draft is dated August 3, 1930, it is due October 3, 1930, i.e. two months after date, although it was not seen until August 9.

The remaining procedure is like in (b) above.
SEVERAL FORMS OF DRAFTS PLATE 53

(a) A FORM OF SIGHT DRAFT (TWO PARTY)

$705.16 No. 181 With interest at \( \frac{2}{3} \) Rochester, Conn. Aug. 3, 1930

At Sight

Pay to the order of Ourselves

Seven hundred five and \( \frac{18}{100} \) Dollars

Value received and charge to the account of Ewing & Eddy

To Oldrich & Hobson Bros. By F. K. Mury

7108 Cass Avenue

Detroit, La.

(b) A FORM OF TIME DRAFT

$905.00 No. 9 With interest at \( \frac{6}{2} \) Rochester, Conn. Aug. 3, 1930

Two months after sight

Pay to the order of The State Trust Company of Rochester, Conn.

Nine hundred five and \( \frac{6}{100} \) Dollars

Value received and charge to the account of Ewing & Eddy

To Oldrich & Hobson Bros. By F. K. Mury

7108 Cass Avenue

Detroit, La.

(c) A FORM OF TIME DRAFT

$405.76 No. 7 With interest at \( \frac{6}{2} \) Rochester, Conn. Aug. 3, 1930

Two months after date

Pay to the order of The State Trust Company of Rochester, Conn.

Four hundred five and \( \frac{76}{100} \) Dollars

Value received and charge to the account of Ewing & Eddy

To Oldrich & Hobson Bros. By F. K. Mury

7108 Cass Avenue

Detroit

Louisiana
AN AUDIT PROGRAM FOR NOTES RECEIVABLE PLATE 55

PHILPS & GOLDBERG, INC.

Audit Program
May 31, 1930

Holt
6-21-30

Date

Person

Omissions

Omissions

(7) Notes Receivable (Unmatured trade notes with no liens attached)

(a) Prepare a schedule as of 6/21/30, like the one in last year's work papers, from the Notes Rec. Register.
(b) Compare the total with the balance of the G/L account.
(c) Check notes on hand against schedule in all particulars. Do this at the same time as the cash count. All must be assembled together or otherwise controlled to prevent duplication or substitution, etc. Work from this date back to the date of the audit.
(d) In case of collateral notes, account for the collateral. Are these chattel mortgages? Ascertain its value. Confirm the collateral if the note does not disclose what it should be. Do this at the same time that you examine the notes.

(h) Inquire into the usual trade practice of accepting notes. How long are the usual terms? Are the notes usually discounted or held to maturity?
(i) Examine the notes for irregularities. Observe the endorsements of whatever nature, if any. Partial receipts should be endorsed on the notes.
(j) Ascertained the payments which have been received, on these notes, since the audit date. Check to Cash Book.
(k) Make a list of all overdue notes, with details.
(l) Confirm as at 5/31/30 and 6/21/30 all outstanding notes. Why are they not on hand?
(m) Ascertain and confirm as at 5/31/30 and 6/21/30 notes receivable under discount. Review them for bad debts, etc.
(n) Test through interest accounts for missing notes, etc.
(o) Make proper classification of notes for balance sheet presentation. Officers; Employees; Subsidiaries; etc.
(p) Confirm all notes overdue, or over $20,000 each. Confirm all notes if allowed.
(q) Confirm all subcompany notes.
(r) Look up the rating of all notes over $20,000. State the results. Determine financial status of maker and endorsers, if any.

(w) Ascertain the necessary reserve for doubtful notes. Review notes written off. What authority is necessary? See (m) above also. Do not include interest on overdue notes unless collectible.
(x) If any notes have been received in payment of
AN AUDIT PROGRAM FOR NOTES RECEIVABLE PLATE 55 (Continuation)

14-23

(*) Capital stock subscriptions, ascertain whether or not this action is permissible under the by-laws, charter, and state law.
(y) Be careful to get the full and correct facts as to the primary transaction or transactions that gave rise to it.
(z) Trace notes discounted into the Cash Receipts Book. Confirm at banks, etc.

183. Explanation and Comments.-- This exhibit is a section of an audit program at item #7—Notes Receivable.
Note that a reserve is just as vital in stating notes receivable as it is in evaluating accounts receivable.
This program is for a balance sheet audit. In a detailed audit the "ins" and "outs" of the account during the year would be audited, together with a more detailed examination of the interest account.
The student should study carefully this and the other audit programs as they represent in summary form the sum and substance of the text material.

"The following means are at times adopted to cover irregularities with notes receivable:
(a) Claiming that notes are out for collection.
(b) " " " " as collateral.
(c) " " " " for renewal.
(d) " " " have been discounted.
(e) Submitting notes which are not genuine.
(f) Failing to indorse all partial payments on the notes."

By F.W.K.
A FORM OF FOREIGN BANK ACCEPTANCE PLATE 56

London, Egypt  April 28, 1931  $147,689.17

- - - Ninety Days - - - - - - AFTER - - - Sight - - - - - - -

Pay to the order of - The Chelsea Bank, London, Egypt - - - - - - -

- One Hundred Forty Seven Thousand Six Hundred Eighty-nine and 17/100 Dollars

For Value Received and Charge the Same to Account of ____________________________

-- The Boston Cotton Products Co., New York, N.Y. - - - - - - - - -

To The Washington Street National Bank  Drawn by and for the Account of

New York, N.Y.  Fouchs & Cleary, Inc.

U.S.A.  R.M. Fouchs  Treasurer

171 Riley Road

London, Egypt

No. 1017  The transaction which gives rise to this instrument is

the exportation of  Cotton  from  Egypt  

to  New York, N.Y., U.S.A.  

ACCEPTED

Date  May 30, 1931

Payable at  7181 1/2 Nassau St., New York, N.Y.

Bank  The Washington Street National Bank

By  Robert Mason  Cashier

184. Explanation and Comments.-- This plate is self explanatory.
REVIEW QUESTIONS

1. Why does an auditor analyze the interest account in connection with the audit of notes?
2. Describe three ways of showing the notes receivable discounted on the balance sheet.
3. How would you ascertain what notes were discounted?
4. Why are bankers and credit men interested in the amount of notes due from officers?
5. Why should the note account be audited? How can an auditor prepare his schedule without auditing the account?
6. What notes on hand (if any) would you confirm?
7. How does an endorser of a discounted note receivable know when the maker has paid it?
8. Why is there less work involved in auditing notes receivable at the audit date than at a later date?
9. Why is a note considered to be more liquid than an account?
10. Describe how you would audit notes secured by collateral.
11. Describe the workings of a Notes Receivable Discounted account.
12. What is meant by the term "Without recourse" on the note in plate 47?
13. Draw up and fill in a schedule like plate 50. Give on a separate sheet a full explanation of all of the interesting points involved.
14. Draw up a trade acceptance and give its history, telling how it arose, the hands it passed through, etc.
15. What requirements must a trade acceptance meet in order to be eligible for rediscount at a district Federal Reserve bank?
16. Would you advise a business to discount its notes receivable and its trade acceptance? Why?
17. Why should the cash and the notes be accounted for simultaneously?
18. Why isn't it advisable or necessary to confirm all of the notes on hand?
19. Why should an auditor examine the various signatures on a note?
20. What is meant by the term Without Recourse?
21. Is it necessary to confirm notes not on hand for inspection? Make a complete answer.
22. Describe clearly all of the steps you would take to audit the Notes Receivable Discounted.
23. Name some of the various places (or people) which might be holding your client's notes.
24. Draw up and fill in a schedule like plate 51. Give, on a separate sheet, a full explanation of all of the interesting points involved.
25. Is it advisable for a business to loan to its workmen?
26. When is it ultra vires for one business to loan to another business?
27. What are some of the important points to be kept in mind when one is auditing Notes of Affiliated Interests?
28. What balance sheet treatment would you give protested notes? Overdue notes?
29. Why is it permissible to allow the client to draw up the note schedule on regular audit paper headed-up by the auditor?
30. Draw up a power-of-attorney giving the bank the right to sell $10,000 (par value) Holden & Brooks, Inc. 7% gold debentures, if you fail to meet your note for $7000.
31. Take the specific procedure Audit Program (Plate 55) given for Phelps & Goldberg, Inc. and translate it into a general procedure audit program.
185. General Discussion.

186. Definition of Accounts Receivable.

187. Auditing the Underlying Records and Vouchers.

188. Auditing the Journal.

189. Checking Postings.

190. The Receiving and the Shipping Records.

191. The Schedule.

192. Explanation of Plate 57.

193. Explanation of Plate 58.

194. Explanation of Plate 59.

195. Explanation of Plate 60.

196. Explanation of Plate 61.

197. Explanation of Plate 62.

198. The Reconciliation of the Personal Ledger.

199. Verification of Bad Debts, etc.

200. How to Judge Overdue Accounts.

201. Unrecorded Deductions.

202. Accounts of Affiliated Interests.

203. Accounts of Subsidiaries.

204. Installment Accounts.

205. Accounts Sold and Guaranteed.

206. Allowances for Cash Discounts.

207. Confirmation of Accounts Receivable.

208. Certificate on Accounts Receivable.

209. Explanation of Plate 63.

210. C.O.D. Sales.

211. Explanation of Plate 64.

212. Explanation of Plate 65.

213. Consigned Goods.

214. Deposits.


216. Credit Balances.

217. Loans to Officers and Employees.

218. Advances to Subsidiaries.


220. Stock Subscriptions.

221. Accrued Income.

222. Explanation of Plate 66.

223. Explanation of Plate 67.

224. Explanation of Plate 68.

Review Questions.

185. General Discussion.—At the outset of this chapter, the reader's attention is called to the fact that the auditor ought first of all to get acquainted with the particular business under audit, and also with business trends in general as affecting this business. By this the writer means that the competent auditor, particularly on his first audit, will inquire into the kinds of products sold, into the condition of the sales market in respect to these goods, into the length of the credit granted, into the existence or non-existence of a credit department (and if there is one he should find out just how it functions and just how efficient it is, as
reflected by the amount of bad debts for the past few years), and into all other pertinent matters which give the auditor that bird's eye view of the business so necessary to pass intelligently upon the collectibility of the accounts, and upon the effectiveness of the system of internal check at this point.

For example, how erroneous and foolish it would be for an auditor to rush in headlong into classifying the November sales as one to thirty days overdue, when the actual credit terms of this particular business may be sixty days net! Or again, how incompetent the auditor can make himself appear to a credit manager if he (the auditor) recommends that certain overdue accounts be fully covered by a bad debt reserve, whereas the credit manager is able to show him that the delinquency is due solely to a TEMPORARY and widely known business depression, crop infection, flood, drought, or what not (which an alert auditor should know about) in the particular community where the debtors reside! On the other hand, the auditor should be so well posted as not to be led into tacitly accepting the credit manager's opinion that the underlying causes of the slow receipts of cash on account are temporary, whereas the currently available facts are that the locality is definitely on the decline, or permanently crippled for a number of years, etc., as the case may be.

186. Definition of Accounts Receivable.—The term accounts receivable has a definite limited meaning to the auditor. It may be stated as being "accounts arising from sales only." Claims against carriers, loans to individuals, and so on, are not, therefore, properly classified as accounts receivable. To make this distinction forceful, the common designation of Accounts Receivable—Trade, or Trade Debtors, is recommended.

187. Auditing the Underlying Records and Vouchers.—In a detailed audit, the logical point in auditing the accounts receivable is to examine, by thorough tests and scrutiny, the underlying records and vouchers, and thence to proceed into the ledgers. To be specific, the sales invoices should be checked against the sales book, the credit memos against the return sales book, the shipping record against the sales book, and so on, until a certain period, say February, June, and December, has been covered in respect to accounts receivable in all books of original entry.

This period should then be footed and posted to the general ledger, and in part, or in whole, to the personal ledgers. Beyond this verification, certain books of original entry will generally be vouched more extensively. For example, the journal might be selected to be vouched, footed, and posted during the whole year in respect to accounts receivable. Or again, the sales book might be the record selected to receive further auditing. In brief, one record is apt to be audited more thoroughly than its neighbor, either because the auditor feels that the one is more important than the other, or that the system of internal check does not adequately cover the one record, but does sufficiently cover the other record; and so on.

188. Auditing the Journal.—The writer selected the JOURNAL to illustrate the book that might be audited for more than the selected limited period, February, June, and December, because in practice it is very often examined and vouched critically for the whole year in regard to ALL entries—not only the accounts receivable. In fact, this detailed analysis

In rare instances the auditor may find that sales of plant property are mistakenly entered as sales. If so, he must carefully weed out all such errors. See Appendix C, Sec. 14—#1, #2, #3, #4, #5, #6.
of the journal is often made in balance sheet audits, because of the tremendous importance of the types of entry that originate here. Dividend declarations, depreciation charges, depletion charges, amortizations, surplus adjustments and appropriations, adjustments for bad debts, adjustments of errors, accruals, closing entries, and so on ad infinitum, have their origin in the journal, and, as they represent items of major importance, the journal, to repeat, is often audited from cover to cover.

In respect to the journal entries on accounts receivable, the auditor must satisfy himself that they are authorized. Because thefts of cash received from customers are very often concealed by charging off the accounts as bad debts, and so on, the auditor feels it an essential procedure to scrutinize all credits to accounts receivable. Furthermore, the auditor should state in his report, or otherwise call to the attention of the client, the list of bad debts charged off.

An excellent type of journal system is one where each journal entry is supported by a voucher approved by a "high official", in addition to the bookkeeper (Plate 25). But even here, auditors have found that these vouchers have been tampered with by making insertions after the "high official" has signed. Of course, one remedy for this is to have the "high official" keep the duplicates for the auditor to use in auditing the journal.

189. Checking Postings.-- In either a balance sheet audit or a detailed audit, all entries in the Accounts Receivable account in the general ledger should be checked and footed, special care being taken to analyze entries from unusual sources.

In respect to postings to the personal ledgers, a short period, perhaps only a month, may be profitably covered in a detailed audit but this is rarely done in balance sheet audits. In conjunction with this posting, certain accounts should be selected at random, and certain ones with a purpose in mind, to be checked out in complete detail from the personal ledger back into the book of original entry. This type of auditing, called the "analytical method", is a most necessary adjunct to the ordinary "check method" of auditing, as it will often detect fraud that cannot otherwise be readily found. To illustrate, suppose a bookkeeper needed to pass a credit to the extent of his theft to a certain account in the personal ledger. He could cover himself by making a credit direct in the personal account and also an offsetting debit entry in some other personal account, and still have the balances of the personal accounts agree with the controlling account. No amount of ordinary checking less than a complete check would be likely to catch these two false entries, whereas the "analysis method" MAY detect it.

Credits for sales allowances must be covered by properly authorized and initialed Credit Slips. When the amount is large, the genuineness of the entry should be substantiated by the auditor by reference to correspondence, etc. Where return sales are concerned, the Receiving Record should be examined in proof thereof. Where the engagement is a detailed audit, and is held from year to year, the auditor can profitably audit a certain portion of the accounts on each occasion, so that in due course all of the accounts from A to Z will have been covered. In the case of accounts receivable, more time should be given to checking of CREDIT postings than to the debit postings, because experience shows that frauds are commonly concealed by unauthorized credits. However, it must not be forgotten that major frauds committed by the management arise through debits not substantiated by actual sales.
190. The Receiving and Shipping Records.—In order to call the reader's attention to their real importance, the writer is devoting a paragraph to the salesmen's order book, and to the receiving and shipping records.

These underlying records are often ignored, but they are basic records and should be used in proving the accuracy and authenticity of the entries in the Returned Sales Book and in the Sales Book respectively. Fraud has been frequently uncovered by this auditing procedure as when, for illustration, a false credit has been passed to a personal account through the Returned Sales Book for returned goods which the receiving records failed to substantiate. So also, important errors, such as including in accounts receivable items not shipped until long after the audit period (or even at all), have been discovered by making use of the shipping records. Again, the client may have passed a credit to a customer at the close of the period, whereas the receiving record proves that the goods were then in transit, i.e. NOT in inventory.

191. The Schedule.—Whether or not an auditor will prepare an elaborate schedule of the accounts receivable will depend upon various circumstances; that is, such a schedule is not necessarily a part of every well executed set of working papers. Thus where the accounts run into the thousands, as in the case of department stores, an elaborate schedule would be out of the question. Plate 56 shows a schedule wherein the accounts are classified by age.

By such an analysis, the auditor's report is able to show to the management, or to a banker, or to a credit man, for example, an important summary picture of the collectibility of all of the accounts. Other important features of such a schedule are the separation of the debit and credit balances, the ascertaining of the amount of cash received upon the audit balances up to the time of the auditor's departure, the ascertaining of the date and origin of the oldest accounts, and the separating of the audit balance into proper subdivisions for use in the balance sheet.

Obviously, the best time to prepare the schedule is at the audit date because later on the accounts quickly become complicated with new debits and new credits. Where the auditor cannot be present at the audit date, he may request the client to prepare the schedule. On his arrival, the auditor will then proceed to check the schedule in detail, or at least by considerable testing. Some auditors, it may be mentioned, invariably ask the client to prepare this schedule, because the work is merely clerical and rather long.

Where the auditor does not prepare a full schedule, his customary procedure is to review the accounts individually, noting on a schedule the names of the accounts, and such details as are necessary; which seem

1 I.E., the RETURNED SALES had not been received by the client.
2 It seems advisable to reiterate that the auditor is interested in: (1) Whether or not the open balance at the audit date has since been liquidated and how; (2) Whether or not the balance represents or includes a charge of a past due dating, seeing that such items are generally in dispute; (3) Whether or not the balance is apparently correct from the face of the account (a few of the accounts may actually be footed); (4) Whether or not any accounts are overdue, remembering that special terms may be granted to certain customers; (5) Whether or not the balance represents certain specific invoices of recent date or is the net balance of the various debits and credits; (6) When the last payment on account was made and how much, and whether the current sales exceed the current
to him to need discussion with the credit manager, or other official. For a schedule of this type, see Plate 60. Such a schedule is adequately sufficient where there is a credit department to inform the management of the condition of the accounts, and where the auditor's report is to be used solely within the business.

192. See Plate 57.
193. See Plate 58.
194. See Plate 59.
195. See Plate 60.
196. See Plate 61.
197. See Plate 62.
198. The Reconciliation of the Personal Ledger. 1 Upon completing a schedule, such as that represented by Plate 58, the auditor will compare its balance with the general ledger balance of the controlling account (or accounts). 2 If the auditor's work does not check, he should ask for the "tapes", or other list, of the account balances which were taken off by the client's office force, rather than attempt to correct his errors alone by going over his work a second time. (Note that the writer does not deem it a disgrace for the auditor to admit having made such an error. Moreover, his duty to the client is to save time by using the "tapes").

Whether or not any adjustment will be made, whenever the details do not agree with the controls, depends upon the attendant circumstances. For illustration, if the audit is a first one and the details have never and can not be made to agree with the controls, the auditor will likely adjust the controlling account to the sum of the customers' accounts, if the former is the greater. But if the details exceed the controlling account, the latter should be allowed to stand as is until the correctness of the former is absolutely established by confirmation with the respective customers (assuming that the client permits it). On the other hand, if the audit is a familiar one, so that the auditor knows that it is only a matter of time before the error will be located, there is no need for an adjustment, and very likely even the audit report will not comment upon it. In between these two extremes are instances which will demand good judgment as to whether or not an adjustment is necessary, and whether or not they should be the subject of a comment in the report.

As a general rule, the auditor never attempts to locate the errors in the personal ledgers, when they do not agree with the controlling accounts, as this is a type of simple routine work which can be done much more cheaply by the client's force,—and sometimes more effectively. Of course, if requested specifically to do that type of work, the auditor should not refuse to do it because of a superior complex.

(cont'd) receipts; (7) Whether or not any dishonored notes or checks have been charged back, and how and when liquidated; (8) Whether or not any of the accounts bear notations of pledges, consignments, receivership, sale, etc.; (9) Whether or not all balances are accounts receivable — trade; (10) Whether or not credits during the last few days of the year to close old accounts are legitimate.

2 Sometimes the auditor will also find a Suspense Ledger to which doubtful accounts are transferred as soon as they become such. This procedure permits the one in charge of collections to keep close tabs on those receivables, even to the extent of writing up the history of an account across the face of the ledger itself. 3 In large department stores, etc., where there are many small accounts and several controlling accounts, it is often (if a good system of internal check) sufficient to examine two or three personal ledger sections leaving it to future audits to eventually check in rotation those remaining unchecked. 4 When the individual accounts
199. Verification of Bad Debts, etc.—As stated in the discussion on the journal (section 187), the auditor must go beyond the mere entries for bad debts, discounts, allowances, sales returns, and the like, for the purpose of satisfying himself that they are not being made to cover up fraud. Two of the best ways to cover the case of bad debts, for example, are either to list them in the audit report, or to show them to the proper official. Again,—an allowance for returned goods can be checked to the receiving records for verification.

200. How to Judge Overdue Accounts.—In judging overdue accounts, the auditor needs at least the following information.

1. Was the debtor chronically slow in his payments in the past? If so, the account is probably good.

2. What kind of an answer has been received to requests for payment?

3. How are business conditions where the debtor lives?

4. Is the balance being reduced, or do the current sales exceed the current cash receipts?

5. If the account is in the hands of an attorney, when was his last report and what did it say?

6. Is the balance for goods or for a dishonored note?

7. Is the balance composed of specific invoices?

8. Is the debtor bankrupt? What dividends have been received? What future ones are expected?

9. What is the debtor's credit rating in Bradstreet's, etc.?

10. Is any officer interested in the business?

11. What do the debtor's financial statements look like?

201. Unrecorded Deductions.—An auditor must make inquiry to see if substantial trade discounts, quantity discounts, or other significant deductions for freight, commissions, etc. are going to be allowed in the future on any of the present existing accounts receivable.

Sometimes, for example, the auditor may meet with the situation where a customer is going to be granted a substantial rebate should his purchases eventually reach a certain volume. If the situation at the audit date, or before the auditor's withdrawal, is such that there is no doubt but that the rebate will be or has been earned by the customer, the auditor should make an allowance adjustment to cover the matter. Or again,—if the sales terms to a particular customer (or customers) are f.o.b. customer's plant, the freight to be paid by the customer and deducted from the gross bill (as frequently happens), the amount of the reductions for freight from the gross billing in the accounts receivable might be worthy of the auditor's attention.

Whether or not these adjustments are entered on the client's books is usually unimportant, so long as the auditor's balance sheet, and profit and loss statement, reflect them.

In case the quantity rebates are to be recorded on the books, the following adjusting entry will be satisfactory in most instances.

(cont'd) receivable are carried in the General Ledger, a very useful audit check can be secured by constructing a controlling account from the totals secured from the General Journal, Sales Book, Cash Book, etc...

At this point it may be remarked that in the main most auditors do not make sufficient use of the client's correspondence files as a primary source of auditing material. Of course, the auditor must always realize (where he is suspicious of fraud) that the possibility exists that fictitious letters may be inserted or that correspondence may be purposely removed; but these cases are so rare under ordinary circumstances as to practically negative their existence.
### Individual Customer's Accounts - Plate 57

**Hawkins & Lester, Inc.**
711 George St.

<table>
<thead>
<tr>
<th>Date</th>
<th>Customer</th>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan. 7</td>
<td>S5</td>
<td>120.10</td>
<td>CR 18</td>
</tr>
<tr>
<td>15</td>
<td>S40</td>
<td>40.68</td>
<td>CR 31</td>
</tr>
<tr>
<td>Feb. 15</td>
<td>S89</td>
<td>119.02</td>
<td>CR 54</td>
</tr>
<tr>
<td>24</td>
<td>251.01</td>
<td>S105</td>
<td>248.61</td>
</tr>
</tbody>
</table>

**Merrill Bros.**
7 1/2 Hillside Ave.

<table>
<thead>
<tr>
<th>Date</th>
<th>Customer</th>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan. 2</td>
<td>S3</td>
<td>109.10</td>
<td>CR 7</td>
</tr>
<tr>
<td>3</td>
<td>S3</td>
<td>16.17</td>
<td>CR 33</td>
</tr>
<tr>
<td>20</td>
<td>S42</td>
<td>89.02</td>
<td>CR 41</td>
</tr>
<tr>
<td>29</td>
<td>S59</td>
<td>116.12</td>
<td>314.24</td>
</tr>
<tr>
<td>Feb. 27</td>
<td>297.26</td>
<td>S109</td>
<td>281.09</td>
</tr>
</tbody>
</table>

**E.L. Hopkins**
404 Rossville Ave.

<table>
<thead>
<tr>
<th>Date</th>
<th>Customer</th>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1931</td>
<td>Balance p. 207</td>
<td>586.45</td>
<td>CR 10</td>
</tr>
<tr>
<td>5</td>
<td>S4</td>
<td>112.57</td>
<td>CR 45</td>
</tr>
<tr>
<td>Feb. 20</td>
<td>S90</td>
<td>248.91</td>
<td>CR 45</td>
</tr>
<tr>
<td>27</td>
<td>1006.05</td>
<td>S109</td>
<td>348.02</td>
</tr>
</tbody>
</table>

**Shaw & Son**
61 Myrtle St.

<table>
<thead>
<tr>
<th>Date</th>
<th>Customer</th>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan. 2</td>
<td>S3</td>
<td>150.09</td>
<td>CR 19</td>
</tr>
<tr>
<td>12</td>
<td>S38</td>
<td>140.16</td>
<td>CR 19</td>
</tr>
<tr>
<td>Feb. 7</td>
<td>S69</td>
<td>61.47</td>
<td>CR 19</td>
</tr>
<tr>
<td>22</td>
<td>CP 51</td>
<td>152.34</td>
<td>504.06</td>
</tr>
</tbody>
</table>

192. **Explanation and Comments.**—(a) The account of Hawkins & Lester, Inc. shows an instance where the discount of an old item is in dispute. (b) The account of Merrill Bros. shows that the old balance of $16.17 has been ignored, whereas later sales have been paid up. (c) The E.L. Hopkins account is an illustration of where the old balance is increasing; as the current sales are more than the current receipts. (d) The Shaw & Son account shows a dishonored note charged back; i.e. that is what the auditor found on analyzing the entry from C.P. 51.

As stated in section 191, it is such irregularities as these which are the points of interest to an auditor when he is reviewing the collectibility of the individual accounts receivable.
A SCHEDULE ON ACCOUNTS RECEIVABLE (2d type) PLATE 59

The Rose, Bingham Company
Accounts Receivable
December 31, 1930

<table>
<thead>
<tr>
<th>Customer</th>
<th>Balance 12/31/30</th>
<th>Due 90 Days</th>
<th>Overdue 180 Days</th>
<th>Overdue 270 Days</th>
<th>Overdue 360 Days</th>
</tr>
</thead>
<tbody>
<tr>
<td>P T Aborne</td>
<td>215.14</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>S S Aloff</td>
<td>2589.75</td>
<td>2500.00</td>
<td>71.42</td>
<td>18.33</td>
<td></td>
</tr>
<tr>
<td>P Alzec</td>
<td>5.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A Bailey</td>
<td>1675.47</td>
<td>1392.21</td>
<td>218.14</td>
<td></td>
<td>65.12</td>
</tr>
<tr>
<td>T Barker</td>
<td>970.50</td>
<td>970.50</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>R Bask</td>
<td>124.29</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A Bates</td>
<td>396.65</td>
<td>127.42</td>
<td></td>
<td>271.23</td>
<td></td>
</tr>
</tbody>
</table>

---

OMISSIONS

| To BB | 16918.45R |
| To H  | 399116.94 259981.42 85691.27 24765.51 15114.27 9768.49 |

194. Explanation and Comments:—Note that the credit balances were sent to schedule BB, the schedule on Accounts Payable.

Your attention is directed particularly to the following columns:

1. Last Receipt, 2. Cash Received, and 3. Remarks.

Observe that when confirmations are sent out, some remarks are in order as to the results thereof.

Finally, the periods selected for aging the accounts vary widely with different types of business, and often among individual businesses of the same type. Consequently, some thought is required to select the proper significant classification periods.
### RIGHT SIDE OF PLATE 59

<table>
<thead>
<tr>
<th>Overdue Over 1 Year</th>
<th>Last Receipt</th>
<th>Cash Rec'd 12/31/30 to 2/7/31 on 12/31/30</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Date</td>
<td>Amount</td>
<td>Date</td>
<td>Amount</td>
</tr>
<tr>
<td>12/29/29</td>
<td>215.14</td>
<td>11/7/30</td>
<td>80.00</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12/20/29</td>
<td>58.61</td>
<td></td>
<td></td>
</tr>
<tr>
<td>11/7/29</td>
<td>65.66</td>
<td>1/15/31</td>
<td>240.00</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td>3795.98</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### AUDIT PROCEDURE

The accounts were tested by 450 confirmations sent out. This was approximately 55% of the number of accounts, but 63% in value. 65% of these customers (i.e. 295) replied. These 295 accounts constitute approximately 56% of all accounts (450), but 49% in value. Minor differences existed in 22 instances. These were straightened out before we left. No large unexplainable discrepancies existed. See schedule H1-a.

For audit procedure, see the Audit Program.
A SCHEDULE OF ACCOUNTS RECEIVABLE (3d type) PLATE 60

The Clarkson Manufacturing Company
Accounts Receivable Bad Debts, Etc.
Audit for the Year Ending July 31, 1929

<table>
<thead>
<tr>
<th>Account</th>
<th>Due</th>
<th>Remarks</th>
<th>Results</th>
</tr>
</thead>
<tbody>
<tr>
<td>7 The Small Wholesale May $657.19</td>
<td>Due</td>
<td>Provide a $200 reserve FF (Adj. #12)</td>
<td></td>
</tr>
<tr>
<td>25 Hadley Corp.</td>
<td>Can't this credit balance to be written off by Mr. of 5% be eliminated?</td>
<td>No auditor's adjustment. FF</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Omissions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>94 Holt &amp; Gooch, Inc.</td>
<td>April $181.43</td>
<td>Good. Chronically slow. FF</td>
<td></td>
</tr>
<tr>
<td>96 Calder &amp; Jordan Bros. May $97.37</td>
<td>Due</td>
<td>8/26/29 FF</td>
<td></td>
</tr>
<tr>
<td>96 Wightman Sons</td>
<td>March $64.89 April $30.65 Bankrupt. Provide reserve of $195.54. FF (Adj. #12)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dec. 1928 $100.00</td>
<td>Due</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Balance Sheet Presentation**

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr. balances</td>
<td>187643.19</td>
<td>(To B/S)</td>
</tr>
<tr>
<td>Cr. balances</td>
<td>6073.57</td>
<td>(To BB)</td>
</tr>
<tr>
<td>Balance per G/L</td>
<td>181569.62</td>
<td></td>
</tr>
</tbody>
</table>

Cash in the amount of $106,147.93 has been received by Sept. 18th on the July 31 balances. See D-1.

For audit procedure, see the Audit Program.

195. Explanation and Comments.-- Plate 60 stands for a type of schedule prepared by an auditor whenever he does not need a full schedule such as that shown by Plate 58.

The inference to be drawn from the schedule is that the auditor reviewed the accounts one by one, and noted what ones needed discussing with the credit manager, or other official. Note that the results of the discussion are always stated.

As also, note that in this particular case the audit procedure is not detailed on the schedule, but that reference is made to the audit program.

The writer desires to reiterate that accounts closed out after the audit date were not necessarily good at the former date, for they may have been credited for returns, allowances, and notes. In fact, in the case of fraud, the fictitious sales may simply have been reversed.
EXPLANATION OF PLATE 58

A SCHEDULE OF ACCOUNTS RECEIVABLE (1st type)

THE ROBINSON CORPORATION

Accounts Receivable and Reserve for Bad Debts
Audit For the Year Ending December 31, 1929

193. Explanation and Comments.—This schedule shows a procedure for aging accounts receivable.

Note that the balances were separated into debits ($147,329.12) and credits ($2,487.16). This latter amount went to schedule #A on trade payables (it could have been set up separately on the balance sheet as "Due to Customers"). No adjusting entry is needed in such a case because the books are not to be adjusted for it.

The reader should observe that in this particular schedule, the distribution of the December balances is AFTER the receipts of cash to January 27 ON THE DECEMBER 31 BALANCES have been deducted. The most common procedure is the one whereby the December 31 balances are distributed intact, the receipts (on December 31 balances) in cash to January 27 being stated in a separate MEMO column. In either case, the important point to be noted is that an alert auditor ascertains for his report the age of the accounts, and/or the cash received thereon up to the date of his withdrawal. For example, the auditor shows that of the $147,329.12 worth of accounts outstanding at December 31, $99,176.15 had been received on them in cash by January 27, the date of the auditor's departure.

Note also that on this schedule the Reserve for Bad Debts has been developed, the total estimated loss being $3,429.51 with a reserve of $6000 to cover it.

Finally,—the reader should observe that forty accounts were completely checked back from the ledger to the books of original entry,—the analysis method.
### A SCHEDULE OF ACCOUNTS RECEIVABLE (1st) PLATE 58

The Robinson Corporation

Accounts Receivable and Reserve for Doubtful Accounts

Dec. 31, 1929

<table>
<thead>
<tr>
<th>Name</th>
<th>Remarks</th>
<th>Balance 12/31/29 Dr.</th>
<th>Balance 12/31/29 Cr.</th>
<th>Receipts to 1/27/30 on the 12/31/29 Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Abertson</td>
<td></td>
<td>4327.60</td>
<td>327.00</td>
<td>2107.40</td>
</tr>
<tr>
<td>Abome</td>
<td></td>
<td>327.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accorte</td>
<td></td>
<td>3207.40</td>
<td>3207.40</td>
<td></td>
</tr>
<tr>
<td>Accross</td>
<td></td>
<td>396.50</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ackerman</td>
<td>Check to receiving record. OK-F.M.</td>
<td></td>
<td></td>
<td>247.10</td>
</tr>
<tr>
<td>Accorde</td>
<td></td>
<td>589.32</td>
<td>589.32</td>
<td></td>
</tr>
<tr>
<td>Adams</td>
<td></td>
<td>676.01</td>
<td>537.01</td>
<td></td>
</tr>
<tr>
<td>Adolph</td>
<td></td>
<td>1987.12</td>
<td></td>
<td>996.40</td>
</tr>
</tbody>
</table>

**Omissions**

<table>
<thead>
<tr>
<th>Totals</th>
<th>147329.12</th>
<th>2487.15</th>
<th>99176.15</th>
</tr>
</thead>
<tbody>
<tr>
<td>To B/S</td>
<td></td>
<td>To AA</td>
<td></td>
</tr>
</tbody>
</table>

**AUDIT PROCEDURE**

1. The Sales Book was checked against invoices for Dec. 1929 and Jan. 1-5, 1930. No errors were found.
2. The Sales Book was also footed and checked to the General Ledger for Dec. Checked into Personal Ledgers for Dec. No errors found.
3. The Shipping Record for Dec. 15-31 and Jan. 1-5 was checked against the Sales Book. No errors found.
4. The Cash Book was checked into the Personal Ledgers for Dec. 15-31. No errors.
5. All unchecked items in 40 accounts from A to K inclusive were traced back into books of original entry. No errors. Accounts were footed and balanced.
6. Drew off this schedule ourselves from the Personal Ledgers.
7. Secured Mr. Saess' signature to the list of bad debts written off.
8. All Journal entries involving accounts receivable were scrutinized and tested for the entire year.
9. Mr. Saess would rather provide a reserve for Abome's account than write it off at this time.
### RIGHT SIDE OF PLATE 58

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Col. 3</td>
<td>Not Due</td>
<td>Overdue</td>
<td>Overdue</td>
<td>Overdue</td>
<td>Date</td>
</tr>
<tr>
<td>(4)</td>
<td>(5)</td>
<td>(6)</td>
<td>(7)</td>
<td>(8)</td>
<td>(9)</td>
</tr>
<tr>
<td>2220.20</td>
<td>2220.20</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>327.00</td>
<td></td>
<td></td>
<td>27.50</td>
<td>299.50</td>
<td>June 1928</td>
</tr>
<tr>
<td>296.50</td>
<td>16.40</td>
<td>157.31</td>
<td>222.79</td>
<td></td>
<td></td>
</tr>
<tr>
<td>139.00</td>
<td>139.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>988.72</td>
<td>874.12</td>
<td></td>
<td>114.60</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

---

**RESERVE FOR DOUBTFUL ACCOUNTS**

| Balance 1/1/29 | 1500.00 |
| Charged off during the year: | |
| C Carson | 567.29 |
| S Baxter | 4.28 |
| M Miller | F S Saess |
| P Tracey | 327.01 |
| S Stokely | 405.07 |
| Balance 12/31/29 | 186.06 |

1929 Provision Adjustment #17 5813.94
Adjusted Balance 12/31/29 6000.00

Note: Mr. Saess is the general manager and Mr. Robinson is the credit manager.
# A Summary Schedule on Accounts Receivable (1st Type) Plate 61

## Schedule H

<table>
<thead>
<tr>
<th>Ledgers References</th>
<th>(1) Balance Per Books</th>
<th>(2) Adjustments</th>
<th>(3) Col. 1 and 2</th>
<th>(4) Final Balance (Dr. or Cr.)</th>
<th>(5) Dr. or Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>A-F TB 24 H-1</td>
<td>148917.21</td>
<td>8651.09</td>
<td>8651.09</td>
<td>140187.39</td>
<td></td>
</tr>
<tr>
<td>#12</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>#8</td>
<td>511.63</td>
<td>157056.67</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>G-L TB 25 H-2</td>
<td>105098.43</td>
<td>3181.87</td>
<td>3181.87</td>
<td></td>
<td></td>
</tr>
<tr>
<td>#12</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>#15</td>
<td>1691.34</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>#21</td>
<td>178.51</td>
<td>106410.65</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>M-Q TB 26 H-3</td>
<td>89481.01</td>
<td>1134.34</td>
<td>1134.34</td>
<td></td>
<td></td>
</tr>
<tr>
<td>#12</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>#5</td>
<td>3187.56</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>#14</td>
<td>903.11</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>#18</td>
<td>1467.78</td>
<td>85056.90</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>R-Z TB 27 H-4</td>
<td>91017.63</td>
<td>2187.59</td>
<td>2187.59</td>
<td>80076.66</td>
<td></td>
</tr>
<tr>
<td>#12</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>434514.28</td>
<td>7215.16</td>
<td>441729.44</td>
<td>15154.89</td>
<td>379803.09</td>
</tr>
</tbody>
</table>

See H-1 to H-4 Below To DD

(Z) Cash received from 10/1/30 to 11/15/30 on the 9/30/30 balances.

<table>
<thead>
<tr>
<th>Balance as above</th>
<th>1930</th>
<th>1929</th>
</tr>
</thead>
<tbody>
<tr>
<td>Acc't Pay.- Dr. Balances (DD)</td>
<td>441729.44</td>
<td>399187.52</td>
</tr>
<tr>
<td>Total</td>
<td>455211.36</td>
<td>403061.71</td>
</tr>
<tr>
<td>To B/S</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year's Credit Sales</th>
<th>1930</th>
<th>1929</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sept &quot;</td>
<td>4486917.53</td>
<td>4497989.76</td>
</tr>
<tr>
<td>&quot;</td>
<td>348915.17</td>
<td>306177.89</td>
</tr>
</tbody>
</table>

196. Explanation and Comments.— The reader should observe how thoroughly the figures are tied-in to other schedules by means of reference numbers. Note particularly that the Customers' Credit Balances of $15,154.89 went to schedule DD on Account Payable, and that the Creditors' Debit Balances of $13,481.92 came from there, and were added in to the accounts receivable to give the final total of $455,211.36.

Note also the last column, and observe that it is extremely important for the auditor to ascertain (just before he leaves the engagement) how much of the accounts outstanding at the audit date was paid up by that time. What can be more important in sizing up the collectibility of the accounts than this information? Also note that when it is not possible to write an adequate heading for a column because of the limitations of space, reference marks may be used to advantage.

Finally, observe that the schedule is drawn up on a two-year comparative basis, and particularly that September credit sales are given for comparison with the total of accounts outstanding at September 30.

(Schedules H-1 to H-4 inclusive would be like plate 56 or 59)
### The Outlet Company

#### Summary of Accounts Receivable

**B/S Audit for the Year Ended June 30, 1930**

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>6/30/29</td>
<td>Balance per G/L and our papers</td>
<td>274669.15</td>
</tr>
<tr>
<td>6/30/29</td>
<td>ADD:</td>
<td></td>
</tr>
<tr>
<td>2587347.62</td>
<td>Sales Book</td>
<td>2319873.41</td>
</tr>
<tr>
<td>25389.64</td>
<td>Cash Payments Book (Advance to SmytheCo)</td>
<td>50000.00</td>
</tr>
<tr>
<td>23489.64</td>
<td>General Journal (notes dishonored) Bartell</td>
<td>7142.63</td>
</tr>
<tr>
<td></td>
<td>Quimby</td>
<td>30539.29</td>
</tr>
<tr>
<td>2365526.41</td>
<td>Total</td>
<td>2735398.21</td>
</tr>
<tr>
<td>2466509.23R</td>
<td>DEDUCT:</td>
<td></td>
</tr>
<tr>
<td>21559.91R</td>
<td>Cash Receipts Book</td>
<td>2348765.48</td>
</tr>
<tr>
<td>69814.39R</td>
<td>Returned Sales Book</td>
<td>19654.39</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>72962.49</td>
</tr>
<tr>
<td>2441382.36R</td>
<td>DEDUCT:</td>
<td></td>
</tr>
<tr>
<td>327842.88</td>
<td>Balance per G/L 6/30/30</td>
<td>294015.85</td>
</tr>
<tr>
<td></td>
<td>ADD:</td>
<td></td>
</tr>
<tr>
<td>12681.45</td>
<td>Credit Balances of Accounts Receivable</td>
<td>To GG</td>
</tr>
<tr>
<td>5814.56</td>
<td>Accounts Payable - Debit Balances</td>
<td>GG</td>
</tr>
<tr>
<td>231.49</td>
<td>Accrued Interest on Accounts Receivable</td>
<td>To F-1</td>
</tr>
<tr>
<td>1359.61</td>
<td>Accrued Interest on Notes Receivable</td>
<td>E-1</td>
</tr>
<tr>
<td>347930.08</td>
<td>TOTAL</td>
<td></td>
</tr>
<tr>
<td>347930.08</td>
<td>DEDUCT:</td>
<td></td>
</tr>
<tr>
<td>43917.23R</td>
<td>Allowance for Doubtful Accounts</td>
<td>To H</td>
</tr>
<tr>
<td>30401.95</td>
<td>Balance per Balance Sheet 6/30/1930</td>
<td>To B/S</td>
</tr>
<tr>
<td>0 K</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

197. **Explanation and Comments.**—Note that this analysis brought to light that a loan of $50,000.00 to the subsidiary, The Smythe Co., was being treated as an account receivable. Also, the analysis disclosed the amount of dishonored notes that was charged back to accounts receivable. This information will be useful to the auditor in determining the adequacy of the allowance for bad debts. Notice also that accrued interest receivable and debit balances of accounts payable, if small in amount, are often added into the accounts receivable in a condensed balance sheet presentation. So also, under these conditions, the accounts are often shown on the balance sheet, "net of allowances."
Sales

Provision for Accounts Receivable Rebates

The debit to the sales account will reduce it to its proper size, and the provision for Accounts Receivable Rebates account will be deducted from the Accounts Receivable account balance, before being stated on the balance sheet.

As to the case involving freight, the following is suggested.

Freight on Sales (or Sales) Provision for Freight Deductions on Accounts Receivable

The treatment of these accounts is the same as that just stated above on rebates.

When the deductions (supra) are actually granted or taken, the entry will be as follows:

Provision for Accounts Receivable Rebates or Provision for Freight Deductions on Accounts Receivable Accounts Receivable

Finally, if provision for "returned sales" is deemed to be advisable the adjustment is:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Returned Sales</td>
<td>1000</td>
</tr>
<tr>
<td>Inventory</td>
<td>(750)</td>
</tr>
<tr>
<td>Returned Sales Expense</td>
<td>(60)</td>
</tr>
<tr>
<td>Accounts Receivable-Returned Sales</td>
<td>1000</td>
</tr>
<tr>
<td>Cost of Sales</td>
<td>800</td>
</tr>
<tr>
<td>Provision for Returned Sales Expense</td>
<td>10</td>
</tr>
</tbody>
</table>

202. Accounts of Affiliated Interests.—Trade accounts receivable from affiliated interests must be stated separately from other trade accounts receivable. This rule is recognized by many leading auditing firms as being an essential classification within the term accounts receivable-trade, itself.

As the full interest (if sizable) of the client in other enterprises should be clearly stated, the auditor must disclose this interest at whatever point in the balance sheet it may appear. Moreover, as the item of Accounts Receivable-Trade—Affiliates is generally apt to be a large one, the current position of the client may in certain cases hinge largely or solely upon the current position of a single company. Furthermore, it is well to keep in mind that if the affiliated interest is hard pressed by business conditions, et cetera, it is not likely that the client will bring suit on an overdue account as quickly as it would do if the account was owed by a complete outsider. (An affiliated interest is one whose policies are IN REALITY controlled by another company, even though there is less than a 51% interest owned in the voting capital stock).

203. Accounts of Subsidiaries.—Likewise, where trade accounts receivable are due from subsidiaries, these must be stated as Trade Accounts Receivable—Subsidiaries, for the reasons stated in section 202. In fact, the necessity for the separation of THIS item is recognized by those who see no reason for it in the case of affiliated.

Moreover, it should be remembered that in a consolidated balance sheet, (which is an essential statement where there are subsidiaries),
the account receivable due from the subsidiary, as shown on the parent company's books, cancels the account payable to the parent company, as shown on the subsidiary's books. That is, it really is not a receivable, any more than the debit balance in a branch control account is a receivable.

Finally, accounts with subsidiaries, and with affiliated interests, must be confirmed direct if the balances are large. No objection by the client to this procedure should be counternanced unless it has REAL merit.

204. Installment Accounts.— If, there are on file in the client's office (and there should be) formal contracts covering the installment sales, the auditor should call for some of them as a basis for proving that the accounts are bona fide, for ascertaining what accounts are overdue, etc. . . .

Despite the fact that on many instances the title to the goods has not passed to the vendor, the usual procedure is to record these transactions as sales, and the accounts receivable as secured by the merchandise. In such cases the auditor is not called upon to revise the accounting entries to make them conform to the legal situation present. It is usually sufficient for him to state: INSTALLMENT ACCOUNTS RECEIVABLE [Title to merchandise with vendor] xxx

By means of the record of foreclosures, the auditor should take care to see that all of the accounts opened in connection with these transactions have been closed out to the reserve for bad debts, or to profit and loss on repossessions, etc.

Lastly, the auditor must give special attention to determining the adequacy of the allowances for bad debts and collection expense because of the large amount of losses and collection expense connected with this type of sales. 3

205. Accounts Sold and Guaranteed.— Before developing this section, a word of explanation will be given.

When the accounts receivable are sold with guaranty, the discount company generally retains a guarantee sum, say 20% of the accounts sold to them. Against this fund are charged all uncollectable accounts, the balance being returned when all of the accounts receivable have matured.

Sometimes the assignee, the finance company, notifies the debtors that it owns their accounts and that, therefore, they must remit direct to it. Usually this is too harsh a method. As customers so notified are very apt to cease buying from the assignor, the latter often refuses to allow this procedure. In this case, the assignor may endorse over the customers' checks to the assignor, or he may deposit the checks in his own bank and issue his own check to the assignee for an equal amount. This procedure also often involves the requirement on the part of the assignee that it be protected by a notation on each ledger account to the effect that it (the finance company) is the assignee of that account.

As a rule, accounts receivable are not sold to raise money except by financially embarrassed businesses, and then only as a final resort, because the fees charged by discount companies are very costly.

At times the discounted accounts are called to the auditor's attention by the low volume of accounts receivable as at the audit date, or by the assignee's stamp on the ledger accounts, or by certain charges noticed when auditing the voucher register, or by the name of the finance company. 1

1Hence, to reiterate, it is often true that a trade account receivable due from/to a subsidiary is really merchandise valued at intercompany sales prices. Thus Parent Company A may make sales to Subsidiary Company B just prior to closing its books in order to decrease its inventories to better proportions. 2Or as deferred income. 3This is especially true if the resale value of the repossessed goods is usually less than the uncollected cost of the goods.
when vouching the checks, or by the name of the finance company when scrutinizing the origin of the account payable balances. But even if no indications are found while auditing, the auditor must not fail to inquire about it of the officers, lest he overlook this essential feature of most all audits.

As to hypothecated accounts, this also is a major item of information so that it behooves the auditor to cover the situation by test and inquiry. In fact, the item is of sufficient importance to warrant securing the client's signed statement thereon.

Moreover, the auditor should personally confirm from the assignee (or pledgee) the amount of the loan, the amount of accounts pledged, and the amount of the guaranty account. Then too, he ought also to read the contract with the finance company in order that he may see if the accounts portray the true situation. Both hypothecated and discounted (i.e., sold with guaranty) accounts receivable must be classified as such on the balance sheet.

As explained and emphasized elsewhere, an audit which fails to disclose any sizable lien whatsoever is deficient in a major aspect. Hypothecated accounts receivable may be set forth thus: Trade Accounts Receivable (pledged-contra) $xxx, and the liability secured therewith should also be clearly earmarked, thus: Notes Payable—Officers (secured—contra) $xxx.

Where the accounts receivable have been sold with guaranty, this fact must also be distinctly stated. Assuming that the original entry was

Cash
Commission Expense
Guaranty Fund with Assignee
Accounts Receivable—Sold,
the balance sheet might show the situation thus:

Accounts Receivable
Loss—Accounts Receivable—Sold

The guaranty account would not, of course, be listed among the current assets, as the cash is not available at will.

Another and doubtless the more correct point of view is stating the accounts is to show the Accounts Receivable—Sold account as a secured liability, and the discounted accounts as a pledged asset. Of course, this is not the legal situation because the accounts are sold, albeit guaranteed. But the practical business aspect of the situation is that a loan was obtained by pledging some accounts receivable.

206. Allowances for Cash Discounts.—Current auditing practice sanctions the showing of the trade accounts receivable without an allowance for cash discounts. However, if a reserve is desired by the client, and if the terms are 2/10 n/30, for example, the auditor can ascertain the proper amount of the reserve by analyzing the receipts on account during the first few days following the audit period. At the next period, even if he should encounter an extremely rare case where the accounts are sold without any guarantee, the auditor should endeavor to show that the small balance of accounts receivable is due to the others having been sold. If this is not done, the readers of the balance sheet will certainly infer that the concern has an excellent collection department and a group of prompt paying customers. What Could Be Further From The Truth. Of course, the auditor need not disclose this situation, but it is this sort of "static attitude" which has done much to curb the growth of public accountability.
the entry should be reversed even though it is not likely that the actual discounts taken will exactly equal the provision.

207. Confirmation of Accounts Receivable.—Before developing this topic, the reasons for independently verifying the accounts receivable will be discussed.

Admittedly, the only absolute proof of the genuineness of an account is in its collection, or acknowledgment by the debtor. Each item composing each balance of the accounts receivable might be vouched back from the ledger into the sales book, and then against a sales invoice, and a shipping record. But unless fraud is suspected, this is an unreasonable procedure, being too costly and decidedly too “heavy”,—and may actually prove nothing because conceivably all of the records could be falsified considerably and not be detected. Again,—even though the books of original entry in respect to the debits are audited in detail, there is no proof that the accounts have not been collected, for the cash may have been received without being recorded.

From these statements it may seem well-nigh necessary to confirm the accounts, if any substantial credence is to be placed in them. But, such a judgment overlooks the fact that where a good system of internal check exists, the material falsifying of the records is extremely hard to accomplish. Moreover, as an auditor is a “watch-dog” and not a “bloodhound”, he is entitled to proceed on the rational basis that judicious tests are always sufficient, except where the terms of his employment are to the contrary, or where his suspicions of fraud have been aroused or ought to have been under the circumstances, or when auditing custom dictates that the accounts should be confirmed.

As a rule, the auditor finds that the client either objects to incurring the cost of a confirmation, or fears that he will lose the goodwill of a customer or two by sending them such a request. The writer feels that there is no basis whatever for this feeling (which is usually due to the assumption that the customer will regard the confirmation letter as a request for payment), because practically all confirmation forms state, “This is NOT a request for payment”. Nevertheless, except in a few cases, as where the internal check on accounts receivable is very poor, the auditor never insists on a direct confirmation if the client objects to it. He relies upon other indications that the accounts are genuine. However, if the accounts are not circularized, the auditor should comment on this omission in his report.

If an auditor has found a good system of internal check WORKING, and if in addition he has tested the sales and shipping records, and has also noted the cash received after the audit date on the outstanding balances, he then feels confident that the accounts are genuine, and that a confirmation of them would reveal only minor errors.

So then, aside from audits featuring the detection of fraud, the confirmation of accounts receivable is rarely undertaken, although obviously it is an excellent proof of the correctness and genuineness of the accounts.

1E.g., Customers accounts of a stock broker, or of a land development company, or of a business with no books of account, for example.
2Sec Appendix C, Sec. 11-1.
3As stated elsewhere, sums due from affiliates or subsidiaries, or from officers and employees, must be confirmed. So also, large accounts, or accounts long overdue, etc. must be circularized, and where replies are not immediately forthcoming, the auditor must follow up with additional requests until replies are received.
As to confirmation forms, plates 63 and 64 stand respectively for the "positive" and the "negative" types. The term "positive" is applied to the former type of confirmation form because a reply is requested even though the account is correctly stated. As it requires a printed form and as it is customary to enclose a stamped and addressed envelope, the cost thereof is somewhat high.

The term "negative" is applied to the other type of confirmation because it requests an answer only when an error exists. Moreover, as the request is usually stamped upon the regular monthly statements, its cost is nil.

As a matter of actual experience, auditors find that the "negative" form of confirmation is only slightly inferior, if any, to the "positive" form, chiefly because many customers fail to reply to the "positive" form if the statement agrees with their books.

As the confirmation of accounts receivable has as one of its leading objectives the detecting of fraud, the auditor must take particular care in sending out the confirmation statements. If the envelopes are stamped returnable to the auditor's address and if he personally mails them directly after having verified the statements against his schedule of accounts receivable, he may rest assured that he has closed every reasonable loophole for fraud. A common error for an auditor to make is either to allow the client to handle the confirmations after he (the auditor) has checked them to his schedule of accounts; or to forget to stamp (or have printed) the envelopes returnable to his address.

To illustrate,—fraud has not been uncovered on several occasions simply because fictitiously addressed envelopes, not being stamped (or printed) returnable to the auditor's address, were either returned to the client (if his address appeared thereon) who then destroyed them, or were passed on by the postal authorities to the dead letter office (if there was no return address). Likewise, it has been found that fraud has existed for years despite these confirmations, simply because the defrauder was allowed to mail the letters and hence was able to abstract or alter certain statements.

As the confirmation returns come back, the auditor will take up the customer's objections with the chief accountant. Many cases are found where a customer has given money to a partner who did not tell the bookkeeper about it. Also, many objections are due simply to the fact that the customer sent his check too late to be recorded on the statement. Thus a check sent on December 31 might not arrive until January 2.

From the discussion above, it might be inferred that all of the accounts receivable must be confirmed and that it must be done as of the audit date only. But this is not the true situation. Time and again, an auditor will confirm the accounts a month (or even two months) before, or after the audit date. This is permissible, but not preferable, because the confirmation will detect systematic fraud just as readily one time as another, and although it does not prove the accounts as of the audit date, it nevertheless indicates, for all practical purposes, that

"It (the letter) was placed in an outgoing mail tray in the auditor's office (internal auditor) where Lewis was working, and it is Dolan's belief that Lewis took the letter out of the tray . . . . . . "—The Detroit News (June 9, 1931)
the accounts are genuine and probably correct. Finally, as there are times when it is not practical to circularize all of the accounts, the auditor often confines his attention to the large accounts, the past due accounts, and certain others taken at random.

208. Certificate on Accounts Receivable.—It may appear to a novice that a client's certificate on accounts receivable is not worth the paper it is written on because it appears that the client will sign it even if there is something wrong or undisclosed. Moreover, it would seem that the auditor himself was employed to do the certifying; as to the correctness of the accounts, not the client. However, the correct point of view is this; namely, that auditors know that there may be important facts, sometimes the most important in the audit, not disclosed by any books-of-account, but which the client is fully aware of. Therefore, the auditor "audits" the client by having him give a certificate. English balance sheet certificates recognize that the auditor must make inquiry of the officers in the following phraseology, "- - - - - - - - according to the best of our information and the explanations given to us - - - " 2 Then too, practically everyone admits that a man who would affirm orally to the auditor a false statement, will generally think twice before he signs one.

209. See Plate 63.

210. C.O.D. Sales.—C.O.D. Sales should never be treated as cash sales. They are true credit sales. In some businesses where the C.O.D.'s are local, they are not recorded until the cash is received. Only a memorandum thereof is made in the meanwhile. In other places, all C.O.D. sales are charged either to a C.O.D. account, kept in the accounts receivable ledger, or to a C.O.D. account kept with each transportation company through whom the shipments were made.

211. See Plate 64.

212. See Plate 65.

213. Consigned Goods.—The carrying of consigned goods, at selling prices or even at cost prices, as accounts receivable is an essential misstatement. On correcting such an error, the auditor must take care to include the goods (at cost) 3 in the inventory. Cost for inventorying, in this case, may include reasonable charges for insurance, freight, etc., when incurred on saleable goods, actually selling at the consignee's. Moreover, the consigned goods must be verified direct with the consignee.

At this time, the writer may as well point out that the consignor

1 If circularization of customers is not feasible, the next best thing is to compare monthly statements of customers' accounts with the Sales Ledgers and then mail them personally having the auditor's return address. The statements should also state (stamped on by the auditor) that any discrepancies should be taken up direct with the auditor. The stamp should be like the ones shown on Plate 64.

2 See Chapter 2, ADDENDUM. 3 I.E., cost or market, or other satisfactory basis. 4 It must be remembered that often postdated invoices are simply memoranda, the goods being returnable or subject to a price adjustment. In the former instance they are inventories; in the latter a valuation reserve is probably needed.
Dear Sir:

In connection with our regular audit of the ____________ (Name of the _ _ Business) ____________, we are enclosing the statement of your account as of ____________ (Date) ____________. Please examine it, and advise us on the attached form below that it is correct, or if incorrect in what particulars. We are enclosing a stamped and addressed envelope.

Are there any other sums due FROM or TO you?

Approved ____________ (Name of Client) ______

Cordially yours,

Robertson and Robinson

By ____________ (Name of Senior Auditor) ______

(This is a request for confirmation, not for remittance)

--- Detach Here ---

No ____________ 192 ____________

Messrs. Robertson and Robinson,

719 Green Street,

Smithsdale, R.I.

Gentlemen:

We have examined the statement of ____________ (Name of Business) ____________ as of ____________ (Date) ____________, and find it to be correct, except as noted below.

Also, there are no other sums due FROM or TO us, except as noted below.

Very truly yours,

__________________________ (Name of Debtor) ______

Exceptions ____________ (Use the other side if necessary)

Additional sums due FROM or TO us: ____________________________

209. Explanation and Comments.—This exhibit is a confirmation (in letter form) of the "positive" type, whereby an answer is requested even though the account is correctly stated.

This method of confirmation is expensive because a stamped and addressed envelope should always be enclosed. Moreover, a printed form is necessary.

It should be noted that there is a place on this form for the client's approval, without which the debtor may refuse to reply to the auditor.
(a) POSITIVE TYPE

Please advise our auditors
Messrs. Gooch and Aldrich
Certified Public Accountants
609 Myrtle Street,
Saylorsville, Mass.,
as to the correctness of this statement.

THIS IS NOT A REQUEST FOR PAYMENT

(b) NEGATIVE TYPE

Please advise our auditors, Messrs. Robertson
and Robinson, 719 Green Street, Smithdale, R.I.,
if you noted any errors in this statement.
Cordially yours, [Name of Client] (Usually typed or stamped)

211. Explanation and Comments.— (a) This is an illustration of a short "positive" type of confirmation form.

Note that it is a stamp, which is placed on the monthly statement.

(b) This is a confirmation form of the "negative" type whereby an answer is requested only in case of error.

Although a failure to receive an objection is not equivalent to a positive confirmation, it is, nevertheless, some indication that the account is correct.

It is recommended that the client circularize in effect the accounts each month by having a clerk (other than the one handling cash or personal ledgers) compare the monthly statements with the personal ledgers. This person should then mail the statements without the intervention of anyone. The statements should invite the customer to communicate with the credit and collection manager direct if there are any errors.
212. Explanation and Comments.—As the most important facts in an audit may not be ascertainable from the books of account, or from other financial records, the auditor is required "to audit" the officers of the business by securing from them all of the information which he deems necessary to complete his audit. Moreover, the competent auditor always puts the officers on record as certifying that they know of nothing whatever, beyond the inquiries put to them by the auditor and as shown by the books of account, which should be revealed to the auditor. This procedure is necessary because obviously the officers could answer all of the questions put to them by the auditor and yet have retained the most important information.

It is generally recognized that a person who would lie orally, will think twice before signing a false statement. Therefore, it is not true that the officers of the client would sign a false Certificate as readily as they would tell the auditor privately that everything was all right. The Certificate is more than a scrap of paper.

In order to simplify matters, an auditor should draw up ONE certificate on all matters on which he desires "to audit" the officers under signature.

A second and more complete certificate is: "Dear Sirs: This is to certify that the following is a full and accurate description of all our current accounts receivable.

Trade Customers $  
Directors, Officers $  
Installment Trade Customers $ 
Subsidiaries (trade) $  
Affiliates (trade) $ 

Against the above sums the Reserve for Bad Debts of $______ is deemed to be adequate.

The above sums do not include such receivables as freight, tax refunds, advances on purchase contracts, lease deposits, sums due from subscribers, etc., unless so labelled.

The balances due from each customer represent specific CURRENT invoices unless the customer usually makes partial payments on account.

No reserves for future rebates, etc. for quantity sales, etc. are necessary.

No claims by customers or others for allowances, returned goods, commissions, price protection rebates, etc. exist except as stated on the books.

No accounts are under discount, assigned, or pledged except as noted above.

No accounts represent goods out on consignment.

The accounts receivable ledgers are in agreement with their respective controlling accounts.

All goods billed have been shipped or are awaiting shipment and hence have been excluded from the inventory.

No sum included above is in dispute.

No sum is due from a bankrupt etc. except as listed above.

The sum of past due accounts is $______ .
The sum of notes charged back is $______ .

WATTSERSON, KNIST, & SLIPSON, INC.
Certificate on Accounts Receivable
As at November 30, 1930

212. Explanation and Comments.—As the most important facts in an audit may not be ascertainable from the books of account, or from other financial records, the auditor is required "to audit" the officers of the business by securing from them all of the information which he deems necessary to complete his audit. Moreover, the competent auditor always puts the officers on record as certifying that they know of nothing whatever, beyond the inquiries put to them by the auditor and as shown by the books of account, which should be revealed to the auditor. This procedure is necessary because obviously the officers could answer all of the questions put to them by the auditor and yet have retained the most important information.

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No reserves for future rebates, etc. for quantity sales, etc. are necessary.

No claims by customers or others for allowances, returned goods, commissions, price protection rebates, etc. exist except as stated on the books.

No accounts are under discount, assigned, or pledged except as noted above.

No accounts represent goods out on consignment.

The accounts receivable ledgers are in agreement with their respective controlling accounts.

All goods billed have been shipped or are awaiting shipment and hence have been excluded from the inventory.

No sum included above is in dispute.

No sum is due from a bankrupt etc. except as listed above.

The sum of past due accounts is $______ .
The sum of notes charged back is $______ .
A FORM OF CERTIFICATE ON ACCOUNTS RECEIVABLE, PLATE 65

WATTERTON, ERNST, & SIMPSON, INC.
Certificate on Accounts Receivable
As at November 30, 1930

Messrs. Lewis and Wood,
(Certified Public Accountants)
Baton, Indiana

Dear Sirs:

This is to CERTIFY that we know of no reason whatever why you may not use the balance of Accounts Receivable - Trade ($483,761.19), less the Reserve for Bad Debts ($7,500) as representing good and collectable accounts due from customers.

These receivables are not subject to any rebates or other deductions, other than noted above (if at all); they are the property of the corporation and are not pledged, except as noted above (if at all); and no other relevant facts exist.

Sincerely yours,
Watterson, Ernst, & Simpson, Inc.
By __ James Watterson ————
    Pres.
By __ F.T. Simpson, Jr. ————
    Credit Manager
should label his consigned goods. If they are not clearly distinguishable from other goods at the consignees, he may not be able to regain his property in case the consignee goes bankrupt.

214. Deposits.—Deposits are not accounts receivable, and hence they must be stated as a separate item on the balance sheet.

For example, the writer has in mind a gymnasium equipment company which charged against the personal accounts receivable of certain cities not only the equipment sold to them but also certain substantial guaranty deposits. These deposits were required by the cities from all bidders on contracts as a guaranty of satisfactory performance. Obviously, such deposits were not only incorrectly included among the accounts receivable, but also improperly classified as current assets, because they were not available until the equipment had been installed, and tested for one year. Again, deposits under leasehold arrangements are not ordinarily current assets, and they are certainly not accounts receivable-trade. The deposit is not usually available to the client until the expiration of the lease, or as the last rental payments. Moreover, if the lease is renewed, the deposit will still be available and may even have to be increased.

215. Advances on Purchase Contracts.—Advances under purchase contracts are NOT accounts receivable, and hence must be stated on the balance sheet as a separate item.

The position of the auditor on this matter ought to be clear to any disinterested party. Besides throwing the uncollected accounts receivable out of proportion to sales, the advances do not fall within the definition of accounts receivable. Moreover, an account receivable is expected to be turned directly into cash without any difficulty, whereas the advances on purchase contracts will be turned into inventories which then have to be sold and are also subject to the contingency of a loss through a drop in the market price. Is it not clear, for example, that $1,250,000 worth of current collectable accounts receivable are ordinarily much different and better asset than $1,250,000 worth of unsold inventories?

To repeat then, advances under purchase contracts are NOT accounts receivable and must, therefore, be classified on the balance sheet as Advances on Purchase Contracts;—albeit they are generally current assets.

Lastly, the amount, if sizable, should be confirmed independently.

216. Credit Balances.—In taking off a list of the balances of the accounts receivable ledger, the auditor will customarily find that some of them are credit balances. The question before him is: How shall these balances be stated? Naturally, if they are insignificant, these balances may be allowed to stand as deductions from the debit balances. But if the credit balances are sizable, they must be set out separately in the balance sheet in conformity with the cardinal rule in accounting that unlike items must never be offset one against the other.

For example, if the credit balance represents an advance deposit received on a sales contract, it ought to be stated among the current liabilities as Advance Deposits Received on Sales Contracts. Or again,—

4This represents the least the auditor can do. In some manner, preferably on the face of the balance sheet but often necessarily in a footnote because of the length of the comment, the auditor should disclose the size of the contract, whether or not it is covered by firm sales orders, its present market value, etc., etc.
if the credit balances represent a large number of small items that will have to be discharged by goods or cash, they may be stated among the current liabilities as Customers' Credit Balances, or Due to Customers. Again, if the credit balance is in the account of one who also sells to the client, it is clearly an account payable. Enough various treatments have been indicated, it is believed, to show the method and the necessity of setting out the credit balances according to their individual nature.

It should not be gathered from the above discussion that the books are necessarily adjusted to agree with the auditor's balance sheet. In most cases the auditor, leaving the records as they are, will make the adjustments only on his work sheet, and hence on his balance sheet.

217. Loans to Officers and Employees.--- Loans to officers, employees or stockholders are items which require a separate caption, "Loans to Officers, Employees, Etc." in the balance sheet. Whether or not they will be classified as current assets depends upon the circumstances, i.e.: some accounts may be current and some may be fixed. The auditor should confirm the large accounts. He should also provide a reserve for the doubtful loans. The credit postings to the loan accounts should be critically examined in order to prove that they are proper entries. If a sizable account should be closed just before the audit period and then opened shortly after, the auditor should discuss the matter with the proper official, as it would seem to be a mere subterfuge to prevent the loan from being reflected on the balance sheet. Ordinary sales of merchandise to officers, employees and stockholders are included in the trade receivables just as any other unpaid credit sale.

218. Advances to Subsidiaries.--- Advances to subsidiaries are often included by a bookkeeper among the accounts receivable. The auditor, however, must set them up as a separate item. If the account is to be received in the near future, it is a current asset. On the other hand, the balance sheet of the subsidiary will often show the auditor that the advances are a permanent loan, in which case they should be shown along with, but separate from, the investment in the stock of the subsidiary, thus:

<table>
<thead>
<tr>
<th>Investment in the Arabic Corporation:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common Stock (100% control)</td>
</tr>
<tr>
<td>Preferred Stock (5% control)</td>
</tr>
<tr>
<td>Advances</td>
</tr>
<tr>
<td>Account Receivable-trade(^2)</td>
</tr>
</tbody>
</table>

As the account can be easily verified by confirmation, the auditor must be careful to do it for it is generally a large item. Of course, if a consolidated balance sheet is prepared, the account will be cancelled against the corresponding liability account of the subsidiary.

219. Claims.---Claims against common carriers, or against an insurance company, or against the state, or the federal government must be proved to be justified beyond a shadow of a doubt, if they are to be allowed as assets. A mere claim for a tax refund, for example, is not an asset by any means,---but in many instances it may have sufficient merit to be a balance sheet footnote.

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1 Credit men often judge (in part) the character of the officer personnel of a company by the appearance of large personal loans.

2 Assuming this is not current.
220. **Stock Subscriptions.**—Stock subscriptions are receivables of a distinctly separate type. The auditor must ascertain whether the accounts are current, or fixed assets, and then place them in the balance sheet accordingly. If the stock has been issued before being fully paid for, the auditor should advise against this procedure in the future.

221. **Accrued Income.**—Accrued income is income that is earned but not yet due. It is generally a current asset, and a reserve may have to be provided against it though this is rare.

On many audits, the accrued income is ignored by the client. If this is not due to ignorance, the auditor may allow the matter to pass by unnoticed if the amount is small. But if the accrual is large, the auditor must at least comment upon its omission by means of a balance sheet footnote.

In checking accruals, the auditor will often find it best to make the computations on the asset schedules. Thus the accrued interest receivable on bonds is best developed on the schedule of bonds. If the auditor’s answer approximates the client’s figure, no adjustment should be made to correct the error, but the clerk who made the computations should be shown her mistakes. On many occasions the auditor may simply test the client’s computations by rough approximation methods.

Although bond interest (except on income bond, etc.) is subject to accrual, dividends are not accruable. If the dividend has been declared, it may be recorded as an asset, but not before then. This is the rule even though the client holds impeachable preferred stocks guaranteed by parent companies with unbroken dividend records of long standing.

The determination of the completeness of the accruals calls for very careful consideration. For suggestions the auditor should refer to previous balance sheets, and review the assets and the income accounts in the present statements. Thus, the item of accrued rent receivable on the balance sheet of a year ago will strongly suggest the existence of that asset again this year. Likewise,—if the present balance sheet lists securities, this is sufficient notice to suppose that there is accrued interest receivable.

222. See Plate 66.

223. See Plate 67.

224. See Plate 68.

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1 At this point the following is interjected: On a few audits, where the client operates a Voucher Register without a Creditors' Ledger, the auditor may find that returned purchases are charged to accounts in the Customers' Ledger. Obviously, these items are not receivables being offsets to liabilities, unless the latter is smaller than the former.
## A Schedule of Accrued Income

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aug. 31, 1928</td>
<td>Balance per G/L and our report</td>
<td>4328.24</td>
<td></td>
</tr>
<tr>
<td>Sept. 1</td>
<td>Reversal entry (Dr. to interest income)</td>
<td>4328.24</td>
<td></td>
</tr>
</tbody>
</table>

### Accounts Receivable - Trade

<table>
<thead>
<tr>
<th>Name</th>
<th>Amount</th>
<th>Rate</th>
<th>Interest Period</th>
<th>Calculation</th>
<th>Accrued Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>James &amp; Hobart Co.</td>
<td>$5187.19</td>
<td>.06</td>
<td>5/365 (7/4-8/31)</td>
<td>49.43</td>
<td></td>
</tr>
<tr>
<td>E J Bartlett</td>
<td>$4678.45</td>
<td>.06</td>
<td>10/365 (3/2-8/31)</td>
<td>139.97</td>
<td></td>
</tr>
</tbody>
</table>

### Mortgage Receivable

<table>
<thead>
<tr>
<th>Name</th>
<th>Amount</th>
<th>Rate</th>
<th>Interest Period</th>
<th>Calculation</th>
<th>Accrued Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ralph Ortwell</td>
<td>$20000</td>
<td>.07</td>
<td>4/30-8/31</td>
<td>471.78</td>
<td></td>
</tr>
</tbody>
</table>

### Notes Receivable

<table>
<thead>
<tr>
<th>Schedule</th>
<th>Amount</th>
<th>Rate</th>
<th>Interest Period</th>
<th>Calculation</th>
<th>Accrued Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>7</td>
<td>$20000</td>
<td>0.07</td>
<td>4/30-8/31</td>
<td>178.36</td>
<td></td>
</tr>
</tbody>
</table>

### Bonds

<table>
<thead>
<tr>
<th>Name</th>
<th>Amount</th>
<th>Rate</th>
<th>Interest Period</th>
<th>Calculation</th>
<th>Accrued Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Parker Paper Co.</td>
<td>$15000</td>
<td>0.07</td>
<td>6/30-8/31</td>
<td>10354.25</td>
<td></td>
</tr>
</tbody>
</table>

### Balance Sheet

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aug. 31, 1929</td>
<td>Balance per G/L, Accrued Interest Receivable</td>
<td>6026.01</td>
<td></td>
</tr>
</tbody>
</table>

### Rents Receivable

<table>
<thead>
<tr>
<th>Name</th>
<th>Amount</th>
<th>Rate</th>
<th>Period</th>
<th>Calculation</th>
<th>Accrued Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>F Martin</td>
<td>2 mo.</td>
<td>45</td>
<td>90.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>S Skorter</td>
<td>1</td>
<td>30</td>
<td>30.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>K Margoobian</td>
<td>1</td>
<td>30</td>
<td>30.00</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Note

- The trade accounts are secured by ample collateral. See Schedule 6.
- No accrued rent receivable in this figure. No tenements were owned at that time.

---

223. Explanation and Comments.—The reader should note that there is no accrued income receivable account on the client's books, but that the total ($6176.01) comes from two ledger accounts; namely, accrued interest receivable ($6026.01), and rents receivable ($150.00).

Also, note that the interest on notes receivable was developed on schedule 7, the notes schedule. (See plates 50 and 51).

Observe that the auditor anticipated the inquiry as to the collectibility of the trade accounts, and hence the advisability of accruing the interest, by stating that they are secured.
Accounts Receivable

1. Vouch the shipping record against the sales book for August and December 1928, and Jan. 1-5, 1929. 1/19/29 HBC
2. Vouch the sales invoices against the sales book for April, July and Dec. Account for the invoices by number.
3. Foot, and post the sales book to the general ledger for April, July and Dec., and to the personal ledgers for Dec.
5. Vouch the credit memos against the returned sales book for Sept. and Dec. 1928. Post entire year to G/Ledger and Dec. to personal ledger. "Note, especially, credits given at the end of the period in order to close old accounts."
7. Vouch all entries in the journal which affect accounts receivable. Make a list for our report of all bad debts written off during the year. 1/21/29 EMF
8. Foot all of the accounts receivable columns in the journal and post to the general ledger.
9. Post the accounts receivable entries in the journal for Dec. 1928 to the personal ledgers.
10. Check 170 personal accounts completely back to books of original entry. Select these accounts at random in the A-F Dec. ledger. Foot them and prove their balances.
11. Foot the accounts receivable columns in the cash book for April, July and Dec. and post to general ledger, and to personal ledgers for Dec. Acritinize for any possible irregularities.
12. Foot the discount columns in the cash book for April, July and Dec. scrutinize for any possible irregularities.
13. Take off the account balances from the personal ledgers. Foot and reconcile to the control accounts. Do not accept any lists without proving them.
14. Age the accounts. Get the facts on those over 90 days old. Fill out the Remarks column completely. Do accounts have any notations on assignments, bankruptcies?
15. Be sure to keep the debit and credit balances separate. Ascertain the reason for credit balances.
16. Ascertain the amount of cash received on the audit balances since the audit date.
17. Set up Reserve for Bad Debts in consultation with credit manager. Have changes to the Reserve been approved by a responsible official?
18. Be certain to get the G/L balance separated into proper subdivisions for the balance sheet.
19. Investigate accounts which are in excess of credit limit fixed when the accounts were first opened.
20. Eliminate the Consignments-Out from the Accounts Receivable and from the Sales. Include in inventories.
21. Confirm by direct correspondence all sums due from affiliates, subsidiaries, employees and officers (if they represent loans on account); accounts over $40,000; accounts over 1 yr. old; and in any other instances which you deem necessary.

22. Are any sales at the end of the period reversed in the subsequent period? Examine these carefully. Prepare schedule showing your results. Are any credits subsequently recharged?

23. Get certificate on Accounts Receivable from the client.

24. Analyze the cause of any credit balances. Are sales charges missing, liabilities, etc., etc.? Are there large credits arising from returned goods or allowances?

25. What claims for rebates, reductions, and the like, have not been taken up? Set up necessary reserves. Any quantity discounts in the near future.

26. Do any accounts receivable represent charges for uncompleted contracts?

27. "Reconcile branch office (domestic and foreign) accounts receivable with their controlling accounts."

28. Are any accounts pledged or assigned? If so, confirm.

29. Are the open balances in the Sales Ledger represented by current specific invoices or are there odd items or old items in dispute?

30. "Examine the individual accounts for notes receivable charged back to the accounts receivable because not paid at maturity."

31. "Record all instances where the accounts show charge-backs caused by the return of customers' checks bearing the bank's stamp "No Funds" or "Insufficient Funds".

32. Review the history of all accounts transferred to the Accounts Receivable Suspense Ledger (i.e. very doubtful accounts). See all correspondence.

33. Examine all correspondence on old accounts for information on compositions, receiverships, etc.

34. Examine notes, loans, accounts payable for names of discount companies. If found, pledged or assigned accounts are likely.

35. "Observe in appropriate cases the effect of Statutes of limitations, e.g., whether the debt arises under a parol or specialty contract."

36. Ascertain if payments of interest are maintained,

37. Ascertain the present value and realizability of the collateral. Why was collateral security necessary?

38. Ascertain if there are offset, and the like.

39. "In case of liquidation, bankruptcy, or composition, ascertain the amount of dividend paid and probability of further payments."

40. " Weed out I.O.U's and sums due from directors, managers, employees, etc. and ascertain if they are being paid up and if those persons are still in the employment of the client.

41. Ascertain what debts, if any, are guaranteed. If any, ascertain the guarantor's financial standing.

42. Is any insurance carried?

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222. Explanations and Comments.——This audit program on accounts receivable of Goldsmith and Howry Bros., Inc. represents a very detailed audit program.
A Form Used in Pledging Receivables

No. ________

This Certifies That _________

Date ________

Is Indebted To _________

For goods sold and delivered as stated below Shipped Via _________

Know all men by these presents that _________ for value received have bargained, sold, assigned, and transferred unto, and by these Presents do bargain, sell assign and transfer unto The Third National Bank of Liverpool, Mass., its successors or assigns, the claim or account set forth in the above statement, and the goods covered by or described therein, and the right to collect and receive all moneys due and to grow due upon the same for sales therein set forth; and _________ hereby constitute and appoint _________ true and lawful attorney irrevocably for _________ and in _________ name and stand but to own, use and benefit, to sell, assign, transfer, set over, compromise, or discharge the whole or any part of the aforesaid claim or account, and for that purpose to do all acts and things necessary or proper in the premises, and to substitute one or more persons with like power, hereby ratifying and confirming _________ said attorney or _________ substitute shall lawfully do by virtue hereof _________ hereby guarantee and certify that this amount so assigned is a bona fide sale and a correct account for goods actually sold and delivered and accepted, and agree that any claim or deductions allowed will be refunded by _________ by allowing the same to be deducted from future advances or by payment of the amount of such deductions in cash at the option of the said Third National Bank of Liverpool, Mass., and _________ also guarantee the payment in full of the above account not more than _________ days after maturity.

In Witness Whereof _________ have hereunto set _________ hand and seal this _________ day of _________ 19______

__________ L.S.

__________ L.S.

__________ L.S.

224. Explanation and Comments.—This plate is self explanatory. The student is requested to become familiar with its contents.
1. What are some of the most common differences which customers report in confirming their accounts?
2. Outline an audit program on discounted accounts receivable.
3. Why ought a consignor to label his goods?
4. When is it necessary to confirm the accounts receivable?
5. Why should an auditor keep in touch with general business conditions?
6. Describe the "negative method" of confirming accounts receivable.
7. How would you check the postings to the personal ledgers in a balance sheet audit? In a detailed audit?
8. Why is it permissible to have the client prepare the accounts receivable schedule (upon audit paper headed by the auditor)?
9. At what price may a consignor carry his consigned inventories?
10. How would you make use of the receiving and shipping records in a detailed audit? In a balance sheet audit?
11. Give one of the inquiries you could make in rating overdue accounts.
12. Describe two methods used by accounts receivable discount companies in collecting the accounts.
13. Would you recommend the confirming of accounts if there was a good system of internal check at this point?
14. What, in your opinion, would be "a good system of internal check at this point"?
15. Why should an auditor get familiar with the products, credit terms, etc. of the business before auditing the accounts receivable?
16. How can the accounts receivable ledger contain credit balances?
17. Draw up and fill in a schedule like plate 52.
18. When would an auditor prepare a simple schedule like plate 53?
19. Why does a discount company retain a Guaranty Fund?
20. Why should the journal be audited more thoroughly than other books of original entry?
21. What use in the report would you make of your schedule on accounts receivable?
22. Suppose that you know that your client ships goods f.o.b. customer freight to be paid and deducted by the customer. What investigation would you make?
23. Why is the "negative method" of confirming accounts considered by some auditors to be as satisfactory as the "positive method"?
24. Do you consider it necessary to confirm consigned goods?
25. Is it worth while to circularize a few accounts?
26. Name two ways of making certain that the bookkeeper was correct in writing off the bad debts.
27. If your list of account balances did not check with the control account, what would you do about it?
28. How might an auditor stumble upon the fact that there were discounted accounts receivable?
29. Give the journal entries required to adjust the accounts receivable for a quantity deduction of $29,614.34.
30. What objections may a client have to the confirming of accounts?
31. Define the term Accounts Receivable.
32. How would you set up on the balance sheet the accounts which have been discounted by a finance company?
33. Of what value is it to ascertain the amount of cash received on the audit balance since the audit date?
34. Why is it necessary to state separately the trade accounts of a subsidiary?
35. In installment sales, who generally holds title to the goods? Why does the auditor ignore this legal fact?
36. Why isn't it common for an auditor to set up a reserve for cash discounts?
37. Is it worth while to circularize the accounts as of a date after the audit date?
38. Describe the "positive method" of confirming accounts receivable.
39. Why is it necessary to separate for balance sheet purposes the debit and credit balances? How would you show them on the balance sheet?
40. What is meant by the following: "If the personal ledgers do not agree with their controls, enter a debit or a credit suspense account in the personal ledger to secure the proper agreement." Is this procedure advisable?
41. Give a list of the different kinds of items that an auditor might find that a bookkeeper had wrongly included as accounts receivable.
42. Tell how you would treat these items (41) on the balance sheet.
43. Draw up an audit program on accounts for a detailed audit.
44. Why is it necessary to audit accounts which have been opened and closed during the period under audit?
45. Draw up a balance sheet of a subsidiary such that the advances to it from the parent company can be shown to be fixed, although the officers say that they are current.
46. Why should a corporation retain its capital stock until it is fully paid for?
47. Cite an instance where an accrued receivable should have a reserve provided against it.
48. The client has computed the accrued interest receivable on notes. Describe fully and clearly how you would check it.
49. What is your opinion of the following?

Simmons Company
Balance Sheet as of November 30, 1922

Current Assets:

Advances to affiliated companies 1,839,472.39

Simmons Limited
Balance Sheet as of November 30, 1922

Current Assets:

Inventories (cost or market, whichever is lower) $821,602.36
Accounts Receivable 350,630.29
Cash on Hand and in Bank 75,358.06
Total Current $1,247,590.73
All Other Assets (combined by the auditor) Total $2,069,871.87

Reserves:

Plant Depreciation $570,304.72
Bad and Doubtful Accounts 122,824.69
Taxes 15,358.93
Employees' Liability 17,631.07
Miscellaneous Others 16,686.25 $ 742,815.66
Advances by Simmons Company 923,328.02
Accounts Payable 159,451.87
Capital Stock and Surplus (combined by author) Total $2,069,871.67

Total $3,895,467.22
49. (Continuation)

Simmons Properties Incorporated
Balance Sheet as of November 30, 1922

Current Assets:
- Inventories (at cost) $35,030.76
- Accounts Receivable 51.99
- Notes Receivable 465,924.36

Total Current Assets $471,007.11

All Other Assets (combined by author) 1,589,110.96

Total $2,110,118.07

Reserves:
- Depreciation $41,477.82
- Taxes 13,306.18 $54,784.00
- Advances by Simmons Company 916,145.37
- Notes Payable 923,000.00
- Capital Stock and Surplus (combined by author) 216,188.70

Total $2,110,118.07

50. What is your opinion of the following?

"Mr. Young, D.R. of the National City Bank, New York:— The treatment of accounts and notes receivable as current assets should be determined largely by the terms of sale used by the concern in question and by the industry in which it operates. There are some cases, such as where merchandise is sold on installment terms and notes are received maturing over a period of months, in which it would be perfectly proper to include as current assets the notes due during a period up to one year.

"On the other hand, the great majority of concerns sell on much shorter terms and any receivables that are past due should be very carefully examined and, if they are found to be very long overdue, they should be shown separately and a proper reserve set up against them. This would include notes receivable taken to close out overdue accounts. Receivables due after one year should be shown separately.

"If it (installment account receivable over one year) is in the ordinary course of business it might be perfectly proper to include it as a current asset, but if it is not due until over a year, it should at least be segregated from the ordinary accounts that you expect to be collected in thirty days.

"I think those (regular sales to employees) should really be shown separately because they are in a sort of class by themselves and if anything went wrong with the business probably the amounts due from employees or officers would be pretty hard to collect."

51. Take the specific procedure Audit Program (Plate 66) for Goldsmith and Howry Bros., Inc., and translate it into a general procedure audit program.

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1"Relations Between Accountants and Bankers"—by H.Y.S.S. of C.P.A., Nov. 1931, (p.4)
THE VERIFICATION OF THE ALLOWANCE FOR BAD DEBTS

225. Analyzing the Debits in the Account.
226. Analyzing the Credits in the Account.
228. Reserve for Doubtful Notes.
229. Classification on the Balance Sheet.
230. Explanation of Plate 69. PLATE 69--A Method of Computing the Reserve for Bad Debts (1st type).
231. Explanation of Plate 70. PLATE 70--A Method of Computing the Reserve for Bad Debts (2nd type).
232. Explanation of Plate 71. PLATE 71--A Method of Computing the Reserve for Bad Debts (3rd type).
233. Explanation of Plate 72. PLATE 72--An Audit Program.

Review Questions.

225. Analyzing the Debits in the Account.--As stated elsewhere in another connection, the charges to the reserve for bad debts must be verified as being legitimate entries, because a cash theft, or accounts which have been received in full, may be written off in this manner.

It may also be recalled that the writer has suggested that the auditor should either bring the list of bad debts to the attention of a high official, or incorporate it into the audit report, or both, as a means of self protection against charges of negligence at this point.

226. Analyzing the Credits in the Account.--As to the credits in the account, these represent either the current provision for bad debts, or bad debt recoveries. Just how the amount of the current provision for bad debt is determined varies from client to client, and is insignificant,—the important thing being the adequacy of the final balance in the reserve, and the fairness of the current charge to expense.

Some clients, for example, favor using a certain percentage of the credit sales, or a smaller percentage of the total sales. This method is ordinarily best suited to instances where the accounts are of small value, and too numerous to be reviewed individually. By using this method, the current profit and loss account bears a charge in proportion to the sales (i.e., income) which is, of course, a substantially accurate method, wherever the per cent is based upon considerable past experience. But the auditor must remember that there are times when it should be obvious that the bad debts will exceed the reserve calculated in this manner. In these cases the auditor must break loose from the magic charm of per cents, and increase reserve to cover the emergency. Thus a period of general and intense business depression should be a sufficient warning to the auditor to disregard past per cents. In such instances the debit should be in part to surplus as representing the additional provision necessary to cover accounts which arose prior to the period under audit.

In brief, if the allowance is set up as a percentage of sales, the auditor must compare the final balance of the account after current losses have been debited to it, with an impartial estimate of the allowance needed to cover the outstanding accounts.

1Bad debt recoveries may be credited to the reserve if small, otherwise to OTHER INCOME or to Surplus, except that if the account relates to the current period it is proper to credit bad debt expense. (The writer favors OTHER INCOME.)
A second method is one whereby the amount of the outstanding accounts at the end of the period becomes the base for figuring the current provision for bad debts at a rate per cent which past experience has shown to be adequate. Under this plan, old debts which go bad can be charged to the reserve until it is used up, and then to surplus. Or, if the reserve is too great, it can be returned to surplus. Current bad debts must be charged to bad debt expense. Of course, whether or not the surplus will be adjusted, as indicated above, will depend in practice upon the size of the amounts involved.

Still another method, usable where the accounts are sizable and/or few, is to estimate the reserve, if any, needed on each overdue account, the amount, of course, necessarily depending upon all of the circumstances involved. Thus, for example, an examination and discussion with the credit manager, of Jones & Co.'s debt of $157.12 may convince the auditor that $75 is an ample reserve for this account. In the same way Sweet & Eddy's account of $14,189.92, although overdue 90 days, may be held to be wholly collectible because an analysis of their account shows them to be chronically slow payers, but, nevertheless, good for 100 cents on the dollar.

With this total estimated reserve as a guide, the actual reserve is set up at a slightly higher figure (usually a round amount). During the period, the old debts which go bad are charged to the reserve until it is used up, and then to surplus— if sizable. Current debts which go bad are charged direct to bad debt expense.

227. Judging the Collectibility of Accounts.—In judging the collectibility of accounts, the following points (sec. 200) should be taken into consideration.

(1) Was the debtor chronically slow in his payments in the past? If so, the account is probably good.
(2) What kind of an answer has been received to requests for payment?
(3) How are business conditions where the debtor lives?
(4) Is the balance being reduced, or do the current sales exceed the current cash receipts?
(5) If the account is in the hands of an attorney, when was his last report, and what did it say?
(6) Is the balance for goods or for a dishonored note?
(7) Is the balance composed of specific invoices?
(8) Is the debtor bankrupt? What dividends have been received? What future ones are expected? (In the absence of information consider the account bad.)
(9) What is the debtor's credit rating in Bradstreet's, etc.?
(10) Is any officer interested in the business?
(11) What do the debtor's financial statements look like?
(12) What information do the correspondence files reveal as to the cause of the delinquency, the pressure exerted to collect, the attitude of the debtor, etc.?

Assuming no fundamental change in business conditions.

The auditor must not forget to inquire if the client carries credit insurance. If it does, the auditor should note in his working papers the amount of insurance and under what conditions the policy is operative.

The reserve should be set at a higher amount to take care of some of the current receivables not yet overdue, but which will assuredly go bad. A more exact method is to charge each old debt as it goes bad to the reserve for the exact amount already set aside for it. The difference adjustment between the amount received and the amount of the loss is
What notations as to collection agents, disputes, etc. are written on the account?

228. Reserve for Doubtful Notes.--- At this point attention is called to the necessity for a reserve for doubtful notes, as well as for a reserve for doubtful accounts (the two reserves may be combined into one reserve if desired), because inexperienced auditors are apt to take the point of view that a note rarely goes bad. Moreover, the possibility of notes and acceptances under discount going bad must not be forgotten when estimating the amount of the reserve.

229. Classification on the Balance Sheet.--- When the amount in the reserve for bad debts represents an honest effort to evaluate the accounts and notes, it ought to be deducted from the asset accounts, except in published statements when the assets may be shown net of reserves. This procedure is justifiable on the ground that the auditor's certificate sufficiently protects a third party as to the existence of an adequate reserve, and on the ground that the amount of the reserve reveals information that is essentially private.

230. See Plate 69.
231. See Plate 70.
232. See Plate 71.
233. See Plate 72.

(cont'd) carried to surplus or bad debt expense, depending upon the size of the adjustment.
A METHOD OF COMPUTING THE RESERVE FOR BAD DEBTS (2d type) PLATE 70

WILLIAMSON & ARNOLD, INC.
Reserve for Bad Debts
Audit for the Year Ending Sept. 30, 1930 Schedule 5a

Balance per General Ledger September 30, 1930

| Balance Sept. 30, 1929 per G/L and our report | 14,629.15 |
| Current Provision (\( \frac{3,155,414.08 \times 1}{2} \)) | 15,827.07 |
| Total | 30,456.22 |

Less -Bad Debts charged off -Schedule 5a-1

| Balance, Sept. 30, 1930 per G/L | 14,905.48 |
| | 15,550.74 |

Audit Procedure
See the audit program.

231. Explanation and Comments.—As noted in the text this method of computing the reserve, i.e. Sales \( \times \% \), is customarily used whenever the accounts are small and very numerous. If properly supervised, it is a satisfactory method because it charges off the losses (i.e. the current provision) against the year which receives the income applicable to those losses.

Note the way in which this schedule is drawn up. The opening line is devoted to a statement of the conclusion of the facts developed in this analysis sheet, including the designation debit or credit as the case may be (here Cr.). In other words, the gist of the whole sheet, the key figure, is set out and labelled clearly and conspicuously in the most prominent position possible.
EXPLANATION OF PLATE 69

A METHOD OF COMPUTING THE RESERVE FOR BAD DEBTS (1st typo)

THE JEFFERS MFG. CO.
Dec. 31, 1929
Accounts Receivable—Reserve for Bad Debts

230. Explanation and Comments.—This exhibit indicates that the auditor did not deem it necessary to draw off a schedule of the personal accounts by age. It appears that he took off his own adding machine list (not shown), getting a net balance of $53,427.92, to which he added the credit balances of $6,987.60, which gave a total of $60,415.52 for the actual receivables, i.e. debit balances. This total ($60,415.52) was, in turn, subject to a reduction adjustment of $6,947.20, being the amount charged therein to customers for returnable containers. On such sales the entry might have been:

Accounts Receivable—Williams & Co. 1325
Sales — A 1200
Containers Out '71th Customers 125

As noted on the schedule, the credit balance ($6987.60) in the customers' ledgers went to schedule 19, which develops the trade payables. Also, note that the amount for the containers ($6,947.20) was a credit account, #33, in the trial balance. The net result ($53,468.32) was, of course, the amount which appeared in the balance sheet as Accounts Receivable—Trade.

Special attention is called to the fact that the auditor used the analysis method of auditing in checking out the 50 accounts in the personal ledger.

Notice also the very thorough test which was given to all journal entries involving accounts receivable, including the securing of the treasurer's approval of the bad debts written off.

A review of the reserve indicates that the client favors setting up a round amount ($800) for the final balance, based upon the expected bad accounts. 1930 debts which go bad will, of course, be charged direct to 1930 bad debts expense. That is, the balance of the bad debt expense account in any year will always consist of current bad debts charged off direct, and a provision for bad debts, i.e. an estimate of the bad debts in the outstanding balances at the end of the year.

Also, note that the auditor has gathered for his report the very important bit of information that $43,329.12 had been received in cash and containers by 1/29/30 on the 12/31/29 balance ($53,468.32).

In conclusion it may not be amiss to emphasize that some allowance should always be made for accounts which are not overdue at the audit date. Too often the auditor looks upon these as being collectible. The same thing is true of accounts receivable—discounted, or sold with guarantee.
A METHOD OF COMPUTING THE RESERVE FOR BAD DEBTS (1st type) PLATE 69

THE JEFFERS MFG. CO.

Accounts Receivable - Reserve for Bad Debts 1/29-30
Audit for Year Ending Dec. 31, 1929 Schedule 5

Accounts Receivable
Balance 12/31/29 per G/L Took off our own list (5-a) $53,427.92
Add - credit balances $6987.60 (To 19)
Total debit balances 60,415.52
Deduct - "Containers out with Customers" account 6947.20 (From T.B.33)
Amount to appear on Balance Sheet 53,468.32

Audit Procedure

(1) By 1/29/30, $43,329.12 of the 12/31/29 accounts had been received in cash and containers.
(2) The shipping records from Dec. 27 to Dec. 31 were checked into the sales record. No errors were found.
(3) Invoices were checked into the Sales Book for Oct. Nov. and Dec.
(4) The Sales Book was footed and crossfooted for Oct. Nov. and Dec. Postings for these months were checked into the General Ledger, and into the Personal Ledgers for the last 15 days of Dec.
(5) 50 accounts in the A-G personal ledger were selected at random and all items therein were checked into the books of original entry. These accounts were footed and the balances were proved.
(6) All account receivable items in the Journal were scrutinized and tested.

RESERVE FOR BAD DEBTS 12/31/29

Balance 1/1/29 per G/L and our report 400.00
#1928 Debts Charged Off during the year - S. Simpson 137.89
F. Sarden 263.28
A. Albert 124.87 526.04
Balance 12/31/29 12/31/29 Provision - adjustment #21 926.04
Adjusted Balance 12/31/29 800.00

1929 Accounts to be Provided for by the Reserve as at:
R. Marstors $137.50 1/7/29
F. Smith & Co. $47.60 3/27/29
Total $185.10

The treasurer approved the bad debts written off.
See Schedule 5b.

#1929 debts which went bad were charged direct to 1929 bad debt expense. See Schedule 61.
A METHOD OF COMPUTING THE RESERVE FOR BAD DEBTS (3d type) PLATE 71

GOLDSMITH, HOWRY & SONS
Reserve for Bad Debts
Audit for Year Ending July 31, 1930 Schedule 7a

<table>
<thead>
<tr>
<th>Description</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance per G/L 7/31/30</td>
<td>706.41</td>
</tr>
<tr>
<td>Balance July 31, 1929 per G/L and our report</td>
<td>814.81</td>
</tr>
<tr>
<td>Loss - Bad Debts charged off -Schedule (7a-1)</td>
<td>7419.53</td>
</tr>
<tr>
<td>(6604.72)</td>
<td></td>
</tr>
<tr>
<td>Current Provision (adj. #45)</td>
<td>7313.13</td>
</tr>
<tr>
<td>Bal. 7/31/30 ($141,681.42(Acct.Rev. balance) x 1/2% =)</td>
<td>706.41</td>
</tr>
</tbody>
</table>

Audit Procedure
See the Audit Program.

Bad Debts for Federal Tax \$7419.53

282. Explanation and Comments.— Under this plan the final balance in the reserve is figured at a certain percent of the final balance of accounts receivable, sufficient current provision (here adj. #45—\$7313.13) being made to secure this result.

As in plate 59, the allowable deduction for bad debts in computing the federal tax is the amount actually charged off, namely \$7419.53.

The method used here is somewhat different from that explained in the text (sec. 228), but the results are the same.
(10) **Reserve for Bad Debts**

(1) Check the opening balance against the closing balance per our Dec. 31, 1930 schedule CC-a.
(2) Prepare schedule for this audit. Same columns and headings as CC2 of last year.
(3) Show clearly the nature of all credits to the account such as recoveries, additional monthly provisions, etc. Give names, details of computations, etc.
(4) State clearly in your Comments the basis on which the Reserve is conducted. For example, % of credit sales; % of gross sales; % of accounts outstanding at Dec. 31? Specific accounts? Etc.
(5) Does the reserve include an amount to cover collection expenses on the installment accounts? How much?
(6) Show the name and amount of each write-off against the Reserve. Have Mr. Faraday approve these bad debts.
(7) Does the reserve make provision for doubtful notes? If not, why not?
(8) Is the Reserve balance adequate? How did you arrive at your conclusions?
(9) Take into consideration the collections made since the close of the period.
(10) Does the reserve make provision for doubtful notes and accounts under discount?
(11) Ascertain whether allowances are necessary for discounts, rebates, freight, etc. Set up in a special reserve.

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223. **Explanation and Comments.**—This plate is self-explanatory. Study also Plate 66. The writer desires to interject here that it is usually advisable that accounts which are written off should be transferred to a "suspense ledger", controlled by an account in the general ledger. This procedure lends itself to following up the accounts, whereas no method at all in this respect usually means that these accounts are gladly forgotten. Vigorous, LONG-LIVED, and PERSISTENT collection methods DO yield results.
**REVIEW QUESTIONS**

1. Describe four common methods of providing for bad debts.
2. Add a point or two to section 216 on "Judging the Collectibility of Accounts".
3. What two treatments can be given to bad debt recoveries? Which one do you prefer, and why?
4. In what way may the federal income tax procedure for bad debts be different from that of the client?
5. How would you protect yourself against improper charges to the reserve?
6. Is it advisable to show the reserve as a separate item on the balance sheet? Elaborate your answer.
7. What is your opinion of the following?

   "We have been requested to charge separately to surplus bad debt losses considered to be unusual losses during the present period of depression, and the clients submit that, at least in part, such unusual losses are due to inaccuracies in bad debt reserves for prior periods." Accordingly we would like to know what should be the treatment in the accounts of unusually large losses from bad debts due to the present depression.

   **Answer No. 1:** "With regard to (a), it is, of course, obvious that losses from bad debts are greater in periods of depression than in periods of prosperity, and we believe it has been the experience of industrial companies generally that considerable increases have been necessary for bad debts in the past two years. While it would undoubtedly be conservative practice to establish reasonably substantial reserves in prosperous times to provide for possible future losses from bad debts, we do not think that failure to provide ample reserves in the past would warrant charging to surplus losses now incurred which conceivably might have been provided for previously. However, reserves for bad debts are largely estimates at best, and probably it will be found that the necessity for making unusually large provisions at this time is not due principally to inaccuracies in previous reserves but is a result of business conditions arising during the current year, which could not have been reasonably foreseen. It follows, therefore, that bad debt provisions should all be absorbed in the profit-and-loss account, and it has been our experience that this practice is being followed practically without exception. Such charges may, of course, properly be shown as a separate item in the profit-and-loss statement."

   **Answer No. 2:** "It is quite rare to find a commercial business of any size which can accurately ascertain at the end of each accounting period the exact amount of the losses which will be sustained in collection of the accounts receivable at a particular date. It is, therefore, generally admitted that the balance-sheet allowance for bad debts, with the resulting charge to the income account, is at best a careful estimate. There may be an occasional case in which there would be justification for charging bad debts to surplus, but, as a rule, such charges should be made to current income account. If a concern has set up reasonable estimates of anticipated bad debt losses, and if, due to general business conditions such as exist at the present time, the amount of losses is abnormally high, then it would seem that such bad debt losses should be charged to the income account of the period in which the accounts are determined to be uncollectible."
7. (continuation)

Answer No. 3.—"As a matter of basic principle, every so-called surplus adjustment is, in fact, a correction of the operating results of some year. There are cases in which losses arise which clearly apply to the operations of a prior year and may, therefore, be properly charged against surplus. In a restatement of the surplus account, analyzed as to earnings of prior years, such an adjustment would be directly applied against the operations of the particular year affected.

"If it can be demonstrated logically that a reserve for bad debts, at the beginning of the year, was insufficient on the basis of facts ascertainable at the time, the relative increase in reserve for bad debts should be treated as a charge against surplus."—"J of A", August 1932.

8. Take the specific procedure Audit Program (Plate 72) for Luck & Logan, Inc., and translate it into a general procedure audit program.
CHAPTER 17

THE VERIFICATION OF INVENTORIES

234. The Classification of Inventories.
235. The Classification of Inventories in Consolidated Balance Sheets.
236. The Composition of Inventories.
237. Inventories Subject to Liens.
238. Explanation of Plate 73.
   PLATE 73 - A Form of Trust Receipt (1st type).
239. Explanation of Plate 74.
   PLATE 74 - A Form of Trust Receipt (2d type).
240. Explanation of Plate 75.
   PLATE 75 - A Form of Inventory Sheet.
241. The Original Count Sheets.
242. Initialising the Inventories.
243. The Duplicate Tag Method of Inventorying.
244. Explanation of Plate 76.
   PLATE 76 - A Form of Goods-in-Process Duplicate Inventory Tag.
245. Should the Auditor Take the Inventory?
246. Book Inventories.
247. Analyzing Book Inventories.
248. Analyzing the Cost System.
250. Methods of Pricing - Introduction.
251. Valuation at Cost.
252. Valuation at Cost or Market, Whichever the Lower.
253. Definition of Market.
254. Valuation below Cost, or Selling Market.
255. Valuation at Market Less Selling Expense, Administrative Expense, Etc.
256. Valuation by the Retail Method.
257. Explanation of Plate 77.
   PLATE 77 - A Form of Schedule for Valuing Inventories by the Retail Method.
258. Base-stock Inventories.
259. Carrying Charges.
260. Inventories of Partnerships.
261. Interest.
262. Obsolete and Slow Moving Goods.
263. Miscellaneous Comments on Checking Quantities.
264. Goods Received on Consignment.
265. Goods Out on Consignment.
266. Explanation of Plate 78.
   PLATE 78 - A Form of Account Sales.
267. Commitments.
268. Advance Payments.
269. Testing Footings, Extensions, Summaries, Etc.
270. The Detection of Errors by the Use of Schedules.
271. Miscellaneous Comments on Supplies.
272. Explanation of Plate 79.
   PLATE 79 - A Section of an Office Supply Inventory Schedule.

It seems advisable to remark at this point that it is the inventories which are most commonly manipulated by TRUSTED OFFICIALS in case of fraud not actually involving theft, hence the difficulty of detecting it. Thus a managing official may inflate the inventories in order to show the necessary profit to justify his retention for another year; the executive officers (i.e. the chief stockholders) of a close corporation may inflate the inventories in order to deceive a bank into continuing (or increasing) its present line of credit, etc., etc.
275. Miscellaneous Comments on Raw Materials.

276. A Schedule on Inventory Reserves (1st type).

277. A Schedule on Inventory Reserves (2d type).


279. A Schedule on Goods-in-Process Inventory.

280. A Schedule on Finished Goods Inventory.

281. A Section of a Finished Goods Inventory Schedule.

282. Valuation of Inventories in the Profit and Loss Statement.

283. Intercompany Profit in Inventories or Consolidated Balance Sheets.

284. The Client's Inventory Certificate.

285. A Form of Inventory Certificate. (1st type)

286. A Form of Inventory Certificate (2d type).

287. The Auditor's Comments in His Certificate.

288. Natural Business Year.


290. An Audit Program for Inventories.

291. A Master Schedule on Inventories.

292. A Form of Merchandise Collateral Note.

293. A Schedule on Price Testing.

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234. The Classification of Inventories.—The standard (and satisfactory) classification of inventories on the balance sheet is finished goods, work-in-progress, raw materials, and operating supplies. In practically all balance sheets for management or credit purposes, the division of inventories into these four classifications constitutes one of the auditor's main duties. Without this information, important comparisons and ratios cannot be made. For example, if the inventories are unclassified, how can a banker compute the per cent which the finished goods, work-in-progress, raw materials, and operating supplies are of the total inventory, for comparison with last period, etc. etc.

As to operating supplies, these are sometimes listed among the Deferred Charges to Operations, but the better practice is to consider them as current assets. Of course, it is true that these items so not enter directly into the finished product in the same way that raw materials are often combined into a single amount, but this practice is not desirable.

235. The Classification of Inventories in Consolidated Balance Sheets. Where there is an outside market for the finished goods of each of the companies, good accounting procedure permits the combining of the finished goods of each of the companies as the finished goods on the consolidated statement, and the combining of the goods-in-process, and raw materials in a like manner.
one. For example, if Company A sells all of its finished product to Company B as its sole raw material, should Company A's inventory of finished goods be listed as raw material or as finished goods? If it is listed as finished goods, then why shouldn't Company B's raw material, which is the same identical thing, be listed also as finished goods? But if this is done, what shall Company B's actual finished goods be called? Or again, if Company A's finished product is listed as raw material so as to coincide with the classification given to it by Company B, how shall Company A's raw material be classified?

The following solution of this particular, simple problem is given as a suggestion of the general lines along which difficult situations may be worked out:

![Table]

<table>
<thead>
<tr>
<th>Description</th>
<th>Company A</th>
<th>Company B</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Raw Materials</td>
<td>$461,817.9</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goods-in-Process</td>
<td>$587,143.45</td>
<td>$241,076.76</td>
<td>$828,2144.91</td>
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<tr>
<td>Finished Goods</td>
<td>$382,144.91</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Raw Material</td>
<td></td>
<td>$608,329.59</td>
<td>$608,329.59</td>
</tr>
<tr>
<td>Goods-in-Process</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Finished Goods</td>
<td></td>
<td>$690,461.37</td>
<td>$690,461.37</td>
</tr>
<tr>
<td>Total</td>
<td>$2,970,995.29</td>
<td>$2,970,995.29</td>
<td>$5,941,990.58</td>
</tr>
</tbody>
</table>

236. Composition of Inventories -- Another important duty of the auditor is to see that the composition of each class of inventories is correctly determined. But it should be obvious that in reviewing the items composing each class of inventories, the auditor may find that what he passed as raw material on one client's balance sheet, he may also properly allow as finished goods on another client's balance sheet. Thus, thread is a finished product of a thread mill, but a mere supply in the clothing industry.

From time to time, especially when there is a work-in-process ledger, an auditor may find that work orders, representing repairs, or equipment in process of being made, have been erroneously classified as a part of the work-in-process inventories, simply because it was work in process of being completed. Naturally, only items that are going to be sold can be legitimately understood as being work-in-process. These repairs in process should be either expensed or capitalized (i.e. charged to a depreciation reserve) according to their actual nature, and equipment in process of completion should be set up among the fixed assets. Moreover, machinery withdrawn from the factory because there is no demand for its product, or extra machinery held in reserve for breakdowns, should be weeded out of the inventories and placed among the plant properties. As a rule, these items get into the inventories because the inventory takers found them in the storehouse along with proper inventory items, or they may have been taken from inventory cards, when a perpetual inventory is kept.

Closely akin to these cases are maintenance items, such as large pulleys, major repair parts, shingles, doors, window frames, etc., which may eventually be either capitalized or expensed according to the particular use to which they are finally put. Despite the possibility of their becoming fixed assets, these items are generally included in the operating supplies. But if, for example, they were purchased to complete an addition to a building, they must be classified as fixed assets.

1 Quite often the only feasible plan is to show the inventories in a single total.
237. Inventories Subject to Liens.—As has been emphasized herein time and again, the auditor must consider the matter of uncovering liens a major duty; therefore, he should get the client's certificate as to the amount of inventory, if any, subject to liens, and the amount of the liens. Very often a check of the prepaid insurance account against the insurance policies will reveal this situation (when not disclosed by the client), because the pledgee will generally have in his own possession the fire insurance policies covering the pledged goods. On other occasions the auditor has detected liens on inventories by reading the contents of certain bank charges which have turned out to be for warehouse rent, etc. It will be recalled that a client may arrange to have its bank accept drafts drawn against bills of lading on the understanding that the bank will retain the warehouse receipts for the goods (they having been stored in a public warehouse at the client's expense). Whenever the client needs some of these goods, he must, of course, pay the bank for them, the bank releasing the goods paid for out of the public warehouse.

Although the goods in the warehouse are not the legal property of the client, it is ordinarily legally bound by written agreement to take goods from the bank at the invoiced price. Therefore, the practical view of the situation is that the goods are the client's, subject to a lien by the bank to the extent of the accepted drafts less the partial payments. As this is undoubtedly the truth of the matter, the goods must be inventoried and the liability to the bank must be taken up. Moreover, these goods must be valued at cost or market, whichever the lower, just the same as any other inventory of the client.

In all cases of liens, the auditor must ascertain direct from the pledgee the amount and nature of the security, and the extent of the lien thereon. And, in stating the inventories on the balance sheet, those subject to liens must be so designated, but that fact in itself does not take them out of the current position.

238. See Plate 73.

239. See Plate 74.

240. See Plate 75.

241. The Original Count Sheets.—The inventory sheets which the client gives to the auditor for examination will usually be the fair copies. But as these were very likely built up from original count sheets, the auditor must start in auditing from this latter point rather than from the fair copies. Fair copies may be tampered with at times by the management, but initialled original count sheets, i.e. those made by the inventory takers, are very rarely altered, chiefly because no one, until initiated, expects the auditor to call for them. Moreover, as clerical errors are most apt to creep in here, in transferring and summarizing the information from the count sheets to the fair copies, the auditor must cover this situation by test checking from the count sheets to the fair copies, and vice versa. The guiding principle is, of course, to check the largest items first, and then as many others as time permits. By this method, three-quarters of the amount of the inventory may often be tested by covering only one-eighth to one-quarter of the items.

If a client has destroyed the original count sheets the auditor will naturally have to forego this important checking procedure, but the auditor should see to it that the client is instructed to preserve the count sheets

Before he audits the inventories, the auditor should review the inventory sheets (assuming a first audit) in order to acquaint himself with the nature and amount of the items involved. Next, he should ascertain when and how the inventories were taken, priced, and computed, etc. With such facts as these before him, and only then, can an auditor plan and execute a satisfactory inventory audit program.
EXPLANATION OF PLATE 73

A FORM OF TRUST RECEIPT (1st type)

239. Explanation and Comments.—As pointed out in the text, the pledging or hypothecating of inventories is one of the most important facts which the auditor must ascertain and set forth. Obviously, as the clues are not on the face of the books of account, the ingenuity of the auditor is often taxed in getting at the true facts.

Note the detailed way in which the bank protects itself, no matter whether the property is goods, accounts, or cash.

TRUST RECEIPT

RECEIVED FROM THE ATLAS NATIONAL BANK OF PHILADELPHIA,
hereinafter called the Bank, the goods specified in documents described as follows:

Description of Documents and Draft Secured Thereby

IN TRUST to hold said goods for the Bank, and as the property of the Bank and with the privilege on our part to manufacture and remanufacture the goods without cost and expense to the Bank, keeping the product identified, and to sell the same or the product thereof for the account of the Bank. It is distinctly understood that we have authority to make no other disposition whatever of the said goods or any part thereof or the proceeds thereof, whether by way of conditional sale, pledge or otherwise. The proceeds of the said goods in case of sale thereof and the goods themselves, in the event that they are not sold, shall be held by us at all times in trust for the Bank as security for the payment of the draft drawn by us on the Bank and accepted by the Bank, which draft is hereinafter described, and subject to all the terms and provisions with reference to the care and protection of the said goods and their proceeds and the application thereof in payment of the said draft or other obligation from us to the Bank set out in an agreement with reference thereto addressed to the Bank, signed by us and dated.

The Bank may at any time cancel this trust and the authority given hereunder and take possession of the said goods, wherever the same or the manufactured product thereof may be found, unless the same shall have been delivered to a purchaser and the proceeds of the sale thereof received from such purchaser, and thereafter, the Bank may take possession of the proceeds of the sale thereof, wherever the said proceeds may then be found, and we do hereby assign and transfer to the Bank the accounts of the purchaser or purchasers thereof.

Dated: ____________________
TRUST RECEIPT

New York City ___ __19____-

Received from the Regal Trust Company of New York, for one of the following purposes as indicated by (x).

1. For Expert Shipment
2. For Warehouse
3. To exchange for Domestic Order Bills of Lading (Railroad or Steamship.)
4. For immediate delivery to ____________, Who have/has purchased the same for $_____________ payable ___________ and to obtain from the purchaser the proceeds of the sale.
5. For

the goods and merchandise specified in the documents described below, both such documents and said goods and merchandise belonging to and being the property of the said Trust Company, and in consideration thereof I/we hereby agree to hold said goods and merchandise in trust for it and as its property and to deliver over to the said Trust Company or its assigns, immediately upon the receipt thereof by me/us, and in any event not later than ____________, any one of the following representing the goods and merchandise so described below according to the purpose for which the original documents are withdrawn:

2. Negotiable Warehouse Receipt of Independent Warehouse, Inc., or other warehouses satisfactory to said Trust Company.
3. Domestic Order Bills of Lading. (Railroad or Steamship)
4. Proceeds of the sale of such goods or merchandise, it being understood that immediately upon receipt by me/us of such proceeds the same shall be delivered to the said Trust Company in whatever form collected and whether or not my/our obligation to it shall have matured. It is understood that such proceeds are to be applied by said Trust Company against my/our indebtedness to said Trust Company, whether due or to become due. However, if such proceeds be in notes, bills receivable or acceptances, they shall not be so applied until paid, but held until maturity by said Trust Company, with liberty meanwhile to sell or discount and so apply the net proceeds.
5. The delivery herein is temporarily made to me/us for convenience only, without novation, or without giving me/us any title to the documents or the goods and merchandise they represent, except as trustee and agent for the said Trust Company for the purposes herein indicated.

Said Trust Company may at any time cancel this trust and take possession of said goods and merchandise or any of said documents or of the proceeds of the same wherever said goods and merchandise and documents or the proceeds thereof may then be found or located, and in the event of suspension, proceeding in bankruptcy or assignment for the benefit of creditors on my/our part or of the non-fulfillment of any obligation or of the non-payment at maturity of any indebtedness on my/our part to said Trust Company then in any such case, all obligations, acceptances, indebtedness and liabilities whatever shall forthwith mature and become due and payable.

The said goods and merchandise shall at all times at my/our expense, be fully insured against loss by fire and any other risk that said goods and merchandise may be subject to. On demand, the insurance policies or certificates of acceptable companies will be deposited with the Regal Trust.
Company of New York, the said Trust Company to be designated in the policies as the Assured in the following form: Assured: The Regal Trust Company of New York for account of whom it may concern. Loss to be adjusted with and payable to the Regal Trust Company of New York for account of whom it may concern.

The undersigned in further assurance, agree that insofar as the undersigned may make entries or records of transactions herein set forth or provided for in the books of account of the undersigned, such entries shall definitely indicate that said merchandise and documents and the proceeds thereof are the property of said Trust Company.

Receipt of a copy of this Trust Receipt is herewith acknowledged.

<table>
<thead>
<tr>
<th>Description of Document</th>
<th>Quantity</th>
<th>Goods and Merchandise (Give Marks and Numbers)</th>
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<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Signed ______________________

239. Explanation and Comments.—When read in connection with the comments in the text (see special sections at the end of this chapter), this plate will be self-explanatory.
EXPLANATION OF PLATE 75

A FORM OF INVENTORY SHEET

INVENTORY RETAIL
January 31, 1925
Jones, Auburn & Schultz Corp.

240. Explanation and Comments.—This plate is self-explanatory.

Note that each inventory sheet must be initialed for: (1) called by (2) written by (3) priced by (4) figured by (5) checked by (see upper left hand corner).

Observe that each sheet has been numbered, here 00158, in order to prevent sheets from being lost without being noticed.

Also, observe the underlined words of caution in the upper right-hand corner in regard to the prices being stated on the basis of the unit of quantity listed on the inventory sheet.

Finally, notice that the sheet is checked by having a second person recomput e the retail extension without reference to the original computation. That is, the original computation is placed in the outside Retail Extension column. This column is then detached, and a second person goes over the work, putting her answer in the inside Retail Extension column. The two results are then checked one against the other.
A FORM OF INVENTORY SHEET PLATE 75

<table>
<thead>
<tr>
<th>Code</th>
<th>Description</th>
<th>Quantity</th>
<th>Doz.</th>
<th>Retail Price</th>
<th>Retail Extension</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Pair</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Each</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Called By Written By Checked By

Priced By Figured By Checked By

INVENTORY at RETAIL

January 31, 1925

JONES, AUBURN & SCHULTZ CORP.

-

OMISSIONS

-

(RIGHT HALF)

Glassware per dozen be sure the quantity is in dozens

" pair " " " " " " pairs

" each " " " " " " units

Retail Extension

OMISSIONS
in the future, no matter how soiled they may be. If the client can read them, the auditor also can read them.

242. Initialling the Inventories.— One of the most important things for the auditor to insist on is that everyone of the client's force and everyone of his own force too, for that matter, who does something on the inventories must initial for it. Everyone means EVERYONE, from the millhands who take the inventories to the president inclusive. The reason for this strictness is that its effect is wholesome and very badly needed. As each section of the work is thereby definitely charged against someone, that someone is going to be very careful with his work, whether it be in counting, in pricing, in extending, or in summarizing, etc. Obviously, as too much care is impossible in inventorying, the salutary effect of initialling is very much needed. Moreover, fraud is probably somewhat more difficult to perpetrate under circumstances where initialling is rigorously enforced.

243. The Duplicate Tag Method of Inventorying.—As the duplicate tag method of inventorying is an excellent one, one method of doing it will be outlined in the following paragraphs.

Sometime prior to the date, or period, of the actual inventorying, instructions are issued to the heads of all departments, requesting them to see that all surplus raw materials and supplies are returned to the stores-room; that all obsolete materials and slow moving items are either piled separately or are sent to the proper stores-room; that all semi-finished parts are put in stock; that all goods-in-process or finished material of the same kind is stacked in such a manner as to be readily inventoried.

And such other instructions, peculiar to the particular business, are given, as will result in getting the goods in orderly piles and locations suitable for inventorying.

At about the same time, instruction sheets are issued to everyone who is going to take part in the inventorying. This allows time for the instructions to be studied, and questions thereon answered, long before inventory date. Such instructions might in some instances cover as many as three or four pages. They should embody in detail all of the salient points of proper inventorying, and special instructions on any unusual or difficult items to be inventoried.

As someone must be placed in authority, the assignment is usually given to the client's auditor, the chief cost accountant, or the chief general accountant, because these men are the ones who know most about what constitutes good inventorying. After the selection of a leader, comes the selection of the captains, to whom the responsibility for respective territories, not classes of goods, is assigned. Thus, the chief clerk in the stores-room may be made captain over the supplies room; the purchasing agent may be assigned to the raw material stores-room; the production manager may be given charge of the work-in-process departments, and so on.

The auditor should secure a copy of these instructions for himself so that he may (1) be informed as to what was done, and (2) be in a position to offer suggestions, if any. Obviously, it is preferable for the auditor to consult the client IN ADVANCE of the inventorying, so that he (auditor) may add his suggestions as to how the work should be organized and the inventories arranged to minimize the labor, time, and risk of error. See also Plate 76. It is again emphasized that the inventory taking should be supervised by responsible officials and by those employees who are familiar with the section of the inventory to which they are assigned to take.
unitl every territory of the business is under the captaincy of a responsible and experienced official. These inventory captains, after surveying their respective territories, select a proper number of counters, writers, and checkers, care being taken to select competent men such as salaried employees, bosses, second-hands, stock and factory clerks, technical men, and so on. Laborers are restricted, if possible, to doing the physical work involved.

On the day for commencing the inventorying, the one in authority issues to the captains serially numbered duplicate inventory tags. As each captain is charged with the tags which he receives, from number so and so to so and so, he must return the unused and spoiled ones. Each captain in turn notes the tag numbers which he gives to each of his writers, who are likewise required to account for each tag. Another inventory plan is to tag the goods at leisure during the last month of the fiscal period. Any changes in the quantities, or stage of completion of the goods, are noted on the tags. Thus, if from a pile containing 1055 units when tagged, 150 units are withdrawn, the 150 is deducted on the face of the tag. The chief advantage of this method is that the inventorying can be done without closing down, or at least without as long a shut down as would otherwise be the case. On the other hand, there is a real danger that the changes will not be recorded on the tags.

As the counter calls off the information for the tag, the writer records it. The completed tag is then attached to the physical goods to await the checker who inspects the tags to see that they have been made out properly, and that the quantities stated thereon appear to be in keeping with the goods before him.

When all of the items of a particular territory have been thus tagged and checked, the captain notifies the head authority, who sends an inspector to make a general survey of the work. If the inspector is satisfied, one-half of the tags is pulled and forwarded to the head authority. After his assistants have accounted for all of the tag numbers given to this captain, and have scrutinized the tags (Plate 76) for omissions, incompleteness, and so on, the order is given by the head authority to remove the duplicate tags, or they may be allowed to remain attached to the goods.

244. See Plate 76.

245. Should the Auditor Take the Inventory?-- The problem as to whether or not the auditor should take the inventory has been the subject of long and often profitable discussion, with bankers and creditmen generally on one side, and auditors on the other side.

First of all, it should be pointed out that the duties, responsibilities, and scope of work performed by the auditor have been increasing year by year, so that it was but natural that the question of doing more on inventories should have arisen. To illustrate briefly without attempting to select the most important illustrations, it may be stated that originally an auditor would not hesitate to predict, even freely, in his report, but to-day predicting is absolutely shunned and tabooed. Likewise, in the past an auditor would not pass upon the legitimacy of a transaction, such as an ultra vires investment, but merely show the investment without comment. But to-day, besides naming the investment, the auditor would definitely say in the report that in his opinion the investment is contrary to the provisions of the will, or the charter powers, as the case might be. Again, in the past, an auditor confined himself to reporting, but to-day, the auditor interprets and advises too. In fact, these latter functions bid fair to become the auditor's major field of activity.

The position on inventories taken by the banker and the creditman is
EXPLANATION OF PLATE 76

A FORM OF GOODS-IN-PROCESS DUPLICATE INVENTORY TAG

244. Explanation and Comments.—By the use of tags, a complete and accurate inventory is more certain to be secured than otherwise. After the tags have been filled out and attached to the goods, it is the duty of checkers to review the work, especially to see that everything has been tagged and that the information on the tag is complete and accurate. By using duplicate tags, the chief-in-command can make certain that all of the tags have been pulled from the goods and forwarded to the office for classifying, pricing, extending, summarizing, etc.

The following instructions (see sec. 243) are taken from the 1925 Report of the Sixth Annual Convention of Controllers' Congress, National Retail Dry Goods Association.

STOCK TAKING INSTRUCTIONS
For Yard Goods Department

DO NOT use any slips for recording yardage except Regular Tickets furnished for the purpose. There must be NO exceptions.

1. A numbered ticket will be issued for each bolt of goods and a numbered envelope for each shelf, bin, etc.
2. If a machine is used for measuring, the number of folds is to be entered in the space provided.
3. The person who measures the goods fills out the ticket.
4. When the shelf has been completed, the buyer separates the ticket from the stub, which is left attached to the bolt.
5. He then looks at the yardage marked on the ticket and judges if the bolt corresponds; if not, it is re-measured. It is essential that only an experienced person do this work in order to insure a good check on measuring.
6. The buyer then writes his initials opposite the selling price, to certify to its correctness.
7. After the buyer detaches the tickets from all of the bolts on the shelf, he counts the tickets, entering the number of tickets on the envelope, he also checks the serial numbers seeing that all of the tickets have been accounted for.
8. He then counts the number of bolts, entering this number on the envelope and sees if it corresponds with the number of tickets; if not, he checks up the discrepancy.
9. The tickets are then placed in the envelope and the envelope sealed and left on the shelf.
10. When stock taking is finished, the envelopes are placed in rotation by serial number and turned in to the Audit Department to be figured.
11. At all times, after a bolt has been measured, even though all the other bolts on the shelf have not been measured or the buyer has NOT detached the tickets from the stubs, ALL sales are to be recorded on the face of the envelope.

STIX, BAEHR AND FULLER COMPANY.

Don't Guess - Ask the Controller's Office
A FORM OF GOODS-IN-PROCESS DUPLICATE INVENTORY TAG

As to the tag method in general, it may be pointed out that it is more flexible and easier to classify than the sheet method, seeing that on the latter there would likely be a hodge-podge of unrelated items to be reclassified later.

It is often possible to write up many of the tags (all but the quantities) in advance. Furthermore, it is often feasible to start the inventorying a few days before the inventory date. If this is done, new additions thereto or subtractions therefrom must be noted on the back of the card in the "IN" and "OUT" columns respectively.

Sometimes the tags are in colors, each color representing a specific fact such as raw material, goods-in-process, supplies, finished goods, goods received on consignment, etc.
that in most cases here is the most important item in the current assets, which in turn is the most important aspect of the balance sheet in which they are interested, receiving no actual independent inspection or count, or such a limited examination in this respect as to prevent the auditor from certifying thereto. Naturally, the banker and creditman desire the auditor to assume the same full responsibility on inventories as, for example, on securities.

The auditor's answer to this request on the part of the creditman and the banker is that it is a physical impossibility for the auditor's staff to superintend the taking of every client's inventory, as there are not enough men to go around. Moreover, as it is, many auditing firms must annually employ many temporary men, chiefly clerks and juniors, during November to April to take care of the ordinary peak load of auditing. As this labor turnover is a very unfortunate and detremental situation, however viewed, it is very undesirable to accentuate it by employing inventory takers, who must be dismissed shortly after being employed. Since no promise of steady employment could be offered to any large number of inventory takers, it should be evident that it would be very difficult to recruit enough men of the proper qualifications (appearance, character, education, training, etc.) to properly supervise the inventorying.

Added to this difficulty is the fact that in many cases only very technical men could really tell, if at all, just what they are looking at. Suppose, for example, that the inventory taker calls off, CIEL BLUE #918 — 147 lb. Can it be expected of even an expert that he will know and be able to distinguish between this dye and CIEL BLUE #918, which may be worth only one-half as much? This is not an isolated case in the least, but rather it is typical of a large number of items in an inventory. Again, it may be mentioned that it is impossible to open and inspect packaged goods; it is often impossible to recognize positively goods received on consignment; the cost of inventorying, even if feasible and sensible, would be prohibitive.

For these few among many other substantial reasons, the auditor does not feel able to superintend all inventorying, or to assume the same degree of responsibility for the inventories as for securities. And yet, despite this situation, auditors justly hold, that if they audit the inventory along lines of procedure indicated herein (and well established to-day and undertaken by all competent men), they have gone as far as is practical in the case, and have actually arrived at trustworthy inventory figures.

246. Book Inventories—In many businesses, but especially in those with a full cost system, book inventories are maintained. The problem confronting the auditor is: When may the auditor, if at all, accept the book figures as at the balance sheet date in lieu of an actual physical count? The answer would seem to be that if the book figures are being constantly checked against, and corrected to, the physical count, the book inventories may be legitimately accepted without hesitation.

As a matter of experience, the facts are that with ordinary competent clerks, the book inventories are more apt to be accurate than the count of even good inventory takers. That is, if, for example, an inventory card should call for 3537 pieces, and if the inventory taker should count 3540 pieces, the chances are more than even that the inventory card is correct.
and the counter is wrong.

In regard to checking the book inventory to the physical items, a common method is for the balance-of-stores clerk to issue instructions from day to day to the stores-keeper to count such and such items and report them. If the stores-keeper's count on an item fails to tally with the balance-of-stores clerk's inventory card, a recount must be made, upon which result the difference, if any, will be corrected upon the card. Before passing along, it may be well to note here that the balance-of-stores clerk generally selects the time for counting the inventory items whenever their balances are low. Of course, all cards must be checked against the physical goods at least once a year, whether or not the balance ever does get low.

247. Auditing Book Inventories.—To assure himself that this correcting of the inventory cards to the physical inventory is actually taking place throughout the year, the auditor should locate in the journal the various inventory adjustments. If there are none, it is certain evidence that the book inventories are not being checked to the physical inventories. In addition—the auditor may go to the storesroom and note on the bin tags, if this system is used, what dates the items in the bins were counted. If bin tags are not used, the auditor should recommend their being adopted. Moreover, as such an examination will show the nature and importance of the errors that are being made, it may be possible for the auditor to suggest a remedy for certain of the more important ones.

From the above description, it must not be thought that the auditor accepts the book figures without doing any actual testing himself. On the contrary, the auditor must personally test some of the more important inventory cards against the actual physical goods. As this procedure is comparatively easy and vastly important, it should be evident that time used in this manner is well spent.

As to the necessity of proving the inventory card entries from the date of inspection back to the audit date, the writer has rarely felt it was necessary to do so beyond a very few tests of the most important cards. If, for example, the writer found on January 27 that the inventory card and the physical goods were in agreement, he would ordinarily accept as correct the amount on the card at December 31. But if there was an error at January 27, the auditor must not assume that the same error existed at December 31, until after he has satisfied himself that the entries on the card between December 31 and January 27 are complete and correct.

248. Analyzing the Cost System. Whenever the client has a cost system, the auditor ought first of all to ascertain if it is a part of the financial records, or only some memorandum records, or other hybrid system. If the cost system is one of the two latter types, the auditor cannot over emphasize to the client the value of his changing the cost records to a system which ties in with the books of account.

The second feature that should have the auditor's prompt attention is the composition of the factory overhead. Auditors rigorously exclude from manufacturing expenses, purc selling expenses, interest charges, and administrative expenses. In brief, the factory overhead is strictly limited to FACTORY manufacturing expenses. Of course, if the president, for example, gives considerable time to the factory end of the business, his salary may be PARTLY distributed to the factory overhead, but this procedure must not be regarded as sanctioning, or being the same thing as, the inclusion of

---

1 The report counts of the stores-keeper to the balance-of-stores clerk should also be called for.
2 I should think that the total expense of operating a large plant should not be added on to the cost of the small amount of production. You would have to keep your cost somewhat near normal and charge off your expenses to surplus, if there is one."--Mr. P. F. Gray, Irving Trust Co., N.Y.
ALL administrative expenses in the factory overhead.

Once in a while the auditor may have a client who thinks the more items he puts into the factory overhead, such as interest and administrative expenses, for example, the more conservative he is, because he is showing his costs a little higher than they actually are. Obviously, such a person fails to see that his erroneous methods increase the factory overhead and hence inflate the final inventories and the profits. Therefore, it is not conservative, but decidedly the opposite. This is necessarily so, to repeat, because the percent of the factory overhead to the labor hours, say, is higher than it would be without the interest and administrative expenses. The following table illustrates the point involved.

ILLUSTRATION

<table>
<thead>
<tr>
<th></th>
<th>Case #1</th>
<th>Case #2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Direct Labor Hours</td>
<td>10000</td>
<td>10000</td>
</tr>
<tr>
<td>Total Mfg. Expense</td>
<td></td>
<td></td>
</tr>
<tr>
<td>With Int. and Adm. Exp.</td>
<td>$10000</td>
<td></td>
</tr>
<tr>
<td>Total Mfg. Expense With-</td>
<td></td>
<td></td>
</tr>
<tr>
<td>out Int. and Adm. Exp.</td>
<td>$8000</td>
<td></td>
</tr>
<tr>
<td>Rate Per Hour</td>
<td>$0.80</td>
<td>$1.00</td>
</tr>
<tr>
<td>Material</td>
<td>Job A</td>
<td>Job A</td>
</tr>
<tr>
<td></td>
<td>$505.00</td>
<td>$505.00</td>
</tr>
<tr>
<td>Direct Labor</td>
<td>300.00</td>
<td>300.00</td>
</tr>
<tr>
<td>80 hr. $0.80</td>
<td>64.00</td>
<td></td>
</tr>
<tr>
<td>80 hr. $1.00</td>
<td></td>
<td>80.00</td>
</tr>
<tr>
<td>Inventory Value</td>
<td>$869.00</td>
<td>$865.00</td>
</tr>
</tbody>
</table>

Thus, in case #2, where interest, selling, and administrative expenses are included, Job A must be inventoried at $865.00 whereas its proper cost, case #1, is only $869.00.

The third feature to receive the auditor's attention is the method of distributing each overhead item to the various departments. Clearly one overhead item will require a different basis of distribution than another overhead item even though both overhead items are going (in part) to the same identical department. Thus, the factory taxes may be distributed to the factory departments on the basis of the department asset valuations, whereas the factory lighting expense may be distributed on a watt hour basis.

The next (fourth) feature to be audited is the method of allocating the costs of the various service departments to the production and other service departments. On what basis, for example, are the costs of the medical department to be distributed to the production departments and other service departments? The correct solutions to such problems are fairly easy to decide in theory, but in practice approximation methods must often be resorted to. Thus in theory each department should bear the cost of the services which it received from the medical department. But is it feasible to keep account of the cost of the treatment of each patient? The answer depends, at least to a large measure, on the total
amount of the medical department’s costs to be distributed. If they are large, it may be worth while to do so by the use of refined distribution methods. Ordinarily it will suffice (when the total cost is small) to assume that each patient gets the same amount of treatment. The amount so distributed to each department will, it is hoped, be approximately the same as the correct amount would be by reason of the fact that each department is likely to have a number of accidents of various seriousness.

Following this examination, the auditor must then determine the correctness of the basis of distributing the production department (all service department costs having been closed out to production departments as stated above) overhead to the jobs or processes, as the case may be. As a rule either the direct labor hour basis, or the machine hour basis is the most satisfactory, but it is possible to find good reasons, though the cases are very rare indeed, for using either the direct labor cost basis, the direct material cost basis, or the prime cost basis.

The sixth point to be covered concerns the application of the overhead in instances when the amount of production is MUCH less (or much more) than normal. In such circumstances the regular overhead rates should be used as usual. It is incorrect to revise the rates to these UNUSUAL conditions. Thus it is wrong to saddle, for example, the total overhead on to a production only 60% of normal. If the total overhead were applied, the costs would be incomparable and valueless. Furthermore, the final inventories would be inflated.

So then, assuming that the above analysis has been satisfactory throughout, the book inventory of goods-in-process will be substantially accurate, the goods-in-process cost sheets showing, as a rule, the direct materials used, the direct labor cost, and the departmental direct labor hours (assumed basis) upon which the various departmental overhead rates are to be (or have been) applied.

Finally, the auditor must ascertain how the unabsorbed (or over-absorbed) burden(s) is being handled.

In most instances, it is NOT proper to place it on the balance sheet. "Thus it was improper for The Hillsdale Manufacturing Company to defer the 1925 factory overhead expense in excess of the actual production rate (25%) with the intention, according to the directors' minutes, of absorbing the deferred overhead account 'in the next two years, if normal production is attained.'"

In many instances it is proper to carry the burden account forward on the MONTHLY balance sheets, but NOT on the year end balance sheet.

Accordingly, it is the writer's opinion that the burden account should be absorbed in Profit and Loss Statement either as a separate item or included in the various regular expenses. Ordinarily, it is not proper, although frequently done, to transfer the account to surplus.

249. Auditing Goods-in-Process When There Is No Cost System.—Still another inventory problem coming under the head of cost system is that of goods-in-process. Without a cost system the gauging of this amount of goods-in-process and the stage of completion which has been reached, are at best often a guess on the client's part. So also as a result, the client's valuation of its goods-in-process is a very difficult one for the auditor to substantiate. Ordinarily then, the best that an auditor can do in checking up on the client without a cost system is to compare this year's quantities of goods-in-process class by class and stage of completion with those of last year at the same stages. If this year's quantities are not comparable to those of last year, the auditor ought to review the matter with the client to the satisfaction of the auditor. Although the auditor rarely finds any errors, much less fraud, nevertheless he should continue to get an explanation on each audit for any radical
changes from period to period. As to the pricing of goods in process, where there is no cost system, all that the auditor can generally do is to see that the prices progress reasonably from stage of completion and are not jumped at the same stage of completion from one period to the next without due cause. Of course, the auditor will have to make due allowance for any price changes necessitated by a drop in the market price of the raw materials, or of the direct labor, as at the audit date.  

250. Methods of Pricing — Introduction. — As the pricing of inventories calls for considerable judgment, arbitrary rules-of-thumb do not give satisfactory results. Therefore, the writer will not attempt the impossible by giving such rules.

251. Valuation at Cost — Although cost means not only the invoice price, but also the freight and handling costs, the insurance charges, etc., to the place of sale or use, these special charges are rarely ever included in the unit cost price for inventorying except where they are sizable. For example, if coal is bought f.o.b. at the mines, the freight and the handling costs may be large enough to merit their inclusion in the unit cost figure. But if a few dozen boxes are being priced in a factory supply inventory, no attempt is made to ascertain charges thereon.

When book inventories are not kept, the true costs are too difficult for the average clerk to work out so that the auditor must take care to see that the cost figure applied to large quantities is not one taken from an invoice for a small quantity, even though it is of recent date. Thus, suppose an inventory actually consists of 10,000 items as follows:

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>October 30</td>
<td>30000</td>
<td>$75000</td>
</tr>
<tr>
<td>November 15</td>
<td>5000</td>
<td>13000</td>
</tr>
<tr>
<td>November 20</td>
<td>20000</td>
<td>51000</td>
</tr>
<tr>
<td>November 30</td>
<td>10000</td>
<td>25700</td>
</tr>
<tr>
<td>December 7</td>
<td>30000</td>
<td>75300</td>
</tr>
<tr>
<td>December 27</td>
<td>5000</td>
<td>13000</td>
</tr>
<tr>
<td>October 25</td>
<td>100000</td>
<td>$253000</td>
</tr>
</tbody>
</table>

As shown, the true cost value of this inventory is $253,000, whereas the client, not having a book record to give it the true average cost, is very apt to price it at $260,000; that is, at $2.60 a unit, which is the

Overhead, too, may change, but not so often as direct labor and materials. E.g. "In valuing inventories at the end of 1932, adjustments were made for the decline in market prices of purchased materials and for reduction in labor rates, as well as for a manufacturing overhead substantially below the actual overhead for the year."—Profit and Loss was charged with the "Difference between pricing inventories at a normal manufacturing overhead instead of actual overhead."—National Cash Register Co.—1932.

2 If selling prices are low, goods-in-process are often valued at selling price less cost to complete less selling, administrative, and financial expenses (and possibly profit). The basis of valuing the inventory should be stated on the balance sheet.  

4 If cash discounts are treated in the profit and loss statement as a deduction from purchases, the invoice cost must likewise be reduced thereby for inventory cost. This could be done by a valuation reserve (set up at the average rate of discount taken) debited to Discounts Earned. This entry should be reversed at the first of the next period.  

When there is a cost system, the following methods of "pricing-out" materials are most common: First-in, first-out;
price on the latest invoice. But an auditor checking this price of $2.60 a unit will notice that the invoice calls for only 5,000 units, whereas the inventory contains 100,000 units. Naturally, he will reject this price of $2.60 per unit for one on a recent invoice for a very substantial quantity, say the 30,000 units at $2.51 on December 7. Of course, even then the inventory is not correctly valued at true cost, but it is very much nearer correct than the client's figure of $2.60 per unit.

252. Valuation at Cost or Market, Whichever the Lower.---The most common basis for inventorying is cost or market, whichever the lower. That is, each item in the inventory must be listed both at cost and at market; the lower of the two figures being taken for the inventory. Sometimes an auditor will have a client who, constructing his inventory on the two bases, both at cost and at market, has used the basis whose grand total is the lower. Of course, this procedure is incorrect.

ILLUSTRATION

<table>
<thead>
<tr>
<th>Articles</th>
<th>No</th>
<th>Cost</th>
<th>Market</th>
<th>Cost or Market</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>1</td>
<td>5</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>B</td>
<td>1</td>
<td>7</td>
<td>8</td>
<td>7</td>
</tr>
<tr>
<td>C</td>
<td>1</td>
<td>3</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>D</td>
<td>1</td>
<td>9/24</td>
<td>10/23</td>
<td>9/21</td>
</tr>
</tbody>
</table>

Thus in the above example, a client might mistakenly use the total value 23, believing that since it is below cost, 24, it satisfies the rule of cost or market, whichever the lower. But the correct procedure, to repeat, is to apply the rule to each and every item in the inventory. Thus the correct inventory value is 21, on the federal income tax basis.

253. Definition of Market.---As to a good definition of the word market, that of the U.S. Treasury Department is offered for consideration. "Under ordinary circumstances 'market' means the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which it is ordinarily purchased by the taxpayer."

One of the most common failures of clients in applying this rule is to overlook the words "in the volume ordinarily purchased by the taxpayer." Thus, an auditor may find that a client has valued a large inventory item on the basis of the market price of a few paltry purchases, whereas the market price for the quantities generally bought by the client are decidedly lower.

Another common error that clients and auditors make is in following (cont'd) weighted average; market price (latest cost) and standard price. The auditor must carefully scrutinize the effect of employing either of the two latter methods. If 31,000 units were requisitioned from the above, the cost by method (1) is 30,000 at $2.50 and 1,000 at $2.60 and by method (2) is 31,000 at $2.514 ($88,000 divided by 35,000).

1. However, many believe that the better method is to lower the cost to the market ONLY IF the TOTAL market is less than the TOTAL cost. Undoubtedly this is true in certain instances.

2. Market value when applied to work-in-process and finished goods means: (a) replacement cost, or (b) finished price less additional cost to complete.
too literally for statement purposes that portion of the rule reading "prevailing at the date of the inventory." For example, if the writer should find that on and about December 31, the market price was lower than usual, and had since recovered by the date of his auditing, say February 14, he would feel inclined to ignore for statement purposes the drop in price on December 31, provided the inventories had not been sold between these dates at the reduced price. On the other hand, if the market continued to decline after December 31, the writer takes the position that the inventory, assuming no firm sales orders based on the old high price of raw material, should be valued for statement purposes at the later lower price. The unit price thereof should be noted parenthetically, after the inventory; thus: Raw Cotton (full description of the raw cotton) at xxx per pound, $1,079,681.14; or some other method of noting the drop in price.

As a result of applying this rule of cost or market, whichever the case, 

The following excerpt is from the letter of a leading public accountant, with regard to the treatment in the certificate or in the report of losses arising after the date of the balance sheet, but before the date of the certificate or report: "With regard to . . . the accountant's responsibility for failure to provide for losses arising after the date of the balance sheet, but before the date of the certificate, this is of course one of the most difficult questions with which we have to deal. It is impossible to lay down any hard and fast rule in such cases, but, generally speaking, I think that any accountant would feel called upon to make some reference to a condition coming to his notice during the intervening time which would inevitably result in very serious loss to the company. For instance, if a manufacturing company's main or only plant were destroyed by fire and did not happen to be covered by insurance, I think the accountant should make some reference to it. There are practical difficulties, however, which the accountant would meet in inquiring into the effect of a drop in market price of raw materials between the date of the balance sheet and the date of the certificate. He would have to make a very full investigation into the commitments and also into the amount of the firm sales orders which, of course, might substantially cover the materials under purchase contract. I think it would be unfair to condemn any accountant for not referring in his certificate to such a condition without knowledge of all the circumstances in each particular case.

'There is a tendency for the credit men of the banks to endeavor to assign an undue proportion of the responsibility for credit risks to the accountant. Many of them would like to be able to take the accountant's certificate or report without any investigation whatever of their own; whereas, there are many other factors affecting the credit of a company which the credit man should inquire into, but which do not come within the scope of the accountant's regular work. Some of them could be inquired into by the accountant, if he received specific instructions to do so, but the bank credit men are usually very loath to ask their customers to instruct the accountant to undertake any work outside of the regular routine; and it is, of course, manifestly impossible for the accountant to undertake such work without definite instructions."—Auditing Problems (p.371) Jackson.

'This is one of the most questions in auditing; it arises whenever commodity prices are falling. If raw materials have been purchased for certain definite orders, covered by contract and with the sale price definitely named, then no cognizance need be given to the condition. But generally this is not the situation . . . .

'The author has discussed this point with senior partners in several leading firms of accountants, and there appears to be not only no agreement as among firms, but, as in this case, partners in a single firm are of entirely different opinions on the matter. The letter quoted in the footnote (page 371 of the text) seems to the author to be a very sane view of
lower, numerous objections are often raised by clients. One such objection is that if the goods are written down to the market value, a loss is taken up now which belongs to the next period when it is realized, if indeed the anticipated loss really is suffered at all. The answer to this objection is that if the anticipated loss is not realized, it is a rare stroke of good fortune. Therefore, sound business practice requires the client to value his inventories on the basis of the impending reduction in their selling prices. In brief, it is good business, not necessarily good logic, to anticipate and absorb losses which are already visible on the horizon, but to ignore profits under the same conditions.

(cont'd) the matter. In a detailed report on the audit there would seem to be no serious objection to calling attention to such further decline in prices following the close of the fiscal period -- - - in the certified accounts, however, the problem is not so easy. The ultra-conservative thing would be to set up in the balance sheet a special reserve for contingencies to take care of such estimated shrinkages, but many companies would object to doing this. But unless this sort of reserve is made in the balance sheet itself -- which means that only the most conservative companies would be affected -- - - it is probable that no specific reference will be made in the ordinary certified balance sheet. Mr. Jordan's argument that intelligent stockholders, to say nothing of bankers and business creditors, would be familiar with the trend of the commodity markets, and accordingly would know what has occurred since the close of the fiscal period, is the one generally given -- - - presumably at present it represents the attitude of the auditing fraternity."--Key and Manual of Auditing Problems (p.95) Jackson.

On the other hand, Montgomery (Preface third edition) says, "Likewise, when copper costs 20 cents and at the date of balance sheet is selling for 18 cents, and after the date of the balance sheet has declined still further, it is equally deceptive to value the copper at 18 cents merely because that happened to be the market price on one day."

"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." --- F.W.Thornton.

The writer agrees most heartily with Col.Montgomery and Mr.F.W.Thornton 1Where goods are held over from one period to another, it is true that a loss may be recognized even though unrealized by sale. This criticism of the rule is unjust: first, because the critic is applying hind-sight,—at the time the best information available was that the goods would be sold and at a reduced price—second, the value of such "irregularities" is usually small and constitutes the usual "exception to the rule".

2"Accounting is not an exact science but a practical art which has evolved through gradual process of trial and error and the application of sound judgment to experience."—Interstate Commerce Commission.

3"There must be some direct connection between good business practice and good accounting practice. It is absurd to claim that any successful or any industry as a whole is subordinate to accounting methods. If business practices are bad and accounting methods are good, the former must yield, but if business practices are good, accounting methods must conform to them. Good business concerns have good cost systems, --- --- ---. GOOD ACCOUNTING PRACTICE MUST NOT BE CONFUSED WITH ACCOUNTING METHODS. THE LATTER WILL PRODUCE ACCURATE COSTS BY MEANS WHICH ARE LARGELY MECHANICAL AND INFLEXIBLE. GOOD ACCOUNTING PRACTICE IS BASED ON OPINION AND THEREFORE IS FLEXIBLE." --Auditing, Theory and Practice,(p.161) Montgomery.
Again, a client, if he knows that JONES & COMPANY, for example, has been allowed, under the cost or market, whichever the lower, rule, to price its inventory of article A at 16¢ a pound, because its cost and market value were each 16¢ a pound, may ask the auditor to explain the logic of insisting that his inventory be priced at a cost of 14¢ a pound when it is the same identical article as Jones'. In reply to this inquiry, the auditor can point out that when JONES & COMPANY priced its inventory of article A at 16¢ lb., no profit—whatever is taken up on Jones' books because it cost them 16¢ a pound. But if the client were to value article A at 16¢ a pound, he would be taking up on his books two cents profit on each pound, since the cost to him was but 14¢ a pound. Obviously, this is a paper profit, as profits arise only on sales.

Although the auditor's explanation is sound, namely, that profits must not be anticipated by the client in this manner, and that JONES & COMPANY is justified in its procedure, nevertheless, there is some genuine basis for the client's discontent at being obliged to list an item at 14¢ a pound, whereas JONES & COMPANY can list it as 16¢ a pound, "simply because it "as unfortunate in buying at a higher price". The solution to the situation is easy, however.

A parenthetical note on the balance sheet giving the market value of the total inventory, as compared with its cost or market, whichever the lower, value, will show all of the facts without taking up a cent of anticipated profits; thus, Raw Materials (at market $1,450,000) vs. $1,017,618.14.

Finally, it should be noted that the term market means the purchase market and not the sales market.

254. Valuation below Cost or Selling Market:—At times, it may be proper for the client to value his finished inventory at less than cost, or selling market, as in the case of a new business whose costs are higher than they will be when the business gets seasoned. But aside from the principle is generally accepted, and is supported by Jennery v. Olmstead (36 Hun 536), that a rise in the market prices over the cost of commodities carried as current assets does not justify a credit profit and loss, or an increase in earned surplus. In the case of Jennery v. Olmstead, the court had to pass on the question of whether an increase in the market value of United States bonds, than which nothing could be more marketable, was a proper credit to profit and loss. The court held that it was not."

(It may be interjected here that the rule of "cost or market whichever the lower" is NOT inconsistent, its opponents' criticism thereto notwithstanding. A prudent business man will always absorb and husband his resources IMMEDIATELY if a loss appears to be certain in the next month or two; and, if he is STILL the same cautious, prudent person he WOULD NOT take up present paper profits (market higher than cost), but ON THE CONTRARY he will wait until he has realized these profits before entering them upon his books.

Again, suppose that "M", a cautious working man, is told by his doctor that an operation costing $1,000 will very likely be necessary in one month unless a miracle happens to improve his condition. Is it not likely that "M" will begin to "cut corners" NOW in anticipation of the $1,000 expense? On the other hand let us assume that "M"'s boss tells him that in a month his pay will likely be raised a $1,000. Will "M" if he is STILL cautious spend NOW as if he had the $1,000 in hand?)

2When less than cost.
similar cases, which are very rare indeed, the auditor must be wary of passing an understated inventory in the name of conservatism, less it be only a scheme on an official's part to reduce taxes, or to understate the profits and net worth in order to buy up the common stock for a song.

255. Valuation at Market Less Selling Expense, Administrative Expense, Etc.-- Certain types of businesses which buy their raw material for so much per pound or per head, and which material is then sorted into grades whose unit cost is hence unknown, sometimes value their finished inventory at selling prices, less profit, selling expense, administrative expense, etc. Thus in the case of meat packers, whose operations are basically fairly constant, and hence are in constant demand. But even such businesses must give publicity to their methods of pricing by stating on the balance sheet and in the report that the inventory is "at net selling price allowing for [mention the items deducted]". (See section 273 for a second treatment of this problem).

256. Valuation by the Retail Method.--The retail method of inventorying is generally used by department stores because of the impossibility of

1 Very often they are stated at the selling price without any deductions whatsoever.

2 Explanations of Terminology: (a) Retail Price--This is the first selling price given to an item placed on sale. It may be raised or lowered in the future, as the merchandise manager sees fit. (b) Selling Price--This is the sum actually accepted from the customer. (c) Purchase Price--This is the net sum paid for an item. It is the invoice price LESS quantity and trade discounts (if any), PLUS freight-in, duty, express-age, and similar charges. Cash discounts MAY be deducted. (d) Mark-up--This is the amount of the difference between cost and ORIGINAL retail price. Ordinarily, it is expressed as a per cent of the retail price. If cost is used as the basis for computing the per cent, it must be specifically mentioned. E.g., purchase price $1.50, retail price $2.50, mark-up $1.00; the mark-up per cent is, therefore, 40%. (e) Additional Mark-up--This is the difference between the original retail price and a higher selling price. It is usually expressed as a per cent of the original retail price. E.g., the previous retail price of $2.50 is changed to $3.00. The increase difference of 50% is an additional mark-up of 20% on the original retail price. (f) Cancellation of Additional Mark-up.--This is a reduction in whole or in part of an Additional Mark-up, hence it can never exceed the latter. It is ALWAYS SUBTRACTED from the Additional Mark-up. E.g.: The previous selling price is reduced from $3.00 to $2.75. The decrease difference of 25% is a "Cancellation of Additional Mark-up; NOT a "mark-down". The latter does not take place until the price is reduced BELOW THE ORIGINAL retail price of $2.50. In fact, if the retail price is reduced from $2.75 to $2.40, two factors are involved: (1) Cancellation of Additional Mark-up of 25% and (2) a Mark-down of 10%. (g) Mark-Down -- This is a reduction from the ORIGINAL retail price, and is expressed as a per cent of the latter. Thus the 10% Mark-down above is a 4% reduction (10/250). (h) Cancellation of Mark-Down--This is a reduction in whole or in part of a Mark-down, and hence can never be greater than the amount of an original Mark-down. E.g., the above selling price of $2.40 is increased to $2.50. The increase of 5% is a "Cancellation of a Mark-down", NOT a "Mark-up. The Cancellation Mark-down is 2%. A Cancellation Mark-down is ALWAYS subtracted from the ORIGINAL Mark-down. (1) Corrections--If the illustrative item purchased for $1.50 should have been marked up only to $2.25, instead of to $2.50 (which was the actual price label), it is necessary to increase the retail price from $2.50 to $2.25. The decrease of 25% is a Mark-down being merely a clerical error, hence it is "entered in red" in the
keeping a book inventory for each of the thousand of items put on sale. But even under the retail method, the keeping track of the mark-ups and their subsequent cancellations, the mark-downs and their subsequent cancellations is in actual practice a problem requiring the most exacting care.

The general outline of the plan is as follows. If goods costing $20,000 are placed on sale at $30,000, the mark-up is $10,000. If subsequently some goods are marked up another $5,000 and other goods are marked down $1,000, the net result is a final selling price of $34,000, or a net mark-up of $14,000. If, now, the sales are $20,000, the inventories will be $14,000 at retail selling prices. As the mark-up is 41.176% \((-\frac{10,000 \text{ plus } 5,000 \text{ minus } 1,000 \text{ equals } 14,000}{34,000}\) \) of sales, the cost per cent is 58.824% of sales. If this per cent (58.824%) is applied to the final inventory of $14,000, the resulting cost figure is $8,235.36.

If on the other hand (a second method), the mark-downs are ignored in the computations of the mark-ups, the mark-ups are $15,000 and the selling price is $35,000. By using these figures we find that the mark-up is 42.86% of the selling price ($35,000 divided by $35,000), and the cost is, therefore, 57.143% of sales. Applying this latter per cent (57.143%) to the $14,000 inventory, we have $8,000 as its cost.

As to whether or not the mark-downs should be included in figuring the cost per cent, the recommended practice is to omit them (second method — and same as Plate 77), as the omission always gives a more conservative inventory (supra $8,000.00 as against $8,235.36)\(^1\).

(cont'd) Mark-up Book. On the other hand, if the illustrative item purchased for $1.50 should have been marked up to $2.75 instead of to $2.50 (which was the actual price label), it is necessary to increase the retail price from $2.50 to $2.75. The increase of 25¢ is NOT an Additional Mark-up being merely a clerical error; hence it is entered in the Mark-up Book.

**SUMMARY**

<table>
<thead>
<tr>
<th>Purchase Price</th>
<th>Original Mark-up</th>
<th>Retail Price</th>
<th>Mark-up</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1.50</td>
<td>$0.00 (40%)</td>
<td>$2.00</td>
<td>$0.50</td>
</tr>
<tr>
<td>$2.50</td>
<td>$0.50 (20%)</td>
<td>$3.00</td>
<td>$0.75</td>
</tr>
<tr>
<td>$2.75</td>
<td>$0.75 (10%)</td>
<td>$3.50</td>
<td>$1.00</td>
</tr>
<tr>
<td>$3.50</td>
<td>$1.00 (4%)</td>
<td>$4.50</td>
<td>$1.40</td>
</tr>
<tr>
<td>$4.50</td>
<td>$1.40 (2%)</td>
<td>$6.00</td>
<td>$2.45</td>
</tr>
</tbody>
</table>

Under the following plan (third method) no part of the month's mark-downs is charged against current profits, hence it is the LEAST conservative.

<table>
<thead>
<tr>
<th>Inventory and Purchases</th>
<th>Cost</th>
<th>Retail</th>
<th>Mark-up</th>
</tr>
</thead>
<tbody>
<tr>
<td>Additional Mark-Ups, less Cancellations thereof</td>
<td>$20,000</td>
<td>$30,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Together</td>
<td>$20,000</td>
<td>$35,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>Less - Sales</td>
<td>$11,428</td>
<td>$20,000</td>
<td>$8,572</td>
</tr>
<tr>
<td>Not</td>
<td>$8,572</td>
<td>$15,000</td>
<td>$6,428</td>
</tr>
<tr>
<td>Less - Mark-Downs, Less Cancellations thereof</td>
<td>$8,572</td>
<td>$14,000</td>
<td>$5,428</td>
</tr>
</tbody>
</table>

**Final Inventory**
Moreover, as the mark-downs are generally on special sales, the goods which remain in the final inventory are more apt to be the goods bearing the high mark-ups; so that the method of neglecting the mark-downs (which are not the same thing as cancellations of mark-ups) is preferable from this point of view.

From the above discussion, it must not be assumed that the necessity for taking a physical inventory is obviated. On the contrary, as with all other book inventories, a physical inventory must be taken from time to time, generally a department or two at once, throughout the year, to which the book figures are adjusted. What then is the chief value of the retail method? Just this: financial statements can be prepared as often as is desired without the necessity of taking physical inventories on each occasion. Moreover, as a complete inventory does not have to be taken at any one time, the store does not have to close for inventorying, and the employees are never placed under the usual strain of taking the inventories and of closing the book at the same time.

257. See Plate 77.

258. Base-stock Inventories.—"The theory of the base-stock inventory is that regardless of the particular particles making up the normal stock, the combined whole is always on hand unchanged as a whole. When first accumulated it is taken at cost and being essentially identical from year to year is continued from year to year at that original cost . . . . "In stressing the fact that the method is not of general application and ignoring the other fact that in the comparatively few cases where it does apply it is the correct method, many writings on the subject fall into the way of condemning a sound principle on the ground that it does not reach beyond its legitimate scope.

"The treasury department is on record on the subject in T.B.R. 65 (1 C.B. 51), the pertinent portions of which are:

"The facts before the advisory tax board do not warrant the conclusion that there has been any general adoption of the base-stock method of taking inventories as an 'account practice,' or that it has had any considerable recognition as the 'best' accounting practice. On the contrary, it is certain that the method has not been widely adopted. . . . Probably more than 95 per cent of the manufacturers and dealers in this country -- certainly a very large majority of them -- keep their books in accordance with methods other than the base-stock method . . . . The 'best accounting practice' set up in Sec. 203 as the guide or standard for the commissioner must be a practice which not only clearly reflects the income but which has been 'regularly employed,' presumably for a number of years, by a majority of the taxpayers involved. A procedure to become a 'practice' must be widely used and must have withstood the changing tests of time. In particular, the fact that so few business concerns use these base-stock methods is strongly suggestive of the truth that it does not truly reflect the income . . . . The effect of the base-stock inventory method is to assign all profits and losses in respect of the minimum inventory to the year in which such inventory is liquidated. This result is accomplished through ignoring sales and exchanges of individual items of the inventory and treating the minimum inventory as a unit . . . . In some cases highly conservative business concerns reckon trading profits by comparing current costs with current sales, disregarding basic inventory gains as quasi-capital gains, but even such concerns do not ordinarily disregard inventory losses. This makes it clear that the basic method is a mere counsel of conservatism, which ignores quasi-capital gains from motives of prudence . . . . The advisory tax board, therefore, concludes that the base-stock inventory method does not 'most clearly' reflect income . .
EXPLANATION OF PLATE 77

A FORM OF SCHEDULE FOR VALUING INVENTORIES BY THE RETAIL METHOD

257. Explanation and Comments.—Plate 77 is a form for computing the inventory on the so-called Retail Inventory Method.

Under the method shown here, the mark-downs, less mark-down cancellations, are not used in computing the net mark-up (37.138%). As explained in the text, this procedure gives a smaller cost per cent and hence a smaller inventory than when the mark-downs are taken into the cost per cent computation. This is as it should be, because the mark-downs generally apply to goods put on special sale. Obviously, these goods, being sold, are not in the final inventory, so that the goods on hand are mainly those which bear the full mark-up per cent, i.e. 37.138%.

As also emphasized in the text, the goods must be highly departmentized, and great care is needed in keeping track of the mark-ups and the mark-downs, together with their subsequent cancellations. Moreover, departmental physical inventories must be taken from time to time (at least once a year), and the estimates computed by the Retail Inventory Method must be corrected thereto.
A FORM OF SCHEDULE FOR VALUING INVENTORIES BY THE RETAIL METHOD PLATE 77

Retail Inventory Schedule - Dept. A

<table>
<thead>
<tr>
<th></th>
<th>(1) Cost</th>
<th>(2) Retail</th>
<th>(3) Mark-up</th>
<th>(4) % of Mark-up</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Opening inventory lines</td>
<td>50147.68</td>
<td>75863.42</td>
<td>25715.74</td>
<td>33.897</td>
</tr>
<tr>
<td>(9) of preceding period</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(2) Purchases</td>
<td>478267.19</td>
<td>741964.58</td>
<td>263697.39</td>
<td>35.540</td>
</tr>
<tr>
<td>(3) Freight, express, and cartage inward</td>
<td>17621.83</td>
<td>xxxxxxx</td>
<td>xxxxxxx</td>
<td>xxxxxxx</td>
</tr>
<tr>
<td>(4) Additional mark ups, less cancellations</td>
<td>xxxxxxx</td>
<td>22763.16</td>
<td>22763.16</td>
<td>xxxxxxx</td>
</tr>
<tr>
<td>(5) Total of inventory plus additions</td>
<td>546036.70</td>
<td>840591.16</td>
<td>312176.29</td>
<td>37.138</td>
</tr>
<tr>
<td>(6) Net sales</td>
<td>xxxxxxx</td>
<td>787281.53</td>
<td>xxxxxxx</td>
<td>xxxxxxx</td>
</tr>
<tr>
<td>(7) Markdowns, less cancellations</td>
<td>xxxxxxx</td>
<td>17643.29</td>
<td>xxxxxxx</td>
<td>xxxxxxx</td>
</tr>
<tr>
<td>(8) Total retail deductions (sum of items (6) and (7))</td>
<td>xxxxxxx</td>
<td>804924.82</td>
<td>xxxxxxx</td>
<td>xxxxxxx</td>
</tr>
<tr>
<td>(9) Resultant retail inventory (retail on line (5), column (2), minus item (8))</td>
<td>xxxxxxx</td>
<td>355666.34</td>
<td>xxxxxxx</td>
<td>xxxxxxx</td>
</tr>
<tr>
<td>(10) Calculation of cost percentage:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) Total percentage</td>
<td>100.000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(b) Percentage of mark-up (line (5) col. (4)</td>
<td>37.138</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(c) Percentage of cost, (a) minus (b)</td>
<td>62.862</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(11) Cost of inventory (item (10c) applied to item (9))</td>
<td>22420.57</td>
<td>xxxxxxx</td>
<td>xxxxxxx</td>
<td>xxxxxxx</td>
</tr>
<tr>
<td>(12) Resultant mark up and percentage (item (9) minus (11))</td>
<td>xxxxxxx</td>
<td>xxxxxxx</td>
<td>13245.77</td>
<td>37.138</td>
</tr>
<tr>
<td>(13) Gross cost of merchandise (difference between cost inventories on lines (5) and (11))</td>
<td>523616.13</td>
<td>xxxxxxx</td>
<td>xxxxxxx</td>
<td>xxxxxxx</td>
</tr>
</tbody>
</table>
The fundamental theory underlying this method is unsound. The usual practice and general object of the basic method is to get the base or constant stock at a figure below cost and hold it there. It arises, not from a desire to measure capital and net income accurately, but to play safe, stabilize profits, and provide reserves against possible future losses. It is a result of essentially the same policy and theory which lead bankers to write down their buildings to a nominal figure and to accumulate hidden reserves. A distinguished British commission—the committee on financial risk attaching to the holding of trading stocks—after a thorough investigation and analysis of this subject, decided against the base-stock method of inventorying in its report submitted December 5, 1916 (04.9224, 1915) 'Accountants,' the committee found in Great Britain, 'with a few exceptions, consider that these practices (the base-stock method of inventorying and the practice among bankers of writing down buildings, accumulating secret reserves, etc.) misrepresent the facts.' And again, referring to the fact that the British board of inland revenue has felt compelled under court decisions to recognize the base-stock method in certain industries, the committee adds 'And it appears that in the absence of a statutory definition the board of inland revenue has felt itself unable to contest the base-stock system of valuation where it has prevailed. As the practice is repugnant to the views which government and the majority of this committee hold as to the correct system of accounting, this concession has not been extended beyond the point of obligation.' The reasons above stated lead to the conclusion that the base-stock method does not conform to the requirements of the revenue act of 1918. This conclusion does not, of course, preclude a taxpayer who values his inventory at cost and who retains identifiable goods year after year from attaining the result with respect to the identifiable goods so retained which would be attained through the use of the base-stock inventory method.

'The base-stock method of inventory does not conform to the best accounting practice in trade or business has not been widely adopted and to sanction it in the case of the very small minority of taxpayers who have used it only for a period of a few years, would work an unjustifiable discrimination against the great majority of manufacturers and dealers who have not. The effect of the minimum inventory method is to assign all profits and losses to the year in which this minimum inventory is liquidated. In fact, however, each sale or exchange of the individual items of the inventory is a realization of taxable profit or deductible loss in the year in which it occurs and a method of accounting which disregards such realization does not truly reflect income. It is taxable when realized. The practical result of the use of this method of inventory gain of one year against an inventory loss of another year rather than to assign to each year its true gain or loss. Its use arises from a desire to play safe and provide reserves against possible future losses. Some undeterminable part of the stock on hand in 1916 remained during the taxable years. All material of like dimensions was piled piece upon piece in perpendicular piles with the result that the material most recently purchased was in fact used. If petitioner had used some means to identify the material so that its inventory could have been priced at cost, it might have obtained a more favorable result. The material in the inventory, however, is undeterminable and there has been offered no basis upon which we can determine cost of the inventory.' (11 B.T.A. 877) "We all know that no manufacturer would consider that he really made any profits in 1917 unless he sold his product at a price more than sufficient to cover the cost of replacing at 1917 prices the new materials which he had consumed in manufacturing that product. The department would, however,
hold that his profits for the year 1917 are to be measured on the basis
of low-priced materials he may have bought in previous years and that high
priced materials purchased in 1917 are, to the extent of any quantity re-
maininf on hand at the end of the year, to be carried forward by inventory
against future years’ operations. Probably no decision of the department
has worked greater hardship on the business interests of the country than
has this decision, which denies to the taxpayer the right to charge off
against his sales or production for the year the cost of the raw materials
purchased during that year to replace consumption.—(Mr. Fernald)

“The severe criticisms of the base-stock theory quoted above are
more apparent than real, for they evidently refer to the use of that method
where circumstances do not warrant its use. The point is that such
criticism overlooks the fact that there are situations where it does pro-
perly reflect the income; where it is exactly the opposite of the writing
down of buildings and accumulating secret reserves; where it is the only
way to represent facts; where it is the best accounting practice; where
it has been in use for years and not discarded; where the fundamental
underlying theory is sound and where the sole purpose of its use is to
measure income accurately.

“The office of the year-end inventory in the operating statement is
elimination, not valuation. The purpose of the inventory entry is to re-
move from the profit-and-loss calculation something that never went into
sales’ cost—to leave it as if the inventory had never been purchased or
produced. Reduction of an inventory below cost is rather a balance-sheet
matter affecting surplus, not income. To hold that operating income can
be truly stated by taking out left-over goods or material at less than
they went in at and by taking out ‘constant’ goods or material at a dif-
ferent price than they went in at is illogical. If the base-stock is the
same stock at the beginning as it is at the end, it clearly, even under
the above apparently adverse authorities, should be taken at original
cost.”—L. G. Pelclust.

“Prior to the war, the National Lead Company divided its inventories
into Normal Stocks and Excess Above Normal. The Normal Stocks were valued
at the lowest price reached by metals in the year 1914. The Excess Above
Normal were valued at cost. The Normal Stocks never change — either in
quantity or value placed thereon. The Excess Above Normal vary in quanti-
ty and value according to the facts. In case of an encroachment upon the
Normal Stock at any branch creating a deficiency, a reserve is created in
the Normal Stock Inventory sufficient to buy the amount of the deficiency
at the replacement value of the metal at that time—the first metal pur-
chased being used to make good the deficiency in the Normal Stock.

“In fixing the amount of Normal Stocks, we determine the amount of
metal (whether lead, tin, copper or antimony) in the following manner:
1. The amount of metal normally in transit to our factories.
2. The amount of raw metal necessary in the factories to prevent
possible stoppage of manufacturing, due to transportation or other facil-
ities.
3. The amount of metal in process of manufacture, which in case of
White Lead extends over several months.
4. The amount of manufactured products necessary to be carried in
stock at factories and warehouses, in order to make prompt deliveries.

“The result is that about 80% of our total inventories is in
Normal Stocks. Inasmuch as the purchases of raw material from month to
month are approximately equal to our sales of metal in the form of manu-
factured products from month to month, we adopt the fiction: that the

1Mr. Fernald, of course, is for the base-stock method.
metal sold in the form of manufactured products during any given month was made out of the metal bought during that month, and the Normal Stock is never touched, and our inventories, therefore, are valued at cost.

For all practical purposes, the Normal Stock is like a piece of machinery which the company has to have always on hand in order to operate. When the price for Pig Lead, for instance, went to $11 a pound, the National Lead Company could not make an actual profit thereon without selling its Normal Stocks but, in that event, it would either have to buy back such Normal Stocks at the then market, or go out of business. In the latter case, it would lose the value of its good will and the cost of the marketing, which would be far greater than any possible profit on sale.

This being true, we do not deceive ourselves by marking up inventory values and taking book profits, upon which we could not realize, to be followed later by book losses of like amount. Bookkeeping is likely to affect policy. By taking book profits on ascending markets of raw material, a company is likely to be led into extravagance and wastefulness. On the other hand, book losses during a period of declining market are likely to be discouraging and may become embarrassing. Our stockholders are also likely to be deceived by apparent high earnings followed by severe losses, if such book profits and losses are reported in our published statements.

The advantage to the Company of this safe and conservative method of taking inventories has been made manifest during the last few years. For instance, the market price of Pig Lead advanced from the low price of $3.40 per hundred pounds, at which our normal stock of lead is inventoried, to $11.00 (or higher) during the war years, and on December 31, 1920, it had fallen to $4.75. Inasmuch as we have never taken any book profits, we do not have to take any book losses. It would have been just as reasonable to mark up the value of our plants and machinery to the replacement value thereof during the war years (with a consequent showing of book profits), and then write them down to present replacement values (with a consequent showing of book losses), as to make similar variations in our Normal Stock.

Of course, as to our Excess Above Normal Stocks—which have always been inventoried at actual cost until written down to the market on December 31, 1920—we have like all others who have inventoried at market or cost (whichever is lower), made profits and losses. But these, while serious, are relatively unimportant.

Because of the unusually rapid and pronounced decline in the market price of metals at the close of the year, it was deemed prudent to create additional Normal Stocks where needed, and inventory all Excess Above Normal Stocks at Market instead of at cost. Inasmuch as the Normal Stock system of inventory, as above described, automatically creates in itself a Metal Reserve, the Metal Reserve of one million dollars—created in 1913—was used for this purpose, as originally intended.”—National Lead Company, 1920 Annual report.

"It (referring to Treasury Department) also refused to approve of our Normal Stock system of valuing inventories, in which we adopt the fiction that the merchandise we sell in any month is made out of the raw material we buy that month; and, therefore, the material (both raw and in process of manufacture) in stock when an inventory is taken consists of the same Normal Stock that the Company has had in its possession since the year 1913, and that the price at which it was inventoried in that year represents the 'cost' of such Normal Stock for the purpose of inventories since that date. The government, for the purpose of taxation, requires us to adopt the opposite fiction; i.e., that the merchandise sold in any month was made out of the oldest raw material that the Company has in its possession. The ruling of the government will cause great fluctuation in apparent profits from year to year but, in the long run, will not
affect the amount of taxes the Company must pay. The reason given by the Bureau for the rejection of the Normal Stock system of valuing inventories for tax purposes is, that to allow it in the very few companies that have adopted it would result in any given year in unequal taxation.

... In like manner, our Normal Stock system of valuing inventories eliminates book profits that cannot be realized and book losses that are not suffered. To illustrate:

"The market price of pig lead on December 31, 1921, was $4.70 per hundred pounds, and on December 31, 1922, $7.25 per hundred pounds—an increase of $2.55 per hundred pounds, or, on 60,000 tons (approximately) of lead in our Normal Stocks, an increased inventory value of over $4,000,000 which, on the government method, would appear as an additional profit in 1922. Manifestly, we have not made that profit, because we could realize it only by selling all of our lead and going out of business. Possibly on December 31, 1923, the market price of pig lead may be as low as on December 31, 1921, in which case we would appear to have lost $4,000,000 in our business. Meanwhile the Normal Stock will have remained stationary, and must remain stationary the same as a piece of machinery. Only the Excess Above Normal changes in quantity and value from year to year. Manifestly, such book profits and losses can have no other effect than at times to be unduly depressing, at other times to encourage extravagance and wastefulness, and at all times to be misleading. We, therefore, will make no change in our accounting practice for our own use or in reports to stockholders, but will, of course, conform to the government's requirements in making our tax returns.

"The price of pig lead in New York on December 31, 1922, was $7.25 per hundred pounds, and has since risen to $8.25 per hundred pounds. This price is as high as ruled during the war, when the production in the United States was over 500,000 tons per annum. The estimated consumption of pig lead in the United States in the year 1922 is 476,000 tons—the largest ever known in peace times.

"In declining markets we necessarily lose the difference between the price of raw material when contracted for, and value when sold as a finished product. Hence the creation of the Metal Reserve of one million dollars, which we found so useful in 1920.

"Stockholders will note that our custom of valuing Normal Stocks automatically creates a reserve in the inventory that takes up losses as well as profits in such Normal Stocks from changing market prices of lead, antimony, tin, copper, etc. The Metal Reserve gives similar protection to the Excess Above Normal Stocks."—National Lead Company, 1922 Annual Report.

259. Carrying Charges.2—Items which improve with age, such as lumber allowed to season, may bear reasonable carrying charges in addition to the

1See Himmelblau, unit 6 lecture 4

To repeat, transportation and handling costs may also justly be regarded as a part of the cost of materials. However, the task of equitably pro-rating these costs to particular lots or classes of goods is often very difficult as when, for example, a mixed lot of goods comes in the same freight car.

Although it is not a common practice, nevertheless, it is often feasible to include buying expense, insurance, store room expense, etc. in the cost of materials used or sold and in the final inventories.

As to the unapplied balance of this burden account (in which these costs are entered and out of which they are charged as the goods are used or sold) applicable to the inventory, it is customary to treat it as a part of the total inventory. Of course, these costs may be charged directly into the purchases (or raw materials) account thereby increasing the cost per unit.
bare cost, provided the items are saleable, and provided the charges have been paid, i.e. are not mere book calculations. But whenever this is permitted, the auditor must see in every case that the goods are being sold, and that the carrying charges are reasonable, i.e. the grand total cost must be considerably below the selling price. An easy way to check a doubtful item is, of course, to run through the recent sales noting the quantity and the prices received, which, to repeat, must be considerably above the inventory price.

260. Inventories of Partnerships.-- In stating partnership equities, inventories should often be stated at market prices as when, for example, a new partner is to be admitted or an old partner is to withdraw. To illustrate, if the cost is lower than market, the present partners may not want to permit the new partner to enter the partnership on the basis of a balance sheet whose inventory is drawn up at cost. As the entire gain, due to the rise in the market, belongs to the old partners, the inventory must be valued at market for the purpose of admitting the new partner. For similar reasons a retiring partner should be given credit for his share of the rise in the market value of the inventories.

261. Interest.-- As to the problem of including an interest and/or rent charge in the factory overhead when none is actually paid, the writer feels that the auditor ought to give the client what he wants without any lengthy pros and cons, just as long as the final inventories and other essentials are reduced to eliminate the inflation due to these features. Exact eliminations are not necessary; reasonable approximations are satisfactory for all practical purposes.

262. Obsolete and Slow Moving Goods.¹ -- One of the most important angles of auditing procedure in connection with inventories is the examination for obsolete and slow moving items.² As inventory cards reveal this information very easily, the auditor must be certain to cover this important point. Obsolete goods will be evidenced, of course, by the fact that there have not been any withdrawals, or at least only a few insignificant withdrawals, for some time. Likewise, slow moving goods will also be reflected by the fawness, and the smallness of the requisitions.

When there are no book inventories, obsolete and slow moving goods may be detected at times by the fact that the same approximate or identical quantities reappear period after period on the auditor's inventory working papers. Then too, obsolete goods may also be detected when the auditor checks the inventory prices against purchase invoices, because he will not be able to find a recent invoice to support the price used. Of course, certain obsolete and slow moving materials may remain undetected, but this will be because they were not listed by the auditor on any of his inventory schedules. But as the auditor's inventory schedules are drawn up so as to contain all the important inventory items, the very fact that the undetected obsolete goods are not on a schedule means that they are insignificant in amount.

Again, obsolete and slow moving semi-finished and finished goods

¹At inventory time it is important that broken lots, obsolete style-goods, damaged goods, shopworn goods, spoiled goods, etc. (and corresponding items in factories, etc.) be separated and so labelled.

²In manufacturing concerns the auditor MUST see if there is a balanced inventory of the parts that go to make up an assembled unit. If not, the assumption, until proven otherwise, is that some of the parts will never be disposed of.
are often detected by showing on the inventory sheets (Plate 83), the amount of recent "December and January" sales. Obviously, if the "December and January" sales are negligible in comparison with the inventory quantities, the auditor must investigate the whys and the wherefores. Usually, the answer is that the goods are obsolete, or the market is cluttered or permanently inactive, although many times it is simply due to a temporary slump or other temporary cause which will soon right itself.

As to the next problem of what to do with the obsolete or slow moving goods, the answer clearly is that they must be either written off the inventory altogether, or reduced in price to the extent that seems necessary in view of all of the facts. Out and out obsolete goods must not be valued at more than junk prices. Slow moving raw materials must be valued in the light of the quantity on hand. For example, if the quantity is large in relation to the factory requisitions, the influence is that eventually a large part of the material will become obsolete or spoiled (e.g., peanuts in a candy factory). The obsolescence should, of course, be anticipated by a mark-down NOW; to wait another period is too late. Likewise, slow moving goods—in-process and finished goods must be valued in the light of the amount of current sales and at least at a figure below the sales market sufficient to allow for selling, administrative, and financial expenses, and possibly profit.

ILLUSTRATION

<table>
<thead>
<tr>
<th>Market Price</th>
<th>17¢</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling and Administrative, Etc. Exp.</td>
<td>2</td>
</tr>
<tr>
<td>Not</td>
<td>15¢</td>
</tr>
<tr>
<td>Profit</td>
<td>1</td>
</tr>
<tr>
<td>Preferable Inventory Price</td>
<td>14¢</td>
</tr>
</tbody>
</table>

The 14¢, not the 15¢, must be the figure used in valuing the inventory item if any considerable portion of the inventory falls into this class. This is so because it is universally understood that the inventory has been valued in the main at a price that will yield a profit, except for unforeseen circumstances. The above term, market price, is, of course, not readily definable, as it means less than the present market price if there is a continued decline in the market, or if the quantity of goods to be unloaded is so great that the market price is bound to drop in accordance with the law of supply and demand.

263. Comments on Checking Quantities.— One of the common tests applied by auditors to inventories is the so-called gross profit test; that is, if the gross profit per cent for this period is not comparable to that of last period, the final inventory quantities (presumably) are incorrectly stated. This test is based on the assumption that if there are no unusual factors, the ratio per cent of gross profit to sales, if properly classified, should be approximately the same from period to period. But, as the

It should be fully grasped that the quantity to be disposed of MATERIALLY affects the selling price and hence the inventory price of obsolete, damaged and slow moving goods. Mr. Kahn: I have heard it said that bankers, when they read a balance sheet, except that the inventory, as stated thereon, will eventually, in the normal process of the business, bring normal profit. That question, I should imagine, arises particularly where there is a large quantity of unseasonable or defective merchandise
conditions generally vary from period to period, the writer feels that the test is of very limited usefulness. This is especially true if the sales are not highly departmentized on the profit and loss statement, or if the final inventory is not figured at cost. To illustrate, if five different classifications of goods with gross profits of from thirty to sixty per cent are grouped on the profit and loss statement in one sales figure, little faith can be placed in the gross profit test as a detector of inventory errors. For example, any shifting from one period to another of the ratio of the quantities sold in each classification would vary the gross profit ratio considerably. Likewise, if the gross profit per cent is figured, for example, with the final inventory valued at cost or market, whichever the lower, a drop in the market will make the gross profit test entirely unreliable.

Moreover, it should be remembered that as sales, returned purchases and allowances, opening inventory, returned sales and allowances, purchases, and freight-in, are also all a part of this gross profit computation, a shifting of the gross profit ratio might be caused by errors in any one or more of these factors, as well as by errors in the closing inventory. The only reason, and admittedly a good one, for assuming that the error is in the closing inventory rather than in any one or more of the other named factors, is because experience shows it to be the one most apt to be incorrect. But even if the auditor is convinced that it is the final inventory which is wrong, and not one of the other six factors, he is still far from having located the error, because the mistake may be either in quantities, in unit prices, in extensions, in footings, in summaries, or combinations of them.

Briefly stated, the gross profit is not reliable in most instances because the sales are not departmentized enough, and/or the final inventory is not figured at cost. Moreover, if reliable, it should be kept in mind that the error may be in any one of seven places, or in combinations of them.

As explained elsewhere, another excellent check on quantities can be secured by showing on the inventory working schedules (Plates 62, 63, and 84) the quantities for the previous period. Time and again auditors have had errors and fraud brought to their attention by this procedure, when it would have otherwise escaped their notice altogether. Of course, as there is no substitute for the actual checking of the inventory against the physical goods, an auditor must do a reasonable amount of such checking, however disagreeable it may be. If the quantities are in piles and of considerable value, estimates should be secured from several technical men in the client's employ. Again, if the units are valuable and distinct, as in the case of bales of cotton, for example, the auditor should make a "Reconciliation" from independent sources,—the answer being the number of units which must be reported in the physical inventory. (cont'd) carried forward.

"Is the accountant justified in valuing that merchandise at what he considers realizable value, what it could be sold for in the market, taking into consideration its unseasonability and its defectiveness; or, must he still further reduce the value of that to take into account a normal profit?"

"Mr. Gray: I think all the bankers would agree that if they can get out of the inventory the amount that is stated on the balance sheet, without taking into consideration any of the profit or expense of selling the inventory, they would be well satisfied. . . . . I do not know of any reason, unless there is a large block of obsolete material on inventory, which would take a terrific amount of expense in order to dispose of. I do not believe there is any theory which calls for allowing expense in disposing of an ordinary inventory."—"Relations Between Accountants and Bankers", N.Y.S.S. of C.P.A., Nov. 1931 (p.11)
For instance, a "Cotton Reconciliation" gives the bales on hand, plus the bales purchased per cotton invoices, minus the bales rejected per credit memoranda, and minus the bales opened per the mill superintendent's report. These independent figures of the auditor will thus show the number of bales that should be reported in the final physical inventory. Of course, in addition to building up his own record of the number of bales that ought to be on hand, the auditor must also go to the storehouse to satisfy himself that all the bales are actually there, for the superintendent might conceivably report on hand what ought to be there and not what was there. At times the auditor will find that the main office keeps a cotton record. By accounting therein for each bale by itself, the cotton recording clerk in the main office can tell before hand just what bales (all bales are distinctively lettered) the mill superintendent must list in his independent physical inventory, it it is to be correct.

Whenever goods are out at finishers, dyers, throwsters, bleachers, on consignment, in public warehouses, and so on, the auditor must verify them by personal direct correspondence. Even when warehouse receipts are on hand for inspection, it has been found advisable to confirm the goods direct with the warehouse man. If a business had some of the client's goods last period, the auditor should work on the assumption that it has some of the client's goods this period. If the present inventory does not list any goods out with that business, the auditor ought to inquire about it rather than assume that the omission is correct.

When the client's cost system is not a part of the financial records, tests must be made to see that for each work-in-process record there actually is, or was, work-in-process. On numerous occasions auditors have found that work-in-process records have not been withdrawn from the work-in-process folder when the goods were finished and placed in stock.

In connection with both accounts payable and inventories; the auditor should make a careful check of the paying records for the last few days of the period against the voucher register to see that there is an invoice for each receipt of goods, and to see that those invoices have been recorded in the proper period. It may be, for example, that goods received and inventoried on December 31 have been erroneously entered in the voucher register in January of the next period. Likewise, the receiving records and inventory sheets may show goods, the invoices for which are not entered in the voucher register at all because, perhaps, the invoices have been unknowingly misplaced or lost.

Under some accounting systems there is no purchase book or voucher register, the invoices, when paid, being entered and distributed through the cash disbursements book. In such instances the auditor finds it necessary to examine all of the invoices paid after December 31, plus all of the unpaid invoices in the UNPAID INVOICES file. This search for invoices applicable to the period under audit is made by the auditor not only in order that he may check the client's adjustment for unrecorded trade liabilities as at December 31, but also to satisfy himself that ALL trade...
liabilities have been taken up.

When the receiving records are poor and inadequate, the auditor, in reviewing the December and January entries in the voucher register, will have to take up with the proper person all important invoices dated just prior to, and just after December 31 for the purpose of ascertaining the date of the receipt of the goods, and thereby determining the correctness of the distribution of the charges as between the period under audit and the succeeding one. That is, the difficulty of ascertaining when the goods on invoices dated about December 31 were received (because of the lack of proper records) must not be used as an excuse for omitting this important job of allocating the invoices to the proper fiscal period.

In many cases, invoices dated in December may prove to be for goods not received until January. If the terms are f.o.b. point of shipment, the title is usually with the client, but if the terms are f.o.b. client's factory, the title at December 31 was with the shipper. Only in the first case, then, when the terms are f.o.b. point of shipment need the auditor treat the goods as in transit by taking up both the asset and the liability. But, as a matter of fact, auditors ignore in-transit items of this sort unless in their opinion the omission would be an essential misstatement as when, for example, the amount involved is significant, or the drop in the market price of the in-transits is considerable. On the other hand, the auditor sometimes finds that goods on invoices dated along the very first of January were actually received in December and inventoried on the thirty-first. Of course, if the books are still open, the adjusting entry is a debit to purchases, and a credit to accounts payable, or, if the books are closed, the debit is to surplus.

Another feature of the inventory procedure, from the angle of the voucher register, and which is also connected with the auditing of accounts payable, is the comparing of merchandise creditors' statements against the list of open accounts payable in the voucher register. Time and again, especially in small businesses where no complete receiving record is kept, auditors have found important differences between the creditors' statements and their accounts on the client's books. Generally the goods have been received and inventoried, but the invoices thereon have been omitted from the books. In some audits, the situation may be that the goods have been received for some months and hence inventoried, but the management refuses to pass the invoices because they are in dispute for one reason or another.

All goods in the shipping department should be inventoried on sheets prominently headed SHIPPING ROOM—OMIT. The auditor should identify each lot of goods as either having been billed, or not billed to customers as of December 31. Of course, all goods should have been billed and omitted from the inventory. The writer, it may be noted, does not feel that it is sufficient merely to ignore, i.e. omit from inventory sheets, goods which have been billed, because of the reasons exemplified in the following situations.

If the auditor should find inventoried on these special sheets, billed goods that were not shipped soon after the audit date, he ought to investigate the reasons for it. For example, he may find instances of forced billing. In these cases, if the title has not already passed as of the audit date, the goods must be included in the inventory, while both the sales and the accounts receivable must be reduced. But if, on the

1Sometimes goods—in-transit are omitted from the accounts, but are made the subject matter of a footnote. Also, merchandise on hand (but unpaid for) purchased and intended for the next season's business, as is prevalent among shoe manufacturers and dry goods jobbers, MUST be detailed in a footnote (preferably embodied in the accounts). See Appendix C, Sec. 10-1.
other hand, the title to the goods has legally passed to the purchaser, the goods merely being held for some time at the purchaser's request, the auditor can sanction the client's position on the matter, provided the client has no prior record of having accepted cancellations.

Before closing this section on quantities, it may be well to state that if any bank is holding in warehouses or elsewhere, goods which the client has contracted to take in the future, these goods must be inventoried and the liability taken up. This procedure is required despite the fact that the goods are not the legal property of the client.

Finally, the auditor often finds it advisable to note the quantities of raw materials used, as compared with the raw material stocks on hand; the size of the goods-in-process inventory, as compared with the cost of goods manufactured; and the size of the finished goods inventory as compared with the cost of sales. Such comparisons are often successful in detecting gross errors or fraud. Moreover, it is an excellent way of sizing up the operating efficiency and present condition of the business.

264. Goods Received on Consignment.—All items in the inventory must be the property of the client. If the goods have been received on consignment, for example, these must be inventoried, but carefully excluded from the balance sheet figure. Moreover, in the writer's opinion, it is not sufficient for the auditor to simply ignore the consigned goods by excluding them. He must also confirm those inventories direct with the consignor. Cases are known, for example, where a client has fraudulently, or erroneously credited sales of consigned goods to its own sales account. Obviously, no better way to detect this fraud or error can be found than by confirming the consigned goods inventory with the consignor.

Of course, consigned goods received need not be shown on the balance sheet, but if the client does not object to it, the writer feels that the auditor should give this information by entering it short, i.e. not in the money column. In specific cases this information is actually paramount, because of the very small amount of inventory which appears on the balance sheets of these businesses. In such instances the inventory, being out of line, suggests a secret reserve, a gross error, or what not. If some notation of the consigned goods is made on the balance sheet, the peculiarity is immediately accounted for, but otherwise the interested party will be obliged to ask the client about it. Naturally, the auditor who anticipates and answers by a properly drawn up statement is the auditor who not only survives, but also prospers.

265. Goods Out on Consignment.—As can be seen, we are considering here the counterpart to the problem just treated above. In checking up on this matter, the auditor must rely in part upon the veracity of his client, for how can an auditor tell when a shipment is a sale, and when it is a consignment? But in those cases where the goods are admittedly out on consignment, the auditor must rigorously exclude them both from the accounts receivable and from the sales but include them as inventories. If the consigned goods are merely memoed on invoices kept in special files, i.e. not recorded in books of account, the auditor ought to question the person in charge thereof, whenever there is no consigned inventory with a business which had some last period according to the auditor's working papers.

1It may be remarked here that the auditor should ascertain the competence of the person(s) making the quantity estimates of bulk material. Obviously, two persons should collaborate in making those estimates.

2Bank statements often show as an asset and as a liability the "Customers' Bonds Held for Safekeeping".
In addition to this auditing, the auditor must confirm the consigned inventories with the consignees, not only to verify the existence of the goods, but also to ascertain that the consignee are keeping proper record of them. In respect to this latter point, the auditor should ascertain in what way his client is marking the consigned goods so as to legally distinguish them from similar goods of others also with the same consignee.

Moreover, the auditor must see that the client has secured a statement of account (Plate 78) from the consignees as at audit date so that all sales and expenses for the period may be recorded.

In costing the inventory of goods out on consignment, proportional charges for insurance, freight, and so on, up to the time of receipt by the consignee, may be properly included whenever they relate to saleable goods. Of course, the rule of cost or market, whichever the lower, is just as applicable to consigned inventories as to inventories on hand.

Although consigned goods may be included in the regular inventory, it is ordinarily better to state them separately on the balance sheet as Inventories Out on Consignment, because this notation gives some additional insight into the client's business, the importance of which may be invaluable to someone interested in the company.

The treatment of goods sent out on approval depends largely on the particular circumstances, i.e. on the per cent of returns, etc.

266. See Plate 78

267. Commitments—As has been emphasized, an auditor who is not able to go beyond the figures in the financial books is not an expert auditor. For example, in the case of purchase commitments, these contracts are often the key note in sizing up a business; and yet they are rarely recorded in the books of account because it is not in accordance with accounting principles to do so.

As a rule, therefore, purchase commitments are not brought into the accounts, but are given by the auditor as footnotes on the balance sheet, or in the report. Even so, to repeat, such footnotes may contain the kernel of the proper analysis of the financial condition of the company.

If commitments are unusually large for the business under audit, but are not covered by firm sales orders based on the commitment prices, and if the commitment prices are in line with market quotations, the following form of notation illustrates the essential information that must be given. "As at June 30, 1929 the company has purchase commitments for raw material not covered by firm sales contracts, deliverable equally during July, August and September 1929 to the cost value of $2,079,000. The account is payable on delivery of the goods. The commitment prices are in harmony with the market quotations as at June 30, 1929."

If the business did have firm sales contracts quoted on the basis of the commitment prices, the notation might be as follows: "As at June 30, 1929 the company has purchase commitments for raw materials to the cost value of $2,079,000 of which $1,943,000 worth has been assigned to firm sales contracts quoted on the basis of the commitment prices. The goods are receivable equally during July, August, and September 1929 and are payable on delivery. The commitment prices are not in excess of the market quotations as at June 30, 1929."

If the commitments are very favorable, and there are no firm sales contracts quoted on the basis of the commitment prices, the following notation is suggested. "As at June 30, 1929 the corporation has purchase

1 "(We required a) commitment statement of purchases, and a complete statement of contracts of sale with a list of the customers and the amounts of the various contracts."—Mr. Riley of Brown Brothers Harriman & Co., N.Y.
266. **Explanation and Comments.**—As stated in the text, the auditor must be certain to have his client record all the transactions of consigned goods made before the end of the audit period. Likewise, if the client is a consignor, the auditor should ask the client to secure an Account Sales from each consignee as at the audit date.

### ACCOUNT SALES

**ARTHUR S ANDERSON CORPORATION**

41109 Chicago Boulevard
Witchita, Indiana

To  The Crosby Fruit Exchange Co. Principal
711 Ocean Grove Ave.
Sacramento, Calif.

No  717  
Date  8/10/29

---

**Received**

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Quantity</th>
<th>Unit</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aug 8</td>
<td>Consignment</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Sold**

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Quantity</th>
<th>Unit</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aug 10</td>
<td></td>
<td>375 boxes</td>
<td>F407</td>
<td>34.00</td>
</tr>
<tr>
<td></td>
<td></td>
<td>580 boxes</td>
<td>F445</td>
<td>4.50</td>
</tr>
</tbody>
</table>

**Freight & Cartage** (bills attached)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>250.18</td>
</tr>
</tbody>
</table>

**Commission 7%**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>287.70</td>
</tr>
</tbody>
</table>

**Net Proceeds - Check #7176**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>537.88</td>
</tr>
<tr>
<td></td>
<td>3572.12</td>
</tr>
</tbody>
</table>
commitments for raw materials not covered by firm sales contracts. These are to be received in August to the cost amount of $1,763,000, and are payable in September. The market value of these commitments on June 30 was $2,089,000 and on July 31, $2,117,000.

On the other hand, if the commitments are unfavorable, the last line above might read, "The market value of these commitments on June 30 was $1,529,000, and on July 31, $1,416,000."

If the commitments are especially favorable, but are covered in part by firm sales orders quoted at the commitment prices, this notation is acceptable. "As at June 30, 1929 the Company has purchase commitments for raw materials to be received in August and September to the cost value of $3,765,000, payable in November. On the basis of their total value of $4,585,000 as at June 30, there is a possible market profit of $400,000 on the free material, after excluding materials at cost of $1,347,000 which have been assigned to firm sales contracts based on the commitment prices."

If the commitments are unfavorable, the last line of the above notation might read somewhat as follows: "On the basis of their total market value of $2,987,000 as at June 30, there is a probable market loss of $530,000 on the free material, after assigning, at cost, materials of $1,374,000 to firm sales contracts quoted upon the commitment prices."

266. Advance Payments.--On some occasions the auditor may find that the client has made advance payments against future merchandise purchases. If so, these amounts must be stated distinct from, and yet along with, the inventories. This separation of the advances is an important one because it shows that purchase commitments have been entered into, which fact, as we have already pointed out, may be the major key note to a correct appreciation of the financial condition of the business. Of course, if the advances are made against purchases of fixed assets, the sums must be listed under Plant Assets, or, if they are loans, they must be classified as such.

As stated in section 216, the advances may be concealed, more often through ignorance than through deceit, among the accounts receivable. An analysis of the unusual debits to the accounts receivable controlling account should, of course, disclose such sums because the debit will come from the cash disbursements book, whereas the ordinary debit to this account comes from the sales book. Likewise, when the auditor ages the accounts, he may detect that it isn't an account receivable at all.

Another common hiding place for advances is among the accounts payable. If they are here, the chances that they will be uncovered are good. Obviously, the debit to the accounts payable controlling account from the cash disbursements book will not reveal it, as it did in the case of the accounts receivable controlling account, because the ordinary debit to accounts payable comes from the disbursements book. But, on the other hand, the list of account payable balances which tie in with the controlling account will show the advances as a debit balance, whereas

It may be interjected here that commitments are not usually subject to inventorying because the seller has not set aside the goods for the buyer. In fact, the order may not yet be started on production. If the goods are segregated, however, the buyer should take them up in his inventory. Furthermore, if the buyer has paid a definite price for goods not yet in existence, or, if in existence not segregated, the price is subject to the rule of 'cost or market' or other sound basis, thus: "Merchandise Contract at Cost or Market, Whichever the Lower."
the ordinary balances are, of course, credit balances.

269. Testing Footings, Extensions, Summaries, Etc. — In testing inventory extensions, the auditor rarely ever attempts to do it accurately, such as by using computing machines or even by multiplying it out on paper. For example, if an extension is $1467.17, it is sufficient if the auditor can see mentally, or by rough calculations on paper, that the answer lies between $1500 and $1500. So also, in testing footings, it is often sufficient for the auditor to get a mental picture of the thousands by passing his eye down the hundreds and thousands columns. If the client’s figure is within one or two thousand of the auditor’s mental figure, the auditor may rest assured that the client’s figure is correct. Experience has proven that it is very rare indeed for a sizable error to remain undetected by employing these rough approximation methods.

Whenever decimals are involved, the extensions should be scrutinized much more carefully, because experience shows that sizable errors frequently creep in, in such computations. So also, extensions involving prices per dozen, prices per hundred feet, and similar cases, must be given more than usual care, lest the quantities be stated other than in dozens, or in hundred feet, etc.

A good procedure for checking extensions is, to repeat, to glance at each quantity and its unit price, and then come to a mental conclusion as to the approximate answer, or if it is evident that its value is very small no answer need be attempted. The wrong method, used by many auditors, is to test only large extensions. In doing so, the auditor may pass over a small extension which would be a large one if correctly computed. The process is illustrated in the following problem.

**PROBLEM**

- 16 x $65.21 = $1043.36
- 17 x 18.50 = 314.50
- 15 x 6.31 = 94.65

In the first extension the auditor would mentally say that 16 x 5 equals 80, and that 15 x 5 equals 80; therefore, $883.36 for 16 x $55.21 is okay. Again, 15 x 18 equals 270; and 2 x 18 equals 36, therefore 17 x $18.50 very probably gives $314.50. Likewise, he would say that 15 x $5.31 is small, and so is the answer; therefore, it need not be tested. It is the wrong method to say that $94.65 is too small to be tested because the figure might have been 357 x $18.61 equals $94.65. The auditor takes little risk by using these rough approximation methods when it is considered that usually these figures have already been gone over twice with the use of computing machines.

In regard to summaries, these must be checked very carefully since time and again the totals of individual sheets, after having been carefully computed, have never been carried forward into the summary, because of one Inventory Reserves are often used to set up shrinkages when (1) a loss on the inventory is expected but the amount thereof cannot be definitely determined, as in the case of a rapidly changing market; (2) where it is desirable to keep the records on a cost (or other) basis; (3) when the records have been closed; (4) when the perpetual inventory records would have to be changed throughout; (5) etc. The auditor should ascertain how the extensions have been made, for, if the computations were made by professional operators by machine, and rechecked, the testing and scrutinizing may legitimately be much less than when it has been done by the client by "hand and mental processes."
slip up or another.

The following procedure for checking inventories is recommended by the writer. After having checked the extensions of an inventory sheet, do not proceed to the next sheet to repeat the process, but rather finish that sheet by adding it. Be certain to put a distinctive tick [such as /] opposite the extensions which have been checked and underneath the page total, in order to show that the page has been extended and footed. The use of distinctive ticks for specific meanings is considered an excellent aid to thorough checking, despite the fact that some auditors regard it as "old time stuff".) As the next step, check this total forward to the next page or the summary, as the case may be. In each instance, place a distinctive tick against the total forwarded, and one against the total brought forward. In this way finish one page at a time rather than do all the extensions on all of the sheets, then all of the additions, and so on. The former method is much more conducive to correct checking than is the latter method. To illustrate, suppose that there are two totals on one page. Is it not clear that only the total at the bottom of the sheet may get into the summary unless they are checked off directly after having been proved? Finally, above all never check from the summary back to the sheet totals because an omission will never be caught except by pure luck;— always check FROM sheet totals INTO the summary.

270. Detection of Errors by the Use of Schedules.—One of the surest ways for the auditor to catch inventory price errors is for him to prepare a schedule like Plates 70, 71 and 72. If last period's inventory, which is copied for comparative purposes on to the current schedule, contains an item of large amount which does not reappear in the present inventory, the auditor must ascertain the reason for it. It is very likely that the amount this period is correctly stated, and hence is actually too small to be listed again on the present schedule. But then again, a comparison of the present unit price with that used last period may show a radical discrepancy, such that when adjusted the difference in amount may be very significant. Or again, if a significant amount appears in this period's inventory for which the schedule has no counterpart for last period, the auditor must also ascertain the why's and the wherefore's. To elaborate, the writer recalls an audit on which some labels were listed in the current period's inventory at a sizable amount. On attempting to place this item on the schedule opposite the same item for last period, the auditor could not find the corresponding item. On first thought, the auditor decided that the item must have been too small to be listed last period, but on second thought he decided to find out rather than guess about it. As a result, he asked for the perpetual inventory card and received it, but as it was a new one, he was unable to find last period's figures on it. The auditor therefore called the purchasing agent's attention to the matter, and was informed that there must be an error as the inventory was impossible. The actual story was this. The price at the top of the inventory card was the price per box of 100 labels, but as the requisitions were always for less than one box, the quantities were changed from boxes to the number of labels, without the price at the top of the card being changed correspondingly. In brief, the current inventory amount was 100 times too large, which excess, by the way, ran into thousands of dollars.

271. Miscellaneous Comments on Supplies.— In the case of an office supply inventory, the auditor may find that it has been stated at a round
amount, thus revealing that no physical count has been taken. If the valuation is apparently conservative, and if the amount is insignificant when compared with the other valuations on the balance sheet, the auditor may pass it without comment. Ordinarily, however, this applies only to office supplies, and not to factory supplies, which are generally of importance.

As a rule, the unit price of an item in an office supply inventory is vouched only when the amount of the extension is sizable, and even then, no attempt is made to see if the market price is lower. However, if a recent purchase invoice for an important item is not available, that fact tells the auditor that the item may be obsolete or slow moving. An alert auditor will always investigate this clue immediately, and mark the item down ruthlessly, if obsolete.

In reviewing the unit prices of a factory supply inventory, an auditor often makes no rigorous endeavor to ascertain the market prices of even sizable items. If the unit price can be checked against a current purchase invoice, this verification is acceptable in most instances. Nevertheless, there may be numerous items in a particular factory supply inventory which the auditor must be careful to check against market quotations. To illustrate, if in a cloth printing works the dyes are carried as supplies, they must be checked against current market quotations, because they usually run into considerable money. It may be added here that the work of checking the inventory prices against the market quotations can be speedily accomplished if the client has been instructed to get quotations from its creditors as of the audit date.

272. See Plate 79.

273. Miscellaneous Comments on Raw Materials.—The raw materials inventory is practically always subjected to a rigorous check against recent purchase invoices and against current market quotations. At times, an apparent error in pricing will turn out to be correct, even though the market price is lower than the cost price used in the inventory. The situation may be that these specific raw materials were purchased to cover firm sales contracts quoted upon raw material at the same price as in the inventory. Therefore, the pricing of these inventory items at cost is legitimate, provided the client has not had any past experience of allowing the firm sales orders to be cancelled.

On some audits the auditor may find that the unit cost price of an item cannot be checked to any purchase invoice, due to the fact that the item, when bought, was mixed with other like goods, but of different grade. Thus, if a manufacturer should purchase some ungraded raw material for such and such a price, the problem involved is to set the unit prices paid for the different grades of the raw material into which the original purchase is finally sorted. The following example illustrates the case of a purchase of article A, which is sorted at the factory into grades 1, 2, and 3.

EXAMPLE
Assumptions

(1) Purchase 100,000 lb. of unsorted article A at 17¢ lb.
(2) Market prices at date of purchase: grade 1, 20¢ lb.; grade 2, 18¢ lb.; and grade 3, 15¢ lb.
Smith & Smith, Inc.  
Office Supply Inventory  
Audit for the Year Ending June 30, 1929

<table>
<thead>
<tr>
<th>Item Description</th>
<th>1929</th>
<th>1928</th>
</tr>
</thead>
<tbody>
<tr>
<td>#718 Envelopes</td>
<td>522.00</td>
<td>467.30</td>
</tr>
<tr>
<td>#714 Envelopes</td>
<td>493.50</td>
<td>627.50</td>
</tr>
<tr>
<td>#4181 L.S. Paper</td>
<td>772.50</td>
<td>419.50</td>
</tr>
<tr>
<td>#19 pencils</td>
<td>195.00</td>
<td>210.60</td>
</tr>
<tr>
<td>Miscellaneous items under $100 - not checked</td>
<td>Total 8176.90</td>
<td>Total 10366.40</td>
</tr>
<tr>
<td></td>
<td>1467.80</td>
<td>993.70</td>
</tr>
<tr>
<td></td>
<td>9644.10</td>
<td>11359.10</td>
</tr>
</tbody>
</table>

(To B/S)

Audit Procedure

The above prices were checked to purchase invoices. The quantities were tested to the physical goods. No items are obsolete.

272. Explanation and Comments. — This plate on office supplies shows that the unit prices were checked against recent purchase invoices. As a rule, no attention is paid to market prices in valuing inventories of this type, but care is always taken to weed out obsolete material, and to mark down all slow moving items.

Note that the major items are listed in detail and compared with the figures for the prior period. By doing this, the number of unit prices which were vouched is clearly shown. So also, because of the comparison, any large errors should be detected. Thus, if in 1929 the value of the #718 envelopes was $3,547.50, the auditor would investigate carefully to see if the 1929 quantity or price has been misstated.

Finally, note that the total of the vouched items ($8,176.90) is shown so that the office manager, senior, or other person can readily tell what percent of the total inventory has been vouched.
Solution

<table>
<thead>
<tr>
<th>Grade</th>
<th>Sorted Unit</th>
<th>Market Price</th>
<th>Value at Market</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>10000 lb</td>
<td>20¢ lb.</td>
<td>$2000.00</td>
</tr>
<tr>
<td>2</td>
<td>70000</td>
<td>18</td>
<td>12600.00</td>
</tr>
<tr>
<td>3</td>
<td>20000 lb.</td>
<td>15</td>
<td>3000.00</td>
</tr>
<tr>
<td></td>
<td>100000 lb.</td>
<td></td>
<td>$17600.00</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Grade</th>
<th>Ratio of Cost to Market</th>
<th>Inventory Value at Cost</th>
<th>Unit Cost Unit Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>96.59%</td>
<td>$1931.85</td>
<td>$19.31¢ lb.</td>
</tr>
<tr>
<td>2</td>
<td>&quot;</td>
<td>12170.40</td>
<td>17.39</td>
</tr>
<tr>
<td>3</td>
<td>&quot;</td>
<td>2097.75</td>
<td>14.49</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$17000.00</td>
<td></td>
</tr>
</tbody>
</table>

274. See Plate 80.

275. See Plate 81.

276. Miscellaneous Comments on Goods-in-Process.— In checking the unit cost prices of goods-in-process, the auditor will meet with considerable difficulty if there is no cost system. In many such cases the best that the auditor can do is to see that the unit prices are reasonable; that they increase in orderly fashion as the goods advance from department to department; and that they are not different from the unit prices of last period, except in legitimate cases, such as, for example, when there is a drop in the market price of the raw materials.

As emphasized before, if a cost system is being used, it is necessary to analyze the composition of the factory overhead in order to see that the overhead is distributed to departments on reasonable bases, and to see that each department's overhead is applied to the jobs or process on a sound basis. Following this verification, the auditor should take several of the goods-in-process ledger sheets for the purpose of verifying in detail the material and labor charges against material requisitions, time cards, etc. If there are no errors thus far, the auditor may accept all of the goods-in-process ledger sheets as being correctly valued. The mathematics on each ledger sheet will, of course, be tested and scrutinized. Furthermore, the auditor must check several important ledger sheets against the physical existence of the goods. If the auditor arrives at or soon after the audit date, the goods will probably be in process. But if he arrives much later, the auditor will often have to verify the former goods-in-process as now being certain finished goods on hand or shipped, etc.

A reduced market price in the raw material, or any marked reduction in the cost of labor, or possibly in the overhead, will have to be given effect to in the goods-in-process inventories. On the other hand, if the goods are for specific firm sales orders, a drop in the market, either for labor, or for raw materials, or for overhead, will not affect the unit costs, provided the client has no past custom of accepting cancellations 1

1That is, sizable reductions at "Dec. 31" in material, labor, and/or overhead costs in the immediate future.
274. **Explanation and Comments.**—As stated in the text, it is often desirable to keep separate in the profit and loss statement the amount of loss due to the drop in market prices as at the audit date. When such a program is followed, the credit is very often made to an Inventory Reserve account rather than direct to the Inventory account itself. On a balance sheet presentation, however, the net figure is usually presented, as the amount of loss suffered in this respect is deemed to be too private for general publication.

Note, however, that this corporation appears to charge and credit operations with the inventories at cost, since it adjusts the reserve at the end of the year through the Surplus account.

<table>
<thead>
<tr>
<th>The Alberta Corporation</th>
<th>Banks 6-23-30</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory Reserve B/S</td>
<td>Schedule D-12</td>
</tr>
<tr>
<td>B/S Audit for the Year</td>
<td></td>
</tr>
<tr>
<td>Ended May 31, 1930</td>
<td></td>
</tr>
<tr>
<td>Balance per G/L and</td>
<td>158641.74</td>
</tr>
<tr>
<td>Audit Report 5/31/30</td>
<td>(To D)</td>
</tr>
</tbody>
</table>

Balance per G/L and Audit Report 5/31/29

| Raw Cotton                  | $89,567.48 |
| Materials and Supplies     | 9,157.34   |
| Goods-in-Process           | 32,887.85  |
| Finished Goods             | 67,149.39  |
| **Total**                  | **$188,762.06** |

To reduce the 5/31/30 balance (credit Surplus) Adj. #32 (30120.32)

<table>
<thead>
<tr>
<th>Balance per G/L and Audit Report 5/31/30</th>
<th>158641.74</th>
</tr>
</thead>
<tbody>
<tr>
<td>Raw Cotton</td>
<td>$73,814.32</td>
</tr>
<tr>
<td>Materials and Supplies</td>
<td>7,993.87</td>
</tr>
<tr>
<td>Goods-in-Process</td>
<td>27,015.43</td>
</tr>
<tr>
<td>Finished Goods</td>
<td>49,816.12</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$158,641.74</strong></td>
</tr>
</tbody>
</table>
A SCHEDULE ON INVENTORY RESERVES (2d type) PLATE 81

The Elsie Company
Inventory Reserve
May 31, 1930

<table>
<thead>
<tr>
<th>Balance 5/31/29</th>
<th>Cr.</th>
<th>188762.06</th>
</tr>
</thead>
</table>

Credited To:
(b) Cost of Sales Fin. Goods 45781.57 (144413.71)

Balance applicable to 5/31/29 goods in 5/31/30 inventory 44348.35

Charged To:
(a) Cost of Goods Mfg'd R.M. and G-in-Process 75843.09
(b) Cost of Sales Fin. Goods 38450.30 114293.39

Balance 5/31/30 158641.74 (To D)

<table>
<thead>
<tr>
<th>Raw Cotton</th>
<th>Bal.5/31/29</th>
<th>Debits</th>
<th>Credits</th>
<th>Bal 5/31/30</th>
</tr>
</thead>
<tbody>
<tr>
<td>89567.48</td>
<td>67860.30</td>
<td>42127.22</td>
<td>73814.32</td>
<td></td>
</tr>
</tbody>
</table>

| Materials and Supplies | 9157.34 | 7653.91 | 6700.44 | 7993.67 |
| Goods-in-Process | 32887.36 | 32887.85 | 27015.43 | 27015.43 |
| Finished Goods | 57149.39 | 45781.57 | 38450.30 | 49818.12 |

Total 188762.06 144413.71 114293.39 158641.74

These reserves reduce the inventories to a "Cost or Market" basis.

275. Explanation and Comments. This plate contains the same data as plate 80, but the method of handling of the Reserve is altogether different.

Whereas in plate 80 the final reserve is arrived at by debiting or crediting Surplus (for an amount sufficient to raise or lower the beginning balance to the final balance necessary), this Reserve is debited with the amount applicable to the goods which have been consumed and/or sold during the period and credited with the amount necessary (less the amount left in the Reserve) to bring the final inventories down to the basis of valuation, say, cost or market, whichever the lower.

Under this plan, the Profit and Loss Statement (for internal use) will show as separate items the eight adjustments (4 debits and 4 credits). Of course, for publication the Statement will be prepared in the ordinary manner without revealing this private information.

Another common method of handling the Inventory Reserve is as follows:

12/31/24 Reduction of Inventories to Cost or Market xx
Inventory Reserve xx
To record the reduction of the inventory to cost or market. See folder 7, file 3.

1/1/25 Inventory Reserve Surplus xx
xx
To reverse the Dec. 31, 1924 entry thereby stating the inventory at cost.
of firm sales contracts.

Again, if the market selling price of an item of finished goods is such that the item had to be revalued below cost, the same item in the goods-in-process will have to be marked down proportionally. Likewise, the same sort of reduction must often be made when a client has unfulfilled sales contracts quoted at prices below the present cost and for quantities in excess of those in the finished goods inventory.

If a client has taken up the profit on long time uncompleted contracts, the auditor must set forth this fact on the balance sheet. Thus, to illustrate, if a contract to build a plant, estimated to cost $2,650,000, is secured at a figure of $2,975,000, the following balance sheet arrangement would be acceptable, assuming further that the contract is one-half completed at a cost of $1,325,000 and that $97,000 has been received on account:

Construction Contracts (at cost and proportional profit) $1,487,500
Less--Payments Received on Account 97,000
$1,390,500

Of course, if the cost to date for completing one-half of the construction was more than one-half of the estimated cost, the profit taken into the balance sheet will have to be based upon these facts and not upon the original estimates. For example, if in the above case the cost to date was $1,400,000, the profit will only be $87,500 (i.e. $2,975,000 - (contract price) - minus $2,800,000 (total cost to complete on the basis of the actual expenditures to date) equals $175,000 - (total profit) times 1/2 (portion of contract completed) equals $87,500 (profit earned to date).

Again, if the contract will result in a loss, it must not be valued at more than the proper proportion of the contract price, i.e. the cost then will be reduced by the extent of the loss to date. In "cost plus" contracts, it may be added, no loss is possible. Therefore, in such instances, the costs to date and the proportional profit thereon may be treated as accounts receivable.

As to contracts in process where the process is of short duration, such as the processes of a manufacturing business, no profit whatever should be taken up.

277. See Plate 82.

278. Miscellaneous Comments on Finished Goods.1--As shown in Plate 83, the unit cost prices for the finished goods are compared with the prices secured in recent sales, and especially in those sales occurring just after the audit date. If the margin between the cost price and the selling price is not sufficient to bear the future selling, financial, and administrative expenses, including also a reasonable profit, the cost price must be reduced to allow for these items. This procedure must be insisted upon, because the common understanding is that the inventories are stated in the balance sheet at prices which are expected to yield a profit when the goods are sold. As to finding the proper amount to be allowed for selling

1To repeat, inventories are often valued at selling price less selling, administrative, and financial expenses (and possibly profit) where (1) the goods are extremely marketable (2) the selling price is either lower than cost or the margin between the two (selling price above cost) is so small as to result in a loss on disposal (3) joint-cost problems as in the case of live-stock bought by the hoof and (4) the cost or replacement cost is unattainable as when properties bought for a lump sum are being broken down into proper accounting units.
A SECTION OF A GOODS-IN-PROCESS INVENTORY SCHEDULE PLATE 82

The Helltwell Mfg. Corp.
Goods-in-Process Inventory Audit for the Year Ending Dec. 31, 1929

<table>
<thead>
<tr>
<th>Order No.</th>
<th>Material Cost</th>
<th>D. Labor Cost</th>
<th>Overhead</th>
<th>Total Cost</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>3018</td>
<td>190.27</td>
<td>266.12</td>
<td>219.51</td>
<td>675.90</td>
<td></td>
</tr>
<tr>
<td>3021</td>
<td>191.22</td>
<td>459.47</td>
<td>226.39</td>
<td>877.08</td>
<td>This machine is being made for the client Adj.#16</td>
</tr>
<tr>
<td>3036</td>
<td>143.41</td>
<td>667.07</td>
<td>453.77</td>
<td>1364.25</td>
<td></td>
</tr>
<tr>
<td>3101</td>
<td>401.50</td>
<td>302.85</td>
<td>259.19</td>
<td>963.54</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>3185.19</strong></td>
<td><strong>37143.22</strong></td>
<td><strong>31718.27</strong></td>
<td><strong>100714.68</strong></td>
<td></td>
</tr>
</tbody>
</table>

Misc. under 600.00

| | 15341.06 | 17524.59 | 19262.89 | 52128.54 |
| **Total** | 47194.25 | 54667.81 | 50981.16 | 152843.22 |

Las. Year Dec. 31, 1928

| | 63742.83 | 69095.95 | 65338.87 | 19817.63 |

**Audit Procedure**

(#{}) Those jobs were checked completely to material requisitions, labor tickets, etc. The overhead was applied at departmental rates on a direct labor hour basis.

For further details, see the Audit Program.

277. **Explanation and Comments.**—This plate is an illustration of a goods-in-process inventory kept under a cost system. In this schedule the jobs totalling more than $600 are shown in detail, whereas all of the others are grouped together in a total figure. Note that those jobs which were tested thoroughly back to original vouchers are designated, so as to show definitely the extent of the tests which were made. So also, observe that the figures for last year are given for comparison, and to show that the inventory for this year is not "ridiculous", or such as should arouse the auditor's suspicions of fraud or gross error.
expense, financial expense, administrative expense, and profit, these can be approximated from the per cent computations on the Profit and Loss Statement, provided more exact methods are not available.

**ILLUSTRATION**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$100000</td>
<td>100%</td>
</tr>
<tr>
<td>Cost of Sales</td>
<td>70000</td>
<td>70%</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>$30000</td>
<td>30%</td>
</tr>
<tr>
<td>Selling Expense</td>
<td>10000</td>
<td>10%</td>
</tr>
<tr>
<td>Gross Profit on Sales</td>
<td>$20000</td>
<td>20%</td>
</tr>
<tr>
<td>Administrative Expense</td>
<td>8000</td>
<td>8%</td>
</tr>
<tr>
<td>Net Profit on Operations</td>
<td>$12000</td>
<td>12%</td>
</tr>
<tr>
<td>Financial Expense (net)</td>
<td>5000</td>
<td>5%</td>
</tr>
<tr>
<td>Net Profit</td>
<td>$7000</td>
<td>7%</td>
</tr>
</tbody>
</table>

For example, from the above condensed profit and loss statement, we see that the selling expense is 10% on the dollar; that the administrative expense is 8% and that the profit is 7%. If, therefore, the cost of an article is 22¢ but the market is only 20%, the inventory price should be about 14¢, i.e. (20% (market) minus 2% (selling expense), i.e. 20¢ x 10%) minus 1.6¢ (administrative expense, i.e. 20¢ x 8%) minus 1¢ (financial expense - i.e. 20¢ x 5%) minus 1.4¢ (profit, i.e. 20¢ x 7%); or (20¢ (market) times 70% (cost of sales) equals 14¢ (inventory value).

If the selling price is amply above the cost price, the latter should be checked as follows. If the cost system is not reliable, the auditor should ascertain that the prices are not being shifted from period to period without due cause, such as a change in the price of the raw material and/or of the direct labor. The auditor can readily ascertain what price changes have been made by drawing up his current inventory schedule with complete information as to last period's unit price for each of the major items.

If the cost system is found to be reliable (having been audited), a number of completed job sheets should be checked in detail to the direct material requisitions, the time cards, etc. The audited sheets should then be checked to the finished goods stock cards. From this point the auditor should test the unit prices on the finished goods stock cards against the unit cost prices on the inventory sheets. Of course, if the business is a merchandising one, checking the goods to cost records means checking them against current purchase invoices, or against the figures in the retail inventory schedule. If the retail method of inventorying is used to value the inventory, the auditor must not only run through the method of keeping track of the mark-ups and the mark-downs, but also run through the computations thereof. In brief, he must verify the figures of each item in the retail inventory schedule (Plate 77).

Furthermore, in computing the cost of the finished goods, the auditor must always keep in mind the necessity of making an allowance for any
drop in the market price\(^1\) of raw materials and/or of direct labor. At times
the figuring of the reduction in these items is very difficult, especially
if there is no cost system. But some move in this direction can be and
must be made. For example, in a business with no cost system, suppose that
the materials in article A suffers a decline of 20% and the direct labor a
decline of 10%\(^2\). And suppose further that the Statement of the Cost of
Goods Manufactured, for the classification of goods into which article A
falls shows that the material is 60% of the total cost, the direct labor
30%, and the overhead 10%. Finally, suppose that the cost of sales ratio
in the Profit and Loss Statement for this classification of goods is 70%. If,
now, there is in the inventory $300,000 worth (at selling price) of article
A, the correct reduced basis might be approximated as follows:

<table>
<thead>
<tr>
<th>Actual Selling Price</th>
<th>$300,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of Sales</td>
<td>70%</td>
</tr>
<tr>
<td>New &quot;Cost&quot;</td>
<td>$210,000</td>
</tr>
<tr>
<td>Material 60%</td>
<td>$126,000 less 20% reduction equals $100,800</td>
</tr>
<tr>
<td>Labor 30%</td>
<td>66,000 less 10% reduction equals 55,700</td>
</tr>
<tr>
<td>Overhead 10%</td>
<td>21,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$210,000 Adj. Inventory Value $179,500</td>
</tr>
</tbody>
</table>

This method is not recommended, except as a check, since the mill superin­
tendent should be able to divide with sufficient accuracy the cost of any
item into the divisions of labor, material, and overhead. With these
figures before him, the auditor can get at the necessary reduction more
readily and accurately than he can by using the methods shown in this
illustrative problem.

In conclusion, it must be explained that undelivered sales contracts
often have a tremendous bearing upon the correct valuation of the finished
goods, as well as upon the goods-in-process, and the raw materials. For
example, assume that there is 100,000 yards of cloth of style #1819 in the
finished goods inventory at a cost of 23¢ a yard with the market at 24¢.
Is it not evident that the inventory price would have to be reduced con­siderable below 22 7/8¢, say to 18¢, if the client had an undelivered
sales contract for 98,000 yards at 22 7/8¢. Moreover, if the undelivered
sales contract was for 1,400,000 yards, for example, the goods-in-process
of 500,000 yards (assumed) for this style #1819 would also have to be
reduced proportionately, and the raw material for the balance of 800,000
yards would likewise have to be priced accordingly; i.e., at a figure such
that the cost of a yard of finished cloth would be 18¢. In such an in­
stance, since the market price of 24¢ has no bearing whatever on the
problem, the extreme importance of reviewing the cost price in the in­
ventory in the light of the sales contracts should be very evident.

\(279.\) See Plate 83.

\(280.\) *Intercompany Profit in Inventories of Consolidated Balance
Sheets.*—In many inventories there is an element of inter-company profit

---

\(1\)As at or immediately after "December 31".

\(2\)As at or immediately after "December 31".
The Alpha Manufacturing Corporation
Summary of Finished Goods with Albert Green & Sons, Agents
Audit for the Year Ending December 31, 1929

<table>
<thead>
<tr>
<th>Style No.</th>
<th>Style</th>
<th>Quantity</th>
<th>Grey Price</th>
<th>Finishing Cost</th>
<th>Total Amount</th>
<th>Selling Price</th>
<th>Quantity</th>
</tr>
</thead>
<tbody>
<tr>
<td>843</td>
<td>1716</td>
<td>140967</td>
<td>05</td>
<td>021</td>
<td>076</td>
<td>10713.49</td>
<td>102 - 105</td>
</tr>
<tr>
<td>917</td>
<td>5127</td>
<td>341778</td>
<td>061</td>
<td>047</td>
<td>108</td>
<td>36912.02</td>
<td>11 - 114</td>
</tr>
<tr>
<td>603</td>
<td>5013</td>
<td>487621</td>
<td>127</td>
<td>105</td>
<td>282</td>
<td>113128.07</td>
<td>25 - 25</td>
</tr>
<tr>
<td>432</td>
<td>4178</td>
<td>245599</td>
<td>187</td>
<td>037</td>
<td>224</td>
<td>55014.18</td>
<td>25 - 255</td>
</tr>
<tr>
<td>777</td>
<td>6309</td>
<td>761381</td>
<td>120</td>
<td>061</td>
<td>201</td>
<td>153037.58</td>
<td>21 - 222</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Style No.</th>
<th>Quantity</th>
<th>Grey Price</th>
<th>Finishing Cost</th>
<th>Total Amount</th>
<th>Selling Price</th>
<th>Quantity</th>
</tr>
</thead>
<tbody>
<tr>
<td>143</td>
<td>6342</td>
<td>487840</td>
<td>126</td>
<td>07</td>
<td>195</td>
<td>95616.64</td>
</tr>
<tr>
<td>121</td>
<td>6297</td>
<td>341742</td>
<td>11</td>
<td>092</td>
<td>202</td>
<td>69031.88</td>
</tr>
</tbody>
</table>

Total Above: 5147936
Miscellaneous: 462842
Grand Total: 5616241 yd

279. Explanation and Comments.—This plate shows a section of a Summary of Finished Goods. It should be noted that the quantities, grey prices, finishing costs, amounts, and selling prices are compared for each of two years. Such a comparison, when taken in conjunction with the quantities listed on the Grey goods schedule, is extremely valuable in showing the changes by styles in the inventory stocks carried. Moreover, these quantities are compared by styles with the sales for December and January, in order to ascertain which styles are moving, which styles are slow, and which styles are dead. For example, style #777 is dead because the October to January sales are insignificant. As a result, the note on the schedule shows that adjustment #41 reduced this style to 18 cents a yard.

In conclusion, observe that the selling prices are given, so as to make a comparison of them with the inventory prices. In the case of style #148, the selling price in January of 19 cents a yard for 247,000 yards was below cost. The auditor evidently required the style to be priced at 17 cents a yard (which reduction was a part of adjustment #41) as of December 31st.

<table>
<thead>
<tr>
<th>Price</th>
<th>Price Cost</th>
<th>Sell. Prices</th>
<th>Sales</th>
<th>1929</th>
<th>1930</th>
<th>1930</th>
</tr>
</thead>
<tbody>
<tr>
<td>05'</td>
<td>02'</td>
<td>08'</td>
<td>8459.47</td>
<td>10' - 10'</td>
<td>117000yd</td>
<td>70</td>
</tr>
<tr>
<td>06'</td>
<td>05</td>
<td>11'</td>
<td>39070.34</td>
<td>None</td>
<td>110</td>
<td>114</td>
</tr>
<tr>
<td>12'</td>
<td>10'</td>
<td>23'</td>
<td>122055.90</td>
<td>25^2 - 25^5</td>
<td>253000</td>
<td>150</td>
</tr>
<tr>
<td>16'</td>
<td>03'</td>
<td>22'</td>
<td>86370.28</td>
<td>25^4 - 25^6</td>
<td>249000</td>
<td>None</td>
</tr>
<tr>
<td>12'</td>
<td>08'</td>
<td>21</td>
<td>134797.53</td>
<td>None</td>
<td>15</td>
<td>21 (M)</td>
</tr>
</tbody>
</table>

---

**OMISSIONS**

| 12' | 07 | 19 | 69232.50 | 19 | 19 | 247000 | None (P) | 247 | 19 | None |

| 11' | 09' | 21' | 123894.14 | 24' - 24' | 595000 | None | 445 | 24' | None |

\[ \frac{1073020.01}{64731.68} \]
\[ \frac{1137751.69}{110943.65} \]

**Adjustment \#41**

| 283288.04 R |

\[ \frac{110943.65}{110943.65} \]

**R Red**

**M Sales in Nov.**

| 10 | 210 |

**" Oct**

| 17 | 210 |

**P By Adjustment \#41 style \#146 is reduced to 17 cents, and style 777 to 18 cents.**

**K No January and February sales, but a review of the Oct., Nov., and Dec. sales shows that the style is current. It is still on production. Mr. Green assures me that it is not obsolete.**

**AUDIT PROCEDURE**

For extent of the verification, see the audit program.
which leading auditors and businesses unhesitatingly eliminate in a consolidated balance sheet since the goods have not been disposed of to outsiders. Naturally, it is often very difficult or even impossible to determine the exact amount of the intercompany profit in the final inventories, but some deduction can usually be readily made which will approximate the true figure (if it could be ascertained) with sufficient accuracy for all practical purposes. Even in those cases where it is impossible to know what is the approximately correct reduction, it is always possible to deduct an amount which is definitely known to be somewhat too great. While this procedure is not ideal, it is very practical, and necessary under the circumstances.

As to whether or not the portion of the inventory belonging to the minority interest should be valued with the intercompany profit included therein is a small matter, and one for the client to decide upon, as there is no reason why the auditor should object to either method. Personally, the writer favors eliminating all intercompany profit, and showing the minority interest's surplus at a proportionally reduced amount (the reduction should never be charged wholly against the surplus of the major interest), because the consolidated balance sheet is drawn up for the purpose of showing the net consolidated position. The majority interests, it should be remembered, can ascertain their true respective net worths ONLY from the balance sheets of their own companies. As they have no particular interest in the consolidated balance sheet, no injustice is done them however it may be drawn up.

According to some, any profit in intercompany inventories at date of acquisition should be eliminated, even though the actual sales and purchase transactions were made prior to the establishment of the major holding. For example, if any of the subsidiaries were affiliated prior to the acquisition of the major interest in these subcompanies, and one of such subsidiaries had an inventory which had been sold to it by another affiliated subsidiary, such intercompany profit should be eliminated, at least to the extent of the major interest.

In the writer's opinion, if the transactions took place before the newly purchased businesses became subsidiaries of the purchaser, the latter is justified if it does not wish to eliminate the intercompany profit. Assume, for example, that Co. A sells to Co. B and that there is no inter-stockholdings between them. If, now, Co. C purchases a major interest in Co. A and Co. B, the intercompany profit in inventories need not be eliminated, because Co. C will have paid, presumably, the full price for these inventories. The same reasoning applies even if Co. A owned Co. B, and Co. C purchased Co. A, and hence Co. B also.

281. Valuation of Inventories in the Profit and Loss Statement.--In certifying to a profit and loss statement, the beginning inventory, as well as the final inventory, must be audited with care, and the majority of authorities hold that both inventories must be valued on the same basis. To illustrate, if the opening inventory is not audited, it may be incorrect, for one reason or another, in which case the profit certified to will also be incorrect. Or again, if the opening inventory, even though audited, is on a cost basis and if the closing inventory is on a cost or market, whichever the lower, basis, the profit for the period is a hybrid, being neither on the one basis nor on the other? At least this is the contention of many, perhaps most, auditors.

1This "minority" opinion is based on the belief that goods sold to the minority stockholders is NOT sold in the same sense as goods sold to TOTAL outsiders.

2If the basis of valuing the beginning and final inventories is materially different, attention MUST be drawn to this fact by some sort of a notation.
Ordinarily, most profit and loss statements are drawn up with both inventories stated on a cost or market, whichever the lower, basis. While this procedure satisfies many auditors, as just stated above, the writer finds it objectionable, because (to him) it makes a statement incomparable with its predecessors, and uniformative in itself. The two following statements bring out the points involved, and express the writer’s personal views on the subject for the particular cases stated. The statements in case #1 are the same, as are those in case #2, except for the method of arrangement and presentation.

ILLUSTRATION

CASE #1

A retail merchandise business

Assumptions

<table>
<thead>
<tr>
<th></th>
<th>Cost</th>
<th>Market</th>
<th>Cost or Market</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory, Jan. 1</td>
<td>$140,000</td>
<td>$180,000</td>
<td>$138,000</td>
</tr>
<tr>
<td>Inventory, June 30</td>
<td>115,000</td>
<td>110,000</td>
<td>105,000</td>
</tr>
</tbody>
</table>

Solution

<table>
<thead>
<tr>
<th>Method</th>
<th>$850,000</th>
<th>100%</th>
<th>$850,000</th>
<th>100%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales (net)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of Sales:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventory, Jan. (C or M)</td>
<td>$130,000</td>
<td>$180,000 (Market)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purchases (net)</td>
<td>650,000</td>
<td>650,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Freight-in</td>
<td>5,000</td>
<td>5,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$793,000</td>
<td>$835,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventory, June 30 (Cost or Market)</td>
<td>105,000</td>
<td>115,000 (Cost)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net</td>
<td>$688,000</td>
<td>84.7</td>
<td>$720,000</td>
<td>84.7</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>$162,000</td>
<td>19.1</td>
<td>$130,000</td>
<td>15.3</td>
</tr>
<tr>
<td>Add–Inventory Adjustment</td>
<td></td>
<td>32,000</td>
<td>3.8</td>
<td></td>
</tr>
<tr>
<td>Balance¹</td>
<td>$162,000</td>
<td>19.1</td>
<td>$130,000</td>
<td>15.3</td>
</tr>
</tbody>
</table>

¹ Another usual method is to carry both inventories at cost.

The following gives the Inventory Adjustment account in T form:

```
+-----------------------+                      +-----------------------+                      
| Inventory Adjustment Account |                      | Opening inventory adj. | 42000                  |
| Closing inventory adj.     | 10000                |                        |                      |
```

In brief, then, the writer’s views are that the opening profit and loss inventory should be stated at market, so that the business may start

¹Note: From here on the profit and loss statement will be drawn up as usual.
each period just as if it were brand-new, and so as to keep out of the gross profit any non-operating profit due to the market's being in excess of cost. Likewise, the final inventory should be valued at cost, so as to keep separate any loss due to a drop in its market value. Of course, the balance sheet must show its inventories on a cost or market, whichever the lower (or other conservative) basis.

To repeat, the opening inventory is valued at market because it is assumed that there is a rough relationship between market (replacement cost) and selling price.

### ILLUSTRATION

#### CASE #2

**Assumptions**

<table>
<thead>
<tr>
<th></th>
<th>Cost</th>
<th>Market</th>
<th>Cost or Market</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory, Jan. 1</td>
<td>$125,000</td>
<td>$100,000</td>
<td>$90,000</td>
</tr>
<tr>
<td>Inventory, June 30</td>
<td>130,000</td>
<td>90,000</td>
<td>86,000</td>
</tr>
</tbody>
</table>

#### Solution

<table>
<thead>
<tr>
<th></th>
<th>Usual Method</th>
<th>Suggested Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales (net)</td>
<td>$860,000 100%</td>
<td>$860,000 100%</td>
</tr>
<tr>
<td>Cost of Sales:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventory, Jan. 1 (Cost of Market)</td>
<td>$90,000</td>
<td>$100,000 (Market)</td>
</tr>
<tr>
<td>Purchases (net)</td>
<td>700,000</td>
<td>700,000</td>
</tr>
<tr>
<td>Freight-in</td>
<td>5,000</td>
<td>5,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$795,000</td>
<td>$800,000</td>
</tr>
<tr>
<td>Inventory, June 30 (cost or market)</td>
<td>$86,000</td>
<td>$130,000 (Cost)</td>
</tr>
<tr>
<td><strong>Net</strong></td>
<td>$709,000</td>
<td>$675,000 78.5%</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>$151,000</td>
<td>17.6%</td>
</tr>
<tr>
<td>Less-Inventory Adjustment</td>
<td>$185,000</td>
<td>21.5%</td>
</tr>
<tr>
<td><strong>Balance</strong></td>
<td>$34,000</td>
<td>3.9%</td>
</tr>
</tbody>
</table>

The following gives the Inventory Adjustment account in T form:

<table>
<thead>
<tr>
<th>Inventory Adjustment Account</th>
</tr>
</thead>
<tbody>
<tr>
<td>Closing inventory adj. 44000</td>
</tr>
<tr>
<td>Opening inventory adj. 10000</td>
</tr>
</tbody>
</table>

In brief, then, the writer's views are that the opening profit and loss inventory should be stated at market, so that the business may start each period just as if it were brand-new, and so as to keep out of the gross profit any non-operating loss due to the market's being less than cost. Likewise, the final inventory should be valued at cost, so as to keep separate any loss due to a drop in its market value.

1Except that any of last year's inventory should be priced the same as at "January 1".
2From here on the profit and loss statement will be drawn up as usual.
Of course, the balance sheet must show its inventories on a cost or market, whichever the lower (or other conservative), basis. For this reason, if the market value of the opening inventory is greater than cost or market, whichever the lower, the adjusting entry at the beginning of the new period is as follows:

January 1

<table>
<thead>
<tr>
<th>Opening Inventory</th>
<th>- - - - - - - - - - - - - -</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory Adjustment</td>
<td>- - - - - - - - - - - - - -</td>
</tr>
</tbody>
</table>

To bring the opening inventory to market value
(The adjustment account is, of course, a profit and loss item.)

Naturally, the market value could never be below the cost or market, whichever the lower, basis.

Likewise, if the "cost or market" value of the final inventory is on the books and is lower than cost, the difference is a debit to the adjustment account and a credit to the final profit and loss inventory, or the final inventory could be brought on to the books as follows:

December 31

<table>
<thead>
<tr>
<th>Final Inventory (Balance Sheet) (At cost or market)</th>
<th>291,451.18</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory Adjustment (Cost-Market) (P&amp;L)</td>
<td>17,187.45</td>
</tr>
<tr>
<td>Final Inventory (P&amp;L) (At cost)</td>
<td>308,638.63</td>
</tr>
</tbody>
</table>

To record the balance sheet inventory at cost or market and the profit and loss inventory at cost, the difference being charged to the Inventory Adjustment account.

282. See Plate 84.

283. The Client's Inventory Certificate.—In practically all instances, an inventory certificate (Plate 85) should be secured from the proper officials of the client. The writer holds to this belief despite the opinion of many others to the contrary. Perhaps there is no more reason for requesting an inventory certificate than there is for requesting one on notes receivable; perhaps it does seem that under this procedure the senior auditor will inevitably tend more and more to rely on the client's certificate than on his own independent analysis and verification; perhaps clients who would falsify inventory sheets would also just as readily as not sign a false inventory certificate; perhaps it may appear that the auditor is "passing the buck" by getting a certificate from the very one whom he is auditing;—but the writer is unable to entertain these views because they are really only "perhapses" and not realities.

In the writer's opinion, the value of a certificate is unquestionable. For example, a short statement of inventory rules in the certificate has brought to the attention of many officials regulations with which they were not familiar, or which they had overlooked. Thus on occasions some items were wrongly excluded, obsolete material was incorrectly priced, raw materials, goods-in-process, and finished goods were incorrectly valued with an element of intercompany profit, and so on. Moreover the signing of an inventory certificate has a needed salutary effect, similar to that secured at law by using a seal, because it is "their solemn act and deed". Likewise, just as a cardinal principle of management is that all orders must be in writing and signed, so that there may be no misunderstandings or perjuries, and so that responsibility may be fixed, so also the inventory certificate fixes the client's responsibility, and also prevents him from stating that he did not understand that the inventory should have been priced thus and so, or should not have been included such and such consigned
EXPLANATION OF PLATE 84
A SECTION OF A GREY GOODS INVENTORY SCHEDULE

THE SMITH MANUFACTURING CO.
Summary of Grey Goods at the Mill
Audit for the Year Ending Dec. 31, 1929

282. Explanation and Comments.—Plate 72 shows a section of a Summary of Grey Goods. The chief thing to be noted in the schedule is that the quantities, prices, and amounts are compared for 1928 and 1929. By making this comparison, the auditor is able to observe, among other things, any radical changes in the unit costs. Naturally, these unit costs should remain fairly constant from year to year unless, indeed, there are some legitimate reasons for their changing, such as an increase or decrease in the cost of raw cotton, labor, and so on. In the case of each substantial change in a unit price, the auditor must satisfy himself that it is justified and correct. Therefore, by the preparation of such schedules, the auditor can readily catch any arbitrary manipulation of unit costs. Moreover, such a schedule reveals the style changes in the grey stocks carried. However, to make a more important comparison than this, the auditor must ally this schedule with his Goods-in-Process and his Finished Goods schedules. By adding together the quantities in these three schedules for any particular style of each of the two years, the auditor can compare the real change by styles in the inventory stocks of the business. In addition, by observing the quantity of the sales by styles for November, December, January, etc., the auditor is in an excellent position to ascertain which styles are fast moving, which styles are slow moving, and which styles are dead.

Finally, it should be noted that only the most important items are listed in detail, whereas the small items are grouped under Miscellaneous. Moreover, the grand total figure of the schedule is the true grand total of the grey goods inventory.
A SECTION OF A GREY GOODS INVENTORY SCHEDULE

THE SMITH MANUFACTURING CO.

Summary of Grey Goods at the Mill
Audit for the Year Ending Dec. 31, 1929

Schedule K

<table>
<thead>
<tr>
<th>Style</th>
<th>1928 Quantity</th>
<th>Price</th>
<th>Amount</th>
<th>1929 Quantity</th>
<th>Price</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>291</td>
<td>182,497 yd</td>
<td>$6,625.69</td>
<td>120,487 yd</td>
<td>$7,437.76</td>
<td></td>
<td></td>
</tr>
<tr>
<td>612</td>
<td>197,043</td>
<td>12,019.62</td>
<td>220,178</td>
<td>15,260.86</td>
<td></td>
<td></td>
</tr>
<tr>
<td>501</td>
<td>51,797</td>
<td>6,578.22</td>
<td>63,145</td>
<td>8,019.42</td>
<td></td>
<td></td>
</tr>
<tr>
<td>417</td>
<td>540,392</td>
<td>101,053.30</td>
<td>631,050</td>
<td>119,268.45</td>
<td></td>
<td></td>
</tr>
<tr>
<td>309</td>
<td>770,890</td>
<td>92,506.80</td>
<td>558,779</td>
<td>68,171.04</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Omissions

<table>
<thead>
<tr>
<th>Style</th>
<th>1928 Quantity</th>
<th>Price</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>297</td>
<td>78,309</td>
<td>6,613.99</td>
<td>89,347</td>
</tr>
</tbody>
</table>

Total 3,614,132 yd $401,168.65 3,766,496 yd |

Misc. 110,547

Total 3,724,679 yd $411,449.62 3,922,137 yd

Audit Procedure

For the extent of the verification, etc., see the audit program.

The unit prices were checked to the cost records. These figures, however, are nothing more than some records built up by the mill superintendent; that is, neither he nor we could check them up against any accounts in the ledger.
goods, and so on. Finally, it must certainly be admitted that persons are much more careful of what they write above their signatures than they are of what they say orally.

284. See Plate 85.

285. See Plate 86.

286. The Auditor's Comments in His Certificate.—As to what comments are required in the AUDITOR'S CERTIFICATE on inventories, some auditors take the position that the verification of quantities is not generally included within the scope of an audit, and that therefore the auditor need not specifically state that the quantities were not verified, if such is the case. The writer, however, maintains that since leading auditors are specifically stating what they have done in regard to quantities (because something is actually being done along this line now-a-days), it is now reasonable to assume that an auditor has covered this important phase of auditing inventories to his own satisfaction, even though his certificate is silent on this point.

287. The Natural Business Year.—In the chapter which developed the qualifications required of an expert auditor, the necessity of his having constructive ability was emphasized. This talent can often serve the client in connection with inventories, by advising those whose businesses are seasonal to change their fiscal year from the calendar year to that time when their inventory stocks are at their lowest. Such a time is obviously the end of the natural business year, whereas any other date, such as the fetish December 31, is purely artificial.

By adopting the natural business year, the client's force is able to take inventories and gather the other various accounting facts for closing the books, without the customary nerve racking rush attendant when it is done during a busy period. Since this is a dull period, the inventories will be low. Moreover, the office force will have a subnormal working load. Therefore, for these two reasons, among others, it is usually possible for them to present the final statements much sooner after the fiscal date than is customary.

Besides smoothing out the working load of the office force and others, and besides having the final statements available earlier, the natural business year presents the balance sheet at its best. This is likely to be true in regard to the company's liquid position, for then the inventories and the accounts receivable are at their lowest, whereas the cash is at its highest.

If the auditor meets with the client's objection that the federal income tax requirements can not be met if a natural business year is adopted, he can readily dispose of this mistaken idea by showing the client that all that is required is to give formal notice of the change to the department. Of course, the computation of the tax, for the year in which the change is sanctioned by the department, is upon a special basis, but as the procedure has been definitely established and published, no particular trouble should arise at this point, nor does the client suffer any penalty of any sort.

From the auditing firm's personal viewpoint, much is to be gained for itself if a client can be persuaded to change from a calendar year to a natural business year. Under existing conditions, the bulk of the auditing work falls between November and April with the result that many juniors are hired for this period only. This situation is obviously detrimental to securing the proper type of men to work up into seniors and partners, since it is not to be expected that competent young men are going to take kindly to being repeatedly hired and fired every other six months until such time
as they are able to secure a permanent place on an auditor's staff. In addition, the burden which falls upon the auditing firm's permanent staff of working night and day, and of supervising so many raw recruits, is not only disastrous to the work, but also to contentment. No one is especially pleased at having to work under great pressure all of the time during one period, and then having to sit around practically idle during the succeeding period.

Furthermore, auditing firms would gain through the general adoption of a natural business year. Since it distributes the work throughout the year, more engagements could be handled with the same sized staff. As a result, both principals and staff would profit financially. And in addition, as collections from clients would come in much more regularly throughout the year, the amount of receivables which a firm would have to carry would be reduced substantially.

266. The Federal Income Tax Regulations. 1

REGULATIONS 74

Art. 101. Need of Inventories.--In order to reflect the net income correctly, inventories at the beginning and end of each year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. The inventory should include raw materials and supplies on hand that have been acquired for sale, consumption, or use in productive processes, together with all finished or partly finished goods. Only merchandise title to which is vested in the taxpayer should be included in the inventory. Accordingly, the seller should include in his inventory goods under contract for sale but not yet segregated and applied to the contract, and goods out upon consignment, but should exclude from inventory goods sold, title to which has passed to the purchaser. A purchaser should include in inventory merchandise purchased, title to which has passed to him, although such merchandise is in transit or for other reasons has not been reduced to physical possession, but should not include goods ordered for future delivery, transfer of title to which has not yet been effected. Taxpayers are not required to file with their returns for 1928 and subsequent taxable years certificates of inventory on Form 1126.

Art. 102. Valuation of Inventories.--Section 22 (c) provides two tests to which each inventory must conform:

(1) It must conform as nearly as may be to the best accounting practice in the trade or business, and

(2) It must clearly reflect the income.

It follows, therefore, that inventory rules can not be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. In order clearly to reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is substantially in accord with these regulations. An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income.

The bases of valuation most commonly used by business concerns and which meet the requirements of section 22 (c) are (a) cost and (b) cost or market, whichever is lower. (For inventories by dealers in securities, see article 105.) Any goods in an inventory which are unsalable at normal

1 It may be stated here that it is often worth while for the auditor to compare the inventory figure given by the client on his tax return(s) with that given to him.
EXPLANATION OF PLATE 85

A FORM OF INVENTORY CERTIFICATE (1st type)

284. Explanation and Comments.—Plate 85 represents an inventory certificate commonly secured by auditors from the chief officials of the business under audit.

This form should be printed, even though it may need to be re-moulded frequently for particular audits, because it will meet with less objection from clients. A printed form seems to imply that "everybody is doing it", whereas a specially drawn up form does not have that psychological weight.

Attention is called to the fact that the certificate is packed with just as many basic principles of sound inventorying as the auditor can get into a reasonable sized sheet.
A FORM OF INVENTORY CERTIFICATE PLATE 85

INVENTORY CERTIFICATE

of

at _______ 193__

Summary of Inventory

<table>
<thead>
<tr>
<th>Items</th>
<th>Basis of Valuation</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Raw Materials</td>
<td></td>
<td>$</td>
</tr>
<tr>
<td>Goods-in-Process</td>
<td></td>
<td>$</td>
</tr>
<tr>
<td>Finished Goods</td>
<td></td>
<td>$</td>
</tr>
<tr>
<td>Supplies</td>
<td></td>
<td>$</td>
</tr>
</tbody>
</table>

Certificate

Being fully familiar with the above, we hereby certify that in our opinion the above inventory is full and complete in every respect, and
(a) was taken by actual and careful count, weight, or measurement as of the close of business at _______ 193__ except as follows:

(b) was the unencumbered property of this company, except as follows:

(c) was all of the inventory; and was net of all internal or intercompany profits, except as follows:

(h) No goods were included which had been sold or which were not the company's property; all liability on goods was properly taken up and all obsolete, damaged, and similar items were priced at not more than net salvage value.

(i) The signatures on the various inventory sheets are those of the employees who respectively made the physical check of the stock, set the price, and/or made the calculations.

(j) No purchase commitments have been entered into at a cost exceeding present market value, except as follows:

(k) No sales contracts have been entered into at a cost exceeding present market value, except as follows:

(l) Adequate provision has been made for all imperfect goods and for depreciation of stock which is obsolete and/or inactive, except as follows:

(m) We know of no reason whatever why you may not use the above values as representing inventories taken in accordance with the federal income tax rules and regulations which we have read except as follows:

By ________________
Title

By ________________
Title
EXPLANATION OF PLATE 86

A FORM OF INVENTORY CERTIFICATE (2d type)

285. Explanation and Comments.-- In former years, but not now, this Certificate of Inventory had to "be submitted by all taxpayers engaged in a trade or business in which the production, purchase, or sale of merchandise of any kind" is an income producing factor.

"The principal certificate will be signed by the taxpayer or an executive officer and the subsidiary certificate by officers and employees (such as department heads, superintendents, etc.) designated by the taxpayer or executive officer. If the taxpayer who fills in the principal certificate actually directs and observes the taking of the inventory, the subsidiary certificate need not be filled in."

In addition to the above instructions, which appeared on the back of the Certificate of Inventory, there were given articles 1611-16 inclusive from Regulations 69, the substance of which is given in section 288 of this text.
**CERTIFICATE OF INVENTORY**

U.S. Internal Revenue
(To be filed with Collector of Internal Revenue with Income Tax Return)
FOR CALENDAR YEAR 1927

Or for fiscal year begun ___ , 19__, and ended ___ , 19__

Name ____________________________
Address ____________________________

---

**PRINCIPAL CERTIFICATE**

<table>
<thead>
<tr>
<th>Name</th>
<th>Title or position</th>
<th>Part of inventory taken</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>P. T. Sweet</td>
<td>Controller</td>
<td>Supplies</td>
<td>$69,072.57</td>
</tr>
<tr>
<td>M. R. Sweet</td>
<td>Asst. Controller</td>
<td>Raw Materials</td>
<td>319,118.44</td>
</tr>
<tr>
<td>R. N. Hartz</td>
<td>Managing Director</td>
<td>Work in Process</td>
<td>198,143.68</td>
</tr>
<tr>
<td>S. F. Greene</td>
<td>Factory Supt.</td>
<td>Semi-Finished Stock</td>
<td>260,891.42</td>
</tr>
<tr>
<td>M. M. Campbell</td>
<td>Vice-president</td>
<td>Finished Stock</td>
<td>361,245.17</td>
</tr>
</tbody>
</table>

**Total** $1,248,471.28

Sworn to and subscribed before me this 10 day of March , 1928.

**Notary Public**

---

**SUBSIDIARY CERTIFICATE**

I (or we), the undersigned employees of the taxpayer named above, swear (or affirm) that I (or we) personally directed and observed the taking of the parts of the inventory set opposite my (or our) names, and, to the best of my (or our) knowledge and belief, is true and complete in every respect; that I (or we) have carefully read the instructions on the reverse side of this form; that this inventory was taken in accordance therewith; and that the following named persons whose separate certificates are subscribed hereon or attached hereto are the officers and employees under whose personal direction the various parts of this inventory were taken:

---

**Signature**

<table>
<thead>
<tr>
<th>Name</th>
<th>Title or position</th>
<th>Part of inventory taken</th>
</tr>
</thead>
<tbody>
<tr>
<td>Peter T. Sweet</td>
<td>Controller</td>
<td>Supplies</td>
</tr>
<tr>
<td>Manton R. Sweet</td>
<td>Asst. Controller</td>
<td>Raw Materials</td>
</tr>
<tr>
<td>Russell H. Hartz</td>
<td>Managing Director</td>
<td>Work in Process</td>
</tr>
<tr>
<td>Sam F. Greene</td>
<td>Factory Supt.</td>
<td>Semi-Finished Stock</td>
</tr>
<tr>
<td>Marshall M. Campbell</td>
<td>Vice-president</td>
<td>Finished Stock</td>
</tr>
</tbody>
</table>

Sworn to and subscribed before me this 10 day of March , 1928.

**Notary Public**
prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, add or broken lots, or other similar causes, including second-hand goods taken in exchange, should be valued at bona fide selling prices less cost of selling, whether basis (a) or (b) is used, or if such goods consist of raw materials or partly finished goods held for use or consumption, they shall be valued upon a reasonable basis, taking into consideration the usability and the condition of the goods, but in no case shall such value be less than the scrap value. Bona fide selling price means actual offering of goods during a period ending not later than 30 days after inventory date. The burden of proof will rest upon the taxpayer to show that such exceptional goods as are valued upon such selling basis come within the classifications indicated above, and he shall maintain such records of the disposition of the goods as will enable a verification of the inventory to be made.

In respect to normal goods, whichever basis is adopted must be applied with reasonable consistency to the entire inventory. Taxpayers were given an option to adopt the basis of either (a) cost of (b) market, whichever is lower, for their 1920 inventories; the basis adopted for that year is controlling, and a change can now be made only after permission is secured from the Commissioner. Application for permission to change the basis of valuing inventories shall be made at least 30 days prior to the close of the taxable year for which the change is to be effective. Goods taken in the inventory which have been so intermingled that they can not be identified with specific invoices will be deemed to be the goods most recently purchased or produced, and the cost thereof will be the actual cost of the goods purchased or produced during the period in which the quantity of goods in the inventory has been acquired. Where the taxpayer maintains book inventories in accord with a sound accounting system in which the respective inventory accounts are charged with the actual cost of the goods purchased or produced and credited with the value of goods used, transferred, or sold, calculated upon the basis of the actual cost of the goods acquired during the taxable year (including the inventory at the beginning of the year), the net value as shown by such inventory accounts will be deemed to be the cost of the goods on hand. The balance shown by such book inventories should be verified by physical inventories at reasonable intervals and adjusted to conform therewith.

Inventories should be recorded in a legible manner, properly computed and summarized, and should be preserved as a part of the accounting records of the taxpayer. The inventories of taxpayer on whatever basis taken will be subject to investigation by the Commissioner, and the taxpayer must satisfy the Commissioner of the correctness of the prices adopted.

The following methods, among others, are sometimes used in taking or valuing inventories, but are not in accord with these regulations, viz:

1. Deducting from the inventory a reserve for price changes, or an estimated depreciation in the value thereof.
2. Taking work in process, or other parts of the inventory, at a nominal price or at less than its proper value.
3. Omitting portions of the stock on hand.
4. Using a constant price or nominal value for so-called normal quantity or materials or goods in stock.
5. Including stock in transit, whether shipped to or from the taxpayer, the title of which is not vested in the taxpayer.

Art. 103. Inventories at cost.—Cost means:

1. In the case of merchandise on hand at the beginning of the taxable year, the invoice price of such goods.
2. In the case of merchandise purchased since the beginning of the taxable year, the invoice price less trade or other discounts, except
strictly cash discounts approximating a fair interest rate, which may be
deducted or not at the option of the taxpayer, provided a consistent course
is followed. To this net invoice price should be added transportation or
other necessary charges incurred in acquiring possession of the goods.
(3) In the case of merchandise produced by the taxpayer since the
beginning of the taxable year, (a) the cost of raw materials and supplies
entering into or consumed in connection with the product, (b) expenditures
for direct labor, (c) indirect expenses incident to and necessary for the
production of the particular article, including in such indirect expenses a
reasonable proportion of management expenses, but not including any cost of
selling or return on capital, whether by way of interest or profit.
(4) In any industry in which the usual rules for computations of cost
of production are inapplicable, costs may be approximated upon such basis
as may be reasonable and in conformity with established practice in the
particular industry. Among such cases are (a) farmers and raisers of live
stock (see article 106), (b) miners and manufacturers who by a single pro-
cess or uniform series of processes derive a product of two or more kinds,
sizes, or grades, the unit cost of which is substantially alike (see article
107), and (c) retail merchants who use what is known as the "retail method"
in ascertaining approximate cost (see article 108).
Art. 104. Inventories at market.—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, and is applicable in the cases—
(a) Of goods purchased and on hand, and
(b) Of basic elements of cost (materials, labor, and burden) in goods
in process of manufacture and in finished goods on hand or in process of
manufacture for delivery upon firm sales contracts (i.e., those not legally
subject to cancellation by either party) at fixed prices entered into before
the date of the inventory, which goods must be inventoried at cost.
Where no open market exists or where quotations are nominal, due to
stagnant market conditions, the taxpayer must use such evidence of a fair
market price at the date or dates nearest the inventory as may be available,
such specific purchases or sales by the taxpayer or others in reasonable
volume and made in good faith, or compensation paid for cancellation of
contracts for purchase commitments. Where the taxpayer in the regular
course of business has offered for sale such merchandise at prices lower
than the current price as above defined, the inventory may be valued at such
prices less proper allowance for selling expense, and the correctness of
such prices will be determined by reference to the actual sales of the tax-
payer for a reasonable period before and after the date of the inventory.
Prices which vary materially from the actual prices so ascertained will not
be accepted as reflecting the market.
Art. 105. Inventories by dealers in securities.—A dealer in securi-
ties, who in his books of account regularly inventories unsold securities
on hand either—
(a) At cost;
(b) At cost or market, whichever is lower; or
(c) At market value,
may make his return upon the basis upon which his accounts are kept; provided
that a description of the method employed shall be included in or attached to
the return, that all the securities must be inventoried by the same method,
and that such method must be adhered to in subsequent years, unless another
be authorized by the commissioner. For the purpose of this rule a dealer in
securities is a merchant of securities, whether an individual, partnership,
or a corporation, with an established place of business, regularly engaged
in the purchase of securities and their resale to customers; that is, one
who as a merchant buys securities and sells them to customers with a view to
the gains and profits that may be derived therefrom. If such business is simply a branch of the activities carried on by such person, the securities inventoried as here provided may include only those held for purposes of resale and not for investment. Taxpayers who buy and sell or hold securities for investment or speculation and not in the course of an established business, and officers of corporations and members of partnerships who in their individual capacities buy and sell securities, are not dealers in securities within the meaning of this rule.

Art. 106. Inventories of live stock raisers and other farmers.—
Farmers may change the basis of their returns from that of receipts and disbursements to that of an inventory basis provided adjustments are made in accordance with one of the two methods outlined in (1) and (2) below. It is optional with the taxpayer which method is used, but, having elected one method, the option so exercised will be binding upon the taxpayer, and he will be precluded from filing amended returns upon the basis of the other method.

(1) Opening and closing inventories shall be used for the year in which the change is made. There should be included in the opening inventory all farm products (including live stock) purchased or raised which were on hand at the date of the inventory, and there must be submitted with the return for the current taxable year an adjustment sheet for the preceding taxable year based on the inventory method, upon the amount of which adjustment the tax shall be assessed and paid (if any be due) at the rate in effect for that year. Ordinarily an adjustment sheet for the preceding year will be sufficient, but if, in the opinion of the Commissioner such adjustment is not sufficient clearly to reflect income, adjustments for earlier years may be accepted or required. Where it is impossible to render complete inventories for the preceding year or years, the Commissioner will accept estimates which, in his opinion, substantially reflect the income on the inventory basis for such preceding year or years; but inventories must not include real estate, buildings, permanent improvements, or any other assets subject to depreciation.

(2) No adjustment sheets will be required, but the net income for the taxable year in which the change is made must be computed without deducting from the sum of the closing inventory and the sales and other receipts, the inventory of live stock, crops, and products at the beginning of the year; provided, however,

(a) That if any live stock, grain, or other property on hand at the beginning of the taxable year has been purchased and the cost thereof not charged to expense, only the difference between the cost and selling price should be reported as income for the year in which sold;

(b) But if the cost of such property has been charged to expense for a previous year, the entire amount received must be reported as income for the year in which sold.

Because of the difficulty of ascertaining actual cost of live stock, and other farm products, farmers who render their returns upon an inventory basis may at their option value their inventories for the current taxable year according to the "farm-price method," which provides for the valuation of inventories at market price less cost of marketing. If the use of the "farm-price method" of valuing inventories for any taxable year involves a change in method of valuing inventories from that employed in prior years, the opening inventory for the taxable year in which the change is made should be brought in at the same value as the closing inventory for the preceding taxable year. If such valuation of the opening inventory for the taxable year in which the change is made results in an abnormally large income for that year, there may be submitted with the return for such taxable year an adjustment statement for the preceding year based on the "farm-price method" of valuing inventories, upon the amount of which
adjustments the tax, if any be due, shall be assessed and paid at the rate in effect for such preceding year. If an adjustment for the preceding year is not, in the opinion of the Commissioner, sufficient clearly to reflect income, adjustment sheets for prior years may be accepted or required.

Where returns have been made in which the taxable net income has been computed upon incomplete inventories, the abnormality should be corrected by submitting with the return for the current taxable year a statement for the preceding year in which such adjustments shall be made as are necessary to bring the closing inventory for the preceding year into agreement with the opening complete inventory for the current taxable year. If necessary clearly to reflect income, similar adjustments may be made at the beginning of the preceding year or years, and the tax, if any be due, shall be assessed and paid at the rate of tax in effect for such year or years.

Art. 107. Inventories of miners and manufacturers.—A taxpayer engaged in mining or manufacturing who by a single process or uniform series of processes derives a product of two or more kinds, sizes, or grades, the unit cost of which is substantially alike, and who in conformity to a recognized trade practice allocates an amount of cost to each kind, size, or grade of product, which in the aggregate will absorb the total cost of production, may use such allocated cost as a basis for pricing inventories, provided such allocation bears a reasonable relation to the respective selling values of the different kinds of product.

Art. 108. Inventories of retail merchants.—Retail merchants who employ what is known as the "retail method" of pricing inventories may make their returns upon that basis, provided that the use of such method is designated upon the return, that accurate accounts are kept, and that such method is consistently adhered to unless a change is authorized by the Commissioner. Under this method the goods in the inventory are ordinarily priced at the selling prices, and the total retail value of the goods in each department or of each class of goods is reduced to approximate cost by deducting the percentage which represents the difference between the retail selling value and the purchase price. This percentage is determined by departments of a store or by classes of goods, and should represent as accurately as may be the amount added to the cost prices of the goods to cover selling and other expenses of doing business and for the margin of profit. In computing the percentage above mentioned, proper adjustment should be made for all mark-ups and mark-downs.

A taxpayer maintaining more than one department in his store or dealing in classes of goods carrying different percentages of gross profit based upon an average of his entire business, but should compute and use in valuing his inventory the proper percentages for the respective departments or classes of goods.

289. See Plate 87.

290. See Plate 88.

291. See Plate 89.

292. See Plate 90.
289. **Explanation and Comments.**—The reader should make a very careful study of this excellent program. Its length is indicative of the importance of properly verifying inventories.

(From—"Verification of Financial Statements"—Federal Reserve Board)

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-process ledgers, and finished-product records and stock records (if these are maintained) for verification of quantities, prices, and values. Any material discrepancy must be satisfactorily explained.

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

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

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

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

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

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

(r) In the case of companies manufacturing in fulfillment 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 separate heading.

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

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

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

ADDITIONAL SUGGESTIONS

(1) Is the insurance coverage adequate? Does the policy vary with the increase and decrease of the inventories? Who protects the goods out with others?

Some few concerns are dealing with cash discounts from the point of view of their neglect. Thus suppose that an invoice of goods for $10,000 is billed at 2/10 n/30. The entries would be as follows.

Merchandise
Accounts Payable

Jan. 8
$9800
9800

Accounts Payable
Cash

Jan. 17
$9800
9800

OR
Feb. 6
Purchase Discounts Neglected
Accounts Payable
Cash

$200
9800
10000

OR
Merchantise
Purchase Discounts Available
Accounts Payable

Jan. 8
$9800
9800
10000

Accounts Payable
Purchase Discounts Available
Cash

Jan. 17
$10000
200
9800

OR
Feb. 6
Cash

Accounts Payable
Cash

10000
10000
(2) How is the salvage material priced? Trace through several items for the purpose of ascertaining if the salvage price plus the cost of remaking exceeds the cost of the same item when no errors are made.

(3) Ask for the inventory manual and become familiar with its instructions. What errors do you find? What improvements can you suggest?

(4) How were the goods-in-process inventoried and priced?

(5) Check the inventories with those stated in the federal income tax return.

(6) Check the reasonableness of the rate (s) of overhead against the overhead in the Profit and Loss Statement.

(7) Review the inventory taking with the one who was in charge of it all. Do the same with some of the subordinates. Stress in your inquiry the method of determining, inventorying, and pricing the slow moving, obsolescent, etc. goods. Have these goods pointed out to you in the inventory sheets.

(8) Has freight, etc., been added to the inventory of goods out on consignment? Are the goods being sold?

(9) Are the inventory tags satisfactory from the point of sufficient information for proper pricing?

(10) Account for all (used and unused) inventory tags, or other forms. Check tag numbers to inventory sheets.

(11) Are there any materials with outside firms for special work, on consignment, at exhibitions, etc.? Get a signed list of places where inventories are. Check the inventory against statements obtained from those places.

(12) Are any fixed assets included as inventories? E.G. tanks for compressed gas, spare motors, obsolete machinery.

(13) What materials were estimated? How? Were the estimators qualified?

(14) Check sales invoices at end of period against shipping record, against inventory sheets to determine if any billed goods have been included as inventory.

(15) Eliminate goods received from others for repair.


(18) How do the Sales Contracts affect the pricing of the inventory?

(19) Check material in bonded warehouses by direct correspondence. Do not accept the receipts as satisfactory evidence. Does the client inspect the goods at the warehouse as they are received? Are these goods usable and/or salable?

(20) Separate materials purchased for the construction of additional plant.

(21) Inspect insurance policies for liens on inventories. Is the insurance adequate?

(22) Test and scrutinize the component parts of the inventory as to general accuracy and propriety. Compare with prior inventory.

(23) If a first audit, see that the beginning inventory is correct and is prepared on the same basis as the final inventory.

(24) Make a special task of examining stores cards for inactive items.

(25) Examine the method of receiving and delivering merchandise. Check the Receiving Record against the Voucher Register, and the Shipping Record against the Sales Book.

(26) Obtain certificates on prices and quantities from vendors wherever there are purchase commitments.

(27) What costs have been added to the invoice cost in the case of raw material inventories and supplies? Are these additions justified?

(28) Secure an inventory certificate from the client.

(29) Take inventory of goods received on consignment but EXCLUDE from inventory. Confirm with consignor.
(36) See that residuals and by-products are properly valued. Usually at sales price less cost of selling.
(31) Eliminate intercompany, interbranch and interdepartmental profits.
(32) If goods at consignees are not selling, see if a reserve is needed for loss, expense etc.
(33) If the retail (or other) method of valuing inventory has been used, test the records thoroughly. Is the method reasonable?
(34) Include goods-in-transit inward. Add to the liabilities.
(35) Review the records for window dressing; e.g., few receipts of goods in last months of period, large receipts soon thereafter.
(36) No construction work in progress must be allowed as inventories.
(37) Make a comprehensive test to see if data on ORIGINAL inventory tags was correctly transferred to the "fair copy" inventory sheets.
(38) If the "fair copy" inventory sheets have not been prepared systematically (all like items in one place), ascertain the reason for it. Be on the watch for fraud, such as duplication of quantities or variations in unit prices used.
(39) Are the unit prices given in the same unit terms as the quantities? Is it wrong, for example, to have the quantity in feet and the price in yards, even if the final answer is correct?
(40) Test the quantities of raw materials and supplies with the maximum specified on stores cards, with recent purchases, apparent needs, etc.
(41) Test the lot quantities of goods-in-process against work or production schedules to determine if they approximate the quantities usually scheduled through the shop.
(42) Compare present quantities of obsolete goods in the present inventory with quantities shown last year. "Examine all data concerning changes in specifications or design and discontinued models, products, or parts." Does the planning (or other) department have records of obsolete materials? If so, examine them.
(43) In the case of goods-in-process see that the unit prices for labor and overhead are made up of an unbroken sequence of operations up to and including the last operation so far performed.
(44) Ascertain if the original inventory sheets actually contain enough information to do the costing properly. Must estimates necessarily have had to be used.
(45) Have freight handling charges, insurance, etc. been added to goods consigned-out? To what extent are these additions justified?
(46) Will any material become deteriorated or obsolete before it can be economically used up?
(47) From account sales on goods consigned-out, ascertain the amount of inventory, and the accounts receivable. See that these are properly treated. Do the same with account sales on goods received on consignment.
(48) State the basis of valuing the inventories both on the balance sheet and on the profit and loss statement.
(49) Where like items appear in different sections of the inventory, see that the same unit prices are used.
(50) What parts are both produced and bought? Are they priced the same? If not, why not?
291. Explanation and Comments.— As stated in the text, the auditor must uncover all liens on inventories and other properties; therefore, the existence of collateral notes payable (such as the one illustrated here) is of very vital concern to him.

Note the 20% protection feature of this note.

The reverse side of this note reads as follows: The undersigned hereby assent to all the terms and conditions of the within note, and hereby consent that any security pledged may be exchanged or surrendered, or the time for payment of said note extended from time to time, in the discretion of the holder, without notice to or further assent from the undersigned, who will remain bound upon this note, notwithstanding such exchanges, surrenders, or extensions.

WAIVING DEMAND NOTICE AND PROTEST

By _________________________________
On demand after date, for value received, I, the undersigned, hereby promise to pay to THE MILK STREET NATIONAL BANK OF BROCKTON, or order at the said bank, ____________ Dollars with interest at the rate of ______ per centum per annum until paid, having pledged to the said bank, as general collateral security for the payment of this and any other liability of the undersigned, direct or indirect, joint or several, due or to become due, now existing or which may hereafter arise, the following described merchandise:

and do hereby give to the holder hereof full power and authority, upon the nonpayment of this or any other of the aforesaid liabilities when due or at any time or times thereafter, to sell, assign, transfer and deliver the whole or any part of said security or of any security substituted therefor or added thereto, at any brokers' board, or at public or private sale, with or without notice and advertisement, at the option of the holder hereof; and do further agree that the holder hereof may become a purchaser at such sale, if at any broker's board or at public auction, and may hold the security so purchased as the holder's own property absolutely, free from any claim of, or in the right of, the undersigned. The undersigned do also give to the holder hereof full power and authority at any time to demand, sue for, receive, and collect any moneys or money damages which may be or become payable under, or on account of, any goods, instrument, or other security pledged hereunder. In case of the sale or other disposition of the whole or any part of the security aforesaid, or the collection of any money thereunder, or on account thereof, the holder hereof may apply the proceeds of such sale, disposition or collection to the payment of all legal or other costs and expenses of collection, sale, and delivery, and of all expenses incurred in protecting the security or the value thereof as hereinafter provided, and may apply the residue of such proceeds to the payment of this note or of any then existing liability of the undersigned to the holder hereof, whether then payable or not, returning the overplus to the undersigned; and in case of any deficiency the undersigned agree to pay to the holder hereof the amount thereof forthwith, with legal interest. The holder may also upon any such non-payment apply the balances of all deposit accounts of the undersigned in the same way that the holder is authorized to apply the proceeds of any sale of the security hereunder.

The holder hereof may pay storage, transportation, and refrigeration charges, insurance premiums, taxes, assessments, liens and other expenses necessary or convenient to protect, preserve, or collect the security or any part of it, or the value thereof, or any right pertaining thereto, and may charge against the undersigned all expenditures so incurred; but the holder hereof shall be under no duty or liability with respect to the protection, preservation, or collection of any security held hereunder, nor of any rights pertaining thereto, beyond the safe custody of documents in its possession. The undersigned hereby agree that if, in the opinion of the holder, the market value of the security hereby or hereafter pledged to secure this note, after deducting all charges against the same, should at any time be less than the amount of this note and ______ per centum thereof added thereto, the undersigned will, upon demand, deposit satisfactory additional security so that the market value of the security pledged hereunder, after deducting all charges, shall always equal the amount of this note plus such additional percentage.

The undersigned further agree that no delay on the part of the holder hereof in exercising any right hereunder, shall operate as a waiver of such right or of any right under this note.

Name ____________________________________________

Address ____________________________________________
A SCHEDULE ON PRICE TESTING PLATE 90

THE CARR PAPER BOX CO.
Price Test of Supplies
Audit as at Dec. 31, 1930

<table>
<thead>
<tr>
<th>Description</th>
<th>Unit</th>
<th>No.</th>
<th>Unit Extension</th>
</tr>
</thead>
<tbody>
<tr>
<td>P.C. Coal #12</td>
<td>Ton</td>
<td>150</td>
<td>7.90 1165.00</td>
</tr>
<tr>
<td>(Specific Large Items)</td>
<td></td>
<td></td>
<td>(Details Omitted)</td>
</tr>
</tbody>
</table>

Total of the Above 45,472.29
Miscellaneous Small Items to Balance 3,489.12
Total Supplies (before adjustments, if any) 12/31/30 48,961.41

Audit Procedure
The above shows the large items in this inventory, and the miscellaneous items to balance. Extensions, footings and recaps have been checked. The prices have been tested in schedule K 14a. Quantities were tested for those marked (#).
A SCHEDULE ON PRICE TESTING PLATE 90

<table>
<thead>
<tr>
<th>Correct Price</th>
<th>Quantity</th>
<th>Client's Correct Price</th>
<th>Where Obtained</th>
<th>How Verified</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/30</td>
<td>150T</td>
<td>4.40</td>
<td>F. Bey Coal Co.</td>
<td>Bey Coal Co. Inv.</td>
</tr>
<tr>
<td>3.50</td>
<td></td>
<td>1185.00</td>
<td>letter dated</td>
<td>#6162 dated</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1185.00</td>
<td>1/7/31</td>
<td>12/17/30</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Omissions</th>
<th>Omissions</th>
</tr>
</thead>
<tbody>
<tr>
<td>38614.37</td>
<td>43981.24</td>
</tr>
<tr>
<td>38614.37</td>
<td>5366.87 (Adj. #45)</td>
</tr>
</tbody>
</table>

Note to Reader:—The difference between the "Client's Extension - 12/31/30" column and the "Correct Extension - 12/31/30" column represents the total net error due to incorrect pricing. In this instance the amount of error was 5,366.87. It was taken up in auditor's adjustment #45.
### Green Bros. & Ross, Inc. GRAND SUMMARY OF INVENTORY

Audit For the Year Ending June 30, 1928

<table>
<thead>
<tr>
<th>Schedule</th>
<th>1927 lb</th>
<th>1928 lb</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>(E-1) Finished-With Commission Agents</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>F.T. Curtis Sons</td>
<td>863479yd $ 165787.97 1047653yd $ 213721.21</td>
<td></td>
</tr>
<tr>
<td>M. Manson</td>
<td>1785321 364205.49 1517227 321673.32</td>
<td></td>
</tr>
<tr>
<td><strong>(E-2) Finished-With Bleacheries, Etc.</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Slater &amp; Renfew</td>
<td>468315 84765.01 246147 47260.22</td>
<td></td>
</tr>
<tr>
<td>Sayles &amp; Sayles</td>
<td>287147 49963.58 149863 27724.66</td>
<td></td>
</tr>
<tr>
<td>Whitaker &amp; Jordan</td>
<td>1980140 383107.44 1997234 363566.16</td>
<td></td>
</tr>
<tr>
<td><strong>(A) Total Finished</strong></td>
<td>5384402yd $1052829.49 4946224yd $993915.57</td>
<td></td>
</tr>
<tr>
<td><strong>(E-3) Grey at Mill</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>E. E. Bleacheries, Etc.</td>
<td>170326</td>
<td></td>
</tr>
<tr>
<td><strong>(B) Total Grey</strong></td>
<td>1716475yd $267957.22 2418527yd $409338.91</td>
<td></td>
</tr>
<tr>
<td><strong>(E-4) In-Process at Mill (C) Total</strong></td>
<td>1187342lb $176913.96 1448157lb $218760.65</td>
<td></td>
</tr>
<tr>
<td><strong>(E-5) Waste at the Mill (D) Total</strong></td>
<td>80349lb $8147.18 75148lb $7943.12</td>
<td></td>
</tr>
<tr>
<td><strong>(E-6) Cotton at the Mill</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 1/4&quot;</td>
<td>3187640lb $956292.00 487175lb $146152.00</td>
<td></td>
</tr>
<tr>
<td>1 1/8&quot;</td>
<td>1547816 377388.00 765974 $221444.00</td>
<td></td>
</tr>
<tr>
<td><strong>(E) Total Cotton</strong></td>
<td>4535456lb $1333680.00 1253049lb $367596.00</td>
<td></td>
</tr>
<tr>
<td><strong>(E-7) Supplies (F) Total</strong></td>
<td>$267143.05</td>
<td>$252189.19</td>
</tr>
<tr>
<td><strong>Grand Total (A, B, C, D, E and F)</strong></td>
<td>$3106670.90</td>
<td>$2250743.44</td>
</tr>
</tbody>
</table>

#The cotton purchasing agent has contracted for, but not priced, 4000 bales of 1 1/4" and 3000 bales of 1 1/8". These contracts are with Hooper Inc. and with Small, Fishkorn & Co. They were examined and are given in schedule (E6-a)

290. **Explanation and Comments.**—This plate is a sample of a master schedule, prepared by taking the totals from schedules E-1 to E-7 inclusive. Note that the line-up is a comparison of this year with last year by yards (or pounds) and by dollar amounts.
**ADDENDUM**

**Loans and Discounts Secured by Commodities**

**Merchandise Loans.**—Very often a bank will make a loan on the security of approved, standard, and readily marketable non-perishable staples, if they are properly insured, etc. The bank, of course, does not take physical possession of the commodity but accepts the evidence of ownership, i.e. a warehouse receipt, or a bill of lading.

It should be obvious that such collateral is not as easily valued or cared for as listed securities. The merchandise may not be graded, and it may be subject to shrinkage and/or deterioration. As a result, a large margin of safety is required, and much care must be given in making such loans.

**Warehouse Receipts.**—Formerly warehouse receipts were not as acceptable to banks as they are now after the passage in most states of a Uniform Warehouse Receipts Act, and by the national government of a United States Warehouse Act (1916).

Prior to these enactments, the legal position of a bank on its warehouse receipts was either unsettled, or totally insecure under the laws of many states. Thus an unpaid seller might set up a claim on the goods in the warehouse, which would precede that of the bank which held the warehouse receipt. That is, if the purchaser of merchandise should store it in a warehouse and pledge the warehouse receipt as collateral security on a bank loan, the seller, if he had not been paid, could secure prior claim to the merchandise over any one else, the bank included.

Likewise, if a consignee were to pledge warehouse receipts covering a consignor's goods, the consignor, being the legal owner, could seize the goods irrespective of the bank's possession of the warehouse receipts.

Again,—under the laws of several states, merchandise was considered as being in transit if it were temporarily stored on its route from seller to buyer. Thus a seller could invoke the legal right of stoppage in transit, if the buyer became insolvent. Here again the law slipped in to substitute a claim distinctly detrimental to that of the holder of the warehouse receipt.

**The Uniform Warehouse Receipts Act.**—The Uniform Warehouse Receipts Act provides for a standard form of receipt in much the same way as fire insurance policies are standard. The receipts may be either negotiable or non-negotiable. Furthermore, "A negotiable receipt may be negotiated (a) by the owner thereof, or (b) by any person to whom possession or custody of the receipt has been entrusted by the owner". Then too, "the validity of the negotiation of a receipt is not impaired by the fact that such negotiation was a breach of duty on the part of the person making the negotiation, or by the fact that the owner of the receipt was induced by fraud, mistake or duress, to entrust the possession or custody of the receipt to such person, if the person to whom the receipt was negotiated, or a person to whom the receipt was subsequently negotiated, paid value therefor, without notice of the breach of duty or fraud, mistake, or duress."

It is also interesting to note that "if goods are delivered to a warehouseman, and a negotiable receipt is issued for them, they can not thereafter, while in the possession of the warehouseman, be attached by garnishment or otherwise, or be levied upon under an execution, unless the receipt be first surrendered to the warehouseman, or its negotiation enjoined. The warehouseman shall in no case be compelled to deliver up the actual possession of the goods until the receipt is surrendered to him or impounded by the court."
Sections 48 and 49 provide (1) that "where a person having sold mortgaged, or pledged goods which are in a warehouse and for which a negotiable receipt has been issued, or having sold, mortgaged or pledged the negotiable receipt representing such goods, continues in possession of the negotiable receipt, the subsequent negotiation thereof by that person under any sale, to any person receiving the same in good faith, for value and without notice of the previous sale, mortgage, or pledge, shall have the same effect as if the first purchaser of the goods or receipt had expressly authorized the subsequent negotiation", and (2) that "where a negotiable receipt has been issued for goods, no seller's lien or right of stoppage in transit shall defeat the rights of any purchaser for value in good faith to whom such receipt has been negotiated, whether such negotiation be prior or subsequent to the negotiation to the warehouseman who issued such receipt of the seller's claim to a lien or right of stoppage in transit. Nor shall the warehouseman be obliged to deliver or be justified in delivering the goods to an unpaid seller unless the receipt is first surrendered for cancellation".

The United States Warehouse Act.—This Federal Act provides for the licensing of warehouses (which store certain specified commodities such as cotton, wool, grain, peanuts, potatoes, dried fruit, tobacco, flaxseed, etc.) through the Bureau of Markets, a department under the Secretary of Agriculture.

The Bureau requires a balance sheet of the warehouse to determine its financial condition. Likewise, it must furnish an approved surety bond, and convince the Bureau that the place is thoroughly equipped with men and instruments for properly weighing, inspecting, grading, and storing the commodities submitted to its keeping. Its records must also be very complete, and are subject to examination by the government. Moreover, the Bureau has field examiners who report back on the conditions found at each warehouse, so that if necessary the license can be revoked.

Bills of Lading.—Bills of Lading are evidences of ownership of commodities placed with shipping lines or railroads for transportation to the buyer. Banks often make loans on this sort of collateral security, as when they accept for customers drafts drawn against bills of lading. As a bill of lading does not guarantee the quality or grade of the merchandise it evidences, the bank, in the last analysis, has to rely much more on the character of the buyer than is the case of a receipt of a warehouseman licensed under the federal law, for example.

Trust Receipts.—It is very often necessary for the buyer to sell goods, pledged under a bill of lading or warehouse receipt, before he is able to meet his collateral bank loan. Therefore, unless the buyer is able to substitute some other satisfactory collateral, the bank will have to give him possession of the merchandise under a trust receipt.

There are, of course, different types of trust receipts. Thus, if the original buyer, G, has a purchaser, M, the purport of the trust receipt is to the effect that the warehouse receipt or bill of lading is surrendered by the bank to G for the sole purpose of making the sale to M. Moreover, there are further recitals stating that the goods are held in trust at all times, and that the proceeds of the sale belong to the bank to be applied against the loan and any other due indebtedness. Other types of receipts permit the manufacture of the goods, or may simply allow the borrower to get the goods from the common carrier in order to warehouse them. In this latter transaction, the bank gives the borrower the bill of lading under a trust receipt which requires the immediate return of the warehouse receipt. It is usually stated that the legal status of a trust receipt is a matter of considerable doubt. For our purposes, however, it may be likened unto a chattel mortgage, except that it is not recorded in the public records, etc. Moreover, speaking broadly, the bank can seize the merchandise or the proceeds thereof, if identifiable, anywhere and at any time the debt is paid up.

The Uniform Warehouse Receipts Act.
1. Cite a case where it is correct to distribute the department overhead to the job on the "direct material cost" basis.

2. Who should initial the inventory sheets?

3. What reasons do auditors give for not supervising the actual inventory taking of their clients?

4. What are the chief advantages of maintaining book inventories?

5. Draw up a goods-in-process ledger card for an imaginary job Z.

6. When may an auditor accept a book inventory in lieu of a physical inventory?

7. Explain why it may be advisable and necessary for an auditor to include in his inventories, goods which may be in the name of a banker.

8. Why does an auditor compare (by items) the December and January sales with the inventory of finished goods?

9. An auditor finds that the market price of a very numerous and slow moving finished article was 19¢ on December 31, 17¢ on January 15, 16¢ on January 31, and 16¢ on February 7 (at which date he is reviewing the inventory although the audit is as of December 31). The cost of the article is 22¢. At what price should the auditor value the article? Make further assumptions if necessary, but be certain to state them.

10. How would you protect yourself against overlooking liens on inventories?

11. State a complex situation of intercompany inventories, and then give your opinion as to how they should be classified on a consolidated balance sheet. Arrange the items under the major caption of INVENTORIES.

12. What is the most common cause of inflation of intercompany inventories? Give the accounting entries to take care of the situation.

13. Define and illustrate the rule of "cost or market, whichever the lower," basis for valuing inventories.

14. Why should the auditor insist on getting the original count sheets?

15. Would you insist on your client inventorying goods received on consignment? Give reasons for your answer.

16. When would you (the client) check your physical inventories against your book inventories?

17. Of what value is it to separate the different classes of inventories?

18. Draw up an inventory card and show thereon five purchases and three withdrawals on the basis of "first bought, first used."

19. Do problem 18 using an average cost basis.

20. What would you do if you found that the inventory sheets were not initialled?

21. Your client tells you that he brings his inventory cards into agreement with his physical inventories whenever he finds errors during the course of his systematic check-up. How would you check him up?

22. Name some ways in which the duties, responsibilities, and scope of work of professional auditors has increased.

23. If an auditor feels certain that his client is continually correcting his book inventories to his physical inventories, is it worth while for the auditor himself to check the book inventories back to the physical inventories?

24. What are two reasons why an auditor confirms the consigned inventory with the consignee?

25. Why is it necessary to confirm with the consignor goods received on consignment?

26. How do book inventories readily reveal obsolete and slow moving goods?

27. What are the arguments for valuing the minority interest's share of the intercompany inventories at cost (i.e. with the intercompany profit included therein)?

28. Name two very common ways in which auditors find obsolete and slow moving raw materials and supplies.
29. How would you check the original count sheets and the "fair copies"?
30. Why should indistinguishable goods be marked by the consignor?
31. On January 15 you call on your client and start checking his inventory cards. Would you work your count on January 15 back to December 31? Give reasons for your answer.
32. Is it ever proper to value the inventory of a partnership at market? Make your answer definite and complete.
33. Why should a cost system tie-in with the financial records?
34. When is it permissible to place part of the president's salary in the factory overhead expenses?
35. What is the general attitude of bankers and creditors toward having the auditors supervise the actual taking of their clients' inventories?
36. Why is it permissible to include insurance and freight (up to the time of receipt by the consignee) as a part of cost? Why not include it after the consignee gets the goods?
37. Explain how machinery might get into the inventories.
38. Describe the "stage by stage" method of checking-up on goods-in-process.
39. Why is the direct labor hour basis considered to be one of the most satisfactory methods of distributing the factory overhead to the job? How would you show on the balance sheet any goods out on consignment? Why?
40. Under what circumstances may carrying charges be loaded on to an inventory?
41. How would you value the operating supply inventory?
42. What use can an auditor make of last year's list of consignees?
43. What is the most important inventory comparisons and ratios on both balance sheet and the profit and loss statement?
44. How would you check the prices of an office supply inventory?
45. Why do meat packers price their inventories?
46. Give several reasons why it is better to treat operating supplies as a current asset rather than as a deferred charge.
47. How might you detect liens on inventories when they are not disclosed by the client?
48. How might an auditor classify certain "operating supplies" as fixed assets?
49. Why does an auditor need a Statement of Account as of the audit date?
50. Name and explain the most important inventory comparisons and ratios on both balance sheet and the profit and loss statement.
51. How would you check the approximate inventory price?
52. Give reasons why it is better to treat operating supplies as a current asset rather than as a deferred charge.
53. When is it permissible to place part of the president's salary in the factory overhead expenses?
54. Explain how machinery might get into the inventories.
55. How might an auditor classify certain "operating supplies" as fixed assets?
56. How would you check the prices of an office supply inventory?
57. When might an auditor classify certain "operating supplies" as fixed assets?
58. How might an auditor detect liens on inventories when they are not disclosed by the client?
59. Solve the following problem. Purchased 50,000 lb. of K at 45¢, which yielded 9,500 lbs of #1 grade, 30,000 lbs of #2 grade and 10,000 of #3 grade and
61. (continuation) grade. Selling prices: grade 1 - 55¢, grade 2 - 49¢, and grade 3 - 42¢. Find the cost price of each grade.

62. Comment fully on the following:

Inventories of Merchandise less Drafts
($12,272,734) drawn against Foreign Consignments .................. $79,458,567.59

63. Comment fully on the following:

Inventories:

Cylinders for the Shipment of Compressed Gas ............ $28,828,314.16
Less-Reserve for Depreciation 6,044,754.65 22,783,559.53
$52,611,022.77

64. Do you agree with the answers given to the following question? If not, why not?

"Question: We would like your opinion as to the best method of recording profit and loss on exchange on the books of a business where the home office is shipping merchandise to various branches in foreign countries. The rate of exchange in these countries varies considerably from month to month.

"If these branches enter the purchases from the home office at the current rate of exchange, their ratio of gross profit will show large variances from month to month, and it is extremely difficult for the home office to ascertain, at the end of the month, from the statements rendered by the branches, whether or not a reasonable percentage of gross profit has been earned. Would it not be more adequate to have the branches enter the purchases from the home office at a standard rate of exchange, and disregard the daily fluctuations? Of course, when remittances are made to the home office the profit or loss on exchange would then have to be taken up. Is there any objection to such procedure?

"Answer No. 1. - The method most generally followed by companies having foreign branches is to have the branches take up the merchandise shipped to them in dollars with corresponding dollar liabilities to the head office, and to have the branches convert these accounts into the local currencies at current rates. The periodical reports made by the branches in these cases are usually expressed in the local currency and are converted into dollars at the head office by using the average monthly, quarterly or annual rates, as the case may be, for the profit-and-loss accounts and the end-of-the-period quoted rates for current assets and liabilities, excepting inventories which the branch would report in dollars. Fixed assets should be converted at actual rates of exchange prevailing at the time when purchased. The difference arising from conversion on the above basis represents an exchange profit or loss which ultimately may not be realized, depending upon the exchange situation when the net assets are finally realized. Many concerns doing business abroad try to protect their profits on sales in foreign countries by hedging in foreign exchange, thus endeavoring to offset or evade exchange losses on realization of proceeds of sales.

"Regardless of the method of accounting adopted, the foreign manager should be informed of the dollar costs to the foreign branch of the merchandise shipped to the foreign branch by the home office, so that he may be able to calculate the prices in the foreign currency at which he must sell his merchandise in order to yield a fair dollar profit.

1922 Consolidated Balance Sheet of Armour and Company.
1924 Consolidated Balance Sheet of Union Carbide and Carbon Corporation.
profit. It is sometimes thought desirable (though it is not always done) to have the foreign branch report to the home office both the dollar and foreign currency figures relating to sales and cost of sales.

"It should always be borne in mind that the method adopted by the foreign branch in keeping its accounts may affect the amount of the income and other taxes paid in the foreign country and for this reason the inventory of merchandise in the foreign country is sometimes not sold to the foreign branch, or to the foreign company acting as agents or representatives, but remains the property of the home company and is carried even in the foreign branch accounts in dollars only.

"The adoption of a standard rate such as your correspondent suggests might make the bookkeeping a little easier, but if exchange with the countries in which he is dealing fluctuates from month to month as much as he suggests, the adoption of a standard rate might simply obscure the true results. We should be inclined to recommend a standard rate only if exchange were fairly stable."

"Answer No.2: We are of the opinion that the procedure is proper, and that it would meet the needs of the situation as outlined. In addition to keeping the accounts of the branches on the basis of a standard rate (ordinarily par) or exchange and making an adjustment for the difference whenever remittance is made by the home office, there would naturally be an adjustment made at the close of each year for the difference between the rate used in the accounts and the current rate of exchange with respect to the current assets and liabilities.

"The adjustments made at the time of sending remittances together with the adjustment or the difference in exchange applicable to current assets and liabilities at the beginning and end of the year, respectively, would indicate the profit or loss on exchange for the year. However, it is borne in mind that this segregation between the trading and exchange elements in foreign exchange can never be entirely accurate when there are violent fluctuations of exchange, as such fluctuations, to some extent at least, affect the prices of goods in foreign markets (or in the American market if goods are imported from abroad). In other words, the selling price of the goods, expressed in the currency in which sold, would be higher or lower than the equivalent of the par of the origination currency plus a normal rate of profit, depending on whether the currency in which the sale is being made is at a discount or a premium compared with the origination currency."

65. Do you agree with the answer given to the following question? If not, why not?

"Question. A large bakery contracts, say, during July, 1929, for a supply of flour at a stated price, to be made and stored by the mill and shipped on order of the bakery. Billing is to be made as shipped.

"On or about December 20th, the bakery orders a quantity of this flour to be shipped. Shipment is made, and invoice is rendered as of the date of shipment.

"The flour is received January 1st and subsequently.

"Shipment is made under negotiable bill of lading, sight draft attached, the mill being both consignor and consignee. Upon payment of the draft, the agent bank negotiates the bill of lading to the bakery.

"The foregoing are the facts. The following is the question:

"Knowing that this flour was "lifted," is it correct to consider the

cost of the flour in transit at December 31st to be a direct liability?

"Has the auditor the right to influence his December 31st report by knowledge which he acquired after that date?

"Answer: With reference to the first question raised, it is our opinion that the liability for flour in transit should be taken up on the books at December 31st, even though the shipment had been made sight draft, bill of lading attached, to the order of the flour mill. The question as to when the title passed is entirely a legal one, and even if we were to assume that title did not pass, legally, until payment was made to the bank, we do not think that the method of payment fixed by contract should in any way alter the situation with respect to the disclosure of a liability such as is described in your letter.

"As to the second question, it is our opinion that the auditor has the right to influence his December 31st report by any knowledge acquired after that date which may affect the assets or liabilities of December 31st."

66. Do you agree with the answers given to the following question? If not, why not?

"Question: An auditor (A) has been doing the work of a manufacturing company (X) for a number of years. This manufacturing company is affiliated with a processing company (P) which the auditor does not examine. At the close of 1930, X Company had a large inventory of its main raw material and, being desirous of reducing this, sold a substantial amount (practically one-third of its entire inventory) to P company. Company P borrowed money on warehouse receipts on this merchandise and paid company X in cash in full. Company X thereupon paid off a large amount of current indebtedness, which, of course, had the effect of improving its current ratio.

"In 1931 company X will gradually repurchase from P, either in processed state or original raw state the raw materials sold by it at the end of 1930 to company P.

"Company X having sold the raw materials to company P at cost insists that no mention of this transaction be made by the auditor in his report. The auditor, on the other hand, feels that since this was not a transaction in the inventory and was consummated at the end of the year with an affiliated company, some mention should be made of it in his report. In your opinion, what position should the auditor take, and how emphatic should he be if not in agreement with the client?

"Answer No. 1.--It seems to us that the question turns to a considerable degree upon what is meant by an affiliated company. If the affiliated company is a controlled or substantially owned company, then we think that the auditor in his report should mention the transaction. On the other hand, if the affiliated company is independently owned by the same interests and there is no onerous obligation on Company X, then on the statement of facts in your letter we do not think the auditor could insist on making mention of the transaction in his certificate.

"The question is one of so-called "window dressing," which always gives rise to some of the most difficult situations with which an auditor has to deal. In certain cases where a company resorts continually to such practices, the auditor's only remedy is to decline the audit on the ground that it is a bad moral hazard. This particular transaction was apparently fully disclosed to the auditor, but it is quite possible that information regarding similar transactions might be withheld from him.

"Answer No. 2.--From the facts, as stated by the correspondent, we

are disposed to think that he need not be insistent upon stating all the facts regarding the transaction in his report. We are influenced in this decision largely by the statement that company X will gradually repurchase the stock from company P; that is to say, the transaction was not obviously a window-dressing subterfuge which was reversed at the beginning of the succeeding period. Further it is difficult to see that the transaction was prejudicial to the interests of the stockholders of the creditors of company X.

"Answer No. 5.--This is one of many cases which come close to the border line and in respect of which one should have considerably more information than that presented in the inquiry.

"Generally speaking, if either a written or oral agreement exists between the respective companies regarding the repurchase of material, or if previous practice or admission on the part of either indicates that such will be the case, the transaction must be disclosed by a qualification in the auditor's certificate. On the other hand, one may well suppose in cases in which a change in the policy of a company might justify the disposition of a substantial portion of inventory, at costs, and if it were clearly demonstrated that the transaction did relate to such a change in policy no such disclosure would be necessary. Obviously such a change in policy could not contemplate a repurchase of such material in the ensuing period.

"When it is stated that the companies are affiliated, we assume that neither is a subsidiary of the other, but rather that both are controlled by the same interests. The question of inter-company relationships between parent and subsidiary therefore does not enter into the case.

"The auditor in this case seems to have made up his mind that the materials in question will be purchased in the ensuing period, and in the circumstances it is incumbent upon him to insist upon reference to such repurchase arrangement in his certificate."

67. Do you agree with the answers given to the following questions? If not why not?

"Questions:

(1) Should a reserve be provided for this decline in market prices, and if so, on what basis?
(2) If no reserve is set up, should a comment upon the decline in market prices be made in the certificate or report? or
(3) Should the decline in market prices be disregarded since it occurred after the date of the balance sheet?

"Answer No. 1.--It is our opinion that the inventories, the subject of your inquiry, are properly valued in the balance-sheet at the lower of cost or market. At the same time, a reserve should be provided for the decline in market prices, the amount of such reserve being the difference between the inventory valuation and the value to which the market has declined. We are assuming a decline in prices stabilized within reasonably definite limits, since if the downward price movement still continues, the stated reserve must be based on a consideration of the circumstances, and governed by a prudent conservatism. If, on the other hand, no reserve is made, appropriate comment should be offered in the certificate.

"Answer No. 2.--In reply to questions one and two, we believe that either a reserve should be set up or suitable comment made disclosing the fact of the decline of market prices and its effect on the financial position of the company. The answer to question three is, of course, that the

decline in market prices should not be disregarded.

'We believe, however that the inquirer should consider other factors than those mentioned in your letter. It is quite conceivable that a substantial decline might have occurred between March 1st and May 20th without impairing the financial status as shown on the March 1st balance-sheet. That is, the entire inventory might have been liquidated before the decline in prices occurred. It is manifest that if such were the case any reference to the decline in market prices would give an unjustified impression as to the client's financial condition.

'The measure of the reserve or of the qualifying comment should be the loss actually sustained and the potential loss still to be realized, in respect to the values shown as of March 1st. If the client had liquidated one half his inventory at a definite loss, such loss, together with the decline in value on the unliquidated portion, should represent the reserve requirement or amount to be embodied in the comments.

'It is seldom possible to trace the liquidation of inventory satisfactorily so as to determine the exact loss incurred at a given date. It is not necessary to comment on the difficulties in establishing the actual and potential loss, but merely to state the principle which must be followed in order that no injustice be done to the client.'

68. How would you check up on the inventory valuation of goods taken in exchange, such as second-hand automobiles?

69. What is your opinion of the following?

"Mr. D.R. Young: The safest (inventory) practice would seem to be taking the actual market prices on statement date and then, if necessary, inserting a footnote explaining that the prices used were abnormally low for certain reasons." 2

70. What is your opinion of the following?

"Mr. Remer: Where the selling price is much lower than the cost, should provision be made for selling expenses and possibly future administrative expenses, especially of the inventory as a whole? Would that be in that category?

"Mr. Young: In the determination of market price you do not usually include the operating expenses. You may be able to sell it out in a short time and you may have to wait a long time. In cases where you can get a fairly accurate market, like in the raw commodities that are traded in on the exchange or between brokers where you can get a reasonable market price I think the safest thing is to take the market price, and the expenses, of course, will have to come out. No one expects that you could dispose of all the product without some expense involved." 3

71. What is your opinion of the following?

"Mr. Tauritz: But, along the same line of thought—that of preparing a balance sheet on the fifteenth day of March for a firm and having it read as of the thirty-first of December—if the accountant has noticed any material change in the valuation since the closing of those books, would you expect him to make a footnote on the balance sheet prepared for you?

"Mr. Young: That would be entirely in order. In the case of these distress sales you might make a footnote that these valuations were taken at a certain price, but since that time there has been a recovery of

2 "Relations Between Accountants and Bankers"—by N.Y.S.S. of C.P.A., Nov. 1931 (p. 5).
3 Ibid (p. 6).
approximately ten per cent, or approximately twenty per cent. Or, if it went down, it would be up to you to make a footnote to that effect. But, the statement shows the condition, not when the audit is made but when the books are closed.\(^1\)

72. What is your opinion of the following?
"Mr. M.R. Riley of Brown Brothers Harriman & Co. of New York: The accountant explained that it had been his custom for years to eliminate from the liabilities all acceptances under letters of credit (here \$96,000) which covered merchandise still afloat, and, of course, this merchandise in transit item was left out of the assets. No mention was made regarding this procedure in the accountant's comments, nor was the item shown as a footnote on the statement, and as stated before, the accountant certified that these figures correctly set forth the financial condition of the company as of June 30. "In this case, the five banks interested got together and recommended another accountant."\(^2\)

73. What is your opinion of the following change of policy? Why?
"Prior to 1930, semi-finished and finished goods were inventoried at cost. In departing from this policy, rubber and cotton content of semi-finished and finished goods inventories were valued at market prices on December 31, 1930, and a charge (1,935,320.56) was made against Surplus to cover the difference between cost and market. The Company, therefore, entered the year 1931 with raw materials, finished and unfinished goods inventories and commitments, both Domestic and Foreign, valued at the low levels prevailing on December 31, 1930.\(^3\)

74. What is your opinion of the following?
"What should be the treatment of inventory write-downs necessitated by price declines? Requests have been made that we separately charge to surplus computed amounts considered to be declines in inventory values due to the market trend of the past year. The argument submitted in this instance is that the management had no control over these price declines and therefore the item is of an unusual nature and not a proper charge to operations. In particular, we have had this request in one instance wherein the computation of the decline is based on actual items included in the beginning and ending inventories at different values."

Answer No. 1: "With regard to (b) it may be of interest to quote the following from the Institute's Special Bulletin No. 7 issued in December, 1920;

'"It was agreed that it would be in order to show operating profits on the basis of inventories at cost (less usual provisions for obsolete stock, etc.) and the adjustment from cost to market as a special charge against profits or surplus, provided that the procedure adopted was clearly described. In point of fact, the loss from the decline of prices is an offset to the extraordinary profits from increasing prices realized over a series of years and not an operating loss of the year, but as the extraordinary profits in the past years have been included in the ordinary profits, any statement this year either must similarly absorb the corresponding decline or show clearly that this decline has not been absorbed in the operating results.'

"While the present conditions in some respects are comparable to those existing in 1920, it should be borne in mind that in 1920 price declines took place over a comparatively short period; whereas in the

\(^1\)Relations Between Accountants and Bankers"—by N.Y.S.S. of C.P.A., Nov. 1931 (p. 7)
\(^2\)Ibid (p. 6)
\(^3\)1930 Annual Report, The B.F.Goodrich Co.
present instance the trend of market prices has been downward over a period of some two years. There would not appear to be much point to the arguments advanced by your correspondent's client that the price decline is of an unusual nature because the management had no control over prices. Price declines and advances occur from time to time and are usually beyond the control of management, and it would be quite impracticable to attempt to eliminate from operating statements the effect of changes in price levels either of purchases or sales or of fluctuations in volume. Furthermore, we are satisfied that the treatment of an inventory write-down under present conditions as a surplus charge would be locked upon with disfavor by bankers and investors generally, and in any analysis of operating results the write-down would be applied against the current profit.

"We do not think the fact that some of the items upon which the price declines are computed appear in both the opening and closing inventory has any particular bearing on the question. It simply means that the prices of these items have declined during the year and the difference must be absorbed in the write-down. It does, however, raise the question of whether a future write-down is required for obsolete or slow-moving stock."

Answer No.2c: "One of the hazards of any business which carries an inventory is the variation in inventory values due to market fluctuations. In such as such market variations are an essential part of the conduct of such a business, there seems to be no justification whatever for ignoring such variations as proper charges to the income account. In any year in which there are abnormal declines, it might make a better presentation to show such abnormal amount as a separate deduction on the income account. There might conceivably be a case in which there has been a radical, and probably permanent, change in market values of some inventory item, and the inclusion of the full amount of such change might have no particular relation to the operations of the year in question. For example, if some new process for producing raw materials had been discovered, and as a result there had been a radical decline in the market price and it was fairly certain that such reduced price would continue, then such a decline might preferentially be set out separately in the income account, but might be charged to surplus provided adequate disclosure of such surplus charge were made.

"We think it essential that in cases in which justification can be found for charging to surplus items of a class which ordinarily would be charged against the income account there should be adequate disclosure of the amounts so charged to surplus and the nature of such charges.

"On the whole, the questions raised in your letter are of common occurrence under present business conditions, and usually are due to a desire to make the results of operations appear better than they actually are and to a failure to face the facts."

Answer No.3: "So far as provisions for market decline in inventory are concerned, such provisions should be made by charges against operations in the year in which the declines occur.

"Here, again, if it can be clearly demonstrated that inventories at the beginning of the year have, for one reason or other, been overstated, an adjustment of such inventory at the beginning of the year may be made by a charge against surplus, but the provision for such decline as may have occurred during the current period should be charged against current operations.

"As to inventory, it should also be noted that it is accepted practice to provide for substantial declines, which have occurred subsequent to the
date of the balance-sheet (but prior to the issuance of statements), by an appropriation of surplus. This provision is made for the purpose of stating the balance-sheet conservatively on the basis of latest available information, but the losses represented by such an appropriation of surplus should be absorbed in the operations of the ensuing period." — Journal of Accountancy, August 1932.

75. What is your opinion of the following?

"A method of taking the count that has had wide approval 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." — F.W. Thornton

76. What is your opinion as to the adequacy of the following summary of the auditor's duty on inventories?

"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." — F.W. Thornton.
CHAPTER 18

THE VERIFICATION OF PREPAID ASSETS

293. General Discussion. 294. Prepaid Insurance.
295. Explanation of Plate 91. 296. Prepaid Insurance.
PLATE 91--A Form of Insurance Register.
296. Explanation of Plate 92. 297. Prepaid Rent.
PLATE 92--A Letter from an Insurance Broker.
297. Explanation of Plate 93. 298. Working Funds.
PLATE 93--A Letter on Insurance from a Bond Trustee.
298. Explanation of Plate 94.
PLATE 94--A Schedule on Prepaid Assets.
299. Life Insurance. 300. Prepaid Interest.
303. Prepaid Rent. 304. Working Funds.
305. Explanation of Plate 95.
PLATE 95--An Insurance Schedule.
308. Postage and Other Stamps.
309. Explanation of Plate 96.
PLATE 96--A Balance Sheet.
309a. Audit Program.

Review Questions

293. General Discussion. -- Prepaid Assets are known under such other names as Deferred Assets, Deferred Debits, Suspense Debits, Deferred Charges to Operations, and so on. To the indiscriminate accountant, it is often nothing more than a dumping ground for any asset (and even losses) that cannot be classified under one of the other main balance sheet captions. Thus, for example, some accountants place in this category any charges which are held in suspense pending determination of their proper disposition in the accounts, as to whether they are to be treated as assets or expenses; accounts receivable and similar assets the realization of which is doubtful; cost of "stripping" in mining operations and similar advance expenditures; unamortized organization, preliminary development, and experimental expenses; doubtful property expenditures which may be capitalized, or treated as repairs or replacements; merchandise of doubtful marketability; deposits with public utilities; unamortized improvements to leased property; and the like.

The better practice, however, in fact the only correct practice, and which leading auditors and accountants are using, is to divide this "dumpling ground" account into two accounts; namely, Prepaid Assets (or similar name) and Other Assets. Prepaid Assets, as one leading auditor puts it, "are limited to those items which would be paid in any event after the date of the balance sheet, and are not indicative of any expansion of the business, such as advances for capital assets or the carrying forward of extraordinary expenditures for advertising which it is hoped will greatly increase the volume of business, etc." Again, the same auditor says, "Good accounting permits the inclusion among current assets of all prepaid items such as prepaid rent, insurance, interest, taxes, royalties and all other items which are chargeable to current operations or expenses within a year, and are a part of the current and necessary cost of

1See Appendix C, Sec. 6--#52; Sec. 14--#9, #10.
2Montgomery, page 86.
conducting a business which may reasonably be expected to be repaid to the business . . . . . . Moreover, the reimbursement must be as probable as the realizations through sales of raw materials and from other operating costs."

In the second quotation on prepaid assets is stated the very latest trend in the balance sheet classification of this caption; namely, its inclusion as a current asset. The writer favors the limitation of the term to the class of items described in above quotations, but he prefers to set up the prepaid assets under their own main caption directly AFTER the current assets, rather than as part and parcel of the current assets.

By way of further clarifying the term Prepaid Assets, a few of the items falling under this caption will be commented on in general. Usable supplies of current catalogues, or advance payments for current advertising yet to appear in print are acceptable as prepaid assets. On the other hand, a deferred item representing expenditures made for advertising which has already appeared in newspapers, etc., but the benefit from which is EXPECTED to be reaped in the future (i.e. after the balance sheet date), is an item which must be listed under the main caption of OTHER ASSETS. Discount on notes payable of short duration is properly considered to be a prepaid asset, but bond discount is accorded a more satisfactory treatment under OTHER ASSETS. A theoretical treatment calls for their being handled as valuation reserves; i.e., as deductions from their respective liabilities. However, this practice is not recommended. Prepaid commissions and advances to salesmen are prepaid assets, provided they are to be expended in the near future. Current usable supplies of all types and kinds, whether found in the factory or office, are often included under this heading of prepaid assets, but the writer prefers to classify the factory supplies not the office supplies, as Operating Supplies,—a subcaption under INVENTORIES (see section 234).

On the other hand as indicated above, unamortized bond discount, items held in suspense, unadjusted differences in accounts, doubtful accounts and notes receivable, inventories of doubtful marketability, organization expense, deposits of various kinds, expenditures for rearrangement of plant property, costs of stripping mines, unamortized improvements to leased property, and so on, are NOT prepaid assets,—largely because they are not properly chargeable to current operations within a year or two, if at all.

Under ordinary circumstances an auditor is apt to spend too much time in computing, or checking the client's computations of, various prepaid assets. The auditor must recognize that these items need not be accurately stated down to the last penny. Indeed, all that is required is that each accounting period be charged with an approximately equitable proportion of these expenses, and that the remainder left for the balance sheet figure be substantially correct. Moreover, if the client knowingly and regularly omits from his books of account the adjustment for prepaid assets, the auditor may not object to this procedure on a balance sheet audit. The case is not quite clear if the

Montgomery, p. 140. 2This represents the writer's opinion only. The weight of good accounting practice sanctions the inclusion of office supplies among the Supply Inventories. The writer excludes it from the inventories because it never becomes a manufacturing expense and thence a part of the value of the finished goods and goods-in-process, whereas the factory supplies do. 3This assumes that the amount is small. The report, if any, should mention the omission.
profit and loss statement is also to be certified. That is to say that
the omission of the prepaid assets from the balance sheet is usually un-
important, because of its small amount in proportion to the total assets.
But on the other hand, its effect on the profits for the period may be
worthy of attention.

Thus the omission of prepaid assets of $5,000 from a balance sheet
with total assets of $900,000 would not constitute an essential misstate-
ment of facts, as the error is only about one-half of one per cent. How-
ever, it is customary for the auditor to mention the omission in his
Auditor's Certificate. On the other hand, the omission of these prepaid
assets from the profit and loss statement, with profits of $80,000, would
be considerable if, for example, the prepaid assets at the beginning of
the period were only $500. (The understatement of profits by the omis-
sion of the prepaid assets would be about 6 per cent.)

294. Prepaid Insurance.—There are two distinct methods of operating
the prepaid insurance account. Under one plan, the account is charged
with all insurance costs, and then relieved of the expired portions at
the statement periods. This plan is suited to instances where an insur-
ance register (Plate 91) is kept. It may be stated here that a register
should be kept whenever the policies are numerous. Moreover, if in addi-
tion monthly statements are prepared, an insurance register is well-nigh
indispensable. The second plan is to charge the insurance expense ac-
count with all costs, and to relieve it of the prepaid amounts by a
charge to the prepaid insurance account.

In the writer's opinion, both the insurance expense and the prepaid
insurance accounts should be examined in detail for the entire year.
This should not be done with the idea that the verification of the amount
of insurance expense and of prepaid insurance is the important objective
to be accomplished, but rather that such an examination may uncover un-
known lions, expired policies, improperly distributed coverage, omissions
of inventory, unrecorded liabilities, and so on.

Therefore, each policy ought to be examined, and those which are
out with various persons, such as with a mortgagee, should be confirmed
direct by the auditor. This is not the customary procedure, but the
writer invariably favors it. He feels that it avails nothing to know
that the assets of a business are worth thus and so, unless they are
known to be adequately insured. The auditor must make it a point to
examine the policies to see that they are in force and are properly
signed and executed. In addition to this, he should draw up for his work-
ing papers a schedule (Plate 95) showing the coverage by name and amount
of each policy, and, having drawn it up, he should study it for inadequacy,
and so on. Thus, for example, it is often true that a client will have a
sufficient total insurance, but it will not be properly distributed over
the various individual units of property, or the policies may not read
uniformly, although they are supposed to cover identical risks.

Moreover, many lions, that would not otherwise have been disclosed,
have been unearthed by auditors by calling for and examining insurance
policies, and/or by examining the insurance expense account, and finding
that premiums were paid on policies which are not presented for examina-
tion. These cases arise most often on the audits of sole proprietorships,

1It is reiterated here that if the amount of insurance is obviously in-
adquate, the auditor should state this fact in his Certificate. When a
report is rendered a section of it should always be devoted to a summary
of the kind and amount of insurance and the value of the property covered.

2It may not be amiss for an auditor to ascertain if the client un-
derstands the meaning of the co-insurance clause.
or of partnerships. Thus, for example, it may appear that Mr. K's store is an unencumbered piece of real estate, until the auditor asks to see the insurance policy. At this point the auditor may be informed that it is held by the Second National Bank as protection for a recent mortgage on the store. As the mortgage money has been used by Mr. K for purposes outside of the business, no entry for it has been made on the store's books of account. Manifestly, the complexion of the balance sheet of the store has been changed radically by this piece of information. Again, goods omitted from the inventory (being out with dyers, printers, etc.) have been caught as a result of examining policies which provided for coverage of goods at these places at a time when the inventory did not show any goods with these concerns. In many of these cases, if the auditor had merely checked the invoices to the Insurance Register, and then tested the prepaid computations—a procedure adopted by some auditors—he would undoubtedly have missed the only salient features really worth while ascertaining on the whole audit.

In the case of insurance carried with mutual companies, there is generally a comparatively large credit refund to be taken into consideration. If the policies are few, the client or auditor can easily arrive at sufficiently accurate results by using the rate of return premium given in the near past. But if the policies are at all numerous, it is customary for the auditor, through the client, to request the insurance company to make the computations, or at least give the expected rate. When liability on workmen's compensation insurance is being checked, the auditor should remember to compute the premiums due on the basis of the actual payroll for the period. Many times the auditor's computation will disclose a large variance from the advance premium, which has been paid on the estimated amount of the payroll.

For a going concern, the proper balance sheet valuation is that reflected in the account when it has been handled as indicated. Computations based on "short rates" are not proper, for there is no reason whatever to believe that the policies will be cancelled before maturity.

Prepaid insurance may properly be considered a current asset from the point of view that if the amount now represented by it were cash, it (the cash) would indeed have to be spent immediately to purchase protection. Therefore, a business with a normal healthy amount of prepaid assets is in just as good a current position as another business with more cash but no or sub-normal prepayments. In fact, as many prepayments result in sizable savings, the business having some shows more evidence of good judgment than does the enterprise without any.

Some auditors, the writer included, although finding no difficulty in following the above reasoning, nevertheless, desire to express what they consider to be a significant shade of difference existing between prepaid assets and current assets, by setting them up directly after the current assets rather than as a part of the current assets. The shade of difference is this: current assets are either cash or items that will be realized in cash within one year from the date of the balance sheet, whereas prepaid assets do not fall within this category. The practice of showing true prepaid assets under Deferred Charges to Operations, i.e. the last item on the balance sheet, is, of course, totally unwarranted.

1 The contingent liability assumed in carrying mutual fire insurance is scarcely ever noted on the balance sheet but should be in many instances, as amply attested to by failures, etc., during the 1930 - 1934 depression. The point should always be covered, not overlooked.

2 See Appendix C, section 6 - #5a.
299. Life Insurance.—On many audits, the auditor will find that the lives of officers or partners have been insured, for the benefit of the business, especially whenever it is felt that the death of an officer or of a partner, will cause a temporary slump in the business. In such instances, it is expected that the money received on the policy will ease the loss caused by the death of the insured.

There are several methods of keeping the insurance account. Under one plan all of the premiums are capitalized until, if ever, the value in the account is equal to the face of the policy. The point of view is that since it is very probable that an individual with the rank of an officer will continue with the business until his death, and since the business intends and very likely will keep the policy in force until then, the amount of insurance that will be collected at the death of the insured will be at least equal to the amount in the account, and will usually be in excess thereof.

Therefore, the account, if stated on this basis, is conservatively valued at all times. According to the proponents of this plan, the only point at which this treatment of the premiums breaks down is to suppose that the policy may be given up. If so, the cash surrender value will, of course, be much less than the amount in the account. But the ASSUMPTION and INTENTION is that the policy will NOT be given up. This is exactly the same situation as the one which permits certain investments to be carried at cost instead of at market, because it is the INTENTION of the business to keep them for their earnings.

After the other methods of keeping the ledger account have been presented, it will be seen that this method is among the least conservative. Moreover, if this procedure is adopted, the account must be carried under its own name (say, Life Insurance Premiums Paid) as an investment, not as a current asset. In the writer's opinion, it is not a sound procedure because no charge is made to Insurance Expense for the cost of the protection secured, the whole premium being treated as an undiminished investment. (But if the account is carried as just outlined, the cash surrender value should be given in parenthesis, or two accounts may be used: (a) the Cash Surrender Value account for the cash surrender value and (b) the Premiums account for the balance of the annual premiums.)

As we have stated, life insurance is very often taken out by businesses as a security against losses or decreases in profits likely to occur after the death of the insured. Viewed in this light, some auditors feel that in addition to capitalizing the net insurance premiums up to the face value of the policy, there should also be an accompanying journal entry whereby insurance expense is debited and an insurance reserve is credited for the same amount as the net premiums. In this manner a reserve will be created against which the insurance account will be charged at the time of the death of the insured, leaving the cash received, to the amount of the policy, free to be credited to special income. (Under this plan the insurance account must be treated as a fixed asset.)

In regard to the above plan, there have been advanced the objections that a provision against a contingent future loss or reduction of profits of this sort is not a current profit and loss charge, and that insurance expense is overcharged by the portion that should be capitalized as the

1 Or, if bonds, at cost adjusted for the discount or premium involved.

2 If the reserve is not set up, the credit is, of course, to the INSURANCE (asset) account.—at least to the extent of the debit amount therein.
### A FORM OF INSURANCE REGISTER PLATE 91

Clarkson, Gooch & Calder, Inc.
1929 Insurance Register

<table>
<thead>
<tr>
<th>No.</th>
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<th>Company</th>
<th>T Premium 1/1/29</th>
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<tr>
<td>4032</td>
<td>1/1/28</td>
<td>Royal</td>
<td>3 200.00</td>
<td>133.33</td>
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**Questions**

4032 Royal 116.67R (5.00 5.00 5.00)

7669.19 260.14 262.16 262.19 261.17 262.14

R and ( ) Red

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295. **Explanation and Comments**—This plate represents a very detailed register. It is drawn up so as to give the amount of the monthly insurance expense for use in the monthly profit and loss statements. Of course, if the statements are drawn up but once a year, the premiums will be distributed in the register by years, not by months.

Whenever the policies are numerous, and especially if in addition the monthly insurance expense must be computed, the auditor should recommend an insurance register to his client.

The monthly totals are placed on two lines simply for convenience in editing.

On the right side of the plate there has been omitted several of the columns which show the type of coverage. This latter has been given in thousands of dollars.

Observe that policy #40321 Royal was cancelled at "short rate".
### Right Side of Plate 91

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<th>J</th>
<th>A</th>
<th>S</th>
<th>O</th>
<th>N</th>
<th>D</th>
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<th>Con Sprinkler Bldg tents ler</th>
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<td>5.00</td>
<td>5.00</td>
<td>5.00</td>
<td>5.00</td>
<td>5.00</td>
<td>57.70</td>
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### Omissions

(5.00 5.00 5.00 5.00 5.00 5.00)

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<tr>
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<td>20</td>
<td>300</td>
<td>150</td>
<td>175</td>
<td></td>
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</table>
EXPLANATION OF PLATE 92

A LETTER FROM AN INSURANCE BROKER

JORDAN & JORDAN, INC.

296. Explanation and Comments.—In some instances the auditor will be able to get a certificate from the client’s insurance broker as to the amount of unexpired insurance. If one is employed, the auditor should also be careful to secure a statement of the coverage, too.

The opportunity is again seized to emphasize that if the insurance policies are on hand, they should be carefully examined, and checked to the insurance schedule. The examination of the policies should be made because it may reveal unknown liens, liabilities, etc. Moreover, it may possibly reveal certain uninsured assets, or even unknown (to the auditor), or overlooked (by the client) assets. Furthermore, if the report is to go to a banker or credit manager, a comment on the amount and adequacy of the coverage should always be made; hence the need for a thorough review of the policies.

It may be noted (1) that in some instances the amount of the insurance may be helpful in forming an estimate of the worth of an asset; and (2) that there is a possibility of additional premiums on employer’s liability insurance.

Finally, it may be interjected here at this point that the writer believes that the auditor should write to the various insurance companies (assuming no intermediate broker exists) for the purpose of verifying that (1) the policies are in force, (2) have not been borrowed on (life insurance), (3) are payable to the client, (4) etc. etc. This precaution is necessary because various riders may not be posted on to the policies, such as a rider which changes the name of the beneficiary.
Gentlemen:

At the request of the Holden Mills, Inc., we are pleased to certify to you that the Company's unexpired insurance at December 31, 1930, was as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
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</thead>
<tbody>
<tr>
<td>Fire, Sprinkler</td>
<td>$46,754.17</td>
</tr>
<tr>
<td>Theft and Burglary</td>
<td>5,439.29</td>
</tr>
<tr>
<td>Liability</td>
<td>4,487.42</td>
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<tr>
<td>Elevator</td>
<td>184.37</td>
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<tr>
<td>Boiler</td>
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<tr>
<td>Use and Occupancy</td>
<td>1,757.75</td>
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<tr>
<td>Miscellaneous</td>
<td>3,114.95</td>
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<tr>
<td></td>
<td><strong>$64,089.76</strong> (To K-1)</td>
</tr>
</tbody>
</table>

And the coverage is as follows:

- Fire: Buildings $4,715,000
- Fire: Contents 500,000
- Use and Occupancy: Steam Boiler Explosion 50,000 wk
- Sprinkler Leakage: Buildings and Contents 100,000
- Office Burglary: Cash and Securities 125,000
- Fire and Theft: Trucks 20,000
- Accident: Elevator 10,000
- Accident: Trucks 20,000

All of the above policies are payable to the Company, and are in our possession.

Cordially yours,

JORDAN & JORDAN, INC.

By Merrill Jordan

MJ/FM
Messrs. English & Co.,
6107 Prout Avenue,

Dear Sir:

Pursuant to the request of THE YORKGUS WOOLLEN MILLS, INC. on the seventeenth, we are pleased to state that the amount of the insurance in our possession on the Company's property, subject to $5,000,000.00 To DD First Mortgage 7's (dated October 1, 1930 - due 1960) was $8,547,000.00 To F on May 31, 1931.

A list of the policies with the details which you requested will be forwarded to you as soon as we can prepare it.

Very sincerely yours,

William Street, Jr.
First Trust Officer

297. Explanation and Comments.—This plate is given to remind the reader that a bond is nothing more than a portion of the mortgage held by the bond trustee. Hence, where there are bonds payable held by the bond trustee, the auditor will often find that the trustee is the custodian of the insurance policies, just as a mortgagee is in the case of a mortgage on a piece of residential property.

Note also that as many figures as possible (that are stated in a letter from an independent source) are traced back into the working papers, — here to schedules DD and F respectively.
A SCHEDULE ON PREPAID ASSETS

Dingwell & Brown, Inc.
Prepaid Assets
December 31, 1929

(1) Prepaid Interest On

<table>
<thead>
<tr>
<th>Notes Payable - Banks</th>
<th>Due Date</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>6 1/2 15000 6 1/2 1st Nat'l</td>
<td>12/14/29</td>
<td>112.50</td>
</tr>
<tr>
<td>6 3/4 30000 6 3/4 Merchants</td>
<td>11/14/29</td>
<td>225.00</td>
</tr>
<tr>
<td>6 3/4 40000 6 3/4 State Street</td>
<td>12/31/29</td>
<td>600.00</td>
</tr>
</tbody>
</table>

(2) Advertising

The Proctor Advertising Co. Vo. # 12-618 for Jan. and Feb. 1930 advertising, in advance. Check #8961

(3) Rent

The A. E. See Realty Corp. Paid Jan. 1930 rent in advance per Vo. #12-104. Check #8345

(4) Insurance

For details see Schedule D-2

<table>
<thead>
<tr>
<th>Balance</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/29</td>
<td>4527.19</td>
</tr>
</tbody>
</table>

ADJUSTMENT 17 Greene

Prepaid Assets

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Expense on Notes Payable</td>
<td>937.50</td>
</tr>
<tr>
<td>Advertising Expense</td>
<td>3500.00</td>
</tr>
<tr>
<td>Rent Expense</td>
<td>3000.00</td>
</tr>
<tr>
<td>Insurance Expense</td>
<td>4527.19</td>
</tr>
</tbody>
</table>

To record the prepaid portion of the above credited accounts.

AUDIT PROCEDURE:

In the case of the Advertising and the Rent, the vouchers and cancelled checks were secured and their contents noted as given above. See BB and D-2, for the procedure taken on notes payable and insurance.

298. Explanation and Comments. — This plate is given: (1) to illustrate the nature of true prepaid assets as distinct from deferred charges (other assets); and (2) to illustrate the care which is given to locating, defining, and illustrating the "whys and wherefores" of these items. Notice particularly this latter point. Thus the details of the prepaid insurance of 4,527.19 is given on Schedule D-2; in the other instances, the voucher numbers are given and/or the check and note number.
cash surrender value. To be sure, competent managers set apart a portion of the earnings in a surplus reserve for contingencies against a day of expected and/or unforeseen losses, but this procedure is by an allocation of surplus or of profits, but NOT by a charge to some expense account.

Bell states the case for this second method as follows: "If it can be assumed that the individual will continue to be actively identified with the business until his death, and that it will be thought desirable to keep the policies in force, the amount of insurance to be collected will almost certainly exceed the premiums paid, and it would, therefore, seem proper to capitalize all the premiums paid; that is, charge them to an asset account. This is evidently the principle which has actuated the United States Treasury Department in disallowing premiums on such insurance as expenses for income tax purposes. Dividends received should, of course, be credited to the asset account if not deducted from the premiums.

"Notwithstanding the propriety of treating premiums paid as an asset, it seems that if the object in carrying the insurance is to furnish protection against anticipated losses upon the death of the insured, it is necessary to provide a reserve out of the present profits against which such losses may be charged when they are sustained. This result can best be accomplished, in the author's opinion, by capitalizing the premiums and concurrently creating a reserve on the books by charges of the same amounts to expenses; then the investment account, to be realized upon, will be offset by a reserve account, against which future losses can be charged. As far as the future is concerned, the same purpose may be accomplished by treating the premiums as expenses when paid, but this practice is open to the objection that it creates a secret reserve which will be disclosed only upon the realization of the insurance. If, on the other hand, the premiums are capitalized without creating a reserve, realization of the insurance will merely have the effect of conversion of one asset, the investment account, into another asset, cash—except as to any difference between the recovery and the premiums paid, which will have to be considered in any event. In this way a fund will be made available for distribution in case the business is liquidated, but the business may not be able to continue without impairing its capital through losses.

"Thus it will be seen that unless the purpose of insuring the life of an executive is merely to provide a cash fund which to discharge obligations, the object is best effectuated by writing off the premiums, and that it is preferable to do so indirectly; that is, by capitalizing the expenditures and at the same time creating a reserve of equal amount. While this conclusion is predicated upon the assumption, as stated, that the concern will in fact realize upon the insurance, the only possible criticism of the plan, in its application to any conditions, is on the ground of its ultraconservatism. It admittedly withholds from distribution out of the present profits to provide for what may be remote contingency; but the carrying of the insurance indicates that the contingency is regarded as real enough to warrant making provision for it.

"Under this plan of capitalizing the premiums and creating an equivalent reserve, if there is any change in the condition, whereby the insurance is discontinued, it will be necessary only to transfer the reserve to the asset account and to credit to profit and loss any recovery on the policies in the form of cash surrender value or such value as may be agreed upon in case of assignment to another beneficiary. The particular point to be noted is that credits, and not charges, to profit and loss are deferred."

1Bell and Powelson, p. 201.
The third plan (and possibly the most common) is that whereby an account is carried at the cash surrender value of the policy. The cash value at anytime is, of course, the cash surrender value at the end of the paid up policy year minus the discount (often at 6%) to the date under consideration. This conservative method of stating the account is preferred by some auditors, including the writer, because it does not ordinarily take a great deal of pressure, such as a period of reverses, for a business to decide to cut down expenses by dropping all its life insurance policies. That is, the method of capitalizing all premiums is based on an assumption of continuing purpose and intention, which as a matter of experience is subject to too many contingencies to be a usable working basis.

Under this third plan only the difference between the annual increase in the cash surrender value and the amount of net annual premium is charged to insurance expense, the other part being capitalized in the insurance account. Thus the entries would be:

January 1 Life Insurance Expense xx
Cash xx
To record the payment of the net premium

December 31 Cash Surrender Value of Life Insurance xx
Life Insurance Expense xx
To record the increase in the amount of the cash surrender value

In regard to the treatment of the insurance premiums for the first two or three years when there is no cash surrender value, some auditors sanction the capitalizing each year of one-half (or one third) of the cash surrender value; (1) provided the business is a going concern, (2) provided it is the intention of the business to maintain the policy, and (3) provided the balance sheet discloses the method used. The most conservative treatment, and the one favored by the writer, is to expense the premiums until such time as the policy has a cash surrender value. At this time, the cash surrender value is debited, and surplus and insurance expenses are credited for their respective proportions.

ILLUSTRATION
Assumptions
(1) The annual insurance premium is $76.00.
(2) The cash surrender values at the end of two or three years are $54 and $104 respectively.
(3) The dividend paid at the third premium is $7.00.
(4) The policy is dated July 1.
(5) The corporation's fiscal period ends December 31.

Entries

July 1
Prepaid Life Insurance 76.00
Cash 76.00
To record the payment of the first premium.

Furthermore, what assurance is there that the officer will be actively identified with the business until his death? 2Based on the capitalizing of a proportional amount of the cash surrender value during the first two years.
Life Insurance (Cash Surrender Value)

Life Insurance Expense
To record the proportional part of the cash surrender value, i.e. $1/4 \times 54$ (straight line method)

Life Insurance Expense
Prepaid Life Insurance
To reduce the prepaid account to $38.00, being the premium to July 1.

Prepaid Life Insurance
Cash
To record the payment of the second premium

Life Insurance (Cash Surrender Value)
Life Insurance Expense
To record the proportional part of the cash surrender value, i.e. $1/2 \times 54$ (straight line method)

Life Insurance Expense
Prepaid Life Insurance
To reduce the prepaid account to $38.00

Prepaid Insurance
Cash
To record the payment of the third premium, $76 less the $7 dividend

Life Insurance (Cash Surrender Value)
Life Insurance Expense
To record the proportional part of the cash surrender value, i.e. $1/4 \times 54$, plus $1/2 \times 50$ (straight line method)

Life Insurance Expense
Prepaid Life Insurance
To reduce the prepaid account to $34.50

If refined methods are found to be desirable in the treatment of endowment insurance (in order to show that a part of the premium paid is really a charge for the insurance protection plus also a charge representing an amount to be invested with the insurance company, the insurance expense may be assigned the amount that would be paid as the annual premium under a 10 year term policy of the same face amount.

A second method of dividing the premium between the insurance expense and the investment portions is to find the amount of the annual payment necessary to accumulate the face of the policy within the given time concerned at a rate of say 4 or 5 per cent. The difference between

\[1\text{See the text for the scientific method of using the cash surrender value at the end of the paid up policy year less 6 per cent discount to the date at hand.}\]
this sum and the net premium is the insurance expense. The interest will, of course, be recognized as income.

In either case the cash surrender value would be shown in parenthesis on a balance sheet presentation.

As leading auditors are not in agreement as to the proper classification of the cash surrender value as between current and fixed, an auditor will have to give way to whatever classification the client prefers. The writer looks upon the account, even when at the cash surrender value, as an investment, not as a current asset. To be certain, the policy can be credited if necessary, but so can many securities that are classified as permanent investments. Intention not possibilities should govern the classification of the account. This is the majority opinion.

As with other asset accounts, the supporting documents, i.e. policies, must be examined. The cash-surrender value in the account can be checked against the values in the table within the policy. Moreover, the policy must be in the name of the business as the beneficiary, or there must be on hand and in good order an assignment to that effect. It must show evidence of having been accepted by the insurance company, for otherwise it is not effective. If the insured has reserved the right to borrow money on the policy and has done so, there may be no cash-surrender value. Also, if the insured has the right to change the beneficiary at will, the beneficiary named in the policy may actually be already displaced. In short, as many matters affecting the policy are only evidenced by riders, which may not be attached when the policies are presented to the auditor for examination, the auditor should cover all of these several points by direct confirmation with the insurance company. It should be stated, however, that this procedure is not ordinarily taken.

If a policy is in the hands of a pledgee, it and the nature of the debt secured thereby must be confirmed direct by the auditor personally.

In regard to term insurance, or group life insurance on employees, there is ordinarily no value to be set up for it on the books, except the prepaid premiums.

300. Prepaid Interest.--Prepaid interest, and/or prepaid discount must be vouched against notes payable—trade, notes payable—banks, notes payable—brokers, and the like. Of course, some of these notes may give rise to accrued interest payable rather than to prepaid interest.

In drawing up the various schedules on notes payable (Plates 156, 157 and 158) an auditor will often develop thereon the prepaid interest account and the accrued interest payable account.

301. Prepaid Taxes.--The usual difficulty in dealing properly with taxes is in ascertaining the period to which the tax applies. As most tax bills are rather vague on this point, the auditor may have to address a special inquiry on this point to the board of tax assessors. On occasions it may turn out from the answer received in reply to the inquiry that there are no prepaid taxes, but rather accrued taxed payable.

302. Prepaid Advertising.--Any USEABLE quantities of CURRENT advertising matter, or any advance payments for advertising YET TO appear in print, and the like, are properly classified as prepaid advertising.

1"Current and Working Assets: Cash surrender value of life insurance - §277,598.00" National Dairy Products Corp. - 1932
2The letter should also ask if the tax rate or base of assessing values is to be charged. 3Examine and brief all advertising contracts. Do they affect the statements and/or the report?
Extraordinary expenditures made for advertising which has ALREADY appeared in print, or in the radio, etc., but the benefit of which is EXPECTED to be realized in the near future after the balance sheet date, may often be properly deferred to the future. But as the deferred sum is after all only a guess, it must be classified under Other Assets and not under Prepaid Assets.

Prepaid advertising should be checked up against invoices from the advertising agency, and in a general way against the supplies of catalogues, blotters, gift novelties, calendars, and other advertising materials. In most cases the auditor’s chief concern is to see that all obsolete advertising catalogues and supplies have been omitted from the inventory, rather than that the quantities on hand and the invoice prices tally with these used on the inventory sheets.

303. Prepaid Rent.—Under many lease agreements, the lessee must deposit with the lessor a guarantee sum, say one or two months’ rent. If the lease is not renewed and if the lessee has not damaged the property, the guarantee sum pays for the last month or two’s rent. Obviously, in the year in which the lease terminates the guarantee sum is a prepaid asset, if the lease is not to be renewed. But if the lease is to be renewed, the deposit should be treated as an investment.

If the client’s rent is payable monthly in advance, there is no prepaid rent unless the rent date is other than the first of the month, or unless the rent check for the following month has been forwarded in the last month of the period under audit.

304. Working Funds.—As at the balance sheet date, the portion of any advance to employees, such as to salesmen for commissions and traveling expense, which is represented by expense vouchers, must be charged to current profit and loss, the cash balance, representing advances for future expenses, should be treated as a prepaid asset rather than as a part of the sundry cash balances. In so far as feasible, verify the funds by direct correspondence or other independent methods.

305. See Plate 95.

306. Office Supplies.—If the office supplies are usable, and if they are also in reasonable quantities, they may be inventoried at cost, or at a recent price for a considerable quantity. One effective way to ascertain if a supply item is obsolete is to check the inventory price against a recent purchase invoice. If no recent invoice exists, the auditor will generally find it profitable to dig further into the matter of possible obsolescence. Even if there is a recent invoice for the item, the auditor must also consider the quantity as an indicator of possible obsolescence. Market prices are rarely ascertained for pricing office supplies, if a recent invoice price is available. Moreover, an estimated inventory is often satisfactory if the total value is undoubtedly reasonable. Of course, for federal income tax returns, the procedure is not desirable.

307. Factory Supplies.—As stated in the chapter on inventories, factory supplies are more reasonably treated under INVENTORIES than under PREPAID ASSETS. The difference in classification of office supplies and factory supplies is based on the following line of reasoning. First of all, there is the well recognized principle that factory overhead is a part of the inventory value, in addition to direct labor and direct

Assuming that the rent will be paid as usual because of the renewal.
AN INSURANCE SCHEDULE  PLATE 95

The Walker Cotton Mills, Inc.
Prepaid Insurance
December 31, 1931

Balance per G/L and our papers

<table>
<thead>
<tr>
<th>Premiums Paid - Checked to Invoices</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Steam Boiler Explosion</td>
<td>12861.09</td>
</tr>
<tr>
<td>Office Burglary</td>
<td>600.00</td>
</tr>
<tr>
<td>Employers Liability</td>
<td>78110.15</td>
</tr>
<tr>
<td>Sprinkler</td>
<td>8151.25</td>
</tr>
<tr>
<td>Trucks - fire and theft</td>
<td>1804.09</td>
</tr>
<tr>
<td>Fire</td>
<td>45612.94</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>2176.31</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Written Off - Test Checked - No errors found</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Steam Boiler</td>
<td>3186.00</td>
</tr>
<tr>
<td>Office Burglary</td>
<td>650.00</td>
</tr>
<tr>
<td>Employers Liability</td>
<td>166918.00</td>
</tr>
<tr>
<td>Sprinkler</td>
<td>2915.00</td>
</tr>
<tr>
<td>Trucks</td>
<td>2056.00</td>
</tr>
<tr>
<td>Fire</td>
<td>91156.24</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>5514.18</td>
</tr>
<tr>
<td>Returned Premiums</td>
<td>14918.32</td>
</tr>
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</table>

Balance, Certified to by Insurance Broker and as per G/L

<table>
<thead>
<tr>
<th>Policy</th>
<th>Co.</th>
<th>Dated</th>
<th>Term</th>
<th>Premium</th>
<th>Cover</th>
<th>Unex</th>
<th>Unex</th>
<th>Rate</th>
<th>Pired</th>
<th>Fired</th>
</tr>
</thead>
<tbody>
<tr>
<td>B20105</td>
<td>Hartford</td>
<td>1/2/31</td>
<td>5</td>
<td>300.00</td>
<td>4000</td>
<td>4yr</td>
<td></td>
<td></td>
<td>240.00</td>
<td></td>
</tr>
<tr>
<td>S10181</td>
<td>Equitable</td>
<td>1/3/31</td>
<td>1</td>
<td>1450.00</td>
<td>95000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Fire Bldg</td>
</tr>
<tr>
<td>M14131</td>
<td>Globe</td>
<td>11/4/31</td>
<td>1</td>
<td>360.00</td>
<td>20000</td>
<td>10 mo</td>
<td></td>
<td></td>
<td>300.00</td>
<td></td>
</tr>
<tr>
<td>C141815</td>
<td>Phoenix</td>
<td>10/2/31</td>
<td>1</td>
<td>1500.00</td>
<td>325000</td>
<td>9 mo</td>
<td></td>
<td></td>
<td>1125.00</td>
<td>1665.00</td>
</tr>
</tbody>
</table>

Fire Contents; Sprinkler
Total Prepaid Insurance 12/31/31 119556.22

(To E/S)

OPERATION OF ACCOUNTS

There are two accounts. The first one above is that carried with the insurance broker. The second account relates to the Hoboken warehouse, the policies being handled by the company itself.

For the audit procedure, see the Audit Program.

205. Explanation and Comments.--As stated on the schedule, there are two insurance accounts. The first one on the schedule is NOT a mere copy of the ledger account. On the contrary, this detail means that the premiums were audited to invoices, and the computations of the write-offs were checked. The type of certificate received from the insurance broker (K-1) is illustrated in plate 92.

The lower section of this plate represents the type of schedule most often prepared. That is, the policies are listed in detail, including, of course, the facts necessary to compute the prepaid amounts.
material. Secondly, there is a well recognized difference between factory and administrative expense. That is, factory supplies eventually become FACTORY expense, and as such become a part of the inventories, whereas office supplies become ADMINISTRATIVE expense and hence never become a part of the inventories.

308. Postage and Other Stamps.—If postage and other stamps are found in the petty cash drawer, they are better treated under Prepaid Assets than as cash, although no harm is done by the latter treatment. If large quantities of stamps are on hand, the auditor is not allowed this optional treatment, but must always show them under Prepaid Assets.

309. See Plate 96.

309a. Audit Program

(1) Distinguish carefully between true prepaid assets and deferred charges, i.e. Other Assets.
(2) Make certain that the item deferred is (a) of the type proper to defer and (b) that amount is the correct sum that will benefit future operations.
(3) Determine whether or not the client demands that the prepaid assets be treated as current assets. If not, set them up separately.
(4) Small amounts of prepaid assets may be omitted from the balance sheet if the client desires, but the report should mention it. Closer scrutiny should be given to the effect of the omission if a profit and loss statement is prepared. See text.
(5) Verify all computations against invoices, goods, documents, or other PRIMARY evidence, wherever this is possible.
(6) Prepaid Interest:
   (a) Test the interest expense account against the basic items (e.g. notes payable, discounted) to which they relate for possible omission of those liabilities.
   (b) Always check in full the prepaid interest to the schedules to which they relate to see that the interest is taken up on each item and correctly computed; and vice-versa to see that a principal amount exists for each prepaid item.
   (c) Make a review of all schedules to see if any one of them, having prepaid interest, has been entirely omitted from the calculations.
   (d) If thought desirable, treat prepaid interest as a valuation offset to the account to which it relates, rather than as an asset.
   (e) Verify in the case of notes payable, etc., the original prepaid sum by tracing the net proceeds received to the cash book, etc.
   (f) If the client does not handle properly the discount on non-interest bearing notes receivable, consider the advisability of setting up this discount either as an asset or more properly as a valuation offset to the notes.
(7) Prepaid Insurance:
   (a) Review the fire insurance accounts and the POLICIES for the entire year for the purpose of finding unknown liens, omissions of inventory or other assets, unrecorded liabilities, etc. Also see if the policies are in force and properly signed and executed. Test by direct correspondence with insurance company.
   (b) Ascertain if there is ample coverage.
   (c) Is the coverage properly distributed? Are the provisions of the policy being fulfilled as to watchmen, storage of inflammables, etc.? (d) Ascertain if the client understands the meaning of the co-insurance clause.
(c) Does the client need an insurance register?
(f) Verify the existence of policies not on hand. Secure all facts pertaining to the situation such as amount of policy, premium, terms, coverage, reason for its not being on hand, liens and liabilities involved, etc., etc.
(g) Consider the need for showing the contingent liability on policies of mutual companies according to the nearness or remoteness of the assessment.
(h) Are the rebates secured on mutual policies being properly handled?
(i) Review the payrolls to ascertain whether the insurance thereon is a prepaid asset or an accrued liability.
(j) Ascertain if the method of carrying the insurance accounts of life insurance on officers are being correctly kept.
(k) Verify the balance of the "cash surrender value" account against table in the policy. See that the entries in it have been correctly handled. If a first audit, carefully establish the correct amount at the beginning of the period.
(l) Are the policies ACTUALLY made out to the client as the beneficiary? If not, why not?
(m) Verify by direct correspondence with the insurance company the existence or non-existence of loans, etc. on the policies.
(n) If policies are not on hand, verify by direct correspondence. Secure all pertinent facts.
(o) Make proper notations on life insurance for federal income tax report.

(6) Prepaid Taxes:
(a) Make careful inquiry as to just what period the tax applies. If this is not clear from the invoice, write to the tax authorities. Include an inquiry as to possible change in rate of tax or base of assessing values.
(b) If feasible and proper use assessment values as checks against insurance coverage, carrying values, etc., etc.

(9) Prepaid Advertising:
(a) Distinguish carefully between prepaid advertising yet to appear and prepaid advertising already given to the public. Amounts properly deferred in the latter instance are Other Assets.
(b) Where the advertising has already appeared, determine the reasonableness of the basis used to defer some of the charge to future operations. Is the reason for deferring these charges being substantiated by the results, etc. of the subsequent period?
(c) Examine and brief all advertising contracts. Do they affect the statements and/or the report?
(d) Compare appropriations made by directors, etc. with actual expenditures. Show results in the report, if feasible.
(e) Examine into the reasonableness of the advertising supplies of catalogues, calendars, gifts, etc.
(f) Take into consideration past expenditures and future appropriations in reviewing and scrutinizing the correctness of the advertising expense and prepaid accounts.

(10) Working Funds:
(a) Do not treat these as a part of the cash balances.
(b) Make certain that all current expenses have been taken out. For this purpose review reports of salesmen, etc. made subsequent to the audit date, etc., etc.
EXPLANATION OF PLATE 96

A BALANCE SHEET

THE H.S. GOSSARD CO.
Consolidated Balance Sheet - December 31, 1925

PARAMOUNT PUBLIX CORPORATION
Consolidated Balance Sheet - December 26, 1931

309. Explanation and Comments.--This plate (The H.S. Gossard Co.) is
introduced to show that some headway is being made in practice of recogniz-
ing the essential difference between Prepaid Expenses, Advances for Travel-
ing Expenses, etc. on the one hand, and Deferred Charges on the other hand.
Note also that the rent prepaid under the lease agreement was not
-treated as a current asset. Perhaps this sum or a part of it, for example,
is not applicable to the payment of the rent until along toward the end of
the lease (assuming that it is not going to be renewed). Of course, if
the lease is going to be renewed, the deposit is all the more a fixed
asset.

In respect to employees' stock purchase plans, it may be mentioned
here that many of them will be cancelled in periods of depression. For
example, in the 1930-33 depression the stock prices fell so far below
the employees' subscription price as to force many of the corporations to
cancel the contracts in order to maintain their employees' goodwill. Ac-
cordingly, the auditor must be careful to cover this point; i.e. possible
cancellation of employees' stock subscriptions.

This plate (Paramount Publix Corporation) also shows the distinction
between prepaid expenses and deferred charges.

"Reserve for Foreign Exchange Fluctuations -- -- -- $2,315,049.79."
Do you agree to this procedure?
### Current Assets:
- Cash: $317,930.63
- Accounts receivable, less reserves: 677,566.39
- Inventories: 2,069,483.76
- Advances for traveling expenses: 14,757.52
- Prepaid expenses: 23,541.90

### Property:
- Land: 348,049.81
- Buildings, equipment, furniture, automobiles, etc., less reserve: 574,702.67

### Other Assets (including common stock of The H.W. Gossard Co. held for sale to employees)
- Total: $2,965,342.20

---

### Paramount Publix Corporation

#### CONSOLIDATED BALANCE SHEET - DECEMBER 26, 1931

<table>
<thead>
<tr>
<th>Component</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$4,949,282.55</td>
</tr>
<tr>
<td>Accounts receivable:</td>
<td></td>
</tr>
<tr>
<td>Advance to subsidiary companies (not consolidated)</td>
<td>963,526.44</td>
</tr>
<tr>
<td>Advance to outside producers (secured by film)</td>
<td>376,043.31</td>
</tr>
<tr>
<td>Film customers and sundries</td>
<td>4,065,162.83</td>
</tr>
<tr>
<td><strong>Total current and working assets</strong></td>
<td>$37,732,541.60</td>
</tr>
<tr>
<td>Deposits to secure contracts</td>
<td>2,004,139.38</td>
</tr>
<tr>
<td>Investments in subsidiary and affiliated companies not consolidated (including 17,915,992.64 investments in companies in which the voting stock owned is less than 65%)</td>
<td>20,471,949.09</td>
</tr>
</tbody>
</table>

#### Fixed Assets:
- Land: $71,351,578.50X
- Buildings, leases and equipment (after depreciation): 133,160,717.59
- Premiums paid for Capital Stocks of consolidated subsidiaries: 26,498,210.04X
- Advance payments on purchase of real property: 453,148.18

**X** After applying approximately $13,000,000.00 appreciation in land values, based on independent appraisals of 1928 or prior thereto.

<table>
<thead>
<tr>
<th>Component</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred charges</td>
<td>3,205,739.51</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td>$298,304,108.49</td>
</tr>
</tbody>
</table>

---

# Investments include $86,655.25, the Corporation's share of undistributed earnings of non-consolidated subsidiaries owned between 65% and 85%, included in surplus, after deducting $506,009.14 from 1931 profits.

## The Capital Assets of all foreign subsidiary companies have been converted at the rates of exchange prevalent at dates of acquisition; all other assets and liabilities have been converted at current rates of exchange. The reduction in funded debt, arising from the conversion on this basis of the long term liabilities of the British and Canadian subsidiaries, has been carried to reserve.
(c) Verify the funds, where feasible, by independent methods, otherwise by direct correspondence or similarly acceptable evidence.

(11) Office Supplies:
(a) Factory supplies are a part of "inventories"; not so with office supplies.
(b) Make certain that the supplies are usable.
(c) Recent cost prices may be used to value the inventory. In many instances estimates of the total inventory are acceptable to the auditor, though not to the federal government.

(12) Stamps:
(a) Unless in large quantities these may be treated as cash when they are found in Petty Cash funds.
(b) Where there are large sums in stamps, review methods of accounting for them. If methods are poor, offer suggestions for improvement therein.
(c) Count the stamps.
(d) Verify all funds simultaneously, or use other safeguards to prevent manipulation.
1. What is the difference between a deferred charge representing advertising yet to appear, and one representing advertising which has appeared but whose effect is expected to carry over into the following period?

2. How does it happen that there is apt to be an accrued liability for additional premiums on workmen's compensation insurance?

3. Outline fully the accounting treatment for the cash surrender value of life insurance.

4. What are short rated?

5. How would you audit prepaid taxes?

6. How would you audit office supplies? Devote several paragraphs to your answer.

7. What are some of the more common designations for prepaid assets?

8. How would you classify postage and other stamps? Why?

9. In what three places in the balance sheet are prepaid assets often found?

10. How would you audit working funds?

11. How would you audit prepaid interest?

12. How do those who treat prepaid assets as current assets define the term?

13. How would you audit prepaid rent?

14. What reason is there for classifying factory supplies under inventories and office supplies under prepaid assets?

15. Why should all insurance policies be carefully examined? Give illustrations.

16. Outline plan #2 for treating life insurance premiums, etc.

17. Why does an omission of the adjustment for prepaid items usually have more of an effect on a profit and loss statement than on a balance sheet?

18. An auditor capitalized the net insurance premiums on a life insurance policy until the amount in the account is equal to the face value of the policy. What arguments, if any, can you give in support of his plan? Against it?

19. Where would you place on the balance sheet the following items: organization expense, costs of stripping mines, bond discount, unamortized improvements to leased property? Why?

20. With what care should the prepaid asset computations be audited?

21. Draw up an insurance register and complete it with ten entries.

22. What is term insurance? What is group insurance? Have these policies any cash surrender value? Will there be any prepaid insurance to be figured on these policies?

23. What special feature does an auditor have to take into consideration in dealing with insurance with mutual companies? How should it be handled?

24. In what two ways may a prepaid insurance account be kept?

25. Do you agree with the answers given to the following question? If not, why not?

"Question."—Will you be good enough to answer a couple of academic questions as to the location of certain items on a balance sheet, as follows:

1. Surrender value of life-insurance policy

"Our client is doing a combination of wholesale merchandising and commission business and has taken out two policies on the two principals in the business. These policies are payable to the company. The company is paying the premiums. On these two policies the client has borrowed from the insurance company notes to within, say, 75% of the surrender value of the policies.

"We have heretofore carried the surrender value of these policies, less the notes payable on them, as deferred assets; but we are now asked by our client to place the surrender value, presumably the net surrender equity, among current assets. We are of the opinion that this could be done by including the item among securities readily marketable, on the assumption
25. (Continuation) that the cash surrender value is clearly the most liquid form of an investment. We are, however, in doubt about the advisability of including it among these current assets, for Montgomery's Auditing describes current assets as those which are bought for the purpose and with the intention of conversion immediately into cash. It would appear that our client's purpose and intention, judging from past performance, has been to borrow on the surrender value of his life-insurance policies fairly promptly after there was a margin in his favor; and hence his desire to place the item among the current assets is logical. In support of his views, he has seen the balance-sheet of a large eastern correspondent which shows the surrender value among the current assets. On the other hand, our own opinion is, in the absence of a positive practice, that the surrender value for a concern such as his, which is not expecting to go out of business but is doing business in a normal and usual manner, should be shown among investments.

"Answer No. 1:--It is our opinion that it is not proper to include this item under current assets. Our reasons for so doing are, in line with the quotation from Mr. Montgomery's Auditing, that the test of current assets involves three things, purpose, intention and marketability. While the cash-surrender value of life-insurance policies may readily be converted into cash, as is evidenced in this case by the client's borrowing on the policies, at the same time it was not the purpose of the corporation in taking out the policies to create current assets but rather to make an investment and to protect the corporation from losses occasioned by the death of its valuable executives and it is not the intention of the corporation to change the original purpose. Accordingly, we believe that the item should be stated as an investment with the loan against the policy shown as a deduction therefrom. Incidentally, this procedure would result in a more favorable current ratio than if the cash-surrender value were shown as a current asset and the loans as a current liability. It would be absolutely improper, of course, to show the net cash-surrender value less loans as a current asset.

"Answer No. 2: In dealing with the situation here outlined, among others we find as facts:

(a) That the company has set up on its books the cash-surrender value of insurance policies carried on the lives of its principals;
(b) That it considers such cash-surrender value as a current asset;
(c) That where there have been borrowed a part of such cash-surrender value and notes have been executed therefor, the liability on the notes is not included with other liabilities in the balance-sheet but is deducted from the surrender value and the net balance shown as an asset.

"As we understand the question, two points are here raised: (a) is the method of accounting correct and, (b) if so, what is the correct place in the balance-sheet for the asset?

"To arrive at a correct decision the particular circumstances require to be taken into consideration. A balance-sheet prepared on a "going concern" basis is, of course, not necessarily the same as one prepared on a "liquidation" basis. It is assumed that we are here dealing with a going concern.

"Although it is quite common practice to set up—as in this instance—the cash surrender value of such policies, something might be said in favor of carrying—as a permanent asset but not a current one—the total amount invested as premiums, the payments being looked upon
25. (Continuation) As more in the nature of a funding transaction. Although not inferring that we would favor such a practice, we mention it as presenting another viewpoint.

"Insurance on the lives of principles in a business must necessarily be for the protection of the business. Surrender of such policies removes the protection. It is evident, therefore, that the premiums represent investment in protection and in no circumstances can they or any part of them be considered 'an asset bought for or with the intention of conversion immediately into cash.'

'That portion of the premiums paid represented by surrender value, however, certainly has an immediately realizable value, but is it not clear that conversion of such value into cash correspondingly reduces the protection provided by the policies and can only be made at the sacrifice of such protection? Is it not more in the nature of an emergency asset, which could be realized—just as machinery or other more permanent assets could be realized—in case of need but is not purchased with that intent?

"Within recent years an eminent scientist has popularized the word "relativity." Relativity of a specific item to all others in the balance-sheet and to the business itself are considerations having more or less important bearing on proper presentation of facts.

"Current assets ordinarily consist of cash and such other assets as revolve or are being constantly converted into cash as a result of operations incidental to the business. That portion of the surrenders value realized, i.e., the cash borrowed, already appears in current assets (although in the instance cited it should again be pointed out that the notes executed do not appear as liabilities). The balance, which by its very nature must be intended to be carried more or less permanently does not seem to possess the ordinarily understood attributes of a current asset except on a liquidation basis. It is an investment—or part of an investment—which to be justified at all must continue with the business, or at least as long as the conditions justifying it exist.

"To our mind proper and accurate description of an asset is of importance at least equal to the position it may be assigned in the balance-sheet and we further believe that a 'going concern' balance-sheet is strongest when, if classifications are made, doubtful items are conservatively classified according to underlying intent and their relation to the business as a whole."

26. What is your opinion of the following? Why?
DEFERRED CHARGES TO FUTURE OPERATIONS:

Discount on funded debt, less amount written off . . . $1,934,347.90
Prepaid insurance and other expenses . . . . . . . . . 2,210,532.66
$4,144,880.56

19-1
CHAPTER 19

THE VERIFIOATION OF "OTHER ASSETS"
(Deferred Charges to Operations)
310'. General Discussion.

311. Advertising.
312. Deposits.
313. Abru1doned Property.
315. Org&nization Expense.
314. Bond Discount and Expense.
316. Explanation of Plate 97.
PLATZ 97Y-An Analysis of an Organization Expense Account.
318·. Suspense Items.
317. Rearru.ngement of Machinery
EXpenditures.
319 .. Improvements to Leased Property.
320. Ca!:lital Stock Discount.
321. Stol'tlt Losses, Etc.
322. Costs of Stripping.
· 323. Elcperimcntal Expenditures.
Roviaw Questions.
310. Qoneral Discus§iO~·-Although OTHER ASSETS is the last group of
assets on tho balance shoot, it is taken up for discussion at this point ns
a moans of contrasting it with PBEPAIB ASSETS. As stated in tho pre:vious
chapter, deferred items which arc chargeable to the current operations of
the succeeding period arc properl y classified as prepaid nssots, under
Current .Assets, or as c. sopc.rato group just after Current As~et s . Tho
benefit of prepaid assets to the succeeding poriod must be certain, i.e.
they must be m::pcmdituros which would have to bo mo.de from ccsh during the
succeeding poriod1 if tho said prepayments did not already exist. On the
other ho.nd, Othor ~\ssots, often called Deferred Cha.rges to Opor.:-.tions, consist of properly deferred charges, such as bond discount, stri)JPing costs
of mines, rearrangement of machinery expenditures, etc., the benefit of
which will 'be realized in the futuro, but in not less than _§.Q.Y_eral succeeding periods." Tho term, Other Assets, may also be properly expanded to include organization expenditures, certain accounts receivable and similar
assets of doubtful realization, and tho like. Kostor ably outlines this group
of; nsscts ;:uLfoUws: "Almost invariably some items are found arAong tho assets
which do not lend themselves to exact classification under any of tho
standard groups. ~1us thoro are often accounts r ocoivablo which nrc not
current items, nor can they bo classified as inve stments or as fixed assets.
It is best, therefore, excepting whore great condensation is desirable, to
list all items of this kind in a final miscellaneous group entitled, Other
Assets. Tho group is not homogeneous; no uniform principles or formul~ of
valuation apply; each item in it must be treated individually • • • • • • •
• • • • • • , it nill bo necessary hero chiefly to indica to tho typo of i tcm
to bo listod and to explain only ono or two of then. Notes and accounts
roceiv:1blc \'lhich arc neither current nor repros .:mt intentional investments
may bG shown horo. Expense expenditures the allocation of which is to be
mndo to several succocdin~ periods should be listed hero, rather than under
(Prepaid Assets), which group, • • • • • • • , is limited to those items
which will in regular course be charged to tho operations of the naxt fiscal
period and are, therefore, properly to be classed ns a sub-group under
current assets. Bond Discount should, therefore, usually bo sh~m here.
Discount on Capital Stock, IF shown among the assets, belongs hore also ••
• • • • • • J\nd finally the intangible item, orgm1ization expense, is best
included in this miscollc.neous group. n2
Isome lea...-my is permissible as in tho case of fire insurance purchased for
a term of 3 years.
21Coster Volume 2 (p. 364).


19-2

When the title, Other Assets (or Deferred Charges to Operations) is limited to the type of items dealt with in this chapter, the caption is the last one of the assets groups.

The practice of deferring to the future, items which clearly benefit the future, ought to be heartily supported by all auditors. This does not mean that the auditor should be "weak-kneed" in regard to insisting on charging off losses that the client would like to carry along as "souvenir" assets. But it does mean that there is a certain moral duty to the general unsophisticated public to defer proper items, lest they (the public) believe from the profit and loss statements that the business is doing poorly or at least not as well as it really is. It has happened too often that large sums of properly deferred charges have been written off in the name of conservatism. The result has almost invariably been that the insiders have reaped a harvest at the expense of the uninformed public which, having to rely upon audited statements which showed poor earnings, disposed of their stock at a sacrifice.

311. Advertising.—If advertising has already appeared in print, etc., but the benefit of it will not, in fact cannot, be realized until after the period under audit, the auditor may treat the expenditures as "Other Assets." In such instances the true worth and capacity of the auditor is brought into play. If, in the auditor's opinion, the expenditures will produce future business, they must not be charged off against current operations in the name of conservatism, lest the present stockholders be deceived by the incorrect statement of profits. On the other hand, and this is the more prevalent case, the auditor must not allow expenditures of doubtful future benefit to be capitalized. Moreover, the auditor should test out, if possible, the expectations of the client against the actual results. Thus, if certain deferred advertising expenditures have shown themselves to be valueless by the time the auditor has finished his audit, they must not be allowed to remain on the balance sheet, for they are true current surplus charges, i.e. current losses. "The client may maintain that, as of the balance sheet date, the expenditures were of benefit to the succeeding period so far as human judgment could predict. Therefore, the auditor must allow the expenditures as assets, as the balance sheet is a statement as of the audit date." But as just stated, in such instances the true worth and capacity of the auditor is brought into play. No competent auditor ever closes his eyes to any facts which develop after the audit date, be they favorable or unfavorable to the client. In brief, an auditor must state his opinions or fact findings without fear or favor.

312. Deposits.—Many electric and gas companies require a deposit of the consumer as a security against his leaving the community with bills still owing, or as a security for the payment of equipment, etc. If a deposit is comparatively small, and it generally is, it may be carried under Deferred Charges to Operations. If sizable, the deposit should be given more adequate treatment, such as by being listed under INVESTMENTS. It is a material and substantial asset, whereas Deferred Charges to Operations (Other Assets) are often largely immaterial and unsubstantial assets. The deposit must never be listed under Prepaid Assets, because the amount is not available for paying current service bills; the auditor should verify these amounts by calling for the receipts thereon. If there are none, the auditor should ask the client to secure duplicate receipts, provided the sums involved are sizable. If the auditor has the client write to the utility company, he should also have the client request the company

1Assuming a going concern.
2Because of the size of the deposit.
to advise him what bills are owing, and if the deposit is free and unencumbered.

Again,—if, pursuant to the terms of a lease, a deposit is made which is to be accepted in lieu of the last one or more annual rental payments, the amount is often looked upon as an item of Other Assets, i.e. as a Deferred charge to Operations. The writer, however, can see no reason why this item may not be listed as an investment up until the last year, when it may even be properly listed under Prepaid Assets. The reason for the writer's sanctioning this procedure is based on the consideration that Other Assets (Deferred Charges to Operations) are generally looked upon as more or less unsubstantial assets, whereas this "stigma" is not the least bit applicable to these deposits.

Contrary to the opinion of some auditors, the writer can not see that any and every deposit which will be returned within a reasonable time is a current asset. If, for example, the deposit is to be held for three years, which may be a very reasonable time under the circumstance, it ought not to be classed as a current asset.

Sizable deposits should be confirmed at each audit. It is NOT sufficient to dispense with their confirmation after the first audit, although some auditors sanction this procedure. The time consumed in properly checking up this asset by confirmation is negligible; therefore, it can not be considered otherwise than as time well spent.

313. Abandoned Property.—At times a worn-out plant may be abandoned. If in such a case the reserve for depreciation is considerably less than the cost, less the scrap selling price, the client may set the loss up as a deferred charge. Manifestly, the auditor can not sanction such a false treatment of the matter. It is distinctly a charge to surplus.

314. Bond Discount and Expense. As bonds sell better at a discount than at a premium, the nominal rate (i.e. the bond rate) is generally set at less than the expected market rate. Or, viewing it from another angle, we may say that whenever the rate of interest which a bond bears is unsatisfactory to the investing public, the bond will have to be sold at a discount. Thus, if a corporation, whose credit, at credit, etc. etc., is such that it must pay 5% interest on its bonds, issues a $1,000 25 year bond bearing 4% interest per annum, payable semiannually, the discount will be $144.81. That is to say that the bond will sell for $855.19, although it must be redeemed at $1,000 at maturity. The net effect, therefore, is that the buyer gets the 5% interest he demands even though the bond seems to pay but 4%. In brief, when properly viewed, it will be seen that bond discount is a proper charge to the bond interest expense account during the life of the bond, so that the amount in the account (actual interest paid plus the expired discount) will equal the amount of interest demanded by the market, and actually paid out eventually. Every time bond interest is paid, the bond discount account must also be credited and the interest expense account debited for the expired portion of the former account.

In addition to this discount, the expenses of floating the issue, such as commissions, advertising, attorneys' fees, engraving costs, and so on, are properly chargeable to the same account. Moreover, if, in a state which does not allow stock to be sold at a discount, a unit of par value

1This assumes that the lease is not renewed, and hence that the deposit is applied to the payment of the rent.

2See Appendix C, Sec. 14-47.

3Bond discount (but not the floatation expense) may be treated as a valuation offset to the bonds payable. Although this procedure is correct, it is rarely ever followed.
stock and bonds is sold for a price less than the par value of the unit, the difference must be charged to bond discount. Likewise, if bonds are to be retired at a premium, this sum should be spread over the life of these bonds as an additional interest charge, the credit being to a liability account.

The amount written off of the discount account is, of course, in proportion to the expiration of the life of the bonds. The debit is to interest expense, except in special instances such as where the amount is properly capitalized during a construction period. Of course, if the amount of outstanding bonds varies from time to time, through the purchase of them for a sinking fund or as treasury bonds, the discount applicable to these bonds should be charged to surplus if the bonds are cancelled. If, however, the bonds are still kept alive, the discount may be treated as usual; i.e., just as if the bonds were outstanding.

There are at least two methods of figuring the periodic amortization; namely, the scientific method and the straight line method. Both methods give approximately the same results whenever the sums are small and the length of the life of the bonds is short, but under other conditions the results are often widely divergent. Any text on the mathematics of investments will give the reader the necessary information for computing the scientific discount. The method, however, is not nearly as common as the straight line method.

Contrary to standard practice, some auditors, including the writer, permit the carrying forward of unamortized discount beyond the life of the issue to which the discount relates, PROVIDED the periodic interest cost of the new refunding issue (issued just prior to the calling in of the original issue) in interest to be paid, in amortization of both discounts, etc. is below what it was formerly. Thus, if 7% callable bonds due in 1950 are retired at 101 in 1930, the unamortized discount and retiring premium can be carried forward as an additional interest charge of a new issue of 5% bonds, sold to yield 6% to the purchasing investment house. Strict accuracy, of course, limits the time of carrying forward the old discount and the retiring premium to the maturity date of the retired issue. Orthodox standard accounting requires the charging off of the premium and the discount of the retired issue at the time the bonds are retired.

315. Organization Expense.—To the Organization Expense account (Plate 97) may be charged all of the expenditures made to organize the corporation. The most common items of this sort are legal fees paid for preparing the by-laws, securing the charter, etc., state incorporating fees, engraving costs, commissions paid to salesmen for selling the capital stock, engineering costs, etc.

There are at least three distinct plans for handling this account. For example, there are those who would write the account off within three to five years. Another group of auditors favors charging off immediately everything which has no tangible or residual value to the business. Still another group favors permanently capitalizing the LEGITIMATE organization

1 If the premium is CERTAIN and SIZABLE, it should be set up in toto when the bonds are sold, the debit being to the discount account.
2 Deferred Charges: Unamortized debt discount and expense (including premiums and discount on bonds and notes called before maturity, in process of amortization over refunding issues) $32,140,679.34 - Standard Gas and Electric Company - 1952. 3 When standard procedure is departed from, as here, the auditor must hold the balance sheet with, "Subject to comments contained in the accompanying report."
expenditures (because they are as much of an asset for a going concern as is the cost of its tangible property) and subjecting them to amortization over a long period of time.

As the writer sees it, the plan of writing off organization expenditures within three to five years was a program of concerted action on the part of public auditors to combat the unyielding persistency of clients in capitalizing "water" under this caption. In other words, here was a highly watered account which clients stubbornly refused to keep on a sound basis; therefore, auditors met the situation on a compromise basis (which simply means meeting the situation in a practical way) by insisting upon the account's being written off over a period of from three to five years. Those who favor charging off the organization expenditures as soon as they are incurred (which plan would have been a mere chimera in days past) either feel that these expenditures do not have any semblance of an asset, or that the three to five year rule will be winked at. The third group, including the writer, regard these expenditures, when REAL value is received for value paid, as good intangible (and tangible) assets of a going concern, just as goodwill is often an intangible asset of real worth.

Therefore, the auditor's main considerations are: (1) to see that only proper items are permitted to enter the composition of the account and that the values, especially for services, are reasonable; and (2) to see that the account is amortized equitably throughout the life of the business. This, of course, assumes a measure of forecasting that is often highly speculative.

If the auditor can not control the "watering" situation, he must, of course, insist that the account be written off in from three to five years.

Finally, it must be understood that if a client desires to write off the account, few, if any, auditors object to it, because the procedure is conservative, and its absence can not be altogether a secret reserve since the public knows that the business had to be organized.

As just stated, the auditor must carefully scrutinize all entries in the organization expense account. If any services have been paid for with capital stock, this should have the sanction of the directors. If the services are excessively valued, the three to five year amortization rule must be invoked. Commissions paid to salesmen for selling the capital stock, and any other costs of acquiring capital, may be allowed in this account. If the state law permits the sale of capital stock at less than par, or if the stock is of no par value, many auditors favor stating the net amount received for the stock as the opening capital account, but this treatment is not insisted upon by standard procedure.

The two following quotations from well known auditors are given as representing the apparently opposite views of leading auditors.

"Seldom if ever can a business produce income from the day it opens its doors; it is necessarily engaged for some time in perfecting its organization and making preparations for permanently active operations. There are also necessary legal and other expenses in connection with organization. The cost of organization represented by such expenditures is undoubtedly as much an asset for a going business as the cost of its tangible property, the latter being valueless to the business as a utility without additional expenditures for organization."1

"Formerly if the expenses incurred in the organization of the company (such as incorporation fees, legal, engineering, and other expenses, engraving bonds and stock certificates, transfer fees and stamps, etc.) were more than could fairly be charged into current expenses, it was considerable permissible to spread such charges over a term of years, preferably three, but

1 Bell and Powelson, p.255
not more than five. Sentiment is changing as to the wisdom of spreading these expenses over more than three years. The best practice is to charge off immediately everything which has no tangible or residual value. The benefit from such items can not be compared to advertising and exploitation expenses. It is a fallacy to assume that stock certificates, incorporation expenses, etc., have any of the attributes of an asset; and so the sooner the cost appears in the expense account, the better."

Before closing this section, it must be stated that the debit arising from the reduction of the account under the usual methods employed (i.e. numbers 1 and 2 above) is not an operating expense in any sense of the word. In the writer's opinion, it ought to be listed in the profit and loss statement under the main caption of Non-Operating Items. To list it under the main caption of Other Expenses (i.e. financial management expenses), or to charge it direct to Surplus is incorrect, and uninformative respectively (assuming no "Statement of Changes in Surplus")

316. See Plate 97.

317. Rearrangement of Machinery Expenditures.—Another common deferred charge to operations is the cost of rearranging machinery. Obviously, as this expenditure does not add any additional value to the physical machinery, it can not be charged to the machinery account. However, in some few instances it may be capitalized because it is neither a loss nor a current charge to operations; for a loss means that no value is received from the expenditure, and an operating charge means that the benefit of the expenditure ceases with the current period. The common treatment is, therefore, to set up a separate account for these expenditures. They may have to be written off immediately as a loss, if the rearrangement benefits fail to materialize, or they may be carried along, at decreasing amounts, for a very short number of periods if the rearrangement is successful in accomplishing the results desired. The approximate number of periods can not be stated in the absence of the facts of the particular case under consideration.

As an illustration, it may be pointed out that a proper procedure was adopted in 1928 by the Studebaker Corporation when, according to its report of February 14, 1927, "the extraordinary expenses incurred in moving the manufacturing and engineering departments from Detroit to South Bend, including the expenses of plant arrangement resulting therefrom, and for the production of the Erskine Six and the expense of the European showing of said car, were charged against the profits of the last quarter."

The proper procedure would seem to be to treat as losses the depreciated cost of the original "laying down" expenditures plus all of the "uprooting" costs, if the rearrangement is necessitated by original faulty layout of plant, or caused by competitors having this new layout, or caused by the need for the introduction of new modern machinery in an adjoining department, etc., etc. In such instances all of the new "laying down" expenditures are proper additions to the machinery account, if the machinery is laid down in the same plant. If not, the transfer expenditures are also losses.

If, however, the rearrangement is not caused by mistakes nor by the necessity to meet the competitive situation of another business, or businesses in general, but is due simply and solely to such causes as the advanced planning of the efficiency engineers as to how to reduce costs, etc., then the original "laying down" costs need not be touched at all, and all

1Montgomery, p. 620
2It is a true expense if the account is reduced properly over the entire life of the business.
AN ANALYSIS OF AN ORGANIZATION EXPENSE ACCOUNT

ROBERTS & ASSOCIATES, INC.

Organization Expense

Audit for the Year Ending Dec. 31, 1929

Schedule R

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<th>Vo.</th>
<th>Description</th>
<th>Amount</th>
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<tbody>
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<td>1601</td>
<td>J.J. Salisbury - legal fee</td>
<td>1000.00</td>
</tr>
<tr>
<td>409</td>
<td>P. Ashton - promotion expense</td>
<td>500.00</td>
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<td>717</td>
<td>The Payne Co. - books of account, etc.</td>
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<tr>
<td>487</td>
<td>The U.S. Bank Note Co. - engraving</td>
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<tr>
<td>509</td>
<td>A.B. Brooks &amp; Co. - corporate seal</td>
<td>35.00</td>
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</table>

Omissions

<table>
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<tr>
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<th>Amount</th>
</tr>
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</table>

Total 15487.34

Adj. # 18

<table>
<thead>
<tr>
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<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>3000.00</td>
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(To B/S)

Audit Procedure

Each of the vouchers listed above was examined and found to be a proper addition to this account.

The account is being written off to Surplus in 5 years, $3000.00 being written off this year.

316. Explanation and Comments.—This plate is given chiefly to show some of the items which may be properly included in the Organization Expense account.
of the new expenditures are assets, subject to immediate write off if the advantages fail to appear, and to equitable write off over future periods if the advantages are obtained.

Obviously, what is an equitable method of writing off these deferred charges is dependent on the circumstances peculiar to the case under consideration. In theory the periods which get the benefit of the new layout should bear the cost. Practically, a much shorter period MUST shoulder these charges.

318. Suspense Items.—Under this caption are often included items which can not be properly classified at the time the entries have to be made; therefore, the suspense account may have either a debit or a credit balance. If the account is of this nature, the auditor must analyze it very carefully and give to each item its proper treatment.

On other audits, this account will be found to have an entirely different meaning, being used as the final resting place for very doubtful receivables, merchandise of very doubtful value, and so on. In brief, the account is of very questionable value, and, being such, it ought to be written off, or stated at not more than nominal "scrap" values for the respective items.

319. Improvements Permanently Attached to Leased Property.—To many auditors it is a mere matter of choice as to whether or not this account is listed as a property account or a deferred charge. (The writer considers it to be a property account as it represents substantial tangible values.)

If the client expects to renew the lease, it may argue that the property should not be written off faster than at normal depreciation rates. The auditor may adopt this procedure if a renewal option (or other contract arrangement) is secured, but otherwise the auditor is needlessly treading on very dangerous ground. It seems to the writer that if the client is so positive about its renewing the lease, it should at least prepare the way for it, and also give the auditor substantial evidence of its oral affirmations by securing an option.

Manifestly, if the life of the improvements exceeds the life of the lease, the normal rate of depreciation will have to be ignored in favor of a higher rate, such that the improvements will be amortized over the term of the lease.

320. Capital Stock Discount.—Whenever there is an agreement between the purchaser and the corporation that the stock is fully paid for and non-assessable even though issued at less than par value, the discount is not an asset at all. Auditors frequently allow the account to be treated as if it were an asset, but it should be shown as a deduction from net worth.

Moreover, a competent auditor will always ascertain the state law as to the legality of the corporation's procedure in issuing the stock at less than par.

Of course, if the stock was subscribed to at par, the unpaid balance should be treated as a current asset. But, if the calls are not likely ever to be made, the "discount" is at best only an Other Asset. It should be written off against surplus as rapidly as possible, or IMMEDIATELY if it is definitely known that the "discount" will not be called for.

321. Storm Losses, Etc.—On occasions an auditor will find that accident or storm losses, or expenditures made to repair such losses, have been partly capitalized. Thus, if a contingency reserve, standing in the
amount of $950,000, is charged with $1,250,000 for replacement repairs, the
debit balance of $300,000 is not a proper deferred charge. In fact it is
no more an asset than is a deficit. Both have debit balances, both are
often listed among the assets, but both must always be treated as deductions
in the networth section. Montgomery ably states the case thus: "This prac-
tice is not sound, because in the last analysis it simply results in setting up
on the balance-sheet accounts which are in no sense of the word assets.
If the word "assets" means anything at all, there is no justification for
including in it items of maintenance, expended because of necessity, which
do not tend to improve the physical or financial position of the enterprise,
"Perhaps these charges, if incorporated among the costs and expenses
of a current period, tend to hide the normal operations; but if the usual
item is clearly set forth, this procedure is preferable to making direct
charges to surplus. It may be hard to resist the temptation to capitalize
these items, but the practice is to be condemned. It may not sound well or
look well, but it has the advantage of portraying the actual state of
affairs. This is not the case when an attempt is made to call an expense
account an asset. Directors who realize their personal responsibility for
dividends paid out of capital will not vote for a distribution of earnings
which does not take into account expenses actually incurred." 2

To reiterate, if extraordinary expenditures have been made to repair
damages done by storms, accidents, tornadoes, and the like, the client may
have capitalized all or part of them for the time being as a Deferred
Charge to Operations. The usual contention is that the cost of repairing
this damage is obviously not chargeable as an expense to the present period;
therefore, the amounts must be deferred to the future.
The first contention that the expenditures are not a proper current
expense is absolutely correct, but the conclusion drawn therefrom is totally
incorrect. When properly viewed, the damage done by storms, tornadoes,
accidents, and the like, is not an expense to be borne by the future, but
rather a reduction of the profits of the past, i.e. a loss. Indeed, a far-
sceeing management may actually charge to expense and credit to a contingency
reserve an annual sum calculated to take care of just such emergencies. 3
Other far-sceeing managements may see nearly eye on the subject and yet not
charge an annual sum as an expense to operations, but rather provide the
contingency reserve direct out of surplus. In the writer's opinion, however,
this method is not as good as the other method.
As has been stated, the setting-up of these expenditures as a De-
ferred Charge to Operations means nothing more or less than the setting-up
of a loss as an asset! No benefit over what was existing before the storm
has been provided by these expenditures. No improvement of financial or
physical condition has been created over what formerly existed. Therefore,
to repeat, the expenditures must not be treated as Deferred Charges.
The proper treatment to be accorded to such expenditures are as
follows: If an expenditure repairs an item it should be charged to the
Reserve for Depreciation to the extent of the accrued depreciation on the

1 or

\[
\begin{align*}
\text{Total assets} & \quad \text{xx} \\
\text{Deficit} & \quad \text{xx} \\
\text{Total} & \quad \text{xxx}
\end{align*}
\]

2Montgomery, page 615. 3"It is of interest to note that in some kinds
of business (e.g. long distance telephone service) extraordinary casualties,
due to the action of the elements, are regular visitants, and are provided
for by a so called "reserve for extraordinary depreciation" which may be
estimated in advance quite closely by experience extending over a period of
years."—The Committee on Terminology of the A.I.A.
part repaired (if ascertainable), the balance being chargeable to the Reserve for Contingencies, or to Storm Losses if there is no reserve. Thus assume that one-half of an asset (costing $1000 with a depreciation reserve of $400) is destroyed and that it takes $500 to replace it. The entry would be as follows:

Reserve for Depreciation (Name of Type of Asset) 200
Contingency Reserve (or Storm Losses) 300
Cash (or other credit) 500

or

Reserve for Depreciation - (Name of Type of Asset) 200
Contingency Reserve (or Storm Losses) 300
Name of Type of Asset 500
Name of Type of Asset 500
Cash (or other credit) 500

The proper place in the profit and loss statement for the item of Storm Losses, assuming that there is no Reserve for Contingencies, is under the main caption of Non-Operating Losses. On the other hand, if there is a Reserve for Contingencies, the changes in it must be given on the balance sheet if the auditor would make his statement most useful. However, if the management objects to this portrayal of the contingency account, the auditor will have to be satisfied with merely showing the balance of the account. The audit report, on the contrary, must always review the history of the account throughout the entire period under audit.

322. Costs of Stripping.--Before many deposits of ore, and the like, can be removed from the mine, the top soil, etc. must be removed. These costs should be capitalized as Stripping Expenditures (although in many instances no harm is done if they are charged direct to the MINE account). An equitable basis on which to write off this account to future operations is as follows: Divide these stripping and other similar costs by the total number of units which are expected to be extracted from the stripped area. Multiply this answer by the units extracted from the stripped area and the product is the amount to be written off to expense for that year. As the charges to profit and loss by this method are proportional to the quantities mined, the procedure is preferable to one which writes off amounts on some arbitrary basis, such as small amounts in "lean" years and large amounts in "bumper" years, or in equal annual sums.

323. Experimental Expenditures.--The cost of each experiment ought to be kept separate, or at least as many of the costs should be segregated as is feasible. The wrong method is to reason that since only five out of twenty-five experiments have yielded anything of value, the total experimental costs must be divided by five (or by a weighted number) to get the cost of each experiment. The sums, when correctly ascertained, may be written off immediately, or over a more or less definite time or output of product, or permanently capitalized. Thus, if an experiment proves to be valueless, its cost must be written off immediately as an extraordinary expense.

1i.e. the charge is to the STORM LOSSES account IF there is no CONTINGENCY RESERVE account.
2The writer prefers to get such items into the profit and loss statement as deductions from the "regular" non profit charges to surplus. The latter treatment is correct, of course, but the former treatment is more forceful.
3It is recognized that there may be circumstances under which other methods of writing off the account are correct.
expenditure, not as a surplus charge to operations. Likewise, if a little experimental work of temporary value is being carried on continually, it is often proper to charge these expenditures in full to current operations. But if, for example, an experiment has considerable merit and value, the cost thereof may be either permanently capitalized or temporarily capitalized.1 Thus an experiment resulting in a patented process will be temporarily capitalized, i.e. amortized over the life of the patent, whereas an experiment resulting in the purchase of a certain pond of water, rather than another pond, for a bleachery or for an ice house, for example, could be capitalized permanently as one of the costs of the selected pond.

324. Preliminary Development Expense.—If during the first year of operations of a new business, there is a resulting deficit obviously due to getting the machinery in good working order, or due to mistakes which are to be expected under the circumstances, or due to necessary advertising, and so on, the amount thereof may properly be carried forward for a year or two as an item under Other Assets, if it is called Preliminary Development Expense. If, however, the deficit for the first year is due to such causes as a general slump in business conditions or abnormal preliminary outlays, the account must stand as a deficit.

The procedure of calling a halt after the first few months of operations in order to capitalize the deficit (however caused) at this time is not thought to be advisable. If the first year comes through with a profit, it does not seem practical to capitalize any loss sustained during the initial months, even though it were caused by normal preliminary outlays of an unproductive nature (such as expected mistakes).

In the above discussion it has been the writer's thought that conservatism must prevail. No thought of "letting down the barriers" at any point has been entertained for a moment. Mistakes made after the introductory period are a natural and ordinary business expense.

324a. Audit Program.
(1) Deposits:
(a) Do not list as a prepaid asset unless they are available for current use, etc.
(b) If sizable treat as an INVESTMENT. Take up the interest (if any).
(c) Verify amount, etc. by direct correspondence. Ascertain the reason for the deposit, etc.

(2) Abandoned Property:
(a) Such an item must be charged off to surplus immediately, NOT piecemeal.
(b) If the property is only temporarily abandoned, it may be set up as an asset distinct from the regular plant. Label it clearly. Give careful consideration to the value at which it is being carried.

(3) Bond Discounted and Expense:
(a) Verify the original amounts against cash book, directors' minutes, invoices and letters from the underwriter, etc., etc. Are the items in the account proper charges to it? (See text).

1It must be kept in mind that now-a-days every large corporation has a research department the findings of which do not usually give the corporation any sustained advantage over its competitors. Rather, such research merely enables the corporation to stay in business and meet competition on an equal footing with other A-#1 companies.
19-12

(b) Ascertain the reasonableness of the method used to write off the account. Is it charged to the proper account? (Usually to Bond Discount Expense.)

c) If any amount is capitalized during a construction period, ascertain if it is justified and if the sum is correct.

d) If the bonds discount is being amortized "scientifically", verify all of the calculations of the amortization tables.

e) If the account has been written off in a lump sum, determine if the directors or other authority have amortized it. Is there any ulterior motive? Will it distort subsequent profit and loss statements?

(f) If the bonds are to be retired at a premium, see that this additional expense is taken into account periodically.

(g) Ascertain how the unamortized discount on bonds retired is handled. Is the procedure proper? (Usually to surplus)

(h) Where stocks and bonds are issued together for a lump sum price, ascertain the true apportionment of the selling price between these two factors irrespective of what prospectus literature or "surface" appearances seem to indicate.

(i) If feasible, treat the bond discount as an offset to bonds payable.

4 Organization Expense:

(a) Are the charges to this account proper? (See text)

(b) Check all entries to vouchers or other primary evidence.

(c) Is the account being written off rapidly enough, considering the length of life of the business.

(d) An expense should be charged if the account is being amortized very slowly; otherwise surplus can be charged for arbitrary lump sum credits if a statement of changes in surplus is made a part of the report.

(e) Ascertain by whose authority the write-offs are being made.

(f) If commissions on sales of stock are paid for with stock, ascertain by whose authority it is made. Is the commission correct in amount?

5 Improvements Permanently Attached to Leased Property:

(a) Review and abstract the terms of the lease. Does the lessor get the property free or must he pay something for it?

(b) If the lease is renewable, determine in the light of all available facts whether or not it will be renewed, for this has an important bearing on the rate of depreciation when the life of the lease does not coincide with the life of the asset(s).

(c) Treat the improvements as plant property on the balance sheet.

(d) Verify the improvements against vouchers, etc.

6 Capital Stock Discount:

(a) Verify the discount by ascertaining the proceeds received as per the cash book, vouchers, etc.

(b) Verify the sales price against directors' minutes.

(c) If property was received for the stock, how was the value of the property determined? Check the transaction to vouchers, and directors' minutes.

(d) Ascertain if the so-called discount is callable. If so, is the call likely to be made.

(e) On the basis of the facts ascertained in (d), set the account up as an offset to the capital stock account, or as a current asset, or as an "Other Asset".

(f) Can the stock be legally issued at a discount?
(g) If the account is being written off to surplus, ascertain if the directors' minutes authorize this action. (They should.)
(h) If common and preferred stocks are sold for a lump sum price, see that the discount is properly allocated to the two stocks.

**REVIEW QUESTIONS**

1. How would you treat deposits required by a public utility company?
2. What items may be properly included in the bond discount expense account?
3. Is it ever permissible to carry forward the discount on one issue of bonds as a part of the interest cost of another issue of bonds? Elaborate your answer.
4. What items may be included under the category of organization expense?
5. What sort of deferred advertising charges would you classify as prepaid assets? As deferred charges to operations?
6. Draw up a table showing the difference between scientifically apportioned discount and straight line apportioned discount for a $5,000,000 issue of 5% 30 year bonds sold to yield 6%.
7. Outline three distinct plans for handling the organization expense account.
8. May the loss on abandoned property be treated as a deferred charge to operations? Give a detailed answer.
9. How would you handle rearrangement expenditures?
10. Wherein is the difference between prepaid assets and deferred charges, i.e., other assets?
11. When would you cancel the unamortized discount on treasury bonds?
12. What would you expect to find in a suspense account? How would you treat each of these items?
13. A client desires to treat the excess of a storm loss over the reserve therefore as a deferred charge. Write out an answer to his letter of inquiry.
14. How are the costs of stripping a mine handled?
15. Describe the correct treatment of true discount on capital stock.
16. Write a paragraph or two on the proper treatment of experimental expenditures.
17. What are some of the special considerations to be taken into account in the proper treatment of improvements to leased property?
18. What is your opinion of the following? Why?
   "A further charge was made against Surplus covering the entire cost of issuing the $30,000,000 15 year 6% Gold Debentures so that subsequent years' operations will not be charged for any part of this cost."¹
19. What is your opinion of the following? Why?
   "Extraordinary advertising, in excess of what the 1931 sales volume justified, which is considered institutional advertising...864,743.46"²

²Treated as a surplus charge in the 1931 Annual Report, Willys-Overland Co.
CHAPTER 20

THE VERIFICATION OF SECURITIES

325. Contents of the Chapter.
326. Explanation of Plate 98.
   PLATE 98—A Schedule of Securities (1st type).
327. Classification of Securities on the Balance Sheet.
328. Explanation of Plate 99.
   PLATE 99—A Schedule of Securities (2nd type).
329. The Valuation of Temporary Investments.
330. Explanation of Plate 100.
   PLATE 100—A Schedule of Securities (3rd type).
331. The Valuation of Permanent Investments.
332. Explanation of Plate 101.
   PLATE 101—A Schedule of Securities (4th type).
333. The Valuation of Investments in Controlled and Affiliated Companies.
334. Explanation of Plate 102.
   PLATE 102—A Schedule of Securities (5th type).
335. Explanation of Plate 103.
   PLATE 103—A Schedule of Securities (6th type).
336. Comments on Balance Sheet Captions.
337. General Outline of Audit Procedure.
338. Explanation of Plate 104.
   PLATE 104—A Schedule of Securities (7th type).
339. Analyzing the Account.
340. Simultaneous Count of All Securities.
341. Simultaneous Verification of Cash and Securities.
342. Endorsements.
343. Explanation of Plate 105.
   PLATE 105—The Face Contents of a Par Value Common Stock Certificate.
344. Explanation of Plate 106.
   PLATE 106—The Reverse Side of a Stock Certificate.
345. Genuineness.
346. Explanation of Plate 107.
   PLATE 107—The Face Contents of a No-Par-Value Common Stock Certificate.
347. Explanation of Plate 108.
   PLATE 108—The Face Contents of a Bond.
348. Coupons.
349. The Client's Representative.
   PLATE 109—A Coupon.
351. Explanation of Plate 110.
   PLATE 110—A Schedule of Securities (8th type).
352. Accounting for Numbers.
353. Assessments.
354. Receipts in Liquidation.
355. Confirmation of Securities.
356. Explanation of Plate 111.
   PLATE 111—A Letter of Confirmation.
357. Schedule of Securities.
358. Comments on Location of Securities.
359. Explanation of Plate 112.
   PLATE 112—An Audit Program for Securities.
360. Call Loans.
361. Explanation of Plate 113.
   PLATE 113—A Schedule on a Security Count.

Review Questions

325. Contents of the Chapter. In this chapter the discussion deals with securities received in payment of debts, etc., securities held as

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1See Appendix C, Sec. 6 - #3
stock-in-trade and securities held for control (or some interest) in other companies. Securities which are being held in sinking funds, etc., are discussed in the next chapter.

326. See Plate 98.

327. Classification of Securities on the Balance Sheet:—The proper classification of securities on the balance sheet is one of the most important functions of the auditor. As a rule, securities may be divided for balance sheet purposes into the four following classes: (1) those held for temporary investment, or for speculation, or for trade (Plate 98); (2) those held for investment purposes; (3) those held in funds devoted to purposes other than the discharging of current obligations, and the like; and (4) those held for control, or part interest in other enterprises.

Securities falling in the first class are properly listed among the current assets. They must be readily marketable, and the proceeds from their sale must be available, if necessary, for the discharging of current obligations, the purchasing of inventories, and other similar purposes effecting either current liabilities or current assets.

Although the proceeds of a security may be freely available for current purposes, yet if the security is not marketable, it is a fixed asset. On the other hand, although many securities are very marketable, they must be classified as fixed, if the INTENTION of the business is to hold them for investment purposes, in funds, or to secure control or part interest in another enterprise. Ordinarily, common stock would not be classified as current, because business men usually invest their temporarily idle funds in safer securities. Again, the maturity date of the securities usually has no definite bearing on their classification. For instance, securities maturing in two months hence are fixed assets if they are a part of a sinking fund to retire bonds payable due ten years hence. On the other hand, for example, a long term bond due seventy-five years hence may readily be classified as current, if it can be cashed tomorrow and if its proceeds can be used, if needed, to pay off a current note payable.

Securities held for investment purposes, or in funds, such as insurance funds, pension funds, sinking funds, endowment funds, replacement funds, and so on, are customarily placed in the balance sheet directly after the current assets (or Prepaid Assets) under some such captions as, INVESTMENTS, FUNDS, and the like, according to their individual nature.

As we have already noted, neither the marketability nor the maturity date of a security has any necessary bearing on its classification as an INVESTMENT. INTENTION and COMPULSION are the chief determining factors. Thus, for example, if a business has invested some surplus funds for a long period and has selected the securities with an eye to securing the best interest or dividends possible, the securities are fixed assets. On other occasions, the auditor may find that an indenture of the company's bonds payable compels the business to build up a sinking fund. Even if these funds are invested in securities of current maturity, they are fixed assets nevertheless.

The fourth type of security is held for control or interest in another business. Here again marketability and maturity date mean nothing. These securities, most often common stocks, are ordinarily listed directly after the current assets, the auditor must be more careful in ascertaining that it is the intention of the client to dispose of them.

1Including securities held as temporary investments by business concerns.
2See Appendix C, Sec. 15 - #13. 31.E., when the securities are common stocks, the auditor must be more careful in ascertaining that it is the intention of the client to dispose of them.
after the above fixed investments and funds as, INVESTMENTS IN CONTROLLED AND AFFILIATED COMPANIES. Advances to controlled interests, it may be noted here, are also placed under this same caption.

Securities in default should be classified separately at whatever value appears to be sound, with the market value, if ascertainable, given in parenthesis.

329. The Valuation of Temporary Investments.-- Under current practice those securities which are properly classified as current assets (Plate 99) must be valued at cost or market, whichever is the lower. The best method to secure this result is to set up a valuation reserve (see question 71) account so that the cost figures in the investment account may be left untouched. Of course, in presenting the balance sheet, only the net figure, i.e. the investment account minus the credit valuation account, should be given. Under one plan, the market value of a security, if the security has been reduced from cost to market, does not become the cost value for the new period. That is, in establishing the amount of the credit balance in the valuation account, the present market value is compared with the original cost value. However, the other plan, favored by the federal income tax department, is equally acceptable.

If the total market price of the securities is considerable above the cost or market basis, it ought to be shown parenthetically on the balance sheet, thus:

Marketable Securities at "Cost or Market" (market $158,000). . . $154,145.00

If the securities are stock-in-trade, as in the case of investment houses, brokers, etc., they may be priced at market, provided they are so designated on the balance sheet, and provided this method of valuing the securities is constantly adhered to. Thus ---

Preferred Stocks -- at market $1,275,148.00

In ascertaining the market value of securities, common sense and judgment are absolutely necessary. Slight temporary variations from cost, as at the audit date, need not be hedged in applying the cost or market, whichever the lower, rule. Under such conditions the new prices are no more representative of what the securities will yield when sold than is the cost. If the market trend is distinctly and permanently (for a few weeks) downward, it must be recognized in the books of account, otherwise not.

Ordinarily, the latest sale price on a "Calm" Exchange for an active security is taken to be the market price. In the case of less active stocks, the latest bid price (if recent) should be used to indicate market. If, however, there is a considerable margin between the bid and asked prices, the mean price should be used. Also, the auditor must often temper this price by a considerable revaluation if the client holds a very large amount of the securities of a particular corporation, because the inexorable law of supply and demand on a free market will inevitably reduce the present quotation.1

1 The fact that they are in default on interest and/or principal must be specifically mentioned. 2 See Appendix C, Sec. 15 - #15.
3 I.E., if the valuation reserve is set up through surplus, the excess thereof at any audit date should be credited to surplus; and the profit or loss on a sale is the difference between cost and the selling price.
4 I.E., if the reserve is set up by a P & L charge, the book value at any audit date becomes the "cost value" for the subsequent period; and the profit or loss on a sale is the difference between this "cost" and the selling price.
5 I.E., even when market is above cost. 6 See question 72.
### A SCHEDULE OF SECURITIES (1st type) PLATE 98

**The Sheldon Paper Products Corporation**

Securities (Held as Current Assets)

B/S Audit for the Year Ending May 31, 1929

<table>
<thead>
<tr>
<th>Description</th>
<th>Date</th>
<th>No.</th>
<th>Unit</th>
<th>Total</th>
<th>Book</th>
<th>Par</th>
<th>Par</th>
<th>Total</th>
<th>Value</th>
<th>Value</th>
<th>Balance</th>
<th>Changes</th>
<th>Schedule E</th>
</tr>
</thead>
<tbody>
<tr>
<td>Worcester Printing Co</td>
<td>5/24/29</td>
<td>1000</td>
<td>100</td>
<td>100000</td>
<td>90000</td>
<td>00#</td>
<td>100</td>
<td>100000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Mitchell</td>
</tr>
<tr>
<td>7½ 1st Pfd. F-71</td>
<td>7/7/27</td>
<td>500</td>
<td>50</td>
<td>25000</td>
<td>22500</td>
<td>00X</td>
<td>50</td>
<td>25000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>6/29/29</td>
</tr>
<tr>
<td>Bigbee Paper Co</td>
<td>11/1/27</td>
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<td>1000</td>
<td>10000</td>
<td>9000</td>
<td>00X</td>
<td>10</td>
<td>10000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>6/29/29</td>
</tr>
<tr>
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<td>7/4/28</td>
<td>50</td>
<td>1000</td>
<td>50000</td>
<td>55000</td>
<td>00#</td>
<td>50</td>
<td>50000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>6/29/29</td>
</tr>
<tr>
<td>Bury &amp; Cleary, Inc</td>
<td>4/15/28</td>
<td>50</td>
<td>1000</td>
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<td>50000</td>
<td>00X</td>
<td>50</td>
<td>50000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>6/29/29</td>
</tr>
<tr>
<td>6's 1st mtg. dated 2/1/07 due 1937</td>
<td>6/4/29</td>
<td>70</td>
<td>1000</td>
<td>70000</td>
<td>53000</td>
<td>00X</td>
<td>70</td>
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<td>70(53000.00)</td>
<td></td>
<td>6/29/29</td>
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<tr>
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<td>70(53000.00)</td>
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<td>6/29/29</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6's 1st mtg. dated 4/15/1928 due 1958 B 1015/64</td>
<td>4/15/28</td>
<td>50</td>
<td>1000</td>
<td>50000</td>
<td>50000</td>
<td>00X</td>
<td>50</td>
<td>50000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>6/29/29</td>
</tr>
<tr>
<td>Grout &amp; Arnold, Inc</td>
<td>10/20/28</td>
<td>10</td>
<td>1000</td>
<td>10000</td>
<td>9000</td>
<td>00X</td>
<td>10</td>
<td>10000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>6/29/29</td>
</tr>
<tr>
<td>6 1/2's 1st mtg. dated 3/15/27 due 1947 A 110/19</td>
<td>6/4/29</td>
<td>70</td>
<td>1000</td>
<td>70000</td>
<td>53000</td>
<td>00X</td>
<td>70</td>
<td>53000</td>
<td>70(53000.00)</td>
<td></td>
<td>6/29/29</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Verified by Brokers' Advices and Cash Receipts Book**

<table>
<thead>
<tr>
<th>Description</th>
<th>Date</th>
<th>No.</th>
<th>Unit</th>
<th>Total</th>
<th>Book</th>
<th>Par</th>
<th>Par</th>
<th>Total</th>
<th>Value</th>
<th>Value</th>
<th>Balance</th>
<th>Changes</th>
<th>Schedule E</th>
</tr>
</thead>
<tbody>
<tr>
<td>Holt Mfg Corp</td>
<td>6/17/28</td>
<td>50</td>
<td>1000</td>
<td>50000</td>
<td>50000</td>
<td>00#</td>
<td>50</td>
<td>50000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Mitchell</td>
</tr>
<tr>
<td>6's 1st mtg. 4/1/01 due 1931 A 78/127</td>
<td>6/17/28</td>
<td>50</td>
<td>1000</td>
<td>50000</td>
<td>50000</td>
<td>00#</td>
<td>50</td>
<td>50000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Mitchell</td>
</tr>
<tr>
<td>Grout &amp; Arnold, Inc</td>
<td>10/20/28</td>
<td>10</td>
<td>1000</td>
<td>10000</td>
<td>9000</td>
<td>00X</td>
<td>10</td>
<td>10000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Mitchell</td>
</tr>
<tr>
<td>6 1/2's 1st mtg. dated 3/15/27 due 1947 A 110/19</td>
<td>6/17/28</td>
<td>50</td>
<td>1000</td>
<td>50000</td>
<td>50000</td>
<td>00#</td>
<td>50</td>
<td>50000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Mitchell</td>
</tr>
</tbody>
</table>

**Balance per G/L May 31, 1929**

Reserve to reduce to Cost or Market Amount for B/S 5/31/29

( Market 5/31/29 $241600.00 )

326. Explanation and Comments.—In this exhibit we have an illustration of a method that can be employed whenever the day on which the checking up on the securities occurs after the audit date. Here the two dates are May 31, 1929 (audit date) and June 29, 1929 (date of actual examination). As explained in the text, the securities called for by the account as at the date of doing the work (June 29th) must be accounted for, and the intervening transactions must be vouched (cash book, etc.) and worked back to the audit date (May 31st).

Because of the numerous transactions in the account for the year ended May 31, 1929, the auditor did not verify the "ins" and "outs" of the account, as it was a strict balance sheet audit.

Note that each of the securities included in the final balance was included in the interest and dividend test.
### Right Side of Plate 98

<table>
<thead>
<tr>
<th>Book Balance</th>
<th>Par Value</th>
<th>Market Value</th>
<th>Date of Last Coupon</th>
<th>Payable to Client?</th>
<th>Interest and Dividend Test</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>5/31/29</td>
<td>90000.00</td>
<td>100000</td>
<td>5/31/29</td>
<td>OK</td>
<td>0 K</td>
<td>Payable to G Baker for entire year accompanied by a power of attorney signed in blank. Sent in for transfer by us on 6/30/29</td>
</tr>
<tr>
<td></td>
<td>22500.00</td>
<td>25000</td>
<td>5/31/29</td>
<td>OK</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>9000.00</td>
<td>10000</td>
<td>8/1/29</td>
<td>Registered</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>55000.00</td>
<td>50000</td>
<td>7/1/29</td>
<td>Not</td>
<td>Registered</td>
<td></td>
</tr>
<tr>
<td></td>
<td>5000.00</td>
<td>5000</td>
<td>10/15/29</td>
<td>Registered</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>52000.00</td>
<td>50000</td>
<td></td>
<td></td>
<td>Sold for 45000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>9000.00</td>
<td>10100</td>
<td></td>
<td></td>
<td>Sold for 95000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>250000.00</td>
<td>22500</td>
<td>251600</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### Reserve for Market Fluctuations - - Securities

<table>
<thead>
<tr>
<th></th>
<th>Cost</th>
<th>Market</th>
<th>Reserve</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bigbee Paper</td>
<td>22500</td>
<td>20000</td>
<td>2500</td>
</tr>
<tr>
<td>Brown Machine</td>
<td>55000</td>
<td>51000</td>
<td>4000</td>
</tr>
<tr>
<td>Kiburn, Palmer</td>
<td>5000</td>
<td>4500</td>
<td>500</td>
</tr>
<tr>
<td>Holt</td>
<td>52000</td>
<td>45000</td>
<td>7000</td>
</tr>
<tr>
<td></td>
<td>134500</td>
<td>120500</td>
<td>14000</td>
</tr>
</tbody>
</table>

**Audit Procedure**

1. These securities were seen on 6/29/29 at The Hospital Trust Company at about 1 P.M. in the presence of Mr. Sheldon.

2. These securities were seen on 6/29/29 at The Slater Industrial Bank at about 3 P.M. in the presence of Mr. Sheldon.

The account was not audited for the entire year; only the final balance was audited. Interest and dividends were tested only.
A SCHEDULE OF SECURITIES (2d type) PLATE 99

The Burnham Machine Corporation
Bond Securities (Held as Temporary Investments)
Audit for the Year Ending December 31, 1929

(LEFT SIDE)

<table>
<thead>
<tr>
<th>Description</th>
<th>Date of Purch.</th>
<th>No.</th>
<th>Unit of Par Total Units</th>
<th>Value Par</th>
<th>Book Balance 1/1/29 as per our Papers</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Jennings Cloth Co 1st mtg 6% dated 1904</td>
<td>1/15/27</td>
<td>P 780/7</td>
<td>8</td>
<td>1000</td>
<td>8000</td>
</tr>
<tr>
<td>due 1934 Interest Jan 1 and July 1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td># The Rehoboth Corp 1st mtg 7% dated 1901</td>
<td>7/10/27</td>
<td>S 609/18</td>
<td>10</td>
<td>1000</td>
<td>10000</td>
</tr>
<tr>
<td>due 1941 Interest April 1 and Oct 1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td># The Tibeau Soap Works Inc 6% 1st mtg dated 1900</td>
<td>8/16/28</td>
<td>S 142/6</td>
<td>5</td>
<td>1000</td>
<td>5000</td>
</tr>
<tr>
<td>due 1940 Interest March 15 and Aug 15</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

OMISSIONS

Prescott, Ronald & Co 1st mtg 6 1/2 dated 1902    | 1/7/30         | G 297/316 | 20                      | 500       | 10000                                |
| due 1932 Interest Jan 1 and July 1               |                |      |                          |           |                                      |

Total 113625.25 O.K.

AUDIT PROCEDURE

As requested by Mr. Stanley, Pres., we vouched the Securities account for the entire year against brokers' invoices and against the Cash Book. We also accounted in detail for all of the interest for 1929. As we did the auditing on Feb. 15, we were obliged to verify the transactions up to that date. The securities were examined. In each case the market value slightly exceeded cost.

X These securities were examined at the Oldham Trust Company on Feb. 15, 1930, at 9 A.M. in the presence of Mr. J. Poffit, Treas. All coupons were attached.

# Registered in the name of the client. Verified with the respective corporations as per schedules H-1 and H-2.
<table>
<thead>
<tr>
<th>Changes Book in Balance</th>
<th>1929</th>
<th>12/31/29</th>
<th>Changes up to 2/15/30</th>
<th>Balance X</th>
<th>Accrued Interest for Rec. 1929</th>
<th>Income</th>
<th>Sold at Market 12/31/29</th>
</tr>
</thead>
<tbody>
<tr>
<td>8M 8080.00</td>
<td>8M 8080.00R</td>
<td>None</td>
<td>240.00</td>
<td>240.00</td>
<td>8100</td>
<td>8160.00</td>
<td></td>
</tr>
<tr>
<td>April 2</td>
<td>H-1</td>
<td>H-1</td>
<td>4880.00R</td>
<td>4880.00</td>
<td>51</td>
<td>5M</td>
<td>87.50</td>
</tr>
<tr>
<td>5M 5125.00</td>
<td>5M 5125.00</td>
<td>112.50</td>
<td>112.50</td>
<td>5500.00</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>0M</td>
<td>0M</td>
<td>None</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10625.00</td>
<td>10625.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>20 - 3500</td>
<td>20 - 3500</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>15451.25R</td>
<td>98174.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>21495.25</td>
<td>119669.25</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>697.50</td>
<td>6140.50</td>
<td>36950</td>
<td>107450.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>V</td>
<td>0K</td>
<td>V</td>
<td>0K</td>
<td>0K</td>
<td>36950</td>
<td>24900T</td>
<td></td>
</tr>
<tr>
<td>V</td>
<td>Checked to brokers invoices and Cash Book</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>O K</td>
<td>Checked to General Ledger account</td>
<td>Cost of sales</td>
<td>15451.25</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>T</td>
<td>These were sold between 12/31/29</td>
<td>Loss on Sales</td>
<td>1401.25R</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>and 2/15/30</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>E</td>
<td>Not listed on any Exchange. Quotation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>secured over telephone from Hornblower, Jones &amp; Co. of Providence</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

326. Explanation and Comments.—This exhibit illustrates a method for showing the details of an account for the period under audit, together with the transactions occurring after the audit date (here 12/31/29) to the date of actual work (here 2/15/30).

Note that the opening balance was checked against the audit papers of last year, and that all changes were verified against brokers' invoices, and the cash book.

Also observe that both the Accrued Interest on Securities account, and the Income from Securities account are developed on this schedule.
A SCHEDULE OF SECURITIES (3d type) PLATE 100

The Wilson, Thornley Corporation
Securities (Held as Current Assets)
B/S Audit for the Year Ended Dec. 31, 1929

SCHEDULE OF SECURITIES

(LEFT SIDE)

<table>
<thead>
<tr>
<th>Date</th>
<th>Name of Broker</th>
<th>Total Book Value</th>
<th>Cushman &amp; Curtis 1st Pfd 7%</th>
<th>Green &amp; Crawford 1st Pfd 7%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchased</td>
<td></td>
<td>Par $100</td>
<td>Par $100</td>
<td></td>
</tr>
<tr>
<td>Shares</td>
<td>Book Value</td>
<td>Shares Book</td>
<td>Shares Book</td>
<td></td>
</tr>
<tr>
<td>Value</td>
<td></td>
<td>Value</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Jan 1      | On hand per last audit 451895.00 600 65400.00 1500 147000.00
working papers and G/L

Feb 19     | Phelps Bros           | 65450.00 500 50000.00

Mar 7      | " "                   | 1010.00 10 1010.00

--- O_M_I_S_S_I_O_N_S ---

Aug 29     | Patten & Smith         | 103000.00 OCR

Oct 14     | " "                   | 116.33R 116.33R

15 full rights sold

G/L Balance 12/31/29 | 1261788.67 4110 416410.00 7500 734833.67
Reserve TO Reduce TO "C or M" | 27610.00 F-1
Amount For B/S 12/31/29 | 1234178.67 F-1

To B/S

Market Value 12/31/29 | $1,269,000.00 F-1

AUDIT PROCEDURE

All transactions were traced into brokers' invoices.

The securities were inspected on Jan. 2 at the Interstate Trust Company in the presence of Mr. Clarkson at about 12:15 P.M.

The market value of the Cushman & Curtis shares is only $388,800.00. To provide for this difference ($416410.00 - $388600.00 - $27610.00) adjustment #32 for $4143.00 builds up the reserve of $23467.00 to $27610.00. All other market values are above cost. See schedule F-1 for the details of market prices, etc.

All dividends and interest were accounted for. See schedule F-2 for the security count sheet.
**A SCHEDULE OF SECURITIES (3d type)**

**PLATE 100**

The Wilson, Thornley Corporation
Securities ( Held as Current Assets )
B/S Audit for the Year Ending Dec. 31, 1929

<table>
<thead>
<tr>
<th></th>
<th>Hadley &amp; Morrow</th>
<th>Mac Lean Corp.</th>
<th>Hesseltine, Inc.</th>
<th>Profit and</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Amount</strong></td>
<td>6½ 1898-1938</td>
<td>6½ 1924-74</td>
<td>6's 1901-31</td>
<td>(Loss)</td>
</tr>
<tr>
<td><strong>Book Value</strong></td>
<td>J-1 and J-1</td>
<td>J-1 and J-1</td>
<td>A-1 and O-1</td>
<td>On</td>
</tr>
<tr>
<td><strong>Sale Value</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
<th>Book</th>
<th>Amount</th>
<th>Book</th>
<th>Amount</th>
<th>Book</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Value</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>100 M</td>
<td>104000.00</td>
<td>120 M</td>
<td>123600.00</td>
<td>10 M</td>
<td>11895.00</td>
<td></td>
</tr>
<tr>
<td>15 M</td>
<td>15450.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

---

**OMISSIONS**

<table>
<thead>
<tr>
<th></th>
<th>100 M 103000.00R</th>
<th>2000.00</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>None</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>F-2</th>
<th>F-2</th>
<th>F-2</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Value</strong></td>
<td>75 M 78050.00</td>
<td>20 M 20600.00</td>
<td>10 M 11895.00</td>
</tr>
<tr>
<td><strong>Sale</strong></td>
<td>8505.00</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

---

330. **Explanation and Comments:**—This exhibit illustrates a method of developing a schedule in detail whenever the securities are few in number.

Notice that it was necessary to adjust the reserve account by $4,143.00 (adjustment #32) in order to be able to state the securities at cost or market whichever the lower.

Finally, note that when computations are not obvious, as in the case of the 15 rights on the Greene and Crawford preferred stock, full details thereon must always be given in the working papers (here F-1).
A SCHEDULE OF SECURITIES (4th type) PLATE 101

The Oldrich, Hobson & Whitley Corporation
Bonds - Permanent Investments
Audit for the Year Ending December 31, 1929

Bishop

Date of Purchase

1/2/28
6/30/28

Schedule L

A

Date

1/2/28

Description

Description

No.

of

Units

Par

Dr.

1000

8

6000.00

60000.00

Premium

Premium

1250.00

8000.00

2500.00

1250.00R

1. As the securities are being held as permanent investments, the
 premiums and discounts have been taken into consideration on a straight
line basis.

2. The bonds are entered at par, the premium or discount being entered
on their respective accounts.

OPERATION of the ACCOUNTS

1. Those securities which were examined were at the Hospital Trust
Company, the count being at about 11:30 A.M. on Jan. 2, 1930 in the presence
of Mr. Olds. Coupons were attached. Numbers were accounted for.

2. The income from securities was checked out completely for the year.

3. All securities were verified against our schedule of last period and
against brokers' invoices for this year's purchases. There were no sales.

4. We prepared the above computations independently and found them to
check with their G/L accounts.
### Discount Total How Market Accrued Interest Interest Coupons

<table>
<thead>
<tr>
<th>Cr.</th>
<th>Dr.</th>
<th>Verified</th>
<th>Value</th>
<th>Receivable</th>
<th>Income</th>
<th>Attached?</th>
</tr>
</thead>
<tbody>
<tr>
<td>349.20</td>
<td>7650.80</td>
<td>Seen</td>
<td></td>
<td>246.00</td>
<td>240.00</td>
<td>OK</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>240.00R</td>
<td>240.00R</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>240.00</td>
<td>240.00</td>
<td></td>
</tr>
<tr>
<td>38.80R</td>
<td>38.80</td>
<td></td>
<td></td>
<td>240.00</td>
<td>240.00</td>
<td>38.80</td>
</tr>
<tr>
<td></td>
<td>7689.60</td>
<td></td>
<td></td>
<td>7640.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>102500.00</td>
<td>L-I</td>
<td>3000.00</td>
<td>3000.00</td>
<td>3000.00</td>
<td>3000.00</td>
<td>3000.00</td>
</tr>
<tr>
<td>1250.00R</td>
<td></td>
<td></td>
<td></td>
<td>1250.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>101250.00</td>
<td></td>
<td></td>
<td></td>
<td>101000.00</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Omissions**

<table>
<thead>
<tr>
<th>3648.20</th>
<th>638602.30</th>
<th>638560.00</th>
<th>10460.00</th>
<th>42768.90</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 K</td>
<td>To B/S</td>
<td>0 K per G/L</td>
<td>0 K per G/L</td>
<td></td>
</tr>
<tr>
<td>per G/L</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**BALANCE SHEET PRESENTATION**

Permanent Investments at Adjusted Cost (Market: $638560.00)

- Pledged against Notes Payable - Banks: $586419.85
- Free (Market: $49660.00): $60182.45

Total: $638602.30
EXPLANATION OF PLATE 101

A SCHEDULE OF SECURITIES (4th type)

THE OLDRICH, HOBSON, WHITELEY CORPORATION
Permanent Investments
Audit for the Year Ending December 31, 1929

332. Explanations and Comments.—This exhibit shows a plan for drawing up a schedule to handle the computation of premiums and discounts which are generally taken into consideration whenever the securities are held as permanent investments.

The book entries to date for the Jordan Machine Co. Inc. bonds, and the Robins and Wightman Corp. bonds were as follows:

1928

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/2/28</td>
<td>Permanent Investments 6000.00</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Bond Discount</td>
<td>388.00</td>
</tr>
<tr>
<td></td>
<td>Cash 7612.00</td>
<td></td>
</tr>
<tr>
<td>6/30/28</td>
<td>Permanent Investments 10000.00</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Bond Premiums 3125.00</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash 103125.00</td>
<td></td>
</tr>
<tr>
<td>7/1/28</td>
<td>Income from Securities (J.M.Co.)</td>
<td>240.00</td>
</tr>
<tr>
<td>12/31/28</td>
<td>Bond Discount</td>
<td>38.80</td>
</tr>
<tr>
<td></td>
<td>Income from Securities (J.M.Co.)</td>
<td>38.80</td>
</tr>
</tbody>
</table>

1929

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/29</td>
<td>Income from Securities 3240.00</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Accrued Int. Receivable (Reversal)</td>
<td>3240.00</td>
</tr>
<tr>
<td></td>
<td>Cash 240.00</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Income from Securities (J.M.Co.)</td>
<td>240.00</td>
</tr>
<tr>
<td></td>
<td>Cash 3000.00</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Income from Securities (J.M.Co.)</td>
<td>3000.00</td>
</tr>
<tr>
<td></td>
<td>Income from Securities (R.W.Corp.)</td>
<td>3000.00</td>
</tr>
<tr>
<td>7/1/29</td>
<td>Income from Securities (J.M.Co.)</td>
<td>240.00</td>
</tr>
<tr>
<td></td>
<td>Income from Securities (R.W.Corp.)</td>
<td>1250.00</td>
</tr>
<tr>
<td></td>
<td>Bond Premium</td>
<td>1250.00</td>
</tr>
<tr>
<td></td>
<td>Income from Securities (R.W.Corp.)</td>
<td>38.80</td>
</tr>
</tbody>
</table>

The above entries are given in order to make the exhibit easier for the reader to follow.

Note that the market or estimated values have been secured and are shown parenthetically on the balance sheet.

Also note that a brief summary of the Operation of the Accounts is given, as well as the customary notes on Audit Procedure.
330. **See Plate 100.**

331. **The Valuation of Permanent Investments.**—Permanent investments (Plate 100) are (1) those which it is the intention of the business to hold primarily for their dividends or their interest, (2) such other formerly current securities as have turned out to be unmarketable, and (3) unmarketable securities accepted in payment of old debts, etc.

These securities are correctly carried at cost. Whenever stated on a balance sheet, their market or estimated value should also be shown parenthetically. The reason for this treatment is this. As these securities are to be held for a long period of time, there is no need to value them in the books of account at what they will bring today, because today's price has nothing to do with the price which they will bring when they are disposed of,—say five to fifteen years hence. Again, since these securities are being held primarily for their interest and their dividends, the ups and downs of their market value should not be reflected in the profit and loss statement, as would be the case if market value was given effect to. The common law recognizes this fact, since it does not require a business to take into consideration the decrease in market value of its permanent investments in determining the amount of profit available for dividends.

Despite these sound principles of law and accounting just cited, nevertheless, there is something very definitely lacking unless the market or estimated value is shown parenthetically. For example, is there any doubt but what an auditor must take cognizance of a situation where permanent investments originally costing $78,000 have in later normal times

---

1. **See question 73.** 2. Investment trusts should adjust the cost by taking up profits, losses, dividends, etc. thereby solving the question of recording stock dividends.

3. In a period of depression the problem involved has been handled as illustrated by the following life insurance company's balance sheet.

**HOME LIFE INSURANCE COMPANY**

**Financial Statement—December 31, 1931**

**ASSETS**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mortgage Loans on Real Estate</td>
<td>$20,455,330.00</td>
</tr>
<tr>
<td>Bonds</td>
<td>20,648,736.00</td>
</tr>
<tr>
<td>#Stocks: Preferred</td>
<td>2,668,984.00</td>
</tr>
<tr>
<td>Common</td>
<td>16,000.00</td>
</tr>
<tr>
<td>Loans on Policies</td>
<td>20,016,379.59</td>
</tr>
<tr>
<td>Real Estate; Home Office Building</td>
<td>1,500,000.00</td>
</tr>
<tr>
<td>Acquired under Foreclosure</td>
<td>17,741.50</td>
</tr>
<tr>
<td>Cash</td>
<td>992,268.89</td>
</tr>
<tr>
<td>Premiums in course of collection</td>
<td>2,087,555.88</td>
</tr>
<tr>
<td>Interest Accrued</td>
<td>544,255.93</td>
</tr>
<tr>
<td></td>
<td>$379,149,251.79</td>
</tr>
</tbody>
</table>

**LIABILITIES**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Policy Reserves and Funds</td>
<td>$370,296,541.97</td>
</tr>
<tr>
<td>Policy Dividends and Interest Thereon Held on Deposit</td>
<td>1,717,275.00</td>
</tr>
<tr>
<td>Miscellaneous Liabilities</td>
<td>499,066.40</td>
</tr>
<tr>
<td>Reserve Held for Federal and State Taxes Payable in 1932</td>
<td>270,000.00</td>
</tr>
</tbody>
</table>
20-14

If control (Plate 101) in another enterprise is effected by holding less than 51% of the total voting stock, as is often the case when ever the stock is widely held, its valuation treatment should be exactly like that given permanent investments in the preceding section; namely, at cost with the market value (if ascertainable) shown in parenthesis.

The Valuation of Investments in Controlled and Affiliated Companies. 1 If control (Plate 101) in another enterprise is effected by holding less than 51% of the total voting stock, as is often the case whenever the stock is widely held, its valuation treatment should be exactly like that given permanent investments in the preceding section; namely, at cost with the market value (if ascertainable) shown in parenthesis.

If, on the other hand, the control is effected by holding 51 or more per cent of the total voting shares, the cost value in the account should be increased by a proportional share of each year's profits of the subsidiary, and decreased by the amount of the cash dividends received from it and/or by a proportional share of each year's losses (if any).

ILLUSTRATION

(Assumptions)

(1) A Co. owns 60% of the voting stock of B. Co. which it purchased

| Dividends due Policyholders in reduction of Premiums | $ 141,794.17 |
| Funds set aside from 1931 earnings to pay Policy Dividends in 1932 | $2,460,000.00 |
| Security Fluctuation Reserve | $600,000.00 |
| Unassigned Surplus | $3,064,574.25 |

#Values specified by the National Convention of Insurance Commissioners.

Security fluctuation reserve, set forth above, covers the difference between this valuation and actual market values on December 31st, 1931.

(Author's note:--The convention resolved as follows: "... that the committee on valuation of securities of the national convention of insurance commissioners is of the opinion that under present conditions the market quotations on stocks and bonds for a particular day are not a fair standard for the ascertaining of average market value of such securities and recommends as a present substitute therefor the average price of stocks and bonds as reflected by the exchanges for a range of five quarterly periods ended September 30, 1931; and that since the average thus ascertained is approximately the closing market value of securities on June 30, 1931, the prices of June 30, 1931, be taken as the average market value during the current year and that such standard be accepted for the annual statements due as of December 31, 1931, except that securities should not be valued at more than the purchase price if purchased since June 30, 1931.)

1 See contrary opinion in Appendix C, Sec. 15 - #12. 2 Investment trusts should take up profits, losses and dividends thereby solving the stock dividend problem.
for $1,786,145.00 on January 1, 1900.

(2) B Co's profits, losses, and dividends were as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>B Co's Profit/Loss</th>
<th>Dividends</th>
</tr>
</thead>
<tbody>
<tr>
<td>1900</td>
<td>$182,145.00 profit</td>
<td>$150,000</td>
</tr>
<tr>
<td>1901</td>
<td>$ 4,000.00 loss</td>
<td>$150,000</td>
</tr>
<tr>
<td>1902</td>
<td>$107,683.00 profit</td>
<td>$150,000</td>
</tr>
</tbody>
</table>

(Solution)

Show in a T account the B Co's stock account on A Co's books.

If stock dividends are received, no entry need be made in the account for the new shares received, except to change the number of shares noted in the heading of the account.

As in the case of securities held as permanent investments (i.e. solely for the interest and/or the dividends) and like securities held for control but which give less than a 51% interest, the market or the estimated value of securities giving from 51% to 75% control must also be shown parenthetically on the balance sheet. But if the control exceeds 75% (arbitrarily selected), the balance sheet of the subsidiary should be substituted for the investment account. In fact, in such instances a consolidated balance sheet is absolutely necessary if an adequate idea of the business is to be secured.

To summarize,—if the control is less than a 51% interest in the total voting stock, the account should be kept at cost; but if the control is 51% or more, the account should be kept at cost, plus profits, minus dividends and losses, as shown in the illustrative problem. Furthermore, when the control gets as high as 75% (arbitrarily set), the investment account should not be shown on the parent company's balance sheet at all, but in its place should be substituted the balance sheet of the controlled company, the net result giving what is technically known as a consolidated balance sheet.

Of course, at times an auditor is not able to persuade a parent company, even one having as much as complete control of a subsidiary, to permit him to audit the subsidiary in order to be able to draw up an unqualified certificate on the consolidated sheet. In such instances of refusal, the auditor is, of course, obliged to show the investment account on the parent company's balance sheet at cost plus profits, minus dividends and losses where warranted by circumstances of control. The auditor is then warranted to apply an exception to the rule which excludes appreciation from earned surplus. Revaluation on the basis of net asset values of subsidiaries, where warranted by circumstances of control, is but another way of giving expression to a result which would be achieved by consolidating the accounts of two companies. That this procedure may result in an amount of surplus greater than that of the parent company alone, does not place the parent company in the position of having taken credit for unrealized appreciation.

"Exception to the foregoing conclusion (i.e. that an estimated increase in the value of assets does not increase the surplus available for cash dividends) probably may be taken on the ground that it is not applicable in a case where one corporation owns all or a sufficient amount of the stock of another corporation to direct the application of surplus profits, and periodically revalues its investment in the stock of the subsidiary company. Such circumstances seem not to indicate an exception to the rule which excludes appreciation from earned surplus. Revaluation on the basis of net asset values of subsidiaries, where warranted by circumstances of control, is but another way of giving expression to a result which would be achieved by consolidating the accounts of two companies. That this procedure may result in an amount of surplus greater than that of the parent company alone, does not place the parent company in the position of having taken credit for unrealized appreciation."—J.R. Widdison, "The Accounting Review", Dec. 1928.

See Chapter 51, Section 847 for further amplification of this topic.
A SCHEDULE OF SECURITIES (5th type) PLATE 102

The Wilkinson Bleacheries, Inc.
Securities of Controlled Companies
Audit for the Year Ending Dec. 31, 1929

<table>
<thead>
<tr>
<th>Date of</th>
<th>Description</th>
<th>No. of Units</th>
<th>Unit Par</th>
<th>Value Total</th>
<th>Last Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>7/17/24</td>
<td>The Halliwell Bleacheries</td>
<td>1400</td>
<td>100</td>
<td>140000</td>
<td>175605.34</td>
</tr>
<tr>
<td></td>
<td>Common Ctf #814 #1246 80% Control</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>9/21/27</td>
<td>The Reynolds Sheetinng Co., Inc</td>
<td>9000</td>
<td>100</td>
<td>900000</td>
<td>1125782.83</td>
</tr>
<tr>
<td></td>
<td>Common Ctf. #465 #818 #1046 90% Control</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

OMISSIONS

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>No. of Units</th>
<th>Unit Par</th>
<th>Value Total</th>
<th>Last Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>11/6/27</td>
<td>The Carr Bleacheries</td>
<td>10000</td>
<td>50</td>
<td>500000</td>
<td>63942.78</td>
</tr>
<tr>
<td></td>
<td>Common 100% Control Ctf #114 #965 #8168 #8865 #9015</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

T O.K. per our 12/31/28 papers
Z " " " audited P&L Statements
V " " " statement of surplus

OPERATION OF THE ACCOUNTS

A separate account is kept for each of the controlled companies. A proportional share of each subcompany's profit or loss is taken into the accounts together with the dividends actually received.

334. Explanation and Comments.—This exhibit presents a plan for a schedule on controlled companies. Note that many auditors give a brief description of the operation of the account(s) involved, as well as the comments on the audit procedure.

From the various comments on the schedule, observe that the subcompanies have been audited, and that a consolidated balance sheet is to be prepared in addition to the balance sheet of the parent company. In the latter the subcompanies will appear as investment accounts.
The opening balances were checked against our Schedule F of last year. The proportional profits, losses, and dividends were checked against audited profit and loss statements of the respective subcompanies, and the Cash Receipts Book. See schedule K1-9.

We examined the securities at The State Street Trust Company on Feb. 18, 1930 at about 2:30 P.M. in the presence of Mr. Huston and Mr. F. Beckerson.
**A SCHEDULE OF SECURITIES (6th type) PLATE 103**

**E.H. BROOKS & SONS, INC.**

Investments in Associated Companies

February 28, 1930

Schedule G

<table>
<thead>
<tr>
<th>Description</th>
<th>No of Sh.</th>
<th>Par Value</th>
<th>Cost</th>
<th>Additions Feb. 26, 1929</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wilson &amp; Wilson, Inc.</td>
<td>1567 Com.</td>
<td>156700.00</td>
<td>156700.00</td>
<td></td>
</tr>
<tr>
<td>The Harper Corp.</td>
<td>2000 Com.</td>
<td>no par</td>
<td>174000.00</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Omissions</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Corp. E.H.B's Share of Networth</th>
<th>Div. No Current Shares Par % Current Value of Book Current Portion of</th>
<th>Omissions</th>
</tr>
</thead>
<tbody>
<tr>
<td>W &amp; W</td>
<td>20164 12 72 9% 5 86743 24 5000 500000 31.34% 925478 42 290044.93</td>
<td></td>
</tr>
<tr>
<td>H Corp</td>
<td>278943.87 4 50984.87 3000 66.33 500000 31.34% 925478.42 387942.00</td>
<td></td>
</tr>
</tbody>
</table>

| Omissions                      |           |           |          |                         |

| Totals                         | 3764498.71| 1243781.92|          |                         |

**Audit Procedure**

The above securities were seen on 3/20/30 at 9:45 A.M. at The Shamut Nat'l of Philadelphia in the presence of Mr. Pope, Treas. The current purchases were authorized by the Board of Directors. See Schedule 12. The brokers' invoices were examined.

All of the stocks are paying the same dividends as when purchased. The amount of E.H.B's portion of the networth of those companies at the time of purchase was $3963433.61 as compared with $1243781.92 at the present date (see above). No reliable market figures are available. Each company except P. Trask, Inc. is audited by C.P.As. See G1-7. We believe that the securities are conservatively valued.

**Explanation and Comments**—Note that these securities have been kept on a cost basis, whereas the better method (in the case of ownership of more than 50% of the voting stock) is to absorb proportional profits, losses, and dividends. (See section 323)

Notice particularly the amount of information assembled as to the intrinsic worth of these stocks, including that data given on subschedules G 1-7 inclusive.
losses with the market value or estimated value in parenthesis? But a balance sheet drawn up in this manner is generally a sheer waste of time. And, as the persons (bankers for example) most interested in the balance sheet will certainly view it in this light, the client is simply notifying the intelligent public that its ideas on this important subject are woefully astray, or that it has something to conceal.

334. See Plate 102.
335. See Plate 103.
336. Comments on Balance Sheet Captions.—If the total market value of the securities held as temporary funds is considerably above the cost or market, whichever the lower, value, it should be shown on the balance sheet in parenthesis.

Likewise, if the total market value or estimated value of the fixed investments varies considerably from the total cost or adjusted cost, (e.g. in the case of controlled interests, cost plus proportional share of undistributed profit earned by the controlling company since the date of purchase of its stock), it ought to be shown parenthetically on the balance sheet somewhat as follows.

\[
\begin{align*}
\text{INVESTMENTS (at cost):} & \\
\text{The Clarkson Corp. (market $105,000)} & (1840 \text{ common shares}) \quad \$194,000 \\
\text{The Thrace Cotton Co. (market $87,000)} & (500 7\% \text{ pfd.shares}) \quad 50,000 \\
\text{Total} & \quad \$244,000
\end{align*}
\]

OR

\[
\begin{align*}
\text{INVESTMENTS (market $192,000)} & \\
\text{OR} & \\
\text{Total} & \quad \$244,000
\end{align*}
\]

\[
\begin{align*}
\text{INVESTMENTS IN SUBSIDIARIES (at adjusted cost):} & \\
\text{The Hamblin Woolen Corp. (1750 pfd.sh.7's)(market $205,000)} & \quad \$185,900 \\
\text{The Chace Woolen Corp. (10,000) com.sh.)(market $850,000)} & \quad 1,000,000 \\
\text{Total} & \quad \$1,175,900
\end{align*}
\]

If any securities are pledged, this fact must be very clearly disclosed, including also the amount and nature of the item against which they are pledged. For example, among the current assets and current liabilities, one might find the following captions.

\[
\begin{align*}
\text{(a)} & \\
\text{Current Assets:} & \\
\text{(Omitted Items)} & \\
\text{Temporary Investments—(Pledged against Notes Payable—Banks) (At "cost or market")} & \quad \$154,178
\end{align*}
\]

\[\text{1} \quad \text{Of course, if the client carries the account at cost, the auditor should endeavor in some manner to show its value on the correct basis.} \quad \text{2} \quad \text{In so far as this is possible or sensible to do. If the market value is not ascertainable, the book value or other useful indicator of intrinsic worth, such as rate of dividend and period of unbroken payment, or list of annual profits, should be incorporated in the balance sheet, or at least in the report.} \quad \text{4} \quad \text{See also Chapter 48.}\]
Current Liabilities:
(Omitted items)
Notes Payable - Banks (Secured - contra) $140,000

Current Assets:
(Omitted items)
Temporary Investments (Market Value $198,000):
Pledged against notes payable - bank $150,053.17
Free $26,071.42 $176,124.59

If the client has subscribed to the capital stock of another business, the subscription should be placed with the class of assets with which the stock itself will be placed, i.e., temporary investments, permanent investments, or controlled interests.

EXEMPLARY

Current Assets:
(Omitted items)
Temporary Investments (market value $150,470)
Stocks and bonds at cost $119,327.84
Stock subscriptions at par $30,000.00 $149,327.84

As stated elsewhere, ordinarily the best method of stating the subscriptions is to show the subscription price as an asset, and the unpaid balance as a current liability. This method is required whenever the market price is substantially below the subscription price, merely showing one account at the sum paid-in will not suffice. The asset Subscriptions account must be shown at the "cost or market" value, if it is a current asset, or at cost with the market value in parenthesis if a fixed asset. The unpaid balance must be set up in full as a current liability, assuming, of course, that the debt is current. 1

337. General Outline of Audit Procedure.--Leading auditors are agreed

1Treasury stock is NOT an asset but an offset to the capital stock account. If carried as an asset, BOTH the number of shares and the market value thereof MUST BE GIVEN, provided it is not carried at market. Furthermore, in most states it is illegal to acquire treasury stock unless there is ample surplus and unless the creditors are uninjured thereby. Hence it is advisable, according to some auditors, to charge surplus and credit an appropriated reserve for an amount equal to the cost. Some others prefer to deduct at cost the treasury stock from the surplus in order to prevent purchases in excess of surplus. The writer does not recommend either procedure.

Furthermore, the Court (in Western and Southern Fire Insurance Co. v. Murphy, 56 Oklahoma 702, 156 Pac. 685) said: "We are of opinion; (1) that under section 1286, supra, which grants to a corporation the privilege of purchasing its own stock from surplus profits, it is immaterial whether the surplus is obtained from the stockholders or earnings, and so long as the surplus exceeds the amount the company is bound to retain as capital, together with a sum sufficient to cover its debts and liabilities, such surplus profits may properly be used for the retirement of its stock, the term 'surplus profits' implying the difference over and above the capital stock, debts and liabilities, no matter how created; and (2) that the evidence was sufficient to warrant the court in finding that the company in the instant case had a fund of $30,000 surplus with which to retire the MURPHEY stock."
that the correctness of the balances in security accounts must be verified. This means that the auditor must prove that the debits and credits in the accounts are proper and correct in amount, and that he must ascertain what securities and the number thereof which are represented by the balance. In addition to this, the auditor must account for these securities themselves. To be certain, in bank and brokerage house audits it is customary in a strict balance sheet audit to account only for the securities as shown by the final balances of the accounts without a complete analysis of them for the entire year, but this procedure is not adequate in other dissimilar circumstances where the entries are not voluminous (Plate 102). In a detailed audit, all or most of the entries in the account must be verified, whereas in a balance sheet audit sufficient testing must be done to make certain that the checking covers all of the items contained in the final balance.

338. See Plate 104.

339. Analyzing the Account.—The above procedure is at variance with that of many auditors who account for securities as shown by the sub-ledgers without verifying the accuracy of their valuation or of their quantity. Moreover, inexperienced auditors will check securities against any list given them. If the securities agree with the list, they accept everything as being correct as long as the total valuation on that list checks with the ledger account balance. As a matter of fact, the securities presented for examination and as shown by the list could be entirely different from those called for by the books of account. And certainly, the books might call, for example, for 155 Cotton Products Corporation 7% Preferred Shares, whereas the list might call for only 154 of them. Then too, nothing whatever has been done to prove the correctness of the valuation of these securities.

The debits to the account must always be supported by proper vouchers. Commission on purchases, it will be recalled, is a permissible charge to the account, but accrued interest or dividends, if any, must be charged to the interest income account and to the dividends received account respectively. If stock dividends are received, the account must not be increased in value, because the new stocks do not cost anything. But care must be taken to make a memorandum in the account, and thus account for those new shares. (Moreover, in this connection, the auditor may be called upon to prove to the client that all that has happened is that more pieces of paper, called shares, have been issued against the same identical amount of corporate networth represented formerly by the lesser number of shares.)

If rights are exercised, the subscription price is a proper debit to the account as when, for example, a share of stock may be secured for 10 rights plus $100.00.

Credits to the Investment account and all entries to the Profit and Loss on the Sale of Securities account ought also to be checked against sales invoices. If a circumstance is such that no invoice was secured, the auditor must check the price received against quotations on that day in order to see that there is no fraud. Cases are known where the reported cash received from sales of securities, as shown by the cash book, has been so much less than current quotations as to clearly indicate fraud.

The credits to the account should, of course, be at cost, the profit or loss on the transaction going to an account such as Profit and Loss on Sales of Securities. If there were several unidentifiable purchases, the sale should be treated as being made from the earliest purchases.

The rule for ascertaining the credit to the security account for the
The entries in the account were audited against brokers' invoices, etc. for the entire year and found to be correct. The securities were seen on 1/2/30 at about 9:15 A.M. in the presence of Mr. P. Robertson at the 3d Nat'l. Those held by the 1st Nat'l Bank have been confirmed by letter (Al-a).

The receipt of dividends and interest was checked out for the entire year.

# Not listed on the Providence, R.I. Exchange. Quotation received over the phone from Strauss & Rose, Inc. on 1/2/30. SFP

336. Explanation and Comments.—This exhibit is one illustrative of the type where it was possible, because of the fewness of the entries, to show all of the details of the year's transactions.

It should be noted that since the examination took place on January 2d, there were no transactions to be accounted for after December 31st. If the examination had taken place on say February 19th, the auditor would have developed the schedule to that date.

Note that the profit and loss on the sale of securities is often developed in a security schedule. Observe also that it is definitely indicated how each security was verified.

As the securities were to be classified on the balance sheet under current assets, it was necessary to adjust the cost value to a cost or market, whichever the lower, basis. The Reserve for Reduction of Securities to Cost or Market account brought this about, requiring a credit balance of $3,690.00. As there was a reserve of $12,302.00 already on the books, it was necessary to reduce it by the sum of $3,412.00 in auditor's adjustment #29. But note that although there was such an account in the general ledger, nevertheless, it was not shown as such on the balance sheet.
<table>
<thead>
<tr>
<th>Book Balance</th>
<th>Changes in Balance 1929</th>
<th>12/31/29</th>
<th>12/31/29</th>
<th>Market Profit</th>
<th>How Verified on Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/29 Units</td>
<td>Cost</td>
<td>Units Par</td>
<td>Cost</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7387.00</td>
<td>10 492.47R</td>
<td>40 7000</td>
<td>6894.53</td>
<td>7140.00</td>
<td>17.53                Seen</td>
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<tr>
<td>10050.00</td>
<td>100 1000</td>
<td>10050.00</td>
<td>9500.00</td>
<td></td>
<td>Al-a</td>
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<tr>
<td>3455.00</td>
<td>75 .3750</td>
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<tr>
<td>102180.00</td>
<td>50 51090.00R</td>
<td>50 50000</td>
<td>51090.00</td>
<td>50500.00</td>
<td>(1617.00) Seen</td>
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<tr>
<td>171800.00</td>
<td>170 170000</td>
<td>171800.00</td>
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**294872.00**

<table>
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<tr>
<th>O.K.</th>
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<th>400</th>
<th>40000</th>
<th>40000.00</th>
<th>36000.00</th>
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<td>51050.00</td>
<td>50</td>
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</tbody>
</table>

**294872.00**

| O.K. per | 33957.53 | 330750 | 334339.53 | 305687.50 | (1799.47) |
| G/L per  | G/L      |       | G/L       | G/L       |          |

<table>
<thead>
<tr>
<th>G/L</th>
<th>Reserve</th>
<th>Reserve</th>
<th>Adjustment</th>
</tr>
</thead>
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<tr>
<td></td>
<td>1929</td>
<td>1928</td>
<td>1929</td>
</tr>
<tr>
<td>Corcoran Mfg Corp.</td>
<td>10050.00</td>
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<td>Jordan &amp; Keyes</td>
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<td>50500.00</td>
<td>590.00</td>
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<tr>
<td>Packard Tar</td>
<td>171800.00</td>
<td>168300.00</td>
<td>3500.00</td>
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<tr>
<td>Williams &amp; Crawford</td>
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<tr>
<td>Baker Hardware</td>
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<tr>
<td>Totals</td>
<td>323990.00</td>
<td>315100.00</td>
<td>6890.00</td>
</tr>
</tbody>
</table>

**Adjust. # 29**

(BALANCE SHEET)

MARKETABLE SECURITIES at "cost or market" (Market $325000):
Pledged against $150000 Notes Payable - Banks $178100.00
Free $147349.53 $325449.53

CHECK:
Cost as above 334539.53
Less Reserve 8890.00 325449.53
sale of rights is explained in Regulations 74 as follows: 1

Art. 66 Sale of Stock and Rights.—If the shareholder does not exercise, but sells his rights to subscribe, the cost or other basis of the stock in respect of which the rights are issued shall be appointed between the rights and the stock in proportion to the respective values thereof at the time the rights are issued, and the basis for determining gain or loss from the sale of a right on one hand or a share of stock on the other will be the quotient of the cost or other basis assigned to the rights or the stock, divided; as the case may be, by the number of rights issued or by the number of shares held.

Example.— A taxpayer in 1927 purchased 500 shares of stock at $125 a share, and in 1928, by reason of the ownership of such stock, received 500 rights entitling him to subscribe to 100 additional shares at $100 a share. Upon the issuance of the rights each of the shares of stock in respect of which the rights were issued had a fair market value of $120, and the rights had a fair market value of $3 each. Instead of subscribing to the additional shares, A sold the rights at $4 each. The profit is computed as follows:

$125

500 (shares) X $125 equals $62,500, cost of old stock (stock in respect of which the rights were issued)
500 (shares) X $120 " $60,000, market value of old stock
500 (rights) X $3 " $1,500, market value of rights
60,000 of $62,500 equals $60,975.61, cost of old stock apportioned to such stock after issuance of rights
61,500

1,500 of $62,500 equals $1,524.39, cost of old stock apportioned to rights
61,500

$2,000 (proceeds of sale of rights) less $1,524.39 (cost of old stock apportioned to rights) equals $475.61, profit

For the purpose of determining the gain or loss from the subsequent sale of the stock in respect of which the rights were issued, the adjusted cost of each share is $121.95—that is, $60,975.61 divided by 500.

(2) If the shareholder exercises his rights to subscribe, the basis for determining gain or loss from a subsequent sale of a share of the stock in respect of which the rights were issued shall be determined as in paragraph (1). The basis for determining gain or loss from a subsequent sale of a share of the stock obtained through exercising the rights shall be determined by dividing the part of the cost or other basis of the old shares assigned to the rights, plus the subscription price of the new shares, by the number of new shares obtained.

Example: A taxpayer in 1927 purchased 500 shares of stock at $125 a share, and in 1928, by reason of the ownership of such stock, received 500 rights entitling him to subscribe to 100 additional shares at $100 a share. Upon the issuance of the rights each of the shares of stock in respect of which the rights were issued had a fair market value of $120, and the rights had a fair market value of $3 each. The taxpayer exercised his rights to subscribe to the additional shares and later sold one of such shares for $140. The profit is computed as follows:

$1,524.39 (cost of old stock apportioned to rights pursuant to the computation in the example under paragraph (1) plus $10,000 (subscription price of additional shares) equals $11,524.39, basis for determining gain or loss from sale of additional shares.

$11,524.39 divided by 100 equals $115.24, basis for determining

1 As a rule the income tax methods of determining cost of sales of securities in special cases, exchanges, and conversions is satisfactory accounting procedure.
gain or loss from sale of each share of additional stock
$140 (proceeds of sale of share of additional stock) less $115.24
equals $24.76, profit.

The basis for determining the gain or loss from subsequent sale of
the stock in respect of which the rights were issued is $60,975.61 divided
by 500, or $121.95 a share.

If the stock in respect of which the rights are issued was purchased
at different times and at different prices and the identity of the lots can
not be determined, or if the stock in respect of which the rights are
issued was purchased at different times and at different prices and the
stock rights issued in respect of such stock can not be identified as having
been issued in respect of any particular lot of such stock, the basis for
determining the gain or loss from the sale of the old shares or the rights
in cases where the rights are sold or from the sale of the old or new shares
in cases where the rights are exercised, shall be ascertained in accordance
with the principles laid down in article 600.

The taxpayer may at his option include the entire proceeds from the
sale of stock rights in gross income, in which case the basis for determi-
ning gain or loss from the subsequent sale of the stock in respect of which
the rights were issued shall be the same as though the rights had not been
issued.

Another common method in which neither the market price of a right
nor the cost of the original shares has to be known (nor is given consider-
ation if known) is as follows:

ILLUSTRATION

(Assumptions)

500 shares owned
Market price per share $123 (rights on)
5 rights required plus $100 for each new share purchased

SOLUTION

500 shares at $123 (rights on) $61,500
100 " " $100 10,000
600 $71,500

$71,500 divided by 600 equals $119.17, i.e. the new market Value of 1 share
after the new stock has been issued.

Since the subscription price is $100 per share, a person can afford to pay
$19.17 for 5 rights, i.e. he can pay $3.84 for each right. Therefore the
account must be credited with $3.84 for each right sold, the difference re-
ceived being profit or loss.

Still another method for determining the value of a right is as
follows:

ILLUSTRATION

(Assumptions)

(1) (M) Market Value of stock-rights on-- $123
(2) (S) Subscription price $100
(3) (N) 5 rights required for the purchase of each new share
340. Simultaneous Count of All Securities.—A prime essential in the verification of securities is to account for all of the securities of all types at the same time in order to prevent seeing the same securities twice, and in order that some of the securities already examined may not be pledged against securities borrowed to make a shortage good. For example, if on January 18 an auditor were to examine the securities in one fund, and then on January 21 examine the securities in another fund, a shortage in the second fund could be covered up as follows. As soon as the securities in the first fund have been examined on the eighteenth, the defaulter could take them and pledge them against the securities to be borrowed to complete those called for by the second fund. As the examination of the second fund is made three days later (on January 21st), there has been ample time for the defaulter to carry out this scheme. In an endeavor to condone the lax practice of not verifying all securities simultaneously, some auditors point out that such a manipulation of securities, as just cited, is hard to effect since the defaulter does not know which fund is going to be audited first. But the point is that the auditor need not assume ANY risk if he adopts an adequate procedure. Moreover, the auditor can not afford to risk the destruction of his hard earned reputation as an efficient auditor by not doing what is clearly the better auditing procedure; namely, to account for all securities simultaneously. As a matter of fact, a clever defrauder generally gets, in one way or another, the auditor to examine first whatever fund he may desire. He may say to the auditor, for example, "I am going down near the First National Bank to-day on business. What do you say to counting those securities there? If you don't, the gods only know when you'll get another chance." Is there any doubt but what the auditor will go along?

If the securities are too numerous1 to be brought to one point or indeed to any reasonable number of places, as in the case of banks, stock brokerage houses, and the like, it may be necessary to seal vaults or deposit boxes. But effective methods of control of some sort must be exercised, no matter what the procedure may require. Moreover, the records must also be kept under control until the job is completed.

Finally, if the business holds securities for employees, or as collateral, or for any other reason, these also must be accounted for by being brought for inspection to the same place and at the same time as the other securities.

(See Appendix C, Sec.7-#4,#5)

341. Simultaneous Verification of Cash and Securities.—As stated in the discussion of the proper auditing of cash, the securities should be accounted for as of the same date as cash, in order to prevent the substitution of one for the other. Suppose, for illustration, that the securities are accounted for by the auditor as of January 12 and then released. These securities could then be sold or pledged and the money so secured could be deposited to make good a shortage (no entry for this shortage being made in the Cash Receipts book until now) by the time the auditor

---

1When the securities are numerous, the auditors should work in pairs, one examining the securities, the other checking the information as it is called off. Care must be taken to give the EXACT description of the security examined. Thus the Fordson & Edison, 7% Cum. Preferred - class A stock is an altogether different security than the Fordson & Edison Cum.
got around to checking up on the cash as of say January 16\textsuperscript{1} Or the de-
frauder, if he knows that the auditor will bring the audit only to the end
of the fiscal period, here December 31—, will sell or pledge the securi-
ties just before then. The cash balance will, therefore, agree with the
Cash Book balance, and, as the securities will be redeemed on January 1st
or 2d, they will be on hand for the auditor to count in January as of
December 31st.

342. The defaulter in pledging securities for other securities in
the above manner incurs no risk of detection by way of endorsement provided
he gives a power of attorney, which can be destroyed when the securities
are redeemed.

Of course, if the manipulator is crude, he will probably endorse the
securities in blank (Plate 105). In such cases the auditor on noticing the
endorsement in blank should be suspicious, because there is ordinarily no
reason why the securities should have been endorsed at all since they are
supposed to lie in the vault untouched.

If any security is not in the name of the client, it should be sent
to the corporation for transfer (security brokers etc. excepted). On rare
occasions it may be necessary to get the endorsement of the former owner
before this can be done, or on other occasions, it may be necessary to
change the endorsement from bearer to the client's name, because the nego-
tiable character of securities makes an endorsement to bearer risky in
case of loss or theft. Likewise, in the case of bonds, registered either
as to principal or as to principal and interest, the auditor must make
certain that they stand on the payee's books in the name of the client.

If there are treasury stocks, these should be in the name of the
company, or possibly in the name of the treasurer, as treasurer.

343. See Plate 105.

344. See Plate 106.

345. Genuineness.—All stock certificates should be examined to see
that they have been signed under seal by officers of the issuing corpora-
tion, by the registrar, and by the transfer agent, if the stock provides
places for their signatures (Plate 106). In the case of bonds (Plate 107),
these should be signed by the issuing corporation under seal and by the
trustee if a place for its signature is provided.

(Of course, in some instances test and scrutiny is adequately
sufficient.)

346. See Plate 107.

347. See Plate 108.

348. Coupons.—On examining coupon bonds, the auditor must make
certain that all of the coupons are attached. Indeed, in a long term bond,
the coupons (Plate 108) may be worth more than the bond. Of course, in
the case of a large audit, as for example an estate, university, bank, or
(cont'd) Preferred—class B stock. Furthermore, the auditor should realize
that it is never safe to count a package of securities by taking the differ-
ence between the opening and closing numbers; each security should be ex-
amined separately. Of course, the practical requirements of a situation may
induce an auditor to use this procedure, but in using it, he should realize
that "the risk is his". This assumes that this auditor brings his audit
right up to the day of his examination of the securities and the cash, i.e.
on January 12th and 16th respectively. Obviously, he should audit both ac-
counts as of the 12th. \textsuperscript{1}In the case of fully registered bonds, the last
EXPLANATION OF PLATE 105

FACE CONTENTS OF A PAR VALUE COMMON STOCK CERTIFICATE

343. Explanation and Comments.—The reader should realize that this plate gives only the contents of a stock certificate, whereas a certificate is usually (but not necessarily) engraved and embellished in such a manner as to prevent alterations, forgeries, photographing, etc., and in order to make it attractive by the very nature of the excellence of its design and workmanship. Stock Exchanges require engraved certificates of a type conforming to their "rules and regulations."

Note that the corporation, itself, is acting as the sole transfer agent, whereas it has secured The Slater Bank of Woburn, Conn. to act as the registrar. This plan is often adopted by corporations whose stock is not very active. In such instances the company feels that it can handle the clerical work of transferring with sufficient dispatch, and that its office is satisfactorily located for such work. On the other hand, the corporation, feeling the necessity of assuring the investing public that the outstanding shares do not exceed the authorized amount, has secured a bank to be the registrar (i.e. to certify to this fact).
THE FACE CONTENTS OF A PAR VALUE COMMON STOCK CERTIFICATE PLATE 105

Incorporated under the Laws of the State of Connecticut

Number 89 Shares 5

THE JORDAN MANUFACTURING COMPANY
COMMON STOCK

This Certifies that--- Mrs. Ethel W. Burroughs --- is the owner of --- Five --- Fully paid and non-assessable shares of the par value of Twenty-Five (25) Dollars each of THE COMMON CAPITAL STOCK of The Jordan Manufacturing Company of Woburn, Conn. transferable upon the books of the Company in person or by duly authorized attorney upon the surrender of this certificate properly endorsed. This certificate and the shares represented hereby are subject to the laws of the State of Connecticut and to the agreement of association and by-laws of the Company a copy of which is on file with the Transfer Agent, and the clauses of the agreement of association printed on the back of this certificate are made a part hereof. This certificate is not valid until countersigned by the Transfer Agent and registered by the Registrar.

In Witness Whereof The Jordan Manufacturing Company has caused its corporate seal to be hereunto affixed and this certificate to be signed by its duly authorized offices on August 17, 1929.

Karl Worcester Henry Thorndyke
Assistant Treasurer Vice-President

Counterstamped:

The Jordan Manufacturing
Transfer Agent

By:

The Slater Bank of Woburn, Conn.
Registrar

By:

Cashier

(SEAL)

(Face)
THE REVERSE SIDE OF A STOCK CERTIFICATE PLATE 106
(Transfer Section)

For Value Received ________________ hereby sell, assign, and transfer unto: __________________________

Shares of the Capital Stock represented by the within Certificate, and do hereby irrevocably constitute and appoint ____________________________

to transfer the said Stock on the books of the within named Corporation with full power of substitution in the premises.

Dated ___________ 19___

In the presence of ____________________________

By ____________________________

Notice: The signature of this assignment must correspond with the name as written upon the face of the certificate in every particular without alteration or enlargement or any change whatever.

344. Explanation and Comments. -- In auditing securities, the auditor must ascertain that stocks stand in the name of the client, or that the one whose name is on the face of the certificate has signed the transfer section (this plate) to bearer or to the client specifically, or that the client has a power of attorney from this person. Furthermore, whenever the stock is not made out in the name of the client, the auditor should see to it that the stock is sent in for transferring, in order that the client may become the stockholder of record and thereby get the dividends.

Whenever the client's name appears on the face of the certificate, the transfer section ought not to be signed. If it is signed, the auditor should assume that it has been used as collateral. The auditor should then get the facts from the client, always keeping in mind the possibility of its having been pledged as part of a manipulation to make good a shortage in cash or securities. Moreover, the auditor should point out to the client the real danger involved in leaving the transfer signed when the pledged stock is released.
stock brokerage house, this examination is naturally limited to tests. If the bonds are registered as to interest, there are no coupons.

349. The Client's Representative.—On all occasions the auditor must insist that a representative of the client be present throughout the examination of the securities. Several cases are on record where the auditor has been accused by the defaulter of causing the shortage in the securities, by giving them to the auditor while he was alone. The writer considers this word of caution of paramount importance to novices.

In addition to this precaution, many auditing firms insist that their working papers bear the signature of the representative, attesting to the fact that all securities were returned to him. At times this is a good precaution for the auditor to take. It costs him nothing except, perhaps, the scorn of certain fellow auditors of the type who "know it all."

350. See Plate 109.

351. See Plate 110.

352. Accounting for Numbers.—If certain securities ought to remain unchanged from one period to the other, the auditor should take their numbers as a means of seeing that those identical securities are actually presented to him on each occasion. A clue to a manipulation might thus be secured, if the auditor found that different securities were on hand. But other than for this or a similar reason, the security numbers need not occupy the auditor's attention.

353. Assessments.—If stock payable in installments (if the state permits the issuing of stock, e.g. Massachusetts, before it is fully paid for, the stock itself will state this fact) has been subscribed to, the original amount to be paid may be set up as an asset with the amount yet to be paid recorded as a liability. A second way to record those facts is simply to note above the account the original amount to be paid, and to charge to the account only the amounts which are paid. Either method is ordinarily as acceptable as the other one, but if the stock is being held as a permanent investment and if the amounts yet to be paid are considerable and payable within a few months hence, the first method is preferable. The first method is also preferable whenever the market value becomes less than the subscription price. Thus, suppose that a temporary investment 1000 shares have been subscribed to at $100,000, and that $70,000 has been paid on account, the balance being due six months from the audit date. If the market value of these shares (fully paid) drops to $85,000 at the audit date, the account is often stated either at $55,000 (i.e. $85,000 (market) minus $30,000 (payments still due) or at $85,000 with a current liability of $30,000. In the writer's opinion the latter method must be used.

Stock carried on margin ought to be set up as an asset at the purchase price with the amount due to the broker recorded as a liability.

354. Receipts in Liquidation.—If a stock is being liquidated, payments thereon may be noted on the stock, but as a rule inquiry (if the liquidation has come to the auditor's attention) will have to be made of the client. The facts should then be ascertained from independent sources, and if necessary the account should be adjusted to a reduced value, or a parenthetical note on the balance sheet may be in order, if the sums to be received bid fair to exceed the value in the account. (cont'd) Interest payment should be indorsed thereon.
EXPLANATION OF PLATE 107

THE FACE CONTENTS OF A NO-PAR-VALUE COMMON STOCK CERTIFICATE

346. Explanation and Comments.—From the text, the reader should recall that the auditor should examine stock certificates for genuineness. Note that this particular certificate must be signed by a registrar and by a transfer agent in addition to two corporate officers. In some instances the registrar and the transfer agent are the same bank or trust company; but they are not in this instance. The function of the transfer agent is, of course, to transfer the stock (i.e., it performs the clerical work involved in cancelling the old shares and in issuing the new ones. Moreover, to facilitate this transferring of shares from one owner to another, many corporations, particularly those having a large turnover of stockholders, employ a bank in city of the Exchange where the security is listed to act as transfer agent), whereas the function of the registrar is to assure the public by certification that the corporation has not issued any shares in excess of its authorized amount. Clearly then, the function of the registrar is far more important than that of the transfer agent. In fact many corporations act as their sole transfer agent, but pay a bank or trust company to act as their registrar. Of course, a corporation does not have to have (unless required by the Exchange, if a listed security) a transfer agent or a registrar.

The reader should remember that a stock is generally an engraved and embellished certificate. Generally speaking, there is no law requiring certificates, but Exchanges require it if the stock is to be listed there. Thus the Boston Stock Exchange has the following regulation. "The face of every Bond, Coupon, or Certificate of Stock must be printed from steel plates which have been engraved in the best manner with such varieties of work as will afford the greatest security against counterfeiting."

"For each document or instrument there must be at least two steel plates, viz.: A tint plate from which will be printed an anti-photographic color, so arranged as to underlie important portions of the face printing, and a face plate containing the vignettes and lettering of the descriptive or promissory portion of the document, to be printed in black, or in black mixed with a color.

"These two printings must be so made upon the paper that the combined effect of the whole, if photographed, would be a confused mass of lines and forms, and to effectually secure against counterfeiting by scientific or other processes; and the imprint of each denomination of Bonds shall be of such distinctive appearance and color as to make it readily distinguishable from other denominations and issues."

"This above rule includes certificates of deposit."

"In certificates for 100 shares, the figures must be engraved upon their face, and certificates for less than 100 shares must be printed in a different color and the words "certificate for less than 100 shares" must be engraved upon the face.

"Certificates for less than 100 shares shall bear a printed statement on the reverse side, directly back of the column of tens and units, to the effect that the space must not be covered in any way."

Exchanges generally require that the registrar be a different party than the transfer agent.
THE FACE CONTENTS OF A NO-PAR-VALUE COMMON STOCK CERTIFICATE PLATE 107

Incorporated Under The Laws of the State of Texas

Number 705 Shares 49

THE CLARKSON SPOOL CORPORATION
of Pawtucket, California
NO-PAR-VALUE COMMON

This is to Certify that—___.—_ Arthur Baxter —— — — — — — — — — — is the owner of —— — — — — Forty Nine —— — — — — — — — —— fully paid and non-assessable shares without nominal or Par Value of the capital stock of The Clarkson Spool Corporation (herein called "Corporation"), transferable on the books of the Corporation in person, or by duly authorized attorney, upon surrender of this Certificate, properly endorsed. This certificate is not valid until countersigned by the Transfer Agent and registered by the Registrar.

In Witness Whereof, the Corporation has Caused its seal to be hereunto affixed, and this Certificate to be signed by its duly authorized officers.

Milton Wrightman —__— Assistant Sec'y

John English —__— Vice-President

Countersigned - Transfer Agent
The Third National Bank
Fresno, California

By —__— Secretary

Registered:
The Second National Bank
Fresno, California

By —__— Assistant Cashier

(SEAL)
EXPLANATION OF PLATE 108

THE FACE CONTENTS OF A BOND

PUGET MANUFACTURING COMPANY

347. Explanation and Comments.-- The reader should keep in mind that only the contents of a bond (not a reproduction) is given in this exhibit. Ordinarily, bonds are engraved and highly embellished documents.

The reader should study the contents of this sample bond, noting particularly (1) that reference is made to a mortgage and deed of trust under which the trustees are issuing the bonds through the corporation; (2) that the bond may be registered as to principal but not to interest; (3) that the bond is signed under seal by two officers of the corporation; and (4) that the trustee's certificate is on the cover.

At this point it seems desirable to repeat that in an examination of bonds, the auditor should see that: (1) if the security is registered, it is either in the name of the client or endorsed in blank or accompanied by a power of attorney authorizing a transfer; (2) if the bond bears coupons, all the unmatured ones are attached beginning with the coupon bearing the date of the next interest payment; (3) the bonds appear genuine, and are properly signed under seal by the corporate officers, and bond trustee, if any; and (4) in case of some few real estate mortgage bonds not issued under a bond trustee, there should be present certain documents such as: (a) the mortgage, which must be properly recorded, showing the book and page number on which it is recorded in the county record. (b) the insurance policies, which should adequately cover the mortgaged property, and be made out in the name of the mortgagor (the client); (c) the tax receipts—not the tax bill unless, of course, it bears a proper payment stamp; and (d) the guaranteed title policy, which should tally with the description of the property as given in the mortgage deed.
Number
F64250

PUGET MANUFACTURING COMPANY

$1000
First Mortgage Thirty Year Gold Bonds
Per 5 Cent
Due October 15, 1954
Interest Payable
April 15 and October 15
Principal and Interest Payable
at the office of
CHACE TRUST AND SAVINGS BANK
in the city of
New York, New York
or at the Office or Agency of the Company
in the city of
New York, New York

TRUSTEE'S CERTIFICATE
This bond is one of the coupon bonds referred
to in the within mentioned indenture
CHACE TRUST AND SAVINGS BANK
Trustee

By
Parker H. Norman
Vice President

The United States Revenue Tax on this bond has
been paid and stamps have been affixed to the
trust agreement under which it was issued and
duly cancelled.

(Continued)
First Mortgage Thirty Year Five Per Cent Gold Bonds

The Puget Manufacturing Company (hereinafter called the company, for value received hereof) promises to pay to the bearer, or if registered, to the registered holder of this bond, the sum of one thousand dollars ($1,000) in gold coin of the United States of America, or equal to the present standard of weight and fineness, on the fifteenth day of October, 1954, at the agency of the company in the Borough of Manhattan in the City of New York, and to pay interest thereon at the rate of five per cent from October 15, 1924, payable semiannually at said agency, or at the office of the Chase Trust and Savings Bank in the City of New York, as the coupon holder may elect, in like gold coin, on the fifteenth day of April and the fifteenth day of October in each year, but only upon the presentation and surrender as they severally mature of the coupons therefor hereto annexed. Both the principal and interest of this bond are payable without deduction for any tax or taxes, assessments or other governmental charges which the company may be required to pay thereon or to deduct or retain therefrom under any present or future law of the United States, or of any State, County, Municipality or other taxing authority therein.

This bond is one of an issue of bonds of the company, known as its First Mortgage Thirty Year Five Per Cent Gold Bonds, limited to the principal amount of $25,000,000 all of like tenor, date, and amount, numbered from 1 consecutively upwards, and all issued and to be issued under and equally secured by a mortgage and deed of trust dated October 15, 1924, executed by the company to Chase Trust and Savings Bank and Walter G. Marvel as Trustees. For a description of the properties and franchises mortgaged and the securities pledged, the nature and extent of the security, the rights of the holders of the bonds and the terms and conditions upon which the bonds are, and are to be, issued and secured, reference is made to said mortgage and deed of trust, to all of the provisions of which the holder hereof, by the acceptance of this bond, assents.

This bond shall pass by delivery, unless registered in the name of the owner on the books of the company, such registry being noted on the bond by the company, and after such registration, fully noted hereon, no transfer shall be valid unless made on the said books by the registered owner in person or by his attorney, duly authorized, and similarly noted by the company hereon but the same may be discharged from registration by being in like manner transferred to bearer, and thereupon transferability by delivery shall be restored. The registration of this bond shall not affect the negotiability of the coupons, which shall continue to be transferable by delivery.

No recourse shall be had for the payment of the principal or the interest of this bond or for any part thereof or for any claim thereon or otherwise in respect thereof, or of said mortgage and deed of trust against any incorporator, stockholder, officer or director, past, present or future, of the company, whether by virtue of any statute or by the enforcement of any assessment or penalty or otherwise, all such liability being, by the acceptance hereof, and as part of the consideration of the issue hereof, expressly released.

This bond shall not be valid or become obligatory for any purpose unless authenticated by the certificate hereon endorsed of the Chase Trust and Savings Bank, or its successor in the trust.

In witness whereof, the Puget Manufacturing Company has caused this bond to be signed in its corporate name by its President and its seal to be hereunto affixed, duly attested by its Secretary and the coupons for said interest, with engraved signature of its Treasurer, to be attached hereto, this fifteenth day of October, 1924.

Attested by:

_Earl S. Jordan_  
SEAL  

Puget Manufacturing Company  
By Ross K. Hadley  
President
On the fifteenth day of May 1929, the Rome Manufacturing Company will pay to the bearer at the agency of the company in the Borough of Manhattan in the City of New York, or at the Office of the Oxford Trust and Savings Bank, in the City of New York, as the bearer may elect, Twenty-five Dollars in United States Gold Coin, being six months' interest then to become due on its First Mortgage Forty Year Five Per Cent Gold Bond No. F71097 unless said bond shall have been called for previous redemption.

356. Explanation and Comments.—As stated in the text, the coupons of a bond must be accounted for at least to the extent of a reasonable test; first, because coupons are negotiable, and second, because the total value of the coupons is often more than that of the bond itself (i.e. the present value of the coupons is often greater than the present value of the principal).

Note that the $25 (and the principal also) is payable in gold coin. At times this provision is a very valuable one to the investor, and it may become a decidedly detrimental one to the corporation. For example, during and after the World War many German corporations which had guaranteed their bond payments in gold had to default on them due to the great scarcity of gold. As a result, these corporations were either sold to satisfy the bondholders, or the bondholders took over the corporations outright, or the stockholders' holdings were scaled down tremendously in favor of the bondholders. If, however, the bond payments had not been specified in gold, these corporations might have continued unembarrassed, and the bondholders would have been the losers by reason of their receipt of payment in greatly depreciated paper money.
A SCHEDULE OF SECURITIES (8th type) PLATE 110

THE DINGWELL COMPANY, INC.
Securities Held for Temporary Investment
Audit for the Year Ending Dec. 31, 1930

Jan. 17 From Ralph Poffit & Co. Vo. 1-181
#100 sh of Stanley Corp. 1st pfd 7's Par $100 at 125 12500.00
Ctf #7183 Commission 25
Market $11900.00 12525.00

Sept. 8 From Caldwell Bros. Vo. 9 - 462
17 Jeffers & Crawford, Inc. at 96 Par $1000 16660.00
1st mtg 7's Int and S1 dated 1901 due 1951
#B16143 - 59 Commission 21.25
Market $16745.00 16681.25

Sept. 12 From Ralph Poffit & Co. Vo. 9 - 665
25 Arnold Bakery Corp. at 103 Par $100 25750.00
1st mtg gold 7's Int J1 and J1 dated 1916 due 1948
#A 413 - 37 Commission 31.25
Market $26000.00 25781.25

Dec. 19 From Morrison and Hurry, Inc. Co. 12-532
100 sh at 95-Par $50 Smith & Lucas Co. 9500.00
1st Pfd. 6% Ctf #530 Commission 20.00
Market $9500.00 9520.00
Balance per G/L Total Market $64145.00 64507.50
(To B/S)

Audit Procedure

The securities were counted on Jan. 2d at the Equitable Trust and
Guaranty Co. at about 10:30 A.M. in the presence of Mr. Cochran, Trans.
Coupons, Endorsements, Signatures, etc. were O.K.
The security account was verified against invoices from brokers for
the entire year. No change 12/31/30 - 1/2/31
Interest and dividends have been properly accounted for.
No adjustment of the premium or discount on the bonds is necessary
because the securities are being held as temporary investments.
Due to constant fluctuations of the market, the securities are to be
shown as follows:

Balance Sheet Presentation
 Marketable Securities at Cost (market $64145.00) . . . $64507.50

351. Explanation and Comments.-- This plate illustrates a very
simple schedule. A complicated exhibit could have been drawn up, but
the fowness of the transactions lends itself better to this simple
 treatment.
355. Confirmation of Securities.—Any securities which are not on hand because they are out for transfer, or are out for sale or exchange, or are out with a bank for safe keeping, or are out as security, etc., must be verified by direct correspondence (Plate 110) as of the date of accounting for the securities. Under no circumstances should this procedure be departed from even though the securities are on hand a day or two later than the date of count. Moreover, the auditor himself should mail the requests for confirmation after the client has written them. A cardinal point in the writing of a confirmation letter is to include therein a definite statement as to the purpose for which the securities are being held.

As to whether or not the client's letter should state to the holder what securities it is holding, and the reason therefor, is a matter of opinion. Some auditors feel that if the client's letter is silent on this point, the holder's reply is less subject to inaccuracies than if the client makes out the list for the holder to certify. However, the writer feels that the better method is for the client to prepare the list of securities and to state the reason why they are being held, in order that the auditor may be certain of getting all of the facts which he desires, and in order to facilitate the holder's task. In the case the letter is to a depositary, transfer agent, etc. (who receive countless requests annually), the client should prepare the list, if it expects to get a reply.

356. See Plate 111.

357. Schedules of Securities:—If the securities are numerous, the auditor ought to prepare his security schedules (or have them prepared to be checked by him) before examining the securities. This is a very important step for the auditor to take because of the time it takes (a representative of the client being on hand) to write down the facts, and because there is a great inconvenience and annoyance in having to examine and to write alternately. Furthermore, any special difficulties to be straightened out are then known in advance of the count.

As to what facts the schedules should contain, these are not definable abstractly. The various schedules presented in this chapter illustrate various types of schedules drawn up to meet sundry needs.

358. Comments on Location of Securities.—On small audits the auditor may find that the securities have not changed since the audit date and that all of them are on hand, but ordinarily this will not be the situation. Some securities will be on hand, some may be pledged, some may be out for collection, some may be in bank vaults for protection, some may be out for transfer or registration, and so on ad infinitum. And, of course, some of those securities which were on hand at the audit date may have been sold or may have matured. Also now ones are apt to have been bought.

1For example, A is short some securities but tells B, the auditor that they are with broker C, or else in the mail, as he (A) has telephoned to C to send them in. As the securities arrive the next day and are those called for by the books of account, the auditor (B) is satisfied, whereas in truth A had no securities with C but simply put through a HUSH order for these "duplicate" securities. Hence the securities are a brand new purchase, NOT those comprising the shortage. 2Thus it is customary in an audit of stock exchange houses and brokers to send the list of securities to the bank to be checked instead of asking the bank to prepare the list independently. 3When more than one auditor works on a security count, the Working Papers MUST show what part each one took; e.g., who examined and called off the securities and who checked the listed items.
A LETTER OF CONFIRMATION PLATE III

DIAMOND AND CURTIS
Certified Public Accountants

61 Myrtle Ave.,
Boston, California

January 11, 1930

The Equitable Trust Company,
711 Broadway,
Boston, California

Gentlemen:

Please advise US DIRECT if you held at December 31, 1929 and are now holding securities (detailed below) as collateral against notes payable (detailed below) given by The Hibler Lewis Corporation. Is this business otherwise directly or indirectly indebted to you, or has it any funds on deposit?

Approved __The Hibler, Lewis Corporation__
By __Thomas K. Hibler, Treas.____

Cordially yours,

Diamond and Curtis
By __P. F. Swanson__

Description of Collateral

10 M The Wilkinson, Davenport Corporation 1st Mtg. 6's dated 1901 due 1931
150 shares The Schroeder Print Works 7% 1st Preferred Par $100

Notes Payable

$40,000 dated August 27, 1929 due February 87, 1930, Interest prepaid at 4 1/4%.

366. Explanation and Comments.-- This exhibit is a request sent to a bank (where there was no cash balance) for confirmation of securities held against notes payable.

Note that the answer is to be sent direct to the auditors; that the approval of the client was secured so as to make certain that the request would be answered promptly; that the reason why the securities are being held is stated; and that an inquiry is made as to any other liabilities, either direct or indirect.
In brief, it is usually necessary to account for securities which are entirely different from those which were in existence as at the audit date, (and even all of these to be accounted for as of a date after the audit date will not be on hand) and to work back to the audit date. Those on hand will be checked against the schedule, and all others must be confirmed by the auditor.

359. See Plate 112.

360. **Call Loans.**—A call loan is a demand made to a broker against his deposit of collateral securities. Ordinarily such loans are made chiefly by banks to brokers dealing in very marketable securities, such as those listed on the New York Stock Exchange and/or the Exchanges of the principal cities. However, in 1929 when the stock speculation fever was at its frenzied height, many industries supplied brokers with call loans because of the extremely high rates of interest. Indeed millions on millions of dollars of "bootleg loans" were made to brokers in this manner. Businesses invariably found themselves in the unusual position of being able to make more money in this way than they could by using the same amount in the operation of their usual lines of activity.

If in the audit of an industry, the auditor should encounter the situation described above, he should count the securities, ascertain if their market value is sufficient to amply cover the loan, and verify them independently with the broker. In many cases, however, he will not find the securities on hand, as when the loans have been made in the New York call money market through a New York bank or brokerage house. In such instances, the auditor must secure an independent confirmation from the holder-agent.

361. See Plate 113.
(7) SECURITIES (temporary Investments)

These securities must be readily marketable, and the proceeds from their sale must be available, if necessary, for purposes effecting either current assets or liabilities.

(a) Have the client prepare a "list of all securities, notes, warehouse receipts and other negotiable instruments, whether owned or held as collateral". See that sufficient details are given. Check to the security ledger.

(b) Analyze and audit the security account up to the date of the audit. Test to security ledger. Be certain to see invoices for all purchases and sales. See directors' minutes for the sale of $1,000,000 Holton, Inc. bonds. See that accrued interest paid for does not get into the account again this year. If so, take the matter up with Mr. Rose. Watch out for the rights sold in Aug. 1929 on the Greenville Spool Cotton stock. Watch out for the stock dividend from C & R Co.

(c) Prepare the same type of schedule as schedule (3) in last year's working papers.

(d) Check the securities to the client's list and then to the schedule. Or check the client's list to the schedule and the securities against the schedule. Be certain to have a representative of the client on hand at all times. Have all securities brought together at one time. After being counted, do not release securities until everything checks out O.K. with the client's list. Coordinate with Cash Count. Secure representatives' signature.

(e) Bonds: Account for the coupons; if registered, see that the bonds are in the name of the client; trace a few interest items of your own choosing into the cash book; trace out the bond numbers taken off on our 1929 working sheet; compute the accrued interest to date; account for the treasury bonds; if the Futuro Glass Corp. bonds are still pledged, verify them and the amount of the bank loans, etc. Make certain that the bonds are actually the property of the client. Coupon bonds can be borrowed for use during the audit.

(f) Stocks: In the case of the installment stock of The Sunborno Corp., by correspondence the status of the stock; trace out a few dividends at random; see that the client is the stockholder of record on the face of the stock. Has the stock been endorsed? Why?
(7) (Continuation)

(g) See that the securities look regular in all respects.

(h) Securities in default must be classified separately at whatever value appears to be sound, with the market value, if ascertainable, given in parenthesis.

(i) Ascertain the market values and adjust, if necessary, the valuation reserve so as to carry the securities at cost or market whichever the lower. Disregard slight temporary variations of the market from cost. Recognize a lower market only if the trend is distinctly and permanently (for a few weeks) downward.

(j) If the market price is considerably above cost, show it in parenthesis.

(k) Keep in mind that a very large amount of stock can not be sold except at a substantial reduction from quoted prices.

(l) When there have been no recent sales, use the latest bid price (if recent), or possibly the average of the bid and asked prices.

(m) If a security is not listed, have Mr. Oldson prove to you that it is a current asset.

(n) See that rights (if any) are properly handled.

(o) See that stock dividends (if any) are properly handled.

(p) If there are stock subscriptions, place them among the class (temporary, permanent, controlled) of security with which the stocks or bonds will be placed when received. Set up any unpaid balance as a current liability.

(q) Do not treat treasury stocks or bonds as assets, unless client demands it. If so, both the number of shares (or par value of bonds) and the market value thereof must be given. Is the purchase legal?

(r) Record stock purchased or margin at cost with unpaid balance as a liability. Apply rule of cost or market, whichever the lower.

(s) Verify by correspondence all securities not on hand AS OF the date of accounting for the securities. Do NOT accept as the same thing the presence of the securities the next day.

(t) Why are the securities not on hand?

(u) In the case of collateral securities held, see that there is an accompanying power of attorney.

(v) Declared dividends on the Jones Standard Wheel Co. common stock (payable after audit date) may be taken up. Undeclared dividends on the S.T. Steel Co. guaranteed pfd stock must not be taken up.

(w) See that the security ledger is in agreement with the controlling account.

(8) SECURITIES (Investments)

(a) Do everything stated in #7 above if it is applicable.

(b) Carry the securities at cost, but show market or estimated value in parenthesis. If any securities can not possibly make a recovery in price, reduce their value to a conservative sum, assuming their actual value to the client is not equal to their present carrying value.
359. Explanation and Comments.—This plate shows a balance sheet audit program on temporary securities made out in considerable detail for a comparatively new junior auditor.

The sum and substance of this program is (1) that the account was to be analyzed very carefully; (2) that a duplicate of last year's schedule was to be drawn up; (3) that a representative of the client had to be present during the count and the securities had to be assembled at one point; (4) that the securities had to be carefully examined for genuineness, for coupons, and for registering; (5) that a few random tests were to be made for interest and dividends; (6) that the cost or market value was to be used on the balance sheet; (7) that certain items were to be verified by direct correspondence; (8) that treasury securities must be properly treated; (9) that certain bonds were to be traced by number; and (10) that certain items were to receive special attention.
1. In auditing an estate you are unable to find any invoices for securities sold. What would you do about it?

2. What requirements must a security meet in order to be classified as a current asset? What would its caption be in the balance sheet?

3. What is the difference between a Boston right and a Philadelphia right?

4. An auditor finds among the fixed investments, none of which are held for control of other companies, certain securities having a current maturity date. Is this a proper classification for these securities?

5. Why is it necessary to analyze and vouch the security account? To what extent would you do it in a balance sheet audit? In a detailed audit?

6. Under what main caption would you list securities held for control over other companies? Where would you place it in the balance sheet?

7. Why should the market value or estimated value of fixed investments be shown parenthetically on the balance sheet?

8. The market value of a share of stock (right on) is $114. The subscription price to a new share is $100 plus 5 rights. What is a fair price for a right?

9. How would you write the balance sheet caption for some fixed investments which have been pledged against notes discounted at the bank?

10. A stock dividend is received by a client. What entry would you advise his bookkeeper to make? (a) If par value stock. (b) If no-par-value stock.

11. Classify securities into main groups for presentation on the balance sheet.

12. Where in the balance sheet would you place advances to subsidiaries? Why?

13. What precautions would you use in determining the market value of a security as of the audit date?

14. Why is INTENTION the key note in valuing permanent investments?

15. You are given the following list of securities against which to check the securities handed you. The securities tally with the list and the total valuation on the list agrees with the balance in the ledger account. In what way, if any, would you further your verification, assuming that you are making (a) a balance sheet audit and (b) a detailed audit?

100 Shares Ralston 7% Preferred Stock $9870.14
1405 Shares Chico Mfg. Common Stock 28749.58
$38619.72

16. Commission paid to a broker for purchasing stock have been charged to the stock account. Give the adjusting entry.

17. Explain fully just what a stock dividend is.

18. Ascertain the value of a right from the following data. 100 shares on hand. 5 rights plus $150 are necessary for 1 new share. The market value per share (ex-rights) is $180.

19. How may brokers value their securities?

20. If a client exercises his rights, what entry should he make in his security account?

21. What is the rule for valuing temporary investments?

22. What is the law of supply and demand? What bearing has it in actual auditing situations?

23. Ascertain the cost value assignable to a right from the following data. 100 shares on hand at a cost of $39,600. 5 rights plus $150 are necessary for 1 new share. The market value per share (ex-rights) is $175 and the market price per right is $5.

24. A certain stock is not actively dealt in. How would you go about to ascertain its approximate value?
361. Explanation and Comments.— As has been stated in the text, the auditor should be given, or he should prepare for himself, a complete and detailed list of the securities to be examined, BEFORE he undertakes to "count" them. This procedure will show the auditor before hand what special problems, if any, he is up against; it will save the time of the client's representative, and it will permit the "count" to be run off much more smoothly, as it is very difficult and tedious to write and examine alternately.

In some instances the schedule containing the details of the security count will be distinct from the "regular" schedule on securities. Plate 113 is representative of such a "special" schedule.

As a rule, the examination of any considerable volume of securities should be done by the auditors working in pairs. One of the two men should call off to the other the particulars of the issues at the time he counts and examines them. The "receiver's" duty is to see that the list before him tallys with the "caller's" description of what he is seeing.

When large quantities of securities are to be "counted", the auditor is betwixt two problems. On the one hand, there is the urgent necessity of finishing the task expeditiously and in only as detailed a manner as common sense indicates to be the practical thing to do under the particular conditions. On the other hand, there is the real danger of passing the securities without sufficient examination in an effort to please the client or to appear practical, experienced, or what not.

In the writer's opinion, the auditor should err on the side of thoroughness. It requires but a SINGLE slip-up, at some time or other, on an important point for the auditor to lose for himself (and possibly for his firm also) his reputation as an efficient auditor, lot alone standing the cost of possible money damages. Thus in the twinkle of an eye, the efforts of a lifetime may be largely offset. Therefore, while it is obviously necessary to merely run the edges of some of the securities when they are so numerous as to be packaged in fifties or one hundreds, nevertheless, it should also be equally or more obvious that it is necessary to examine enough individual securities in detail as to number, description, maturity, interest or dividend rate, trustee's signature, corporate seal and signatures, unmatured coupons, etc. to satisfy one's self (1) that the actual securities are all there, and (2) that the procedure adopted and the test given represent the quintessence of the best auditing practice.
### A SCHEDULE ON A SECURITY COUNT

**THE FRANK F CARR ESTATE**

**Security Count**

Audit for the Year Ending Dec. 31, 1930

<table>
<thead>
<tr>
<th>Security Numbers</th>
<th>Description</th>
<th>No of Units</th>
<th>Par</th>
<th>Total Par</th>
<th>Coupons</th>
<th>Signatures</th>
<th>Endorsement</th>
<th>Etc. OK?</th>
</tr>
</thead>
<tbody>
<tr>
<td>1942</td>
<td>The Union Salt Works $7 cumulative Pfd.</td>
<td>17</td>
<td>No</td>
<td>---</td>
<td>Yes</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>418</td>
<td>The Austin Soap Co. 1st mtg 6's int Jan.15 and July 15 Dated Jan.15,1926-1976</td>
<td>100</td>
<td>1000</td>
<td>100000.00</td>
<td>Yes</td>
<td>&quot; &quot;</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Omissions**

<table>
<thead>
<tr>
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<th>Description</th>
<th>No of Units</th>
<th>Par</th>
<th>Total Par</th>
<th>Coupons</th>
<th>Signatures</th>
<th>Endorsement</th>
<th>Etc. OK?</th>
</tr>
</thead>
<tbody>
<tr>
<td>A411-450</td>
<td>Grand Haven, Ohio, Improvement 5's int June 1 and Dec 1 Dated June 1,1930 due 1940</td>
<td>50</td>
<td>1000</td>
<td>50000.00</td>
<td>Yes</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>#5432-437</td>
<td>Monguagon Township School District No.8 Wayne County, Miss. 4 3/4's int Mar. 1 Sept. 1 dated Mar. 1,1931 due 1951</td>
<td>6</td>
<td>1000</td>
<td>6000.00</td>
<td>&quot; &quot;</td>
<td>&quot; &quot;</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

| B4l 1/8/31       | 6894500.00 | OK per Security Ledger 1/8/31 |
| #Purch 1/1/31 -1/8/31 | 264900.00 | OK per ledger 1/8/31 |
| B4l. 12/31/30    | 6666100.00 | OK per ledger 12/31/30 |

### Audit Procedure

The above securities were examined and counted to the extent indicated. MacGregor "called" and Shaldon "received". The count took place in the presence of Mr. F.G. English, trustee of the Estate, at the vaults of The Baxter Trust Company on Jan. 8, 1931 at 9:00 A.M.

#Bought between Jan. 1 - 8 incl. 1931
25. If a client is holding certain stock for control in another corporation and yet does not own 51% of the voting stock, how should he value this stock for balance sheet purposes?

26. A client owns 95% of the voting stock of another corporation. How should he keep the ledger account for this investment? The client shows his balance sheet with this account (correctly valued) listed as an investment. What suggestion, if any, would you make?

27. What is the common law rule in regard to the necessity of taking into consideration the fluctuations in value of fixed investments in determining the amount of profit available for dividends?

28. A client, holding securities belonging to certain employees, objects to your accounting for them because they have nothing to do with any ledger account on the books. What position would you assume on the matter? Why? Give a complete answer.

29. Illustrate why cash and securities should be verified simultaneously.

30. In 1928 there were among the permanent investments of a certain client some 7% 50 year gold bonds dated 1890 of par value $850,000. The client bought these bonds in 1920 and carried them at a cost of $745,000. The market value of these bonds in 1928 was $805,000. What adjustment, if any, would you make in the bond account as at 1928?

31. How can a stock be made transferable other than by an endorsement on the back of the certificate?

32. What is the function of a registrar?

33. A certain client holds 62% of the voting stock of another corporation. During the year the subsidiary earns $2,407,387.14 and pays a cash dividend of $1,700,000 and a stock dividend of 100,000 shares of $10 par value each. What entries should the client make on his books?

34. A client has paid 70% on 1000 shares of stock (par value $100), the balance being callable within six months. The market value of this fully paid up stock has dropped to $85 a share. How would you present this situation on the balance sheet, assuming that the stocks are held as temporary investments?

35. If you found that a client's securities were endorsed in blank, what would you do about it?

36. What is the function of a transfer agent?

37. A client owns 51% of the voting stock of another company. Assuming that it has nothing to conceal, is there any justification for the client's stand if it does not want a consolidated balance sheet?

38. What would you do in a security count if the securities are too numerous to be brought to one point?

39. In what ways may bonds be registered?

40. What bearing, if any, has the ratio of the dollar amount of the investment in a controlled company to the total parent company's assets upon the necessity of a consolidated balance sheet, irrespective of the degree of control above a 51% interest?

41. Give an illustrative example of fraud showing the necessity of counting simultaneously the various funds of securities of a client.

42. Name the various possible signatures on a stock.

43. Would you allow a client to mail a request for confirmation of securities? Why?

44. Why should the auditor insist on having the client's representative stay on the job throughout the security count?

45. Where is the trustee's certificate on a bond? How does it usually read?

46. Make a copy of a coupon other than the one in this text.

47. When might an auditor decide to list the security numbers on to his audit schedule?
48. Name the various possible signatures on a bond.
49. How can one tell if a stock is subject to assessments?
50. Make a copy of the assignment of a stock.
51. In the temporary investment account of a client you find an important item of stock for which you are unable to find any bid or asked prices. What would you do about it?
52. Why must a request for confirmation of securities contain a statement of the purpose for which the securities are being held?
53. A certain 50 year 7% bond has coupons. What is the value of the coupons? What is the value of the bond? Assume that the current rate of interest is 7%.
54. Why should all securities be counted simultaneously?
55. To what extent would you analyze the security account of a manufacturing concern if you were conducting a balance sheet audit?
56. At what price should securities held as stock-in-trade be valued?
57. "There are two general divisions of the auditing of accounts for securities owned; namely, (1) the determination of the propriety of the balance in the account itself, as to both book value and the specific securities it represents; (2) the verification of the possession of the securities called for by the account." Elaborate this statement.
58. In connection with securities, what is market value? Suppose there is a wide margin between the bid price of a security and its asked price. What value would you use?
59. How should an investor set up stock carried on margin?
60. Why should the auditor examine the securities as near to the audit date as possible?
61. You enter on February 3 on an audit for the year ending December 31. What securities will you account for; those of February 3 or of December 31, or both? Amplify your answer.
62. Why shouldn't securities be placed under the control of a single person?
63. In conducting a balance sheet audit of a brokerage house would you analyze the security accounts?
64. What are the entries for recording the purchase of $10,000 (par value) worth of bonds bought on April 1, 1950, at 98 1/2 and accrued interest? The 50 year bonds bear 7% interest payable semiannually and are dated January 1, 1925.
65. Is it necessary for the auditor to account for collateral held on loans receivable? Why?
66. Suppose that you are not allowed to audit the accounts of a controlled company. In what way would it effect your certificate?
67. Suppose that a subsidiary or affiliated company is operating at a loss and has a deficit. Should the minority interest of this company be shown on a consolidated balance sheet at the par value of the minority stock or should the minority interest be shown with its share of the deficit?
68. When would you find it necessary to seal a vault containing securities?
69. Comment fully on the following: Can you improve the balance sheet presentation? If so, how?

Detroit, Michigan, March 2, 1931

Price, Waterhouse & Co.

1. Certified Public Accountants
2. Certificate - Burroughs Adding Machine Company
69. (Continuation) - Company Stock held for Corporate Purpose at Cost (market value being less) $2,786,271.69.

Do you agree with the answers given to the following question? If not, why not?

Question: May I obtain, if possible, an idea as to the position that accountants generally are taking as to the treatment of treasury stock in the preparation of balance-sheets at this particular time?

Proposition

X Company purchased approximately 36,000 shares of its own no-par common capital stock of a total of 400,000 shares outstanding, which is listed on the New York stock exchange, during the period from about October 15 to December 15, 1930. This stock has a book value of $37 a share and was purchased at an average cost of $36 a share. The market value of the shares was $19.50 at December 31, 1930, the date of the balance-sheet to be certified. The total cost of the shares purchased amounted to approximately $1,295,000. The total assets of the corporation amounted to approximately $23,500,000. The corporation has several subsidiaries and the total assets above stated are the consolidated assets. The consolidated surplus at December 31, 1930, was approximately $1,500,000, of which approximately $200,000 was represented by parent company surplus, the balance by surpluses of subsidiaries. The parent corporation is incorporated under the laws of Delaware. The corporation intends to resell the reacquired stock when market conditions warrant.

At what value should the treasury stock be listed in the balance-sheet at December 31, 1930, or how should this item be treated?

Answer No. 1.--This question indicates the fallacy of showing treasury stock among the assets of a corporation. The inclusion of this asset in this position at once raises the question as to what value is to be placed upon it, and with depressed security values indicated by the proposition, a factor is brought into the balance-sheet of the corporation which certainly has no place there.

The market value of the shares of stock of corporation X should certainly have no bearing on the presentation of the balance-sheet of that company whether treasury stock is owned or not.

If the treasury stock is to be deducted from the stock issued at par and the net amount of stock outstanding shown, no question is raised as to what value the treasury stock should be given. In the instant case, there will be an adjustment of surplus measured by the difference between the cost of the treasury stock and its par value.

Answer No. 2.--We note that the amount of stock involved is substantial and that the stock is one listed on the New York stock exchange. Your correspondent would therefore doubtless be interested in the following extract from a letter addressed by the stock exchange to a corporation, which recently came to our notice:

"During the last fifteen months, problems arising out of reacquisition of their own securities by listed corporations have forced upon the attention of this committee the necessity for the observance of sound accounting practices in connection therewith.

"Approved practice in this respect is set forth in paragraph 48 of pamphlet entitled, Verification of Financial Statements (Revised), a method of procedure submitted by the Federal Reserve Board for the consideration of bankers, accountants and others. This reads:

"When corporations have temporarily invested funds in the purchase of their own stocks and bonds, these securities technically should be
70. (Continuation) -- 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.

This committee feels that where a corporation has so reacquired any of its securities and desires to set them up on the asset side of its balance-sheet that the number of shares of each class of stock acquired and the par value of bonds acquired should be shown separately upon the balance-sheet and not as a part of current and working assets. The cost of such reacquired securities should also be shown, but may be shown in the aggregate if more than one class of securities has been reacquired.

Supplementing the above, it seems clear that if the stock is to be regarded as an asset, it can only be regarded as an asset to the extent of its market value. We think that the practice of carrying such stock as an asset is fundamentally unsound and that all accountants should insist on full disclosure if it is followed. This seems to us the more necessary because the purchase on the exchanges of a corporation's own stock, with a view to resale at a profit, is itself a transaction of very questionable soundness.1

71. Do your observations bear this out?

"Mr. Whitney, H.E., of the Bankers Trust Co. N.Y.: I would say that the almost universal custom, where the market is less than the cost, for the accountant to make a footnote, or a notation in brackets as to the market value figures (of the marketable securities). But, again I should say it is the exception when a reserve is set up."2

72. Do you agree with the following?

"Mr. Mitchell: An accountant should indicate the number of shares of stock, at least the company's own stock, and the price paid for same, and also give the present market value of the stock. That covers it."3

"Mr. Stranb: If the stock were written down you would not feel it necessary to say so?"

"Mr. Mitchell: No."

"Mr. Wellington: What about the case of the corporation where the sales of stock on the New York Stock Exchange are only a few hundred a day and the corporation owns several thousand, and you know if the several thousand had to be sold it would seriously depress the price?"

"Mr. Gray: Of course, we are running into that situation quite a good deal in a rather inactive market. But, I do not see any other way for the accountant to do but to put it at the market price. If he shows the number of shares he is certainly disclosing all the information that he has."4

73. Do you agree with the following?

"Mr. Fernald: Of course that answer would only apply to cases where the stock is listed on exchange or otherwise have a current market quotation for it. What attitude should the accountant take as to unlisted stocks?

"Mr. Gray: I think then they ought to put it in at cost and if they are going to continue to carry it in the treasury give the number of shares that have been purchased.

1Journal of Accountancy, Sept. 1931, p.231
2Relations Between Accountants and Bankers"—N.Y. S.I.S. of C.P.A. (Nov. 1931)(p.17)
3Ibid. (p.18)
4Ibid. (p.18)
73. (Continuation)

"Mr. Webster: I take it then that you would rather have me tell you the number of shares in the treasury and the cost and allow you to use your banker’s judgment on the question of value, rather than to ask me to place a value on these unlisted shares and not turn it in at over-the-counter-prices where there are current quotations. The responsibility of valuing that stock is yours and not mine. If I understand you correctly, I agree with you heartily.

"Mr. Gray: That would be my opinion.”

74. What is your opinion of the correctness of the following procedure? Why?

"The market value of the marketable securities, other than shares of this Corporation, as at December 31, 1930, was approximately $2,464,310 lower than cost. This amount has been written off and charged to Surplus. On March 1, 1931 the market value of these securities was $767,730.63 greater than on December 31, 1930.”

75. Translate the specific audit program given in Plate 112 for Oldson, Chace & Hodgkiss Mfg. Co. into a general program.

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1 "Relations Between Accountants and Bankers"—N.Y.S.S. of C.P.A. (Nov. 1931) (p.19)
2 1930 Annual Report, Union Carbide and Carbon Corp.
CHAPTER 21

THE VERIFICATION OF FUNDS

362. Definition and Explanation of Funds.

363. Funds and Reserves.

365. Explanation of Plate 114.

366. The Trustee.

368. The Provisions.

370. Explanation of Plate 115.

371. Explanation of Plate 116.

372. Valuation.

373. Explanation of Plate 117.

374. Explanation of Plate 118.

375. The Presentation on the Balance Sheet.

376. Miscellaneous.

377. Explanation of Plate 119.

377a. Audit Program.

Review Questions.

362. Definition and Explanation of Funds.—In common with others, the writer wishes to direct the reader's attention to the fact that the word fund, when used alone, should be reserved solely to designate a sum of money, or stock of convertible wealth, set aside for a special object. That is to say, in brief, that a fund account is an asset, not a liability or a net worth item. The only reasonable exception to this usage, due to an extremely long established practice, is in the case of universities, foundations, and the like, where the word fund is to be found in the net worth section of the balance sheet. Thus, if a Mr. Ross Hadley gives The Riceville Women's College $1,000,000, this item may appear on the balance sheet of the college as follows:

THE RICEVILLE WOMEN'S COLLEGE
General Balance Sheet - June 30, 1930

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities and Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Endowment Assets:</strong></td>
<td><strong>Liabilities:</strong></td>
</tr>
<tr>
<td>(detailed in main captions)</td>
<td>(detailed in main captions)</td>
</tr>
<tr>
<td><strong>Plant Assets:</strong></td>
<td><strong>Endowment Funds:</strong></td>
</tr>
<tr>
<td>(detailed in main captions)</td>
<td>The Ross Hadley Fund  $1,000,000</td>
</tr>
<tr>
<td><strong>Current Assets:</strong></td>
<td><strong>Plant Funds:</strong></td>
</tr>
<tr>
<td>(detailed in main captions)</td>
<td>(detailed in main captions)</td>
</tr>
<tr>
<td></td>
<td><strong>Current Funds:</strong></td>
</tr>
<tr>
<td></td>
<td>(detailed in main captions)</td>
</tr>
</tbody>
</table>
355. Funds and Reserves.—The reader should understand that a fund may exist by itself without a related reserve, and, on the other hand, a reserve may be established without the creation of a fund. Moreover, if both a fund and a reserve are required, or if they are voluntarily created, the amount of each is often identical, but not necessarily so.

If a fund is created without regard to the establishing of a related reserve, the business is simply making certain that it will have the money ready to achieve its objective. In many instances this is, of course, all that the company desires to accomplish. On the other hand, the bondholders, for example, may not only desire that the business accumulate enough money to pay off the bonds when due, but they may also be desirous of making certain that the cash so segregated for the retirement of the bonds does not pinch the current cash position of the company. It should be understood that bondholders do not care to go through the annoyance of, and possible loss from, foreclosure proceedings, even though their bonds are apparently amply secured. An effective way for the bondholders to keep the situation wholesome is for them to require the corporation to create out of profits a reserve equal to the fund. The effect of this primary distribution of current profits is, of course, to lessen by that amount the sum available for dividends. That is, in brief, cash which might have been paid out in current dividends has been withheld under contract and placed in the sinking fund. Moreover, such an entry, by increasing the net worth of the business, also builds up for the bondholders, and equally for other creditors, a larger margin of safety.

ILLUSTRATION CASE #1

(Assumptions)
(1) An annual appropriation to the sinking fund of $40,000 is required.
(2) No reserve is required.
(3) All dividends are paid out as soon as earned.
(4) The balance sheet prior to the appropriation is as follows:

Balance Sheet
June 30, 1930

<table>
<thead>
<tr>
<th></th>
<th>Liabilities</th>
<th>Capital</th>
<th>Profit for the Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$130,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other Assets</td>
<td>2,079,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>2,209,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(Solution)

Balance Sheet
July 1, 1930

<table>
<thead>
<tr>
<th></th>
<th>Liabilities</th>
<th>Capital</th>
<th>Profit for the Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$11,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other Assets</td>
<td>2,079,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sinking Fund</td>
<td>40,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>2,130,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

1 I.E. into insolvency.
2 This is amply demonstrated in every period of great depression (i.e. the time when most mortgage defaults occur). Mortgagors in 1931-33, for example, were practically always willing to grant the mortgagors considerable leniency and concessions in lieu of foreclosure. Property values were then often slightly more than the mortgagors, and profitable rentals were practically non-existent.
3 I.E. the reserve.
Note the perilous condition of the cash position due to the unwise and un-
restricted payment of dividends.

ILLUSTRATION - CASE #2

(Assumptions)
The assumptions are the same as above, except that a reserve equal to the
fund is required to be built up from profits.

(Solution)

Balance Sheet
July 1, 1930

<table>
<thead>
<tr>
<th>Cash</th>
<th>51,000</th>
<th>Liabilities</th>
<th>$1,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other Assets</td>
<td>2,079,000</td>
<td>Capital</td>
<td>1,130,000</td>
</tr>
<tr>
<td>Sinking Fund</td>
<td>40,000</td>
<td>Sinking Fund Reserve</td>
<td>40,000</td>
</tr>
<tr>
<td></td>
<td>$2,170,000</td>
<td></td>
<td>$2,170,000</td>
</tr>
</tbody>
</table>

Note that the tendency of the Sinking Fund Reserve Account is to improve
the cash position (i.e. from $11,000 to $51,000); although, of course, it
is not a guarantee of this result or of its permanency. Also, note that
the margin of safety (the networth) for all creditors has been increased
(i.e. from $1,130,000 to $1,170,000).

ILLUSTRATION CASE #3

If a reserve only is required by the bondholders, the effect is to
build up their margin of safety (the networth) without making provision
for an adequate cash position to meet the principal payments of the bonds
when due.

(Assumptions)
(1) An annual appropriation of $40,000 from current profits to the
Sinking Fund Reserve is required.
(2) All dividends are paid out as soon as earned.
(3) New fixed assets are purchased costing $40,000.

(Solution)

Balance Sheet
July 1, 1930

<table>
<thead>
<tr>
<th>Cash</th>
<th>$51,000</th>
<th>Liabilities</th>
<th>$1,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other Assets</td>
<td>2,079,000</td>
<td>Capital</td>
<td>1,130,000</td>
</tr>
<tr>
<td>New Fixed Assets</td>
<td>40,000</td>
<td>Sinking Fund Reserve</td>
<td>40,000</td>
</tr>
<tr>
<td></td>
<td>$2,170,000</td>
<td></td>
<td>$2,170,000</td>
</tr>
</tbody>
</table>

Note that the cash position may and has been unwisely depleted at the
expense of the bond holders by the purchase of new fixed assets. If the
cash is continually used up, there will not be a sufficient sum on hand
to meet current obligations and interest payments, or future principal
payments. Note, however, that the creditors' margin of safety (networth)
has increased (i.e. from $1,130,000 to $1,170,000).

1Assuming that the new fixed assets do not automatically fall under the
lien of the existing mortgage indenture.
354. Bond Sinking Fund.—One of the most common funds is that which is required by the bondholders to be established for the retirement of their holdings. In such an instance, the bonds payable are known as a funded debt, i.e. the debt is being covered by a fund. At the outset, the auditor must ascertain: (1) who has the legal and equitable title to the fund, and (2) what are the main provisions of the mortgage indenture (Plate 114). Moreover, he must keep in mind that there are three parties involved; namely, (1) the trustee, (usually) (2) the mortgagee (bondholders) and (3) the corporation.

355. See Plate 114.

356. The Trustee.—If there is a trustee, the corporation will have paid to it from time to time certain definite cash payments. In accordance with the terms of the deed of trust, the trustee will probably have purchased, and perhaps cancelled, some of the outstanding bonds of the corporation. In many instances, however, the trustee is free to invest its cash, subject to certain restrictions, in other securities.

The corporation's bonds, which are purchased by the trustee, are often kept alive. As such, they earn interest for the sinking fund, because the bonds are legally outstanding so far as the corporation is concerned. As the trustee and the corporation are distinct legal entities, the possession by the trustee of some of the corporation's bonds does not relieve the corporation of interest payments on those bonds. In many instances, however, the trustee cancels the bonds, as soon as they are purchased, in accordance with the deed of trust. Such bonds should be earmarked by the trustee by some such designation as: "Property of the Bond Sinking Fund (1950); NOT NEGOTIABLE." or "CANCELLED." Later on the bonds (and coupons) may be cremated in the presence of witnesses.

357. The Account.—The sinking fund account MUST be analyzed. If there is a trustee, its reports should be secured from the client's files, in order to see if the entries in the account reflect all of the facts stated in the reports. Moreover, the account must be audited to make certain that the requirements of the trust deed have been fulfilled. Even though there is a trustee, the auditor must not take it for granted that all of the provisions have been lived up to. Most trustees, it may be noted, are not required to act until a specified number of the bondholders have petitioned it about a particular irregularity.

Although it is not customary to accrue a payment to be made to a trustee, it may be necessary to do so, by debiting the sinking fund cash and crediting the current cash (or possibly crediting a liability account), in order to reflect the true current cash position of the corporation. Thus, if (1) an audit was being made as of April 30; (2) a payment of $100,000 was due on May 4; and (3) the cash position on April 30 was $350,000, the auditor would be a mere automaton if he took the position that his audit STOPS as at April 30.

If there is no trustee, there is more need than ever for making a thorough audit of the account. The auditing procedure outlined in the chapter on securities is fully applicable here.

If the securities in the fund are being held for a considerable period, the premiums and the discounts, if any, on bonds should be adjusted periodically. An exception to this procedure is in the case of treasury bonds which are cancelled as soon as they are purchased. Here the total premium or discount should be entered in the capital surplus account (or 1A cardinal principle of proper financing is that a debt should be retired faster than depreciation (or obsolescence, etc.) occurs, i.e. amply within the life of the pledged asset. 2Such, for example, as in common stocks. 3I.E. No contract with the bondholders as to a sinking fund.}
ABSTRACTS FROM A MORTGAGE TRUST DEED   PLATE 114

WILLIAMS, GLEASON CORPORATION  
Abstract of Bonds Payable Indenture  
Audit for Year Ending December 31, 1929

$1,500,000 - 6 1/2s - 1st Mtg.--1920 to 1940--April 15 and Oct. 15

(1) The Hope Trust Company, Cleveland, Utah is Trustee
(2) $75,000 to be paid annually to the Trustee, or such a lesser or
    greater amount as is needed after considering the income, gains,
    losses and expenses of the sinking fund as will increase the
    fund $75,000 each year, valuing the treasury bonds at par and
    other securities at cost, except that the last payment must be
    sufficient to retire the outstanding bonds.

(3) The coupon interest is payable at the offices of the Trustee and
    at the Third National Bank, 411 Vesey St., New York, N.Y.

(4) The fund may be used to purchase any high grade bonds (eligible
    for banks in the State of N.Y.) at the discretion of the Trustee
    at not more than 102 and accrued interest.

(5) Treasury bonds may not be purchased at more than 101 and accrued
    interest.

(6) The Trustee is to be allowed 1/2% on all money invested by it
    together with all expenses attached to the operation of the
    fund.

(7) No common stock dividends may be paid in any year in which the
    ratio of current assets to current liabilities is less than 3 to
    1.

(8) The bonds may be registered as to principal only.

--- Omissions ---

(15) The determination of #7 above, when under dispute, is to be in-
    vested in the company's auditors at that time.

365. Explanation and Comments.— This exhibit shows the nature of
    the items which should be abstracted from a mortgage indenture for
    the auditor's working papers.
in earned surplus, if small). This is the writer's opinion, not the current practice.\(^1\)

Another adjustment for the auditor to take care of arises from the accrued interest receivable at the balance sheet date. This adjustment is set up as usual, the credit being to Sinking Fund Income (a profit and loss account). If the deed of trust requires that the Fund and the Reserve accounts be maintained at the same amount, the auditor must also debit Profit and Loss (or Surplus) and credit Bond Sinking Fund Reserve for a like amount.

Before leaving this section, it may be well to point out that both the accounting and the auditing work is greatly facilitated if at least several accounts are kept to record the various facts. A cash account, a security account or two, a discount account, a premium account, and an accrued interest account are all helpful. In fact, if the securities are varied, the bookkeeper will find that it will pay him to keep a detailed subsidiary ledger, too.

368. The Provisions.--- As has been emphasized, the auditor must abstract for his working papers, the provisions of the trust deed (Plate 114). If the fund does not parallel the terms of the mortgage, the auditor must take whatever position is called for by the seriousness of the breach. Thus, some payments to the fund may be in arrears; certain securities which have been bought may have been forbidden; the computation of the units of ore, coal, or lumber, upon which the cash payments into the fund are computed, may be wrong. Even in the case of voluntary sinking funds, where the corporation is not legally bound to accumulate the fund as originally planned, the departure should be specifically stated in the report.

Whenever the mortgage is wholly or partly on personal property, the auditor must proceed more carefully with his examination. As personal property is generally movable property, there is considerable danger that the pledged property may either be sold or otherwise disposed of without the proceeds (not simply the same book value) being kept SEPARATE as property pledged to the mortgagees.\(^2\)

369. The Audit Procedure for Verifying the Securities.--- If the trustee turns over the bonds to the corporation, they must be accounted for with the same care as that given to the examination of any other securities. As stated above, the bonds should be marked: "NOT VALID", or "VOID".

On the other hand, if the trustee keeps the bonds, they must be verified by direct correspondence with it (usually a trust company) (Plates 115 and 116). As shown by these plates, the auditor also secures at the same time the list of other securities and the cash balance held in the fund. It may be stated here that the various interim reports of the trustee, as to the status of the fund, are not ordinarily acceptable in lieu of this independent verification by direct

\(^1\)The current practice is to regard profits and losses on sales of securities (or purchases of treasury securities) as earned surplus adjustments, whereas the writer regards earned surplus as that which comes from the MAIN operations of the business.

\(^2\)Under certain restrictions mortgaged property can usually be sold, PROVIDED the proceeds thereof are placed in the custody of the Trustee. When an equivalent amount of new property has been purchased, the Trustee must release the aforesaid proceeds.
correspondence. However, they may be accepted for less important purposes, such as in checking (for the time being) the correctness of the entries forming the balance of the account. On the other hand, a formal creation certificate from the trustee is acceptable without other proof. (The situation is similar to bank statements and independent bank certificates).

If there is no trustee, the securities and the cash must be accounted for in the manner outlined in the chapters on cash, and on securities. In the case of treasury bonds and stocks (retired preferred stocks), the auditor should see that they are marked "CANCELLED".

370. See Plate 115.

371. See Plate 116.

372. Valuation.—If the treasury bonds are cancelled as soon as they are purchased, the premiums or discounts involved, if any, may be entered in a non-operating profit and loss account (or they may be entered in capital surplus direct, if the profit and loss statement is not extended to include non-operating gains and losses), so that the bonds may be debited to the bonds payable at par value.

If the treasury bonds are not cancelled but are kept alive, the above procedure in regard to the premiums and discounts may still be followed, but it is better to retain the premiums and discounts and adjust them at each fiscal period. This will result in showing the true earnings of the fund and the true bond values (Plates 117 and 118).

If the fund is invested in other securities than treasury bonds, the values in the accounts should be at cost with the retention and adjustment of the premiums and the discounts, if any.

The total market values should be shown on the balance sheet in parenthesis, but the account itself need not be adjusted to these market values.

373. See Plate 117.

374. See Plate 118.

375. The Presentation on the Balance Sheet.—The sinking funds will ordinarily appear on the asset side of the balance sheet under some such caption as Investment of Reserves, or Sinking Funds.

ILLUSTRATION

Current Assets:
(detailed)

1Although the premiums and/or discounts are carried along in general ledger accounts and adjusted at each fiscal period, nevertheless, such accounts should, in the writer’s opinion, be entered in the NETWORTH section of the balance sheet. However, leading auditing firms sanction their being carried as an asset or deferred income respectively.

In short, here is another instance of a conflict between proper profit and loss statement and balance sheet presentations. The P&L should spread the adjustment over the life of the treasury bonds so as to show what the fund is earning. On the other hand, the premium paid, for example, is NOT an asset.
Prepaid Assets:  
(possibly detailed)
Permanent Investments:  
(detailed)
Investment of Reserves:  
(detailed)
Investments in Controlled and Affiliated Companies:  
(detailed)
Plant and Equipment:  
(detailed)
Intangibles:  
(detailed)
Other Assets:  
(detailed)

Each fund should show the elements of cash, securities, and accrued interest; the treasury bonds, if any, being deducted from the bonds payable account. On some balance sheets the bonds payable account is shown net, but this presentation is not recommended because it does not give the whole story of what has happened.

ILLUSTRATION

INVESTMENT OF RESERVES:

Insurance Fund Securities (market $51,050) $50,315.63
Pension Fund Securities (market $40,500)  41,389.57

Sinking Fund:

<table>
<thead>
<tr>
<th>Element</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$30,091.14</td>
</tr>
<tr>
<td>Accrued Interest</td>
<td>7,904.70</td>
</tr>
<tr>
<td>Bonds (market $245,000)</td>
<td>241,387.45</td>
</tr>
<tr>
<td>(34,871,000 par value of treasury bonds - held by the Trustees - are deducted from Bonds Payable-Contra)</td>
<td>279,382.29</td>
</tr>
</tbody>
</table>

As just illustrated, the market value of the securities should be given as important additional information.

Some auditors favor deducting the whole sinking fund from the bond liability.

376. Miscellaneous.—

(a) If a bond sinking fund agreement is violated, the usual penalty, if demanded by a specified number of bondholders, is to mature the entire issue. But in the case of preferred stock, the penalty is usually one whereby the preferred stockholders get some or sole voting power, or they elect a majority (or other specified number) of the board of directors, or the common stock may simply forego all dividends until the breach is corrected.

(b) It is common for "old time" managers, and also theorists, to favor the creation of a fund equal to the reserve for depreciation, or at least some amount. These two classes of men feel that there should be on hand a fund of cash or marketable securities which can be used at a moment's notice to replace any and all assets as soon as they are retired.

In most instances, the proposition does not work out well, since it is based on the assumption that businesses are usually caught "napping" without available cash for replacements. As a matter of fact, most businesses are able to plan and have on hand sufficient cash to meet all
A CONFIRMATION LETTER FROM A TRUSTEE (1st type) PLATE 115

THE EXCHANGE TRUST COMPANY
Public Square - Loganville, Calif.

Reynolds
7-9-29

July 7, 1929

Jordan, Keyes & Company,
Certified Public Accountants,
R.I. Trust Bldg.,
Riverview, California.

Gentlemen:

As trustees of the First Mortgage 6% Bonds (dated 1900 and
due 1935 with interest payable February 1 and August 1) of The
Chattanooga Stove Works, Inc., we report the following as at June 30,
1929.

(1) Bonds authorized and issued $6,500,000.00 To CC-4
(2) Treasury bonds in sinking fund 1,750,000.00 To CC-4
(3) Cash 17,829.17 To D

Very truly yours,
THE EXCHANGE TRUST COMPANY
By _P.T Kilburn_ — — — —
Auditor

370. Explanation and Comments.— This exhibit is a letter of
confirmation from the sinking fund trustee.

Note that the treasury bonds are kept alive, and that the trustee
is evidently limited to the purchase of bonds of the client.
Dear Sirs:

In reply to your letter dated August 14, 1929, we are pleased to state that as at the close of July 31, 1929 our books showed the following in regard to The Holt Iron Works Corporation of Dorchester, Ill.

(1) Bonds authorized and issued $2,000,000 1st Mortgage 6's 1901-1931 Feb. 1 and Aug. 1 To FFL
(2) Free Cash $4,387.95 To CI
(3) Cash deposited with us on July 30, 1929 to cover coupon interest $36,500.00 To CI
(4) Cremated Bonds $750,000 (par) To FFL
(5) Treasury Bonds alive in sinking fund $30,000 (par) To FFL
(6) Other Securities held in sinking fund
   (a) The Chesapeake Iron Works, Inc. $50,000 (par) To CI
      1st Mortgage 6's dated 1920 due 1940
      Interest Jan. 1 and July 1
   (b) The Pawtuxet Valley Utilities Corp. $15,000 (par) To CI
      1st preferred 7's 150 shares at par $100

All transactions for the period ended July 31, 1929 were rendered to the Holt Iron Works Corporation on our report #818.

Sincerely yours,
THE INTERSTATE TRUST COMPANY
By P.S.Carr. ___________ 
Treasurer

371. Explanation and Comments.—This exhibit represents an example of a confirmation letter received from a sinking fund trustee who had charge of the authorization and issuing of the bonds. Notice that the trustee was also selected to pay the interest; that the bonds are cremated from time to time; and that the trustee has the right to invest in securities other than "treasury" bonds of the client.

Also, observe that the auditor has shown that he has checked the various items on this letter to their respective schedules. Thus, for example, schedule FFL might have had the following summary:

First Mortgage 6's due 1931 $2,000,000 Cla
Less-Cremated and With Trustee 780,000 Cla 1,220,000
such requirements. As a result, the depreciation fund cash that would have been invested in marketable securities is used more profitably to expand the business.

(c) At times, a business may carry all or part of its fire insurance. If such is the case, the auditor must be certain to bring out this fact, both on the balance sheet and in the report because it is unusual and possibly risky. Many (perhaps most) bankers, for example, will flatly refuse to float a loan if the assets are covered in this manner only. As a matter of fact, a company should carry only a part of its own fire insurance, and then only when the destructible units are of comparatively small value, numerous, and widely located. Thus a chain store corporation might find it advantageous to carry its own insurance on the merchandise located in the various retail stores—not in the central warehouses.

The auditor should advise the client to invest his insurance fund cash in first class marketable securities. Under no condition should he invest in treasury stocks or bonds. Moreover, on the whole he should stay clear of local securities, and securities of the same type of business, lest there be a local fire of great magnitude, a local depression, or a general depression in the particular industry. Any one of these happenings would destroy the value and marketability of the treasury securities at a time when the business itself is low, in addition to suffering from the fire loss.

377. See Plate 119.

377a. Audit Program (Bond Sinking Fund)

(1) Ascertain who has the legal and equitable title to the fund?
(2) Abstract the main provisions of the mortgage in regard to the fund (e.g.: "amount of total fund, duration of the fund, dates on which instalment payments fall due, method and basis of establishing the fund, name of trustee, name of Depository, etc.")
(3) Abstract the duties of the trustee. See that he is fulfilling them, especially as to type of securities bought, prices paid, etc.
(4) Analyze the sinking fund account. Check it against the trustee’s reports, cancelled checks, and other primary data.
(5) Amortize the discount and premium on treasury bonds kept alive. Do the same with any other bonds held for long periods.
(6) Accrue the interest on cash in bank, treasury bonds kept alive, other bonds, etc.
(7) See that the Reserve, if any, is equal in amount to the Fund.
(8) See if the cash payment to the trustee is correct in amount, especially if based on computation of ore mined, lumber felled, etc.
(9) Set forth clearly in the audit report (on the statements preferably) any major departures from the bond provisions.
(10) If any mortgage property has been sold, see that the trustee has received the proceeds thereof.
(11) If the trustee turns over to the client the treasury bonds, account for them. Have them voided.
(12) Secure by direct correspondence with the trustee
   (a) the cash balance
   (b) the amount of treasury bonds held
   (c) the amount and details of other securities held
(13) See trustee’s redemption certificates, if any.

1 The practice among owners of large buildings is to make use of the cash withheld from earnings, on account of depreciation, for paying off the indebtedness of the building.” Eggleston, p.159.
373. **Explanation and Comments.** In this exhibit, note that the bond premiums and commissions are amortized, and that the accrued interest receivable, interest income, and trustee's fees and expenses are developed on the schedule, as well as the customary columns for the securities and cash.

T/B stands for trial balance. Thus T/B 20 means that this item on the schedule (Cash $10,912.11) agrees with item 20 on the trial balance. Also, notice that items T/B 18 and T/B 20 are referred to schedule K19-a, which is the letter of confirmation from the trustee.
# Right Side of Plate 117

<table>
<thead>
<tr>
<th>Cash</th>
<th>Accrued</th>
<th>Interest</th>
<th>Trustee’s</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr.</td>
<td>Cr.</td>
<td>Dr.</td>
<td>Cr.</td>
<td></td>
</tr>
<tr>
<td>5856.14</td>
<td>8580.00</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>100000.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>105197.90</td>
<td></td>
<td>1039.15R</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10050.00</td>
<td></td>
<td>10050.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>987.14</td>
<td></td>
<td>987.14</td>
<td></td>
<td></td>
</tr>
<tr>
<td>783.27R</td>
<td></td>
<td></td>
<td>783.27</td>
<td></td>
</tr>
<tr>
<td>8550.00R</td>
<td>11640.00</td>
<td>11640.00</td>
<td>278.34R</td>
<td></td>
</tr>
</tbody>
</table>

(K19-a) 10912.11 11640.00 12809.65 783.27


T/B 20 T/B 21 T/B 87 T/B 59

### AUDIT PROCEDURE

1. The above figures were built up from the trustee’s report, except that the chief accountant, Mr. Nashon, computed, and we checked, the amortization of the premium, and the accrual of the interest at 12/31/29. Straight line basis is used to amortize the premium.

2. The cash payments to the trustee have been checked up against the Cash Book and the cancelled checks, and to the trustee’s reports.

3. The letter from the trustee (K19-a) shows treasury bonds of $388000.00 par value, 2nd cash on hand of $10912.11.

4. All of the provisions - See schedule FF-7 - of the bond indenture have been complied with.
### A Schedule of a Sinking Fund (2d Type)

**English & Sons, Inc.**  
Sinking Fund Trustee  
Audit for Year Ending Dec. 31, 1929

<table>
<thead>
<tr>
<th>Auth. &amp; Issued</th>
<th>TREASURY BONDS</th>
<th>OTHER</th>
</tr>
</thead>
<tbody>
<tr>
<td>3,450,000</td>
<td>Par</td>
<td>Dr.</td>
</tr>
<tr>
<td>1st Mtg. 6's</td>
<td>Discounts and Premiums</td>
<td>Dr.</td>
</tr>
<tr>
<td>Jan. 1 and July 1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dated 1926</td>
<td></td>
<td></td>
</tr>
<tr>
<td>June 1956</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance per our audit papers 12/31/28</td>
<td>450,000</td>
<td>2875.00</td>
</tr>
<tr>
<td>Investment in Treasury Bonds</td>
<td>100,000</td>
<td>425.00</td>
</tr>
<tr>
<td>Total Payments to Trustee</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment in &quot;Other Bonds&quot;</td>
<td>40,000</td>
<td></td>
</tr>
<tr>
<td>Sales of &quot;Other Bonds&quot;</td>
<td>30,000</td>
<td></td>
</tr>
<tr>
<td>Interest Received</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest Allowed by Trustee on Cash Balances</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trustee's Commission and Expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accrued Interest Receivable 12/31/28</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12/31/29</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Premium and Discount Adjustment Totals</td>
<td>550,000</td>
<td>3161.87</td>
</tr>
<tr>
<td>O.K.</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>T/B 20</td>
<td>2/3 21</td>
<td>T/B 22</td>
</tr>
<tr>
<td>K1-c</td>
<td>K1-a</td>
<td>K1-b</td>
</tr>
<tr>
<td>K1-a</td>
<td>K1-c</td>
<td></td>
</tr>
</tbody>
</table>

### Explanation and Comments

This exhibit is much more complicated than the ordinary sinking fund schedule, chiefly because the premiums and discounts are retained and adjusted at each audit period; whereas a common plan is to charge or credit the profit and loss account (or surplus) for the premiums and discounts at the time of their purchase (so that the securities are always carried at par).

T/B stands for trial balance. Thus T/B 21 means that this item on the schedule ties in with item #21 on the trial balance.

Notice that schedule K-1a gives the detail of $550,000 (par value) of treasury bonds; that K-1b gives the detail of the $42,000 (par value) of Other Bonds; and that K-1c (a confirmation letter from the Trustee) gives the verification of the $49,931.16 in cash, the $550,000 in treasury bonds, and the $42,000 in Other Bonds.
RIGHT SIDE OF PLATE 116

<table>
<thead>
<tr>
<th>Premiums</th>
<th>Discounts</th>
<th>Sinking Fund</th>
<th>Accrued Interest Receivable</th>
<th>Interest Income on Sale</th>
<th>Trustee's Fees and Expenses</th>
<th>P &amp; L</th>
<th>12/31/29 Fund</th>
<th>Expenses</th>
<th>of INVESTMENTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr.</td>
<td>Cr.</td>
<td>Dr.</td>
<td>Cr.</td>
<td>Dr.</td>
<td>Cr.</td>
<td></td>
<td>Dr.</td>
<td>Cr.</td>
<td></td>
</tr>
<tr>
<td>55.00</td>
<td>20.00</td>
<td>3127.89</td>
<td>13750.00</td>
<td>102435.00</td>
<td>2010.00</td>
<td></td>
<td>150000.00</td>
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<tr>
<td>650.00</td>
<td>1000.00</td>
<td>39650.00</td>
<td>13750.00</td>
<td>150000.00</td>
<td></td>
<td></td>
<td>8470.00</td>
<td>230.00</td>
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<td>460.00</td>
<td></td>
<td>8470.00</td>
<td>199.50</td>
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<td>950.00</td>
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<td></td>
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<td>30187.00</td>
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<td>1149.12</td>
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<td>1149.12</td>
<td></td>
<td></td>
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<td></td>
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<tr>
<td>917.85</td>
<td></td>
<td>917.85</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>12375.00</td>
<td>12375.00</td>
<td>1375.00</td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td>17340.00</td>
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<td>50881.16</td>
<td></td>
<td></td>
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<tr>
<td>33997.05</td>
<td>917.85</td>
<td>99.07</td>
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<td></td>
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<td>0.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>T/B 23</td>
<td>T/B 23</td>
<td>T/B 19</td>
<td>T/B 24</td>
<td>T/B 43</td>
<td>T/B 37</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kl-b</td>
<td>Kl-b</td>
<td>Kl-c</td>
<td>Kl-a</td>
<td>Kl-b</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

AUDIT PROCEDURE

All provisions of the bond indenture have been complied with.

The above figures were built up from the trustee's reports, together with our computations for the amortization of the premiums and discounts and the accrual of the interest receivable at 12/31/29.

The Certificate from the trustee (Kl-c) shows treasury bonds of $550,000.00 (par), Other Bonds of $42,000.00 (par), and cash $49,931.16.

The Treasury Bonds are kept alive by the Trustee and draw interest.

The $150,000 was paid to the Trustee by check #814.

OPERATION OF THE ACCOUNTS

An account is kept for Sinking Fund Cash.

Two accounts are kept with Treasury Bonds: one called "Par Value of Treasury Bonds" and one called "Net Premiums of Treasury Bonds", i.e. commissions, premiums, and discounts.

Three accounts are kept with "Other Bonds": (1) Par Value (2) Premiums (3) Discounts—with their respective commissions included.

The function of the other accounts (Accrued Interest Receivable, Interest Income on Sinking Fund, Trustee's Fees and Expense, and Profit and Loss on Sale of Investments) is obvious.

Ledger cards are used for a sub-ledger.
A SCHEDULE OF A SINKING FUND (3d t/pc) PLATE 119

THE SHELDON PAPER BAG CO., INC.
Sinking Fund-Treasury Bonds
Audit for Year Ending December 31, 1929

Schedule M

<table>
<thead>
<tr>
<th>Par Value</th>
<th>Name</th>
<th>Amount Bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td>$3,500,000.00</td>
<td>1st Mtg 6's</td>
<td></td>
</tr>
<tr>
<td>dated 1926 due 1946 Int. J 15 and J 15</td>
<td>Other Acct's Debited of Treas.</td>
<td></td>
</tr>
<tr>
<td>2d Nat'l Ex, City, is Trustee</td>
<td>Jeffers 1-2-30</td>
<td></td>
</tr>
</tbody>
</table>

1/1/28 Bal. per our working papers and per G/L 4000.00

Apr. 15 Clarkson Brokerage Co. ) Income from
at 101 and accrued int.) Treas. Bonds 1050.00
Treas. Bond 787.50
Treas Bonds 70000.00

July 2 Journal Page 187-The bonds were sent ) Bonds Pay-
for cremation to the trustee-See Hllas) able 74000.00 (74000.00)

Aug. 15 Clarkson Brokerage Co. ) Income from
at 101 and accrued int. Treas. Bonds 500.00
Treas. Bond 1125.00
Treas Bonds 100000.00

Balance 12/31/29

100000.00 (To B/S)

Audit Procedure

See 1/2/30 in the presence of Mr. Sheldon at about 11:15
A.M. - 100 M - 2d Nat'l Bank.
Bonds to the amount of $175,000.00 have to be in the
hands of the trustee by Jan. 15th of each year.

Explanation and Comments.-- This schedule shows that the corpora-
tion purchases the treasury bonds and sends them to the Trustee for crem-
ation.

Note that the names of the other accounts concerned in each trans-
action are given for the sake of clearness.
(14) Use the bond interest expense account as supporting evidence of the amount of bonds outstanding, etc.
(15) If treasury bonds are cancelled immediately on purchase, pass the difference between the purchase price and par value, together with the sum in the unamortized discount or premium account applicable to these bonds, through surplus, or preferably through a non-operating profit and loss account. If treasury bonds are kept alive, amortize these differences between par, purchase price and issuing price.
(16) Show in parenthesis the market value of the fund.
(17) Show separately the cash, securities, treasury bonds, accrued interest receivable, etc.
(18) Show the treasury bonds as a deduction from the bonds payable.
(19) If thought desirable, deduct the whole fund from the bonds payable.
(20) Determine if the reserve is to be created out of income or surplus.
(21) Whenever possible, see that the trustee's reports are correct.

REVIEW QUESTIONS

1. A corporation agrees to create a fund and a reserve for the retirement of certain bonds. What benefits have the bondholders secured by these two provisions?
2. How would you verify a bond sinking fund which is being held by a trustee?
3. When, if at all, would you accrue a cash payment to a trustee?
4. What position in the balance sheet would you assign to Sinking Funds?
5. What is a funded debt?
6. How would you select investments for a fire insurance fund?
7. Explain how the term fund is used by universities.
8. Why must the Sinking Fund accounts be analyzed?
9. Assume that you are a bond sinking fund trustee. Write a confirmation letter to Arnold and Barker, certified public accountants.
10. Whose interests must the auditor keep in mind when he is auditing sinking funds? Give reasons for your answer.
11. When, if at all, should a business carry its fire insurance? Give a full answer.
12. What is the proper accounting usage of the term fund?
13. Describe the functions and operations of a bond trustee.
14. A certain mortgage is on personal property. What special feature ought to engage the auditor's attention?
15. In what detail would you show the sinking fund accounts in the balance sheet?
16. What common penalties do common stockholders often incur whenever the terms of a preferred stock retirement fund are violated?
17. How would you mark, if at all, treasury bonds which are not to be resold because of certain agreements?
18. When, if at all, would you advise your client to carry a fund equal to the Reserve for Depreciation? Give reasons for your answer.
19. Whose interests must the auditor keep in mind when he is auditing sinking funds? Give reasons for your answer.
CHAPTER 22

THE VERIFICATION OF MORTGAGES RECEIVABLE
LEASEHOLDS

378. General Comments.
380. Explanation of Plate 120.
   PLATE 120--A Schedule of Mortgages Receivable.
381. Checking the Schedule.
382. The Warranty Deed.
383. Explanation of Plate 121.
   PLATE 121--A Form of Warranty Deed.
384. The Mortgage Deed.
385. Explanation of Plate 122.
   PLATE 122--A Form of Mortgage Deed.
386. The Mortgage Note.
387. Explanation of Plate 123.
   PLATE 123--A Form of Mortgage Note.
388. The Insurance Policy.
389. The Title Guaranty Policy, and Tax Receipts.
390. Explanation of Plate 124.
   PLATE 124--An Abstract of Title.
391. The Public Records.
392. The Property.
393. The Balance Sheet Treatment.
394. Comments on and Discussion of Leaseholds.
394a. Audit Program.

Review Questions.

378. General Comments.--For our purposes, mortgages are of two general
classes; namely, real estate mortgages and chattel mortgages. As the name
indicates, a real estate mortgage is a lien on real estate, whereas a chattel
mortgage is a lien on personal property. The term purchase money mortgage
simply means that the seller accepted a mortgage note in part payment of the
selling price of the property.

Obviously, the second mortgage on a piece of property is not as secure
as the first mortgage on that property, but in a particular instance a
second mortgage on one piece of property may be more secure than a first
mortgage on a different piece of property. Thus, if a first mortgage of
$112,000 is taken on a piece of property worth $150,000, it is less secure
than a second mortgage of $30,000 on a piece of property valued at $150,000
but subject to a prior first mortgage of $50,000. For example, if the two
mortgagors should default, and if each piece of property should sell for
only $105,000, the first mortgage of $112,000 would be short $7000, whereas
the second mortgage of $30,000 (in case 2) would be paid off in full with
$25,000 left for the mortgagor.

If the interest or payments on principal on a first mortgage should
get in arrears, the mortgagee may dispose of the property at public sale,
even if the selling price is not sufficient to pay off the holder of the
second mortgage. But the holder of an unsatisfied second mortgage can not
dispose of the property at a price below the amount of the first mortgage.

379. Preparing the Schedule.--Just as a note receivable register is a
useful necessity whenever the business handles a large number of notes, so
also a mortgage register is desirable whenever the mortgages are unwieldy.
From this register the auditor should prepare (or have prepared) his
schedule on mortgages receivable (Plate 120), showing thereon a description
of the premises mortgaged, the location of these premises, the name and
address of the mortgagor, the value of the property mortgaged, a full

1All other conditions being equal.
description of any prior mortgage, the rank of the client's mortgage, the
date and due date of the mortgages, the amount and date of install­
ments required on principal, the interest and dates, the amount of the
mortgage, the receipts during the period on principal and interest, the
accrued interest receivable, the deferred interest income, the various
supporting documents examined, the name and address of participants, the
amount of participation, and such other data as is essential under the
particular circumstances.

380. See Plate 120

381. Checking the Schedule. — After the schedule has been drawn up
from the register, the auditor is then in a position to check the mort­
gage notes, and their supporting documents, against it in all partic­
culars. The balance in the Book Value column, as at the end of the year,
should then be checked to the general ledger account, and this in turn
should be completely traced back into the books of original entry. The
auditor should then trace the interest receipts into the cash book (the
receipts on principal having been checked when the general ledger ac­
count was audited), compute the amortization of discount (if any), the
accrued interest receivable, and the deferred interest income adjust­
ments.

382. The Warranty Deed. — The first document that the auditor
should examine is the warranty deed (Plate 121), in which the seller
warrants his title to the property to be good. This deed should be
signed under seal by the seller in the presence of a witness and ac­
knowledged before a notary public; the name of the grantee should be the
mortgagor; and the deed should bear evidence of having been recorded in
the public records.

383. See Plate 121.

384. The Mortgage Deed. — In examining a mortgage deed (Plate 122),
the auditor should see that it has been sealed and signed by the mortga­
gor in the presence of a witness, and acknowledged before a notary
public; that the client's name appears as the mortgagee (or if not) there
must be a properly executed assignment in the name of the client; that
the deed (and assignment, if any) bears the evidence of having been re­
corded in the public records; and that the description of the property is
the same as that in the warranty deed.

From the wording of the mortgage, the auditor can readily ascertain
whether it is a first or a second mortgage, and what are the requirements
as to interest and installments on principal; and so on.

Furthermore, the auditor should have in mind that it is possible
for a paid up mortgage to remain in the hands of a mortgagee (the dis­
charge of record being accomplished by the issuance of a satisfaction
piece). However, it is customary for an auditor to accept the deed as
evidencing an asset, IF the interest and the installments on principal
(if required) are being received regularly, and IF all other documents
are in order and IF no irregularities appear in the general ledger account.

385. See Plate 122.

386. The Mortgage Note. — As a rule, there will also be a mortgage
note (or notes) (Plate 123) in addition to the mortgage deed, but it is
not necessary that there be one. The deed is the security, whereas the
EXPLANATION OF PLATE 120

A SCHEDULE OF MORTGAGES RECEIVABLE

SAUL SLATER, INC.
Mortgages Receivable
B/S Audit for the Year Ending Dec. 31, 1930

380. Explanation and Comments.—The reader should note that the amount of the mortgages is $387,400.00 (i.e. $361,900.00 held by the client, and $25,500.00 in prior mortgages held by others than the client), whereas the estimated value of the properties is at least $784,000.00.

The figures and information under "Prior Mortgages Held by Others" is merely additional information, BUT IMPORTANT. Thus P.M.Fillebrown also owes M. Marquette $3,000.00 on a first mortgage, as well as $5,000.00 to S. Slater, Inc. on a second mortgage.

Also, observe that the mortgage note of P.M.Fillebrown for $5,000.00 was purchased by S. Slater, Inc. at a discount, which at January 1, 1930 was $500.00 - ($5,000.00 (face value) minus $4,500.00 (book value)).

The vital figures are contained in columns 1 through 4. Column 4 is the sum of columns 1 and 2 minus 3.

By means of insert sheets, all of the information shown in this plate can be confined to a book of ordinary size.

On some audits the auditor may find participation agreements. When this is so, this document (in the hands of a junior participant) takes the place of a mortgage. It usually states either the details of the primary mortgage, or the place where such details may be found, together with a recital that a certain portion of said mortgage has been sold to the within named participant, or to the holder thereof. Accordingly, it should be clear that the agreement is like a bond, the primary mortgage being held by the senior participant, just as the bond trustee holds the primary mortgage indenture.

In handling the bookkeeping entries, it is desirable for the senior participant to record the amount of the primary mortgage in one account and the participation amounts in one or more other accounts.

As the senior participant receives the interest and the installments on principal on the whole mortgage, and distributes the proper proportion(s) thereof to the minor participant(s), the aforesaid accounting system lends itself both to the easiest auditing and to the clearest understanding of these transactions.

Of course, on the balance sheet the net amount, i.e. the whole mortgage less the installment receipts and the participations, should be shown somewhat as follows:

<table>
<thead>
<tr>
<th>Mortgages Receivable</th>
<th>$xx</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less Installment Receipts Thereon</td>
<td>xx</td>
</tr>
<tr>
<td>Net</td>
<td>$xx xx</td>
</tr>
</tbody>
</table>

Less Participations by Others

for the junior participations are not liabilities.
A SCHEDULE OF MORTGAGES RECEIVABLE  PLATE 120

Saul Slater, Inc.
Mortgages Receivable
B/S Audit for the Year Ended December 31, 1930
(1) Schedule M

<table>
<thead>
<tr>
<th>Description</th>
<th>Location</th>
<th>MORTGAGOR</th>
</tr>
</thead>
<tbody>
<tr>
<td>5 Tenement House</td>
<td>114 Blackstone Ave, P.R.Brown, 12 Myrtle St., City Providence, R.I.</td>
<td></td>
</tr>
<tr>
<td>1 Family Bungalow</td>
<td>11217 Detroit Ave, Oscar Brown, 741 Orchard St., City Boston, Mass.</td>
<td></td>
</tr>
</tbody>
</table>

(2) CONTINUATION

<table>
<thead>
<tr>
<th>Value of Property Amount</th>
<th>Prior Mortgages Held By Others</th>
<th>Rank of Mortgage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis</td>
<td>Amount Other Details</td>
<td>Client's</td>
</tr>
<tr>
<td>15000.00 Tax Assessment</td>
<td>3500.00 6% J-12 and J-12 Due 1939 Second</td>
<td>M. Marquette</td>
</tr>
</tbody>
</table>

15000.00 " " NONE First

784000.00 Totals 685000.00

(3) CONTINUATION

<table>
<thead>
<tr>
<th>Date of Client's Mortgage</th>
<th>Maturity Date</th>
<th>Installments of Principal Amount</th>
<th>Installments of Interest Due Date</th>
<th>Rate</th>
<th>Due Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/29</td>
<td>12/31/34</td>
<td>1000.00</td>
<td>Dec. 31</td>
<td>7</td>
<td>B-31 J-30</td>
</tr>
<tr>
<td>2/2/29</td>
<td>2/2/36</td>
<td>900.00</td>
<td>Feb. 2</td>
<td>6</td>
<td>F-2 A-2</td>
</tr>
</tbody>
</table>

( Note: Read from left to right, top to bottom.)
### Book Value Amortization Receipts on Book Value Co-

<table>
<thead>
<tr>
<th>1/1/30</th>
<th>of Discount</th>
<th>Principal</th>
<th>12/31/30</th>
<th>Amortization</th>
<th>Receipt</th>
</tr>
</thead>
<tbody>
<tr>
<td>4500.00</td>
<td>100.00</td>
<td>1000.00</td>
<td>5600.00</td>
<td>9000.00</td>
<td>OK</td>
</tr>
<tr>
<td>6100.00</td>
<td>2/2</td>
<td>900.00</td>
<td>7200.00</td>
<td>10000</td>
<td>&quot;</td>
</tr>
</tbody>
</table>

**OMISSIONS**

<table>
<thead>
<tr>
<th>401700.00</th>
<th>800.00</th>
<th>20600.00</th>
<th>381900.00</th>
<th>555500</th>
<th>Totals</th>
</tr>
</thead>
<tbody>
<tr>
<td>OK</td>
<td>0X</td>
<td>OK</td>
<td>OK</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### (5) Continuation

<table>
<thead>
<tr>
<th>Title</th>
<th>Cash Receipts on Interest</th>
<th>Deferred</th>
<th>Memo of Face Value</th>
<th>RemarKs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Title</td>
<td>Cash Receipts on Interest</td>
<td>Deferred</td>
<td>Memo of Face Value</td>
<td>Remarks</td>
</tr>
<tr>
<td>O X</td>
<td>175.00</td>
<td>140.00</td>
<td>5000</td>
<td>Interest is payable in advance</td>
</tr>
<tr>
<td>O X</td>
<td>216.00</td>
<td>36.00</td>
<td>8100</td>
<td>Ditto</td>
</tr>
</tbody>
</table>

**OMISSIONS**

<table>
<thead>
<tr>
<th>T</th>
<th>4769.43</th>
<th>400000</th>
<th>Totals</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>OK</td>
<td>Z</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### (6) Continuation

<table>
<thead>
<tr>
<th>Name and Address</th>
<th>Amount</th>
</tr>
</thead>
</table>

**OMISSIONS**

<table>
<thead>
<tr>
<th>Total</th>
<th>17000.00</th>
<th>OK per H-l</th>
</tr>
</thead>
</table>

OK Checked to the General Ledger
T Tested to the Cash Book
Z Memorandum information only

For the audit procedure, see the Audit Program.

(Note: Read from left to right, top to bottom.)
A FORM OF WARRANTY DEED — PLATE 121

383. Explanation and Comments.—The most important features of the deed for the auditor to examine are: (1) that the deed is signed under seal in the presence of a witness and acknowledged before a notary; (2) that the name of the grantee is that of the mortgagor; and (3) that the deed should bear evidence of having been recorded in the public records.

WARRANTY DEED

Hannah S. Reid  

  to  

Robert H. Farmsley & 

Edna May Farmsley  

Received for Record
March 21, 1910 at 11:15 o'clock
A.M., and Recorded in Book No. 135 Page 77 of the Records of Deeds in the City of Belleville, R.I.

Witness  

Samuel K. Stowe  

City Clerk.
PLATE 121 (CONTINUATION)

KNOW ALL MEN BY THESE PRESENTS, THAT

I, Hannah S. Reid (widow) of the City of Belleville, County of Washtenaw and State of Rhode Island hereinafter called the Grantor, in consideration of ten dollars ($10.00) Dollars, _ to _ to me paid by _Robert H. Farmley, and Edna May Farmley of the City of Belleville _ state aforesaid hereinafter called the Grantees, the receipt whereof is hereby acknowledged, do hereby give, grant, bargain, sell and convey into the said Grantees, and their _ heirs _ and assigns forever, as joint tenants and not as tenants in common.

__ That lot of land with all the improvements thereon, situated on the westerly side of Lilac street in said Belleville, laid out and designated as lot numbered nine (9) on "Map of House Lots in Belleville belonging to Wallace Reid, surveyed and drawn by Wm. S. Paines, April 30, 1874" said plat being on file on the land records in said Belleville, plat card No.176 to which reference is made. Being the same premises devised to this grantor by last will and testament of her late husband _Frank M. Reid_ of said Belleville, and inherited by the said Frank M. Reid from his father _Wallace Reid_ late of Said Belleville, deceased, intestate being the sole heir at law.

---

TO HAVE AND TO HOLD, the aforesaid premises, with all the privileges and appurtenances thereunto belonging, unto and to the use of the said Grantees, and _their_ heirs and assigns, forever; as joint tenants and not as tenants in common.

And _I_, _the_ said Grantor, _do hereby, for _myself_ and for _my_ heirs, executors and administrators, covenant with the said Grantees and _their_ heirs and assigns that _I am_ lawfully seized in fee simple of the said granted premises; that the same are free from all incumbrances that I have good right, full power and lawful authority to sell and convey the same in manner aforesaid; that the said Grantees and _their_ heirs and assigns shall by these presents at all times hereafter peaceably and quietly have and enjoy the said premises, and that _I_, _the_ said Grantor will, and _my_ heirs, executors and administrators shall, warrant and defend the same to the said Grantees _and _their_ heirs and assigns forever against the lawful claims and demands of all persons.

IN WITNESS WHEREOF, _I_ have hereunto set hand and seal this _21st_ day of _March_ _ in the year of our Lord one thousand nine hundred and ten _

Signed and sealed in presence of

Ralph S. Wightman

Hannah S. Reid _ _(Seal)_

STATE OF Rhode Island

County of Washtenaw _

In _Belleville_ _ on the _21st_ day of _March_ _ A.D. _1910 _

before me personally appeared

Hannah S. Reid _ ________________________

to me known and known by me to be the party executing the foregoing instrument, and _she_ acknowledged said instrument, by _her_ executed, to be _her_ free act and deed.

Ralph S. Wightman
Notary Public
385. Explanation and Comments.--If the mortgages are different from one another and very few, the auditor may read them all, or at least scan their contents, but otherwise a test here and there will be sufficient. Of course, if it is an institution (such as a bank) that is being audited, the mortgage form will be standard, so that if the auditor reads one deed he has read them all except for special instances which will show up in the typewriting (i.e. the printed words of the form need not be read as the peculiarities of the deed will be typewritten).

In all cases the auditor should see that the deed is on the property described in the warranty deed; that the deed is signed and sealed by the mortgagor in the presence of a witness and acknowledged before a notary; that the client's name appears as the mortgagee; that the deed bears evidence of having been recorded; that the principal and interest rates check with those on the mortgage schedule.

NO 1416

MORTGAGE DEED

Robert H. & Edna May Farmsley

TO

THE

NOONSOCKET INSTITUTION FOR SAVINGS

RECEIVED FOR RECORD
IN BELLEVILLE, R.I.
AUGUST 12, 1912
AT 4:50 P.M. AND
RECORDED IN BOOK
NO. 151 PAGE 236

ATTEST

Herbert George
CITY CLERK
We, Robert H. Farmley and Edna May Farmley of the city of Belleville, county of Hamilton and state of Wisconsin, now in the state of Rhode Island.

Send Greeting — Know ye that we, the said Robert H. Farmley and Edna May Farmley, for and in consideration of the sum of twenty-two hundred ($2200) dollars to us, in hand before the ensalving hereof well and truly paid by the Noonsocket Institution for Savings, a Corporation legally incorporated and established, and transacting business in the City of Noonsocket, in the State of Arizona, the receipt whereof we do hereby acknowledge and agree therewith fully satisfied, contented and paid; and thereof, and of every part and parcel thereof, do oxonorate, acquit and discharge the said Noonsocket Institution for Savings, and its Successors forever by these Presents; have given, granted, bargained, sold, aliened, enfeoffed, conveyed and confirmed; and by these Presents do freely, fully and absolutely give, grant, bargain, sell alien, enfeof, convey and confirm unto the said Noonsocket Institution for Savings, its Successors and Assigns forever.

That lot of land with the buildings and improvements thereon situated on the westerly side of Lilac Street in said Belleville, laid out and designated as lot numbered nine (9) on "Map of House Lots in Belleville, belonging to Wallace Reid, surveyed and drawn by Wm. S. Paine, April 30, 1874" said plat being on file in the land records in said Belleville plat card No. 176 to which reference is made.

Meaning and hereby conveying the same premises conveyed to us the mortgagors hereof, by deed from Hannah S. Reid dated March 21st, 1910, recorded in said records, book No. 136, page 77.

TO HAVE AND TO HOLD the said granted and bargained Premises with all appurtenances, privileges and commodities, to the same belonging, or in anywise appertaining to the Noonsocket Institution for Savings, its Successors and Assigns, to its and their only proper use, benefit and behoof, forever.

And we, the said Robert H. Farmley and Edna May Farmley, for ourselves, our Heirs, Executors and Administrators, do covenant, promise and grant, to and with the said Noonsocket Institution for Savings, its Successors and Assigns, that at and before the ensalving hereof we are the true, sole and lawful owners of the above bargained Premises, and are lawfully seized and possessed of the same, in our own proper right, as good, perfect and absolute estate of inheritance, in fee simple; and have in ourselves good right, full power, and lawful authority, to grant, bargain, sell, convey, and confirm the said bargained Premises, in manner as aforesaid. And that the said Noonsocket Institution for Savings, its Successors and Assigns, shall and may from time to time and at all times forever hereafter by force and virtue of these Presents, lawfully peaceably and quietly have, hold, use, occupy, possess and enjoy the said demised and bargained Premises, with the appurtenances, and that free and clear and freely and clearly acquired and discharged of and from all and all manner of former or other gifts, grants, bargains, sales, leases, mortgages, wills, entail, jointures, doweries, judgments, executors and encumbrances of what name or nature soever that might in any measure or degree obstruct or make void this present deed.

FURTHERMORE, we, the said Robert H. Farmley and Edna May Farmley for ourselves, our Heirs, Executors and Administrators, do covenant and engage the above demised Premises to the said Noonsocket Institution for Savings, its Successors and Assigns, against the lawful claims or demands
any person or persons whatsoever, forever to warrant, secure and defend these Premises.

And I the said Robert H. Farmsley do hereby release my right of courtesy unto said mortgagor, its successors and assigns in said premises.

And I, Edna May Farmsley, wife of said Robert H. Farmsley in consideration of the sum paid as aforesaid, do hereby release and forever quit claim unto the said Noonsocket Institution for Savings, its Successors and Assigns, all my right of dower in and to the aforesaid granted Premises.

PROVIDED NEVERTHELESS, that if we the said Robert H. Farmsley and Edna May Farmsley, our Heirs, Executors, Administrators or Assigns shall pay unto the said Noonsocket Institution for Savings, its Successors or Assigns, the sum of twenty-two hundred Dollars, on demand, with interest thereon at the rate of 6 per centum per annum, payable semi-annually in advance till said principal sum is paid whether at or after demand, and all installments of said interest in arrears to carry interest at the rate aforesaid till paid, and shall also pay all taxes and assessments of every kind levied or assessed upon said Premises, then this deed, as also, that certain promissory note bearing even date with these Presents, signed by us the said Robert H. Farmsley and Edna May Farmsley whereby for value received we promise to pay the said Noonsocket Institution for Savings, or order, the said sum with interest as aforesaid at the times aforesaid, shall be and become absolutely void to all intents and purposes whatsoever.

But if default shall be made in the payment of the money above mentioned, or of said interest, at the times aforesaid, or of the taxes or assessments aforesaid as the same become payable, or of any or either of them, or of any part thereof, or if breach shall be made of the covenant for insurance hereinafter contained then it shall be lawful for the said Noonsocket Institution for Savings, its Successors or Assigns, to sell and dispose of together or in parcels all and singular the Premises hereby granted or intended to be granted, or any part or parts thereof, and the benefit and equity of redemption of the said Robert H. Farmsley and Edna May Farmsley our Heirs, Executors, Administrators and Assigns therein, at Public Auction and to bid or become the purchaser at any such sale; first giving notice of the time and place of sale by publishing the same at least once each week, for three successive weeks, in some newspaper printed in said county of Washington; and such sale or sales to be upon the premises sold or elsewhere, as specified in such notice; with power to adjourn such sale from time to time; and in its or their own name or names, or as the Attorney or Attorneys of the said Robert H. Farmsley and Edna May Farmsley (for that purpose by these presents duly authorized and appointed, with full power of substitution and of revocation), to make, execute and deliver to the purchaser or purchasers thereof, a good and sufficient deed or deeds of the same in fee simple; and to receive the proceeds of such sale or sales, and from such proceeds to retain the said sum of twenty-two hundred Dollars, or the part thereof then remaining unpaid, and also the interest then due on the same, together with all expenses incident to such sale or sales, with the taxes, assessments, and premiums of insurance, if any, theretofore paid by said Noonsocket Institution for Savings, its Successors or Assigns, upon said granted Premises; and rendering and paying the surplus of said proceeds of sales, if any there be, over and above the amounts so to be retained as aforesaid, together with a true and particular account of such sale or sales, expenses and charges, to the said Robert H. Farmsley and Edna May Farmsley, their Heirs, Executors, Administrators or Assigns; which said or sales, so to be
made, shall forever be a perpetual bar both in law and equity, against the said __ Robert H. Farmsley and Edna May Farmsley, their __ __ __ Heirs and Assigns, and all persons claiming or to claim said Premises so sold, by, from or under __ them, or any of them.

AND FURTHERMORE We _ _ the said Grantors for ourselves _ _and for our_ Heirs, Executors, Administrators and Assigns, do hereby covenant with the said Noonsocket Institution for Savings, its Successors and Assigns, that insurance against loss by fire shall be kept and maintained upon the buildings on the Premises aforesaid, in such office or offices as the said institution, its Successors or Assigns, shall approve, in the sum not less than _twenty-two hundred_ __ Dollars, and that the Policy or Policies of such Insurance shall be assigned and transferred, or in case of loss made payable to the said Noonsocket Institution for Savings, its Successors and Assigns, as collateral security hereof; and in default thereof do hereby agree that the said Noonsocket Institution for Savings, its Successors or Assigns, may effect such insurance in the name of the said Grantors, their_ Heirs or Assigns, payable in case of loss to said institution, its Successors or Assigns, and the premium or premiums paid therefor shall be a further charge upon said granted Premises secured by these Presents.

IN TESTIMONY WHEREOF, _ _ we _ _ have hereunto set _ _our_ hands and seals this _ 3rd _ _ day of August _ _ in the year of our Lord, One Thousand Nine Hundred and _ _twelve _ _.

Signed, sealed and delivered _ _
in the presence of _ _
Charles K. Rowe _ _

__ Robert H. Farmsley (L.S.)
__ Edna May Farmsley (L.S.)

STATE OF Rhode Island
County of Washtenaw
SS.

In Belleville _ _ in the said County, on the _ 3rd _ _ day of _ August _ _ A.D. _ _1912 _ _ before me personally appeared _ _
__ __ __ Robert H. Farmsley and Edna May Farmsley _ _each and all _ _
to me known, and known by me to be the parties _ _executing the foregoing instrument, and _ _they _ _acknowledged said instrument, by _ _them _ _executed, to be _ _their _ _free act and deed._

Charles K. Rowe _ _
__ Notary Public __
The Noonsocket Institution for Savings, having received and full payment satisfaction of the within Mortgage does hereby cancel and discharge the same.

IN TESTIMONY WHEREOF, said Institution has caused these Presents to be signed and its corporate Seal to be affixed by the Treasurer thereof, duly authorized this ___ 3 ___ day of August ___ A.D. 1926.

Signed and Sealed in presence of

James Chaput

Noonsocket Institution for Savings

___ __ Ralph Lewis
Treasurer

( Bank's Seal )

DISCHARGE RECORDED August 7, 1926

AT 2:55 A.M.

BOOK 269 PAGE 112

F.G.

Herbert George
City Clerk
note is the evidence of the debt.

Ordinarily, payments on principal will have been received, especially if it is a second mortgage. These payments must be recorded on the note (and possibly those for interest). If permitted and feasible, the auditor should confirm the balances due on the notes with the respective mortgagors, or at least make a test of the notes if they are very numerous (as in banks, etc.).

The auditor should keep in mind that an over note does not necessarily indicate a doubtful asset, because the security affords ample protection. In fact, the mortgage may even encourage the mortgagor to allow the debt to continue undiminished.

387. See Plate 123.

388. The Insurance Policy.—If the property is improved, the mortgagor should require the insurance policy. The auditor, in his examination, must see that the description of the property tallys with the mortgage and the warranty deeds; that the coverage is ample; that the policy is in force; that the mortgagee is the payee; and that the policy is signed by the insurance company.

389. The Title Guaranty Policy, and Tax Receipts.—Finally, the auditor should see that the abstract of title, or title guaranty policy (if any) (Plate 124), is in order, and that the tax receipts are on hand. Some mortgagees do not require these documents of the mortgagor, but the careful investor does. Therefore, if they are not on hand, the auditor should recommend that they be secured, because it costs the mortgagee nothing to have this additional substantial protection.

390. See Plate 124.

391. The Public Records.—If an auditor is versed in looking up titles in the public records, he can put his time to extremely good use in verifying that the mortgage has not been discharged, and in ascertaining what are the prior liens (if any) against the property. As yet, however, modern audit practice does not require this verification, because it demands a type of legal training not yet asked of certified public accountants.

392. The Property.—As the auditor is not an appraiser, he is not required to appraise the mortgaged property in order to prove that the loan (mortgage) is really secured. If the fire insurance is sufficient to cover the mortgage, that is accepted as adequate security.

393. The Balance Sheet Treatment.—As a rule, mortgages are investments—not current assets—because their maturity is generally more than one year in the future. Second mortgages and chattel mortgages should be designated as such. And,—if the mortgages are guaranteed by a guaranty company, the caption may as well indicate it.

394. Comments on and Discussion of Leaseholds.—If a client merely has a lease, he should not ordinarily set-up on the financial records any value for it. Thus, if K has signed a 40 year lease at an annual rental of $80,000.00, he must not make record of it on his financial books. Moreover, a simple annual advance payment of a rental under the terms of a lease is not a proper entry in this account. Only those large lump-sum payments made in advance as the total price of a long term lease

1Very often several notes are made out in the amount of the required payments.
On demand for value received we promise to pay the
NOONSOCKET INSTITUTION FOR SAVINGS

OR Order, Twenty-two hundred (2200) Dollars,
at their Banking House, with interest, at the rate of six (6%) per cent per annum, payable semi-annually in advance till said
principal sum is paid, whether at or after maturity and all
installments of interest in arrear, whether before or after its maturity, to carry interest at the rate aforesaid till paid.

This note is secured by mortgage or real estate of even date
herein.

Executed in presence of
Charles K. Rowe
Robert H. Farmsey
Edna May Farmsey

<table>
<thead>
<tr>
<th>Year</th>
<th>Month</th>
<th>Principal Paid</th>
</tr>
</thead>
<tbody>
<tr>
<td>1914</td>
<td>Feb. 2</td>
<td>One Hundred Dollars</td>
</tr>
<tr>
<td>1915</td>
<td>Feb. 2</td>
<td>Fifty</td>
</tr>
<tr>
<td>1916</td>
<td>Aug. 2</td>
<td>Fifty</td>
</tr>
<tr>
<td>1916</td>
<td>Feb. 1</td>
<td>Fifty</td>
</tr>
<tr>
<td>1916</td>
<td>Aug. 5</td>
<td>Fifty</td>
</tr>
<tr>
<td>1917</td>
<td>Feb. 2</td>
<td>Fifty</td>
</tr>
<tr>
<td>1917</td>
<td>Aug. 4</td>
<td>Fifty</td>
</tr>
<tr>
<td>1918</td>
<td>Jan. 30</td>
<td>Fifty</td>
</tr>
<tr>
<td>1918</td>
<td>Aug. 1</td>
<td>Fifty</td>
</tr>
<tr>
<td>1919</td>
<td>Feb. 13</td>
<td>Fifty</td>
</tr>
<tr>
<td>1919</td>
<td>Aug. 2</td>
<td>Fifty</td>
</tr>
<tr>
<td>1920</td>
<td>July 29</td>
<td>Fifty</td>
</tr>
<tr>
<td>1920</td>
<td>Aug. 2</td>
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</tr>
<tr>
<td>1921</td>
<td>Feb. 3</td>
<td>Fifty</td>
</tr>
<tr>
<td>1921</td>
<td>Aug. 2</td>
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<tr>
<td>1922</td>
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<td>Fifty</td>
</tr>
<tr>
<td>1923</td>
<td>Jan. 31</td>
<td>Fifty</td>
</tr>
<tr>
<td>1923</td>
<td>July 20</td>
<td>Two Hundred Fifty</td>
</tr>
<tr>
<td>1924</td>
<td>Jan. 30</td>
<td>One Hundred</td>
</tr>
<tr>
<td>1926</td>
<td>Aug. 3</td>
<td>Nine Hundred</td>
</tr>
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</table>
### PLATE 125 (Continuation)

<table>
<thead>
<tr>
<th>Year</th>
<th>Month</th>
<th>Received</th>
<th>Interest to</th>
<th>Date</th>
<th>Amount</th>
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<tbody>
<tr>
<td>1912</td>
<td>Aug. 3</td>
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<td>Feb. 3 1913</td>
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<tr>
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<td>Jan. 30</td>
<td>6</td>
<td>Aug. 3 1913</td>
<td>66.00</td>
<td></td>
</tr>
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<td>Aug. 2</td>
<td>6</td>
<td>Feb. 3 1914</td>
<td>66.00</td>
<td></td>
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<td>Aug. 3 1922</td>
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<td>27.00</td>
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<td>6</td>
<td>Feb. 3 1925</td>
<td>27.00</td>
<td></td>
</tr>
<tr>
<td>1925</td>
<td>Jan. 30</td>
<td>6</td>
<td>Aug. 3 1925</td>
<td>27.00</td>
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</tr>
<tr>
<td>1925</td>
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<td>6</td>
<td>Feb. 3 1926</td>
<td>27.00</td>
<td></td>
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<td>1926</td>
<td>Jan. 30</td>
<td>6</td>
<td>Aug. 3 1926</td>
<td>27.00</td>
<td></td>
</tr>
</tbody>
</table>

387. Explanation and Comments.—As stated in the text, a note is not necessary, but if there is one (or more) it should show the receipts on interest and the receipts on principal. The auditor must see that the balance of the note (based on the face and the recorded receipts on principal) tallys with his schedule. All the "reading"; i.e., the typewritten material filled in on the printed form, should tie-in with the information in the mortgage deed as to payee, interest rate, maker, etc.
AN ABSTRACT OF TITLE - PLATE 124

TITLE - REID

Title of lot No. 310 Assessors Plat No. 31 being lot No. 9 on plat formerly owned by Wallace Reid.

Hannah S. Reid widow of Frank M. Reid the present owner.

Will of Frank M. Reid.

I, Frank M. Reid of the city of Belleville, in the county of Washtenaw and State of Rhode Island, being of sound mind and memory, do make and declare this my last will and testament, hereby revoking all former wills by me made, in manner following:-

1st. Payment of just debts and funeral expenses.

2nd. I give, devise and bequeath all my real estate and personal property of whatever name and nature and wherever situated of what I am now possessed or to which I am entitled and which I may hereafter acquire to my beloved wife - Hannah S. Reid - and her heirs forever and this legacy and bequest I make having in mind my daughter - S. May Reid - having full confidence that it will be for her best interest that her mother shall hold my estate.

3rd. I nominate and appoint said Hannah S. Reid executrix without bond or inventory.

Will executed Dec. 4, 1901

Witnesses - Charlotte M. Snow, Ralph W. Sears.

Frank M. Reid deceased in Belleville, Dec. 26, 1901

Will duly admitted to probate on waiver of notice of all heirs -

Hannah S. Reid, S. May Reid - Jan. 8, 1902

Hannah S. Reid duly appointed executrix.

Bond - None. Inventory - None.


Belleville Probate Records, File No. 4206

Frank M. Reid inherited the premises from his father - Wallace Reid.

Wallace Reid deceased in Belleville, Nov. 2, 1892, widower, intestate.

Frank M. Reid duly appointed executor on waiver of notice. Said Frank M. Reid being the sole heir at law. Jan. 4, 1893.

Bond - $10,000

Sureties - Frederic Reid, Elias M. Chaput.

Belleville Probate Records, File No. 2902.

Wallace Reid.

Bought of Russell Wilson. Wife - Lucy S.

Horace Duxbury, No dower.

Warranty Deed.

PLATE 124 (Continuation)


C. W. Lush, Justice of the Peace.

Tract of land as platted by Reid and right of way to same - Summer Street.

No further conveyance.

Russell Wilson.
Horace Duxbury

Bought of Frank Dary

Warranty Deed
Dated April 27, 1854, Acknowledged April 28, 1854. Recorded May 2, 1854

Benjamin Capron, Justice of the Peace

Tract of land as platted. Right of way purchased by John O. Dary from

No further conveyances
Frank Dary inherited the premises from his Uncle - John O. Dary by will. See copy below.

In the Name of God, Amen, I John O. Dary of Attleboro, in the county of
Bristol and Commonwealth of Washington being of sound and disposing
mind, do make and ordain this my last will and testament in manner follow-
ing:-

1st. I hereby direct my executor hereinafter named to pay all debts & c.

2nd. I hereby direct my said executor within one year after my decease to
pay to Edwin Jenkins and May B. Jenkins his wife, both of Belleville,
the sum of $150 each, the payment to be paid into the hands of each
of them and no part of said sum to be at any time subject to or to be
taken from any of the debts of said Edwin Jenkins.

3rd. I give, devise and bequeath unto my nephew Frank Dary, Jr. his heirs
and assigns all the rest and residue of my estate both real and
personal of what name or nature soever and wheresoever the same may
be found after paying my just debts, funeral expenses and what I
have given Edwin Jenkins and wife.

Lastly, I hereby appoint my said nephew Frank Dary, Jr. sole executor of
this my last will and testament, hereby revoking and rendering null
and void all former wills by me made.

Will executed December 6, 1849.
Witnesses - Robert Mowry, George Lewis, George A. Lewis.
Will duly admitted to probate April 5, 1850.
Bond - $15,000 Sureties - Elkanah Sherwood, Oscar Clifford.
Frank Dary duly appointed executor.
Belleville Probate Records, File No. 3950.
Will Duly probated in Bristol county, Washington.

John O. Dary.

Bought of Sarah Duxbury and others by Attorney
Frank Dary

Warranty Deed.
Dated Jan. 8, 1934 Acknowledged do Recorded Jan. 24, 1934
Belleville - Taunton Records, Book B. Page 565

Robert Mowry, Justice of the Peace.
Plate 124 (Continuation)

Tract of land situated on the westerly side of the road leading from James French's to the Dolly Sorrell (now South Bend Street) and includes the parcel of land as platted by Wallace Reid.

No further conveyances.

I have carefully examined the title of lot No. 9 on the Wallace Reid Plat, situated on the westerly side of Lilac Street, Belleville, Rhode Island, now owned by

Hannah S. Reid widow of Frank M. Reid.

and find the same good, free from encumbrances, according to the land record indexes in said Belleville, of which the foregoing is a copy.

No attachments or liens.

No pending suits.

Taxes for 1909 paid.

Belleville, Rhode Island, March 19, 1910

Charles Bartlett
Examiner

This tract and lot of land was purchased by Wallace Reid, Feb. A.D. 1860 and inherited from him by his son Frank M. Reid, only heir and by Frank M. Reid devised to his wife - Hannah S. Reid - the present owner.

390. Explanation and Comments.—Very often the abstract of title is prepared by a guaranty company which insures the purchaser against any loss, should it ever be proven that the party who sold him the property had no title to it.

Note the summary by the examiner on the last page. A brief resume of this sort is very desirable. It is the part of the abstract which contains the facts in which the auditor is most interested.
are to be recorded under Leaseholds.

If the life of the lease is long and if the money involved is substantial, the advance premium paid ought to be looked upon as the present value of an annuity, the annuities being the future annual rents. If this theoretically correct procedure is adopted, and it should be under the conditions stated, the annual charges to Rent Expense will be found to be widely variant from the figures obtained by amortizing the advance premium by the straight line method. But if the difference under these two methods is negligible, the straight line method should be used by all means.

Although in general it must be condemned, nevertheless, if a client wishes to capitalize a favorable lease, the auditor will have to acquiesce. His chief concern is then centered around the proper wording of the accounts and of his certificate. The correct method to arrive at the appraised value of the leasehold is to capitalize the present value of an annuity of the difference between the actual rent paid and the rent which the place would yield if subleased. This latter figure should be secured from a reputable realtor,—otherwise the appraisal has no legs on which to stand. Thus, assume that a client has purchased (paid for), on a 5% basis, a 40 year lease at an annual rental of $100,000.00, and that a reputable realtor has certified that the property has a rental value of $125,000.00 per annum for the 20 years of the life of the lease. On this basis, there would be added to the Leasehold account the present value of an annuity of $25,000 ($125,000 - $100,000.00) for 20 years. As a result, the final value in the Leasehold account would be the present value of an annuity of $125,000.00 for 20 years. The selection of the rate of interest to be used in the computation should be conservative. The offsetting credit to the debit entry, which brings the Leasehold account up to the appraised value, should be to a clearly named capital surplus account such as, "Appraisal Surplus —Leasehold." This surplus account will have to be charged annually, with the portion of it which has been realized.

EXAMPLE

(Assumptions)
(1) A lease still has a life of twenty years.
(2) The total advanced premium is now $1,246,221.03.
(3) The appraised premium is now $1,557,776.29.

(Solution)

Leasehold

<table>
<thead>
<tr>
<th>Appraised Surplus —Leasehold</th>
<th>311,555.26</th>
</tr>
</thead>
</table>

To establish the leasehold at its appraised value. 

<table>
<thead>
<tr>
<th>Appraised value —(annual rental $125,000.00 - 5% - 20 years)</th>
<th>equals $1,557,776.29.</th>
</tr>
</thead>
</table>

The value now in the account is $1,246,221.03.

Rent Expense

<table>
<thead>
<tr>
<th>Leasehold Income</th>
<th>77,888.81</th>
</tr>
</thead>
<tbody>
<tr>
<td>Leasehold</td>
<td>47,111.19</td>
</tr>
</tbody>
</table>

To record the decrease in the appraised leasehold value.

1Usually the same rate as that already embodied in the lease,—if not, the appraised value of the lease (above) should be the present value of an annuity of $125,000 at the new interest rate.
22-20

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Appraised value Jan. 1</td>
<td>$1,557,776.29</td>
</tr>
<tr>
<td>Rate of Interest</td>
<td>0.05</td>
</tr>
<tr>
<td>Interest Income</td>
<td>$77,686.81</td>
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<tr>
<td>Appraised Value Jan. 1</td>
<td>1,557,776.29</td>
</tr>
<tr>
<td>Total</td>
<td>$1,635,665.10</td>
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<tr>
<td>Rent Expense</td>
<td></td>
</tr>
<tr>
<td>Appraised value Dec. 31</td>
<td>$125,000.00</td>
</tr>
<tr>
<td></td>
<td>1,510,665.10</td>
</tr>
<tr>
<td><strong>Appraisal Surplus-Leasehold</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Leasehold Income</strong></td>
<td></td>
</tr>
<tr>
<td>To take out of Appraisal Surplus</td>
<td></td>
</tr>
<tr>
<td></td>
<td>realized this year</td>
</tr>
<tr>
<td>Appraisal surplus Jan. 1</td>
<td>$311,555.26</td>
</tr>
<tr>
<td>Interest Rate</td>
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<tr>
<td>Interest Income</td>
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<td>Appraisal Surplus Jan. 1</td>
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<td>Total</td>
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<tr>
<td>Rent Expense</td>
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<tr>
<td>Appraisal surplus Dec. 31</td>
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<tr>
<td>Appraisal surplus Jan. 1</td>
<td>311,555.26</td>
</tr>
<tr>
<td>Appraisal surplus Dec. 31</td>
<td>302,133.02</td>
</tr>
<tr>
<td>Difference (journal entry)</td>
<td>$9,422.24</td>
</tr>
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</table>

By this procedure there will have gotten into operating expense a rental charge of $125,000.00, which otherwise would have been only $100,000.00. At the same time it should be noted that the Leasehold Income account is $25,000.00 greater than it otherwise would have been. Therefore, the net profit remains unaltered, but the results at various stages in the Profit and Loss Statement have been considerably affected.

Another important reason for establishing a leasehold at its appraised value may be that it will improve the condition and appearance of the balance sheet to the extent of enabling the client to obtain the particular line of credit it desires and at more favorable rates. If so, the setting up of the appraised value established by a disinterested expert realtor is not repugnant to good accounting procedure, provided the credit is to a capital surplus account, and provided the auditor’s certificate is qualified.

Whenever a special initial premium is paid for a lease, in addition to the annual rents, this sum must be capitalized and written off equitably throughout the life of the lease. But if only a special initial cash deposit is made (as a guarantee fund to live up to the terms of the lease) in addition to the annual rents, this deposit, since it is to be returned if no damage, etc. is done to the property, must not be written-off. Care must be taken, however, not to set this deposit up either as a part of the leasehold account or as a current asset. If the account is called "Guarantee Deposit with Lesor" and is listed as a fixed asset, it will have been accorded a satisfactory treatment on the balance sheet.

Although a leasehold is an intangible asset from a legal point of view, it is no more so from an accounting point of view than is a stock certificate. A stock certificate is an evidence of certain rights and so also is a leasehold. It would seem, therefore, that a leasehold should be looked upon as an investment rather than as an intangible asset. It is not comparable with goodwill, patents, trademarks, and the like.

The auditor must examine and abstract all leases, particularly in
regard to the name of the lessor and lessee, the length of the lease, 
the method of paying the rentals, the amount of the rentals, the provi-
sion for forfeiting the lease, and so on. If the leasehold is on land, 
the arrangement in regard to the ownership of the client's real property 
thereon at the termination of the lease will be of special interest to 
the auditor. If the leasehold is on a building, the arrangement in regard 
to the condition in which the building must be left by the client when it 
vacates the premises must engage the auditor's attention.

Leading auditors consider it necessary to make inquiry of the client 
and by examination of the accounts to ascertain on every audit what land, 
if any, used by the client is held under a lease. In the larger cities of 
the United States, department stores, hotels, theatres, etc. are commonly 
built on leased premises. The point at issue is often just this; namely, 
that the term of the lease, not the natural life, may be the deciding 
factor in determining the rate of depreciation of the building erected 
thereon, or the lessee may agree to pay the client the final sound value 
of the building, and so on.

Finally, the proper amortization of the leasehold must always be 
considered a major feature of the verification of the account. Obviously, 
if the account is not properly reduced in proportion to the passage of 
time, absolutely nothing will have been accomplished, although careful 
attention may have been given to the debit entries.

394a. Audit Program.
(1) Mortgages Receivable
   (a) Ascertain which are real estate mortgages and which are 
       chattel mortgages. Ascertain exactly what the pledged property is.
   (b) Ascertain the rank (first, second, etc.) of each mortgage.
   (c) Ascertain the full details of each mortgage senior to that 
of the client's.
   (d) Prepare a schedule of mortgages (in as full detail as plate 
       120) from the mortgage register.
   (e) If there isn't any register, do not hesitate to recommend 
one, if in your opinion it is needed.
   (f) Check the mortgage notes against the schedule.
   (g) Examine the warranty deeds. See (1) that the deed is signed 
       under seal in the presence of a witness and acknowledged before a notary;
       (2) that the name of the grantee is that of the mortgagor; and (3) that 
       the deed bears evidence of having been recorded in the public records.
   (h) Examine the mortgage deeds. See (1) that the deed is on the 
       property described in the warranty deed; (2) that the deed is signed and 
       sealed by the mortgagor in the presence of a witness and acknowledged 
       before a notary; (3) that the client's name appears as the mortgagee;
       (4) that the deed bears evidence of having been recorded; and (5) that 
       the principal, interest rates, and all other details check with those on 
       the mortgage schedule.
   (i) Compare the total balance of the schedule with the general 
       ledger balance.
   (j) Check the general ledger account back into books of original 
       entry for entire period or for such a period as seems to be adequate 
       under the circumstances.
   (k) Trace interest receipts into cash book and against the time, 
       interest rate and the outstanding principal amount of the mortgage. Use 
       both the check method and the analysis method of auditing. Make a rather 
       extensive check.

   *This is, of course, the usual basis. However, other bases often sup-
   plant it, as when, for example, the business is primarily based on a 
   wasting asset.
(1) Test the computations of amortized discounts and premiums, if any, and the accrued and deferred interest adjustments, if any.

(n) Always keep in mind that it is possible for a paid up mortgage to remain in the hands of the mortgagor by the issuance of a satisfaction piece.

(n) Examine insurance policies on each mortgaged property. See (1) that the coverage is ample; (2) that the property covered is that which is mortgaged; (3) that the policy is in force; (4) that the client is the payee; (5) etc., etc.

(o) Ascertain from invoices, etc. whether or not the taxes and other assessments have been paid by the mortgagor.

(p) If note or notes (if any) exist, account for them. If a single note, see that interest and principal are properly endorsed thereon.

(q) If qualified to do so, examine the public records.

(r) In one way or another (amount of fire insurance, amount of assessed value, rents collected by mortgagor, etc.) obtain some idea of the value of the mortgaged property.

(s) Separate the notes into good, slow, doubtful, and bad.

(t) Verify by direct correspondence when necessary or simply as a random test check.

(2) Leaseholds.

(a) Only those large lump sum payments made in advance as the total price of a long term lease are to be recorded as leaseholds.

(b) If the life of the lease is long and if the money involved is substantial, the advance premium paid ought to be looked upon as the present value of an annuity, the annuities being the future annual rents.

(c) The mere possession of a valuable lease is usually no basis for recording it as a capital asset. If it is recorded, full disclosure of what has been done must be made throughout the entire life of the lease. Usually a footnote is sufficient.

(d) In certain instances the auditor may be required to call attention to undesirable leases, including those for which there is no record in the financial books of account.

(e) Examine and abstract the leases. Secure (1) the name of the lessor and lessee; (2) the length of the lease, keeping in mind the effect this may have on depreciation rates, etc.; (3) the method of paying the rentals; (4) the amount of the rentals; (5) the provision for forfeiting the lease; (6) the condition in which the property must be left; (7) etc.

REVIEW QUESTIONS.

1. When may a mortgage be a current asset?
2. Why should an auditor search the public records?
3. Read and then summarize the contents of the warranty deed in plate 121.
4. Read and then summarize the contents of the mortgage deed in plate 122.
5. Prepare and fill in with 10 mortgages a mortgage schedule such as in plate 120.
6. If you were going to test the mortgages by confirmation, how would you select them?
7. Give the accounting treatment for mortgages purchased at a discount. How would you show the accounts on the balance sheet?
8. What is meant by participation in a mortgage? Describe the situation completely.
9. Why should the mortgage secure the mortgagor's tax receipts?
10. What is the difference between a real estate mortgage and a chattel mortgage? Name some of the most common types of security for chattel mortgages.